SPECTRUM
Asset Management

Junior-Subordinated Capital Securities Markets

February 2021 Updates

Most credit prices deteriorated under the weight of the US Treasury bond market repricing in February. The move in longer dated treasuries was swift and drew comparisons to the Taper Tantrum of 2013 though the Fed is a long way from reducing the pace of its bond purchases – we'll compare the bond market's move this month to the Taper Tantrum in the outlook section of this report. Real rates on the front end of the curve (e.g., UST 5yr TIPS; @ -1.76%) went up 8bps, but far less than the 32bp rise for 5yr nominal rates -- the 5yr implied breakeven inflation rate (i.e., the difference between the 5yr UST and the 5yr Treasury Inflation Protected Security) rose 20bps to close at 2.42% (the highest level in over 12yrs); and gold prices dropped 6.81% after slipping 2.67% in January. The 30yr US Treasury bond closed the month yielding 2.15% (32bps higher) and the US Treasury 10yr note closed yielding 1.41% (35bps higher). The yield differential between these two longer US Treasury terms narrowed by 3bps to +74bps. The S&P500 rose 2.61% to new highs to close at 3811. The VIX (i.e., Chicago Board Options Exchange Volatility Index) declined swiftly on the rally for most of the month, but then ticked up as equity digested some of its gains the last two days of the month. Overall, markets are transitioning from a COVID impacted phase of central bank support to a post-COVID life seeking independence and self-sustainability, which will take time to do especially as the Fed is in no rush to become an "empty nester" – in fact, as the Fed has shifted to focus more on recovering millions of jobs lost to the COVID response than worrying about rising inflation, negative real interest rates on the front end of the yield curve are likely to last for years. The implication is a steeper curve and higher long-term nominal rates with easy money leading to tighter credit spreads and improving earnings for the global financials.

Before we summarize the outlook below, let's look at performance in some of the more senior corporate credit sectors for comparative references on returns and yield changes:

- The junk market (measured by the ICE BofA High Yield ***h0a0*** index) rose 0.35% to close yielding 4.25% (6bp lower).
- Global bank credit (measured by ICE BofA ***e0ba*** index) declined 1.06% to close yielding 1.53% (15bps higher).
- The BBB rated 5-10yr corporate sector (measured by ICE BofA ***c6a4*** index) declined 1.59% to close yielding 2.23% (27bp higher).

Review of Market Structure:

The market for **global junior-subordinated capital securities** (*i.e.,* "**Jsubs**") is comprised of:

1. Preferred Securities, and
2. Contingent Capital Securities

Each sector has evolved with unique technical, structural, and fundamental features that are discussed and updated below:

Global junior subordinated capital securities (sometimes called "hybrids") are comprised of two sub-sets that represent a broad group of global junior-subordinated capital securities, which can be referenced by two ICE BofA indexes: 1) The ICE BofA US All Capital Securities Index (***i0cs***) and 2) The ICE BofA US Dollar Contingent Capital Index (***cdlr***).

Our litmus test for hybrids satisfies two core characteristics:

1) any non-payment of distributions would <u>not</u> accelerate an event of default (i.e., distributions are "junior-subordinated" to ordinary interest obligations) and,

2) balance sheet classification is something other than common stock under GAAP disclosure.

The US All Capital Securities (***i0cs***) benchmark of preferred securities represents $343 billion (face amount) of investment grade and below investment grade instruments in both the retail $25par market (36%) and the institutional $1,000par market (64%). The USD Contingent Capital Index of US dollar denominated junior-subordinated capital securities ***(cdlr)*** represents $142 billion (face amount) of investment grade and below investment grade fixed-rate instruments with contractual triggers that could subordinate them to common stock in a reorganization that would not fall into a receivership after the bail-in. These two benchmarks combine for a $485 billion universe of fixed-rate junior-subordinated USD capital securities with preferred securities (measured by ***iocs***) being a 71% subset and contingent capital securities (measured by ***cdlr****)* being a 29% subset of the total global USD junior subordinated group.

<u>Preferred Securities</u>

In the preferred securities sleeve, there are four sub-component indexes in the US All Capital Securities Index (***i0cs****)* – this entire index is comprised of global "preferred securities". A **"preferred security"** can represent a capital security issued either through charter amendment (i.e., as a stock) or through indenture (i.e., as a bond) typically within the context of a "<u>gone-concern</u>" statutory authority (*e.g.,* US banks). As a gone concern, a company reorganization would be processed through a bankruptcy court. Preferred security payments are in priority to common stock dividends, yet can be deferred (i.e., payments are cumulative) or eliminated (i.e., payments are non-cumulative) without causing an immediate event of default; any principal loss absorption on a preferred security would be forced only *ex-post* through a statutory resolution in a bankruptcy proceeding.

The four sub-components of the *i0cs* benchmark that consolidate into the retail and institutional sectors of rated preferred securities are:

1. ***ICE BofA Fixed Rate Preferred Index (p0p1) @ 45% of i0cs***
   - Comprised of IG $25par and IG $1,000par US AT1
     - The *p0p1* declined 1.28% this month to close yielding 3.05% (+90bps)
     - Headcount rose by 3, face value rose by $2.4billion
2. **ICE BofA US Capital Securities Index (*c0cs*) @ 25% of *i0cs***
   - Comprised of dated IG $1,000par hybrids (no US AT1)
     - The *c0cs* declined 0.39% this month to close yielding 3.08% (+7bps)
     - Headcount declined by 1; face value declined by $1.3billion
3. **ICE BofA High-Yield Capital Securities Index (*h0cs*) @ 5% of *i0cs***
   - Comprised of BIG $1,000par legacy Tier1 and BIG $1,000par hybrids
     - The *h0cs* declined 0.36% this month to close yielding 3.50% (+6bps)
     - Headcount rose by 2; face value rose by 2.3billion
4. **ICE BofA High Yield Fixed Rate Preferred Index (*p0hy*) @ 25% of *i0cs***
   - Comprised of BIG $1,000par US AT1 and BIG $25par
     - The *p0hy* declined 0.55% this month to close yielding 4.25% (21bps)
     - Headcount was unchanged but face value rose by $1.930billion

Overall, the BofA All US Capital Securities Index (***i0cs***) declined 0.82% in February to close yielding 3.36%, which was 47bps higher than last month's closing yield and a spread of +237bps over comparable US Treasury securities (7bps tighter).

Contingent Capital Securities

A **"contingent capital security"** (i.e., a "CoCo") represents a capital security issued through indenture typically within the context of a "going-concern" type regulatory regime for banking, which would reorganize a potentially insolvent bank through the contracts of its capital before falling into a conservatorship proceeding. CoCos payments are non-cumulative and *pari passu* to common stock dividends and can be reduced or eliminated without causing an event of default. Principal loss absorption on a CoCo could be forced ex-ante through a regulatory action in advance of any bankruptcy proceeding (note that an actual bankruptcy may not happen because enough loss absorbing bail-in capital, including tier-2 capital, could be available through the "living will" of core capital). The ICE BofA USD Contingent Capital Index (***cdlr***) is comprised of US dollar denominated constituents (exclusively), which represent 58% of the mature master multi-currency benchmark (*coco*). We will utilize the USD benchmark (*cdlr*) as it more meaningfully reflects the contingent capital currency types held in our portfolios. The ICE BofA USD Contingent Capital Index (***cdlr***) rose 0.69% this month to close yielding 3.66%, which was 14bps lower than last month and a spread of +290bps over comparable US Treasury securities (24bps tighter).

Snapshot of Junior Subordinated Spread Sector Moves:

	p0p4	p0p4-e0ba	stb8	stb8-e0ba	cdlr	cdlr-e0ba
	(a)	**(b)**	**(a)**	**(b)**	**(a)**	**(b)**
	Retail	**Retail**	**NoCo**	**NoCo**	**CoCo**	**CoCo**
Sample Periods	03/31/2017 to Date		03/31/2017 to Date		03/31/2017 to Date	
Jr-Subs	***Absolute**	****Relative**	***Absolute**	****Relative**	***Absolute**	****Relative**
High	588	251	479	200	660	313
Low	-178	-267	174	53	223	143
Range	766	518	305	147	437	170
Average	31	-81	247	135	339	227
Stdev	129	108	50	30	62	35
Monthend	162	88	242	168	294	220
Sector Spread Score[1]	**1.29**		**0.50**		**-0.46**	
Last Month's Score[1]	**1.14**		**0.61**		**0.01**	

1: Sector Spread Score = {[Monthend(a)-Ave(a)]/Stdev(a)+[Monthend(b)-Ave(b)]/Stdev(b)}/2

Monthend statistical position to average per unit of standard deviation

***Absolute**	1.02		-0.10		-0.73	
****Relative**		1.56		1.10		-0.20

** Absolute = Option Adjusted US Government Spread*
*** Relative = spread to global financials measured by e0ba ICE Bond Index*

Source: Bloomberg, ICE Bond Indices

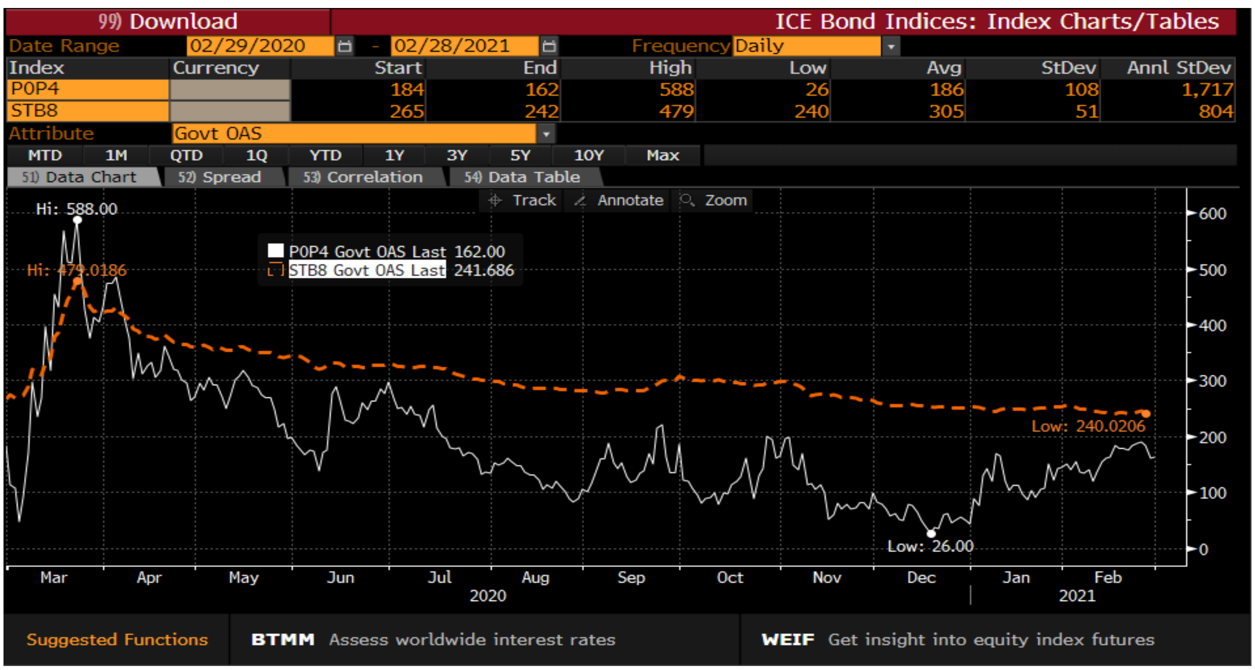
Implications of Market Activity:

$25par Retail Preferred Securities Sector

The retail preferred securities sector declined $2.21 this month which boosted the sector's benchmark yield by 105bps from last month to 3.41% -- overall, spreads widened by 74bps to close at +277bps. This kind of spread move is not unusual for the retail sector because the short-term optionality creates a lot of swing rate to spread – especially when government yields are so low. The monthly standard deviation of the sector's option-adjust spread is 128bps, which means that spreads have widened by 1.6 standard deviations since the beginning of the year. The Equitable Holdings (Ba1/BBB-) deal which kicked off the year with a $300million 4.30% fixed-for-life perpetual preferred stock went down 4.0% from its high ($25.71) to close at $24.69; the $500mm US Bancorp 3.75% fixed-for-life perpetual preferred stock that came last October traded down 4.8% from its high ($24.70) to close at $23.52; Bank of America's $915mm (Baa3/BBB-/BBB) 4.125% fixed-for-life perpetual preferred stock (last month's bell weather issue) traded down 3.1% from its high ($25.42) to close the month at $24.64 – the bell weather issuance this month was $420mm of Telephone & Data Systems (nr/B+/BB-) 6.625% fixed-for-life cumulative preferred stock which slipped 0.60% from its IPO price ($25) to close at $24.85 -- though it only had a few days to trade before month end.

We've discussed our concern that the implication of a continuing $25par market refunding trend with ever lower coupons increases the effective duration risk of the retail sector the lower preferred yields go -- even though the measured duration declines as yields go lower. The negative performance for the $25par sector this month was another good example of the sector's duration sensitivity in reverse as duration went up 0.90yrs (to 5.7) as yields rose (e.g., by 140bps for the p0p4) – the retail sector is getting more fairly valued as its negative convexity is slowly becoming "less bad" as duration rises. The retail sector's spread score of 1.29 this month is improved from last month's score due to the continued price correction. We're cautious of the lower retail coupons as they would be the likely first sale candidates in any stock market correction -- which we think is coming because of: 1) accelerated massive fiscal spending by the Biden Administration, 2) rising long treasury yields anticipating fiscal excess, and 3) accelerating inflation expectations from progressive policies that impose more government controls, economic equity and permanent reliance on Federal Reserve's balance sheet – and likely ultimate tax increases to help pay for an even "greater society".

The graph below shows the spread in the $25par market (i.e., *p0p4*) over the past year compared to the spread in the $1,000 par institutional preferred securities market (*stb8*: a custom weighted combination of ICE BofA's *cips* and *hips*), which we call "NoCos" to distinguish $1,000 preferred securities from $1,000par contingent capital securities (CoCo) risks:

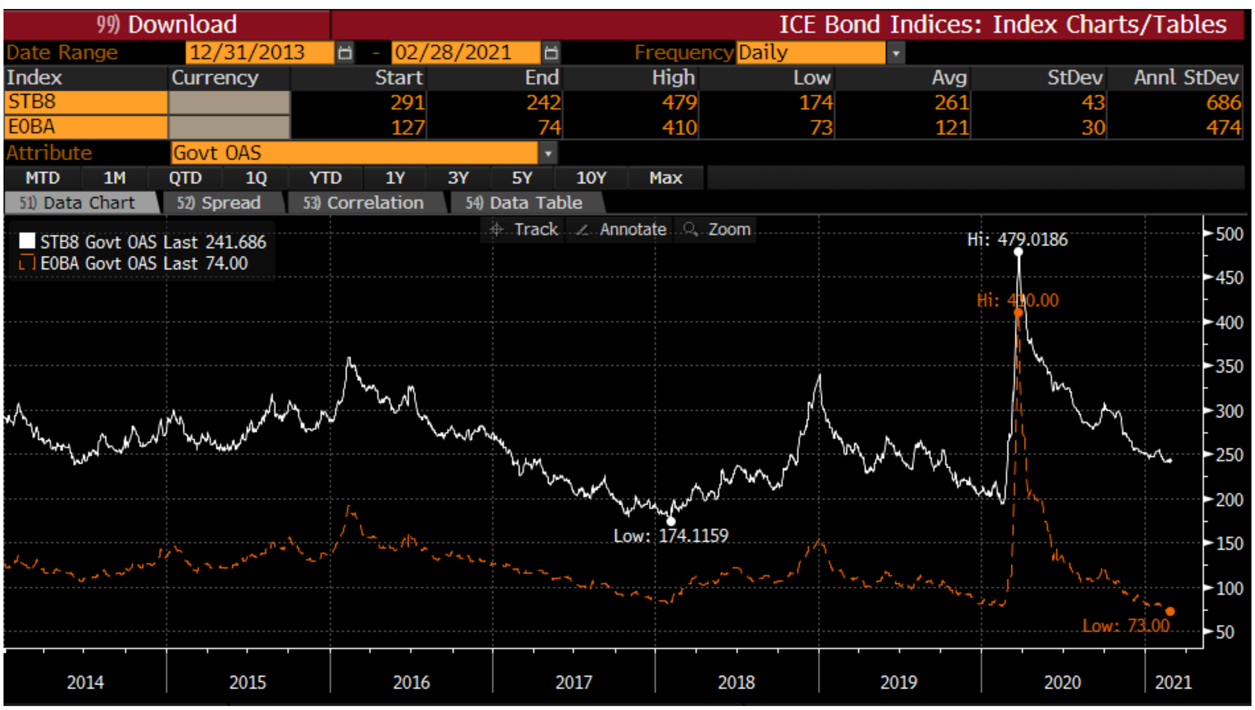


Source: Bloomberg

The low spread this past December marked the high price for the retail sector over the last 12 months and the widest differential from the institutional sector. Generous yields are still scarce and not expected to get much relief from the Fed as they have committed to keep rates low for a substantial period, but the weight of fiscal spending and higher inflation expectations are weighing on the yield curve as longer treasury rates are rising and having a negative impact on this mostly fixed-for-life coupon sector of retail. Continuing conditions of rising treasury long bond yields and equity gains from easy money could set up conditions for an active tax loss harvesting season in the $25par market at the end of the year – time will tell.

$1,000par Institutional Preferred Securities Sector

The $1,000 par institutional sector of the preferred securities market declined $0.89 in tis month. Despite the yield compression, relative values still look attractive because more senior financials have rallied even lower and tighter. The chart below shows the yield-to-worst spread of NoCos (i.e., *stb8*) vs. Eurodollar Banking Index spread (i.e., *e0ba*) since 2013:



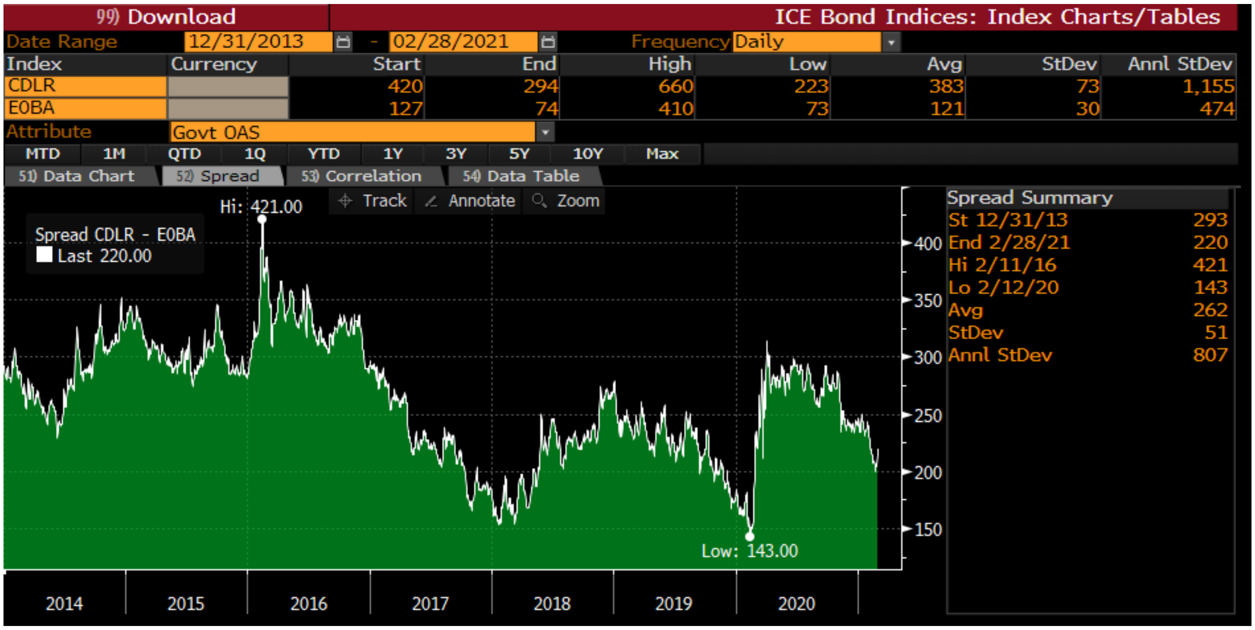
Source: Bloomberg

We look back to 2013 to include three intra-cycle sparks or shocks: 1) the end of the Taper Tantrum (2013), 2) the end of the commodity implosion and high yield (oil) market bust (2016) and 3) the end of the market's revolt to the Fed's overshoot on rates (2018) – and now, the ongoing recovery from the COVID-19 recession. By the end of the month, NoCo spreads to comparable treasuries closed 12bps tighter (+243). Relative to more senior financials, NoCos have room to further tighten because at +168 to senior financials, spreads in NoCos have a relative spread score of 1.10 standard deviations better than average.

There were two notable new deals this month in the NoCo sector: 1) $750mil. Silicon Valley Bank (Baa2/BB) 4.10 fixed-to-refixed perpetual preferred stock @+306 vs. the 10yr constant maturity US treasury, and 2) $800mil. Liberty Mutual Group 4.30% 40yr fixed-for-life non-call 5yr junior subordinated notes @+252bps. Overall, NoCos are scoring as the 2nd best spread value in junior subordination with a sector spread score of 0.50 this month, though the differential of 168bps over more senior financials is still 80bps higher than their retail alternative.

Contingent Capital Securities Sector

The CoCo sector closed $0.20 higher this month as the European bank equities rallied up to what was their prior lows that were triple tested over the years since 2012 only to be broken during the COVID crisis. Granted, European bank equities are still chronically deflated, but nonetheless their 18.3% rally this month was impressive and helped to lift CoCo prices while the rest of junior subordination went down. The graph below shows the spreads in CoCos (i.e., *cdlr*) relative to the spreads measured in Eurodollar bank credit that is not CoCo (i.e., *e0ba*) since the benchmark's inception (Dec-13) – note that CoCos were improved in 2016 after the Pillar-2 capital stack was redefined, thus reducing payment trigger risks for CoCos:



Source: Bloomberg

The relative OAS differential between CoCos and more senior financials tightened by 19bps to close the month with a difference 220bps in favor of CoCos. The relative value opportunity in CoCos compared to more senior financials is now below average statistically, but still seems generous at +220bps. Despite CoCo's overall sector spread score of -0.46 being the lowest of the three junior subordinated sectors, CoCos still provide 52bps of additional spread to NoCos and 132bps of additional spread to retail preferred securities; and offer the highest overall absolute yields. For example, BNP came with a $1.25bil. 4.625% contingent capital security @+334 vs. the 5yr constant maturity US treasury.

Outlook:

Last month we highlighted Chairman Powell's comment that even if unemployment were to decline to low levels again *"that wouldn't be a reason to raise interest rates unless we see troubling inflation or other imbalances that could threaten achievement of our mandate."* Even though February was brutal for longer-term UST security prices, the Fed is unafraid and is standing firm on letting the markets process their own opinions and adjust up rate risk premiums, for now. Just this week, Chairman Powell said that the US economy has "significant ground to cover" and that deflation mechanisms are "deeply ingrained" in the economy. Further, there is a coordinated chorus coming from Fed governors that rising yields are good signs that the Fed is moving towards achieving its goals, which are: 1) recovering the near 10mm jobs that have been lost during the pandemic and 2) sustaining inflation well above its flexible average goal (or target of say, 2.50%). With the personal consumption expenditure (i.e., the PCE) deflator at (just) 1.5% currently, the Fed does indeed have a lot of ground to cover yet. But market signals are pointing in the right direction as the US Treasury 2yr breakeven inflation rate (at 2.60%) is higher than the US Treasury 10yr breakeven inflation rate (at 2.23%) – with real yields on the belly of the curve still deeply negative.

It's unusual for the market to imply 2yr inflation as higher than 10yr inflation – when it has been inverted, it was only marginally positive and for a very brief time on every occasion. There has been a lot of talk about the risk of a taper tantrum, but as we have said, what is happening so far is a reverse taper (being subtly) <u>allowed</u> by growing treasury coupon supply over a constant Fed buying pace. Consider that the $21 trillion US government securities market has grown by 3x since the Great Financial Crisis and by 2x since the Taper Tantrum (QE3). Basically, the Fed is only buying <u>half as many bonds</u> at its current pace as it was during QE3, so a (reverse) taper is already underway – especially considering the $1.9

trillion of additional stimulus that is very likely to come which should hardly be a negative for supporting financial conditions – in fact, it is quite a positive and aligns well with the "go big" desires of Secretary Yellen (and Chairman Powell).

What would (should) also align well are real interest rates – QE3 and the resultant increase in long term rates are what finally combined to move the real 10yr treasury rate back up above zero after a 1 ½ year period of being negative (stemming from the European sovereign debt crisis). Today, the real UST10yr rate (-0.68%) is equivalent to where it was in mid-2013 until it broke above zero and stayed there (even throughout the commodity crisis) until COVID-19 took the economy to its knees.

At some point, (e.g., when the Fed attempts to pullback or "taper" against the relentless fiscal tides perhaps years from now) the equity market will reprice and Modern Monetary Theory will be necessary to save risk assets from collapsing under draining liquidity – especially if real yields return to more recent historic norms of 1% (as they were after the Taper Tantrum); and why wouldn't they if the structure of US government grows to impose more credit reliance (demands) on taxpayers and controls on behavior. In fact, there needs to be a symbiotic relationship between stocks and treasury bonds where one goes down and the other goes up – right now, stocks have gone (way) up, but treasury bonds have not gone down enough to provide an adequate counter force to comfortably absorb a correction in risk assets – follow the real yield on T10s for that.

So, what do higher rates and a steeper yield curve mean for hybrid securities like preferreds and CoCos? They mean playing a good defensive game with hybrids can help keep your fixed income team in contention as core exposure to financials act as functional liquidity processors that can grow earnings with inflation – that's good for credit; and hybrid structures can eventually reset income higher if interest rates rise – that's good for income.

Hybrids can be a relatively safe down-the-capital-structure game tactic compared to investment grade corporates (with higher duration risk in IG) or below investment grade corporates (with higher historical default risk in BIG). Based on our default studies, hybrids offer default risk-adjusted yield spreads that are about 2.4x greater than both IG corporates and BIG corporates. Indeed, the core storyline for junior subordinated capital securities plays on despite longer term rate risk potentially being a headline antagonist this year -- that is:

> *Hybrids offer enhanced yield (less duration) vs. high grade bonds and enhanced credit (less risk) vs. high yield bonds.*

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