Junior-Subordinated Capital Securities Markets

March 2021 Updates

Most credit prices went sideways and spreads moderately tighter as US Treasury prices hit lows for the year toward the end of March. The move lower in longer dated treasuries was mostly done in the overnight sessions but heavy moods in the US weighed on prices too. Real rates on the front end of the curve (e.g., UST 5yr TIPS; @ -1.76%) ended the month unchanged -- the 5yr implied breakeven inflation rate (i.e., the difference in yields between the 5yr UST and the 5yr Treasury Inflation Protected Security) rose 18bps to close at 2.60% (the highest level in over 12yrs); and gold prices slipped 1.52% after dropping 6.81% in February. The 30yr US Treasury bond closed the month yielding 2.41% (26bps higher) and the US Treasury 10yr note closed yielding 1.74% (33bps higher). The yield differential between these two longer US Treasury terms narrowed by 7bps to +67bps. The S&P500 rose 4.24% to new highs to close at 3973. The VIX (i.e., Chicago Board Options Exchange Volatility Index) declined over 30% as the share markets gained momentum and new highs. The transitioning of markets from a COVID impacted phase of central bank support to a post-COVID phase of self-sustainability is an inconsistent process as more countries are reinstating lockdowns as others are trying to be get back to some normalcy. After the Fed meeting this month, Chairman Powell signaled that the central bank would continue purchasing bonds without any thoughts of tapering. The Fed views higher long-term nominal rates (and a steeper curve) as proof of policy success. There is no doubt that Chairman Powell is steadfast in his commitment to create money and inflation (more on this later).

Before we talk hybrids, 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 0.17% to close yielding 4.16% (20bp lower).
- Global bank credit (measured by ICE BofA ***e0ba*** index) declined 1.13% to close yielding 1.73% (18bps higher).
- The BBB rated 5-10yr corporate sector (measured by ICE BofA ***c6a4*** index) declined 1.40% to close yielding 2.50% (24bp higher).

Review of Market Structure:

The market for hybrids or **global junior-subordinated capital securities** (*i.e.,* "**Jsubs**") as we call them is comprised of two core sectors:

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 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 not 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 $342 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 $146 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 $487 billion universe of fixed-rate junior-subordinated USD capital securities with preferred securities (measured by ***iocs***) being a 70% subset and contingent capital securities (measured by ***cdlr****)* being a 30% subset of the total global USD junior subordinated group.

Preferred Securities

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 "gone-concern" 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*) @ 44% *of i0cs***
  - Comprised of IG $25par and IG $1,000par (incl. US AT1)
    - The *p0p1* rose 1.63% this month to close yielding 2.33% (-85bps)
    - Headcount declined by 9, face value rose declined by $4.9billion

2. ICE BofA US Capital Securities Index (*c0cs*) @ 25% of *i0cs*
  - Comprised of dated IG $1,000par hybrids (excl. US AT1)
    - The *c0cs* declined 0.34% this month to close yielding 3.14% (+5bps)
    - Headcount declined by 2; face value declined by $1.9billion

3. **ICE BofA High-Yield Capital Securities Index (*h0c*s) @ 5% of *i0cs***
  - Comprised of BIG $1,000par legacy Tier1 and BIG $1,000par hybrids
    - The *h0cs* declined 0.01% this month to close yielding 3.61% (-2bps)
    - Headcount declined by 2; face value declined by $2.0billion

4. ICE BofA High Yield Fixed Rate Preferred Index (*p0hy*) @ 26% of *i0cs*
  - Comprised of BIG $1,000par US AT1 and BIG $25par
    - The *p0hy* rose 2.23% this month to close yielding 3.56% (-77bps)
    - Headcount rose by 9, face value rose by $7.3billion

Overall, the BofA All US Capital Securities Index (***i0cs***) rose 1.16% in March to close yielding 2.87%, which was 55bps lower than last month's closing yield and a spread of +184bps over comparable US Treasury securities (55bps tighter).

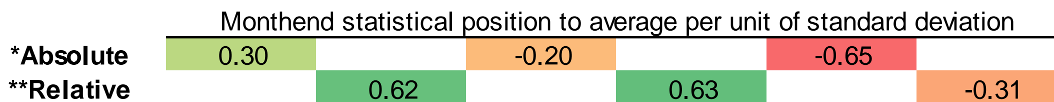
Contingent Capital Securities

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***) declined 0.16% this month to close yielding 3.82%, which was 12bps higher than last month and a spread of +299bps over comparable US Treasury securities (4bps wider).

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	481	201	660	313
Low	-178	-267	175	55	223	143
Range	766	518	306	146	437	170
Average	32	-79	248	136	338	226
Stdev	128	108	49	30	62	35
Monthend	71	-12	238	155	298	215
Sector Spread Score[1]	**0.46**		**0.21**		**-0.48**	
Last Month's Score[1]	**1.29**		**0.50**		**-0.46**	

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**	0.30		-0.20		-0.65	
****Relative**		0.62		0.63		-0.31

** 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 rose $2.57 this month which cut the sector's benchmark yield by 135bps from last month to 2.14% -- overall, spreads tightened by 119bps to close at +162bps. This kind of spread move is not unusual for the retail sector because the short-term optionality creates a lot of swing rate to option-adjusted spread (OAS) – especially when government yield comparisons remain so low. The monthly standard deviation of the sector's option-adjust spread is 128bps, which means that OAS spreads tightened by 0.93 standard deviations this month. The negative convexity created by call options that predominate $25par paper makes the sector's duration decline when its yield declines. In March, the decline in yield cut the retail sector's duration by 1.87yrs to 3.90yrs, which was a 0.90 standard deviation cut – or about statistically equivalent to the change in spread. So, if there are 1.33 units of duration (0.64 standard deviations) left before revisiting the low duration zones of 2019 & 2017, then we estimate that the sector has 1.10% ($\Delta P\% = -1.33 * -0.0128 * .64$) of additional upside potential before facing a major resistance level to going higher in the face of rising rates. US Treasury rates are still 50bps lower than they were when retail OAS spreads were at their tightest (-178bps) to treasuries, which means that there is statistical room available for spreads to tighten more. But, for the $25par market OAS to tighten by much more than another 82bps it would likely require help from the yield curve, that is, for it to flatten and 5yr US Treasury rates to rise toward 2%. A move like this in 5yr Treasuries could happen, but it's not likely until the economy and labor markets improve materially.

The Equitable Holdings (Ba1/BBB-) deal which kicked off the year with a $300mil. 4.30% fixed-for-life perpetual preferred stock rose 0.85% to $24.90; the $500mm US Bancorp (A3/BBB) 3.75% fixed-for-life perpetual preferred stock that came last October rose 1.19%

to $23.80; Bank of America's $915mm (Baa3/BBB-/BBB) 4.125% fixed-for-life perpetual preferred stock rose 0.57% to $24.78; the bell weather issuance last month was $420mm of Telephone & Data Systems (nr/B+/BB-) 6.625% fixed-for-life cumulative preferred stock which zoomed 6.92% to close at $27.10; the bell weather issue this month was $1.5bil. JP Morgan (Baa2/BBB-) 4.55% fixed-for-life preferred stock which rose 1.47% over its IPO price. The retail sector's spread score slipped to 0.46 from 1.29 this month which is no surprise given the positive price move. As spreads tighten and price premiums grow, we're particularly cautious of the lower retail coupons as they would be the likely first sale candidates in any stock market correction – if there is such a thing(?).

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 it has committed to keep rates low until it gets its desired economic outcome, but the velocity of fiscal spending and higher inflation expectations are weighing on the yield curve as longer treasury rates are rising yet equity is climbing and helping to tighten spreads, nonetheless.

$1,000par Institutional Preferred Securities Sector

The $1,000 par institutional sector of the preferred securities market declined $0.46 in March. 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 4bps tighter (+238). Relative to more senior financials, NoCos moved 13bps tighter yet still have room to further tighten because at +155bps to senior financials, spreads in NoCos have a relative spread score of 0.63 standard deviations better than average.

There were two notable new deals this month in the NoCo sector: 1) $2.25bil. Charles Schwab Corp (Baa2/BBB) 4.00% fixed-to-refixed perpetual preferred stock @+317 vs. the 5yr constant maturity US treasury, and 2) $1.25bil. EIX (Ba2/BB+) 5.375% fixed-to-refixed cumulative perpetual preferred stock @+470. Overall, NoCos are scoring as the 2nd best spread value in junior subordination with a sector spread score of 0.21 this month, though the differential of 155bps over more senior financials is 167bps higher than their retail alternative – clearly, the relative values between the institutional sector and the retail sector requires more than opinion on statistical history because the two sectors have opposing convexity characteristics that require consideration.

Contingent Capital Securities Sector

The CoCo sector closed $0.72 lower this month even though the European bank equities sector rallied modestly. European bank equities are still chronically deflated from negative rates and low growth, and their 5.0% rally this month was welcomed though not remarkable enough to offset tempered moods in rates. 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 5bps to close the month with a difference 215bps in favor of CoCos. The relative value opportunity in CoCos compared to more senior financials is below average statistically, but still seems generous at +215bps. Despite CoCo's overall sector spread score of -0.48 being the lowest of the three junior subordinated sectors, CoCos still provide 60bps of additional spread to NoCos and 227bps of additional spread to retail preferred securities; and offer the highest overall absolute yields in banking. For example, HSBC (Baa3/nr/BBB) came with a $1.0bil. 4.70% contingent capital security @+325 vs. the 10yr constant maturity US Treasuries.

Outlook:

The Fed convincingly reiterated that its policies will be **outcome-based**. It explained three desired policy objectives: 1) improved labor markets to achieve maximum employment, 2) inflation above 2% that is not transitory and, 3) once it achieves better than 2% inflation, the Fed wants it to be on track to exceed 2%. Clearly, the Fed explained three objectives to highlight its determination to achieve two primary outcomes: 1) maximum employment and 2) sustained minimum 2% inflation. Chairman Powell probably focused on "transitory" to emphasize that immediate higher inflation expectations will not be viewed as sufficient to have met its 2% sustained inflation goal and that it will not be tapering its bond purchases any time soon. According to Chairman Powell, "*Substantial further progress toward its goals is needed*" and the Fed "*will signal well in advance that it believes its outcomes have been met*." He made certain to distinguish that the taper tantrum (2013) was triggered by a change in the Fed's outlook, but this time no signal will be given until its desired outcome has happened. In other words, the Fed will be very accommodative, and its guide will be a series of convincing data viewed through its rearview mirror. So, we expect that it will take a series of $2\text{-}2^{1/2}$ % (or more) personal consumption expenditure reports for at least 4 straight quarters before the Fed signals it will slow its bond purchases.

But this doesn't mean that the yield curve has nowhere to shift but straight up like it has since January. The yield rise can take a pause and even reverse a bit before resuming. The Biden Administration's likely tax increase later this year will probably make the recovery grind a gear when shifting from recovery into expansion. This will make fiscal spending the primary growth fuel once the vaccine boosters are distributed. A tax increase would likely slow down the pace of rising long term interest rates (and pause the supercharged stock market) but not stop either from rising further because both monetary and fiscal policies (and changes) should work synergistically to aid an expansion.

Hybrid financials should be among the recovery's top credit beneficiaries, and we expect hybrid spreads to tighten by as much as another 70bps along a path of rising 10yr TIPS rates to 0.50% or more. We believe the Fed will maintain its "zero bound" for the target funds rate at least until the real rate on the US Treasury 10yr note (i.e., the 10yr TIPS yield) spends a fair amount of time above zero as it trends to 0.50%. We had warned last year that a Democrat controlled senate handing them full control of the federal government would likely accelerate the pace of rising longer-term interest rates this year -- our target of 1.75% for the US Treasury 10yr yield by yearend was met this month (though adjusted for inflation expectations, the real rate was still -0.60%). Bear markets typically begin cloaked in a spirit of denial as some pundits believe negative longer-term nominal rates in the US are still inevitable – we think not, but time will tell. We believe that the Fed will achieve its goals and that a long-term trend reversal (now underway) points to rising US Treasury bond rates, a steeper yield curve and sustained desired inflation. If the shift to progressive policies in America gains momentum over the next three years, then sustained low rates and wide spreads should ultimately be replaced by sustained higher rates and low spreads as inflation flows through to higher equity prices and a cheaper US dollar. Importantly, the performance path to that end should bode relatively well for hybrids, which are enhanced yield (and lower duration) compared to investment grade corporate bonds; and enhanced credit (and lower default risk) compared to junk bonds.

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April 8, 2021

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