Junior-Subordinated Capital Securities Markets

October 2021 Updates

Credit performance was negative in October as expectations grew for a more hawkish Fed and a taper by November. In fact, during a panel discussion at a virtual conference hosted by the South African Reserve Bank, Chairman Powell stated that "*we are on track to begin a taper of our asset purchases that, if the economy evolves broadly as anticipated, will be completed by the middle of next year… I think it is time to taper and I do not think it is time to raise rates.*" Real rates on the front end of the curve (e.g., UST 5yr TIPS) ended the month 11bps lower at -1.75%; the 5yr implied breakeven inflation rate (i.e., the difference in yields between the 5yr UST and the 5yr Treasury Inflation Protected Security) rose 40bps to close at 2.93% (convincingly breaking out of its 10bps channel it had held for most of the year). On the back end of the treasury curve, the 30yr bond closed yielding 1.93% (12bps lower) and the 10yr note closed yielding 1.55% (6bps higher) -- the yield differential between the two longer US treasuries flattened 18bps to +38bps, well under the wide +85bps set in February when the bond market was singularly fearful of higher inflation but not slower growth. The S&P500 vaulted 6.91% this month closing at an all-time high of 4605. The VIX (i.e., Chicago Board Options Exchange Volatility Index) declined 30% and made a low for the year (15.01) as share markets zoomed to sustain the most immaculate financial conditions on record but for a brief 6-week period in 2007 when conditions were just as good.

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) fell 0.18% to close yielding 4.19% (11bps higher).

- Global bank credit (measured by ICE BofA ***e0ba*** index) fell 0.30% to close yielding 1.81% (15bps higher).
- The BBB rated 5-10yr corporate sector (measured by ICE BofA ***c6a4*** index) fell 0.42% to close yielding 2.43% (10bps 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 $354 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 $156 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 $510 billion universe of fixed-rate junior-subordinated USD capital securities with preferred securities (measured by ***iocs***) being a 69% subset and contingent capital securities (measured by ***cdlr)*** being a 31% 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*) @ 42% *of i0cs***
    - Comprised of IG $25par and IG $1,000par (incl. US AT1)
        - The *p0p1* fell 0.11% this month to close yielding 2.65% (+18bps)
        - Headcount was unchanged, but face value grew by $2.455 billion

2. **ICE BofA US Capital Securities Index (*c0cs*) @ 23% of *i0cs***
   - Comprised of dated IG $1,000par dated hybrids (excl. US AT1)
     - ❖ The *c0cs* fell 0.39% this month to close yielding 3.06% (+13bps)
     - ❖ Headcount was down 1; face value declined by $2.950 billion
3. **ICE BofA High-Yield Capital Securities Index (*h0cs*) @ 6% of *i0cs***
   - Comprised of BIG $1,000par legacy Tier1 and BIG $1,000par hybrids
     - ❖ The *h0cs* fell 0.16% this month to close yielding 3.39% (+7bps)
     - ❖ Headcount was unchanged; face value was unchanged
4. **ICE BofA High Yield Fixed Rate Preferred Index (*p0hy*) @ 29% of *i0cs***
   - Comprised of BIG $25par and BIG 1,000par (incl. US AT1)
     - ❖ The *p0hy* rose 0.23% this month to close yielding 3.28% (+3bps)
     - ❖ Headcount fell by 2; face value rose by $605 million

Overall, the ICE BofA All US Capital Securities Index (***i0cs***) fell 0.09% in October to close yielding 2.98%, which was 13bps higher than last month's closing yield and a spread of +188bps over comparable US Treasury securities (4bps 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 the entity's core capital). The ICE BofA USD Contingent Capital Index (***cdlr***) is comprised of US dollar denominated constituents (exclusively), which represent 61% of

the mature master multi-currency benchmark (*coco*). We will utilize the USD benchmark (*cdlr*) as it more meaningfully reflects the contingent capital currency primarily held in our portfolios. The ICE BofA USD Contingent Capital Index (***cdlr***) fell 0.31% this month to close yielding 3.72%, which was 14bps higher from last month and a spread of +271bps over comparable US Treasury securities (5bps tighter).

Snapshot of Junior Subordinated Spread Sector Moves:

Capital Securities Spread Value Matrix	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	36	-71	244	136	328	221
Stdev	120	103	47	28	63	35
Monthend	63	-12	211	136	262	187
Sector Spread Score[1]	0.40		-0.35		-1.01	
Last Month's Score[1]	0.61		-0.45		-0.97	

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

	p0p4 (a)	p0p4-e0ba (b)	stb8 (a)	stb8-e0ba (b)	cdlr (a)	cdlr-e0ba (b)
*Absolute	0.23		-0.70		-1.05	
**Relative		0.57		0.00		-0.97

** Absolute = Option Adjusted US Government Spread*

*** Relative = spread to global financials measured by e0ba ICE Bond Index*

Monthend estimate of spread duration benefit (units of stdev.)

	Retail	NoCo	CoCo
Spread/mdurMat	-2.19	0.04	-0.40
Probability Estimate to Spread Benefit	1.42%	51.63%	34.30%
		Memo: e0ba	0.11%

Source: Bloomberg, ICE Bond Indices

Implications of Market Activity:

$25par Retail Preferred Securities Sector

The retail preferred securities sector rose $0.28 in October to $106.75 which is ended the (losing) streak set last month which set the first time since late 2018 that the retail sector has declined in price for three straight months – OAS spreads tightened by 21bps. The retail sector price rebounded this month after a slide that bottomed at the beginning of the month which was based primarily on the modest equity retreat to that point -- the S&P 500 index tapped its 100-day moving average for the first time in a year during September into October. Indeed, the retail market has been more positively correlated to the S&P 500 this year than it has during prior years -- it has also been more positively correlated to the US Treasury market too. This is likely because the primary driver to asset prices has been the record unsustainable (ongoing) liquidity flood stemming from the Fed's $9trillion balance sheet. Since March, the retail sector is roughly 48% correlated to S&P 500 returns and 34% correlated to the direction of US Treasury 10yr note returns – this is about 18% and 14%% (in the absolute) respectively, more than normal. Notably, treasuries have gone down and up this year and equity up and more up which is basically translating into a spread tightener helping to support hybrid prices during a slow bleed up in nominal treasury rates. As a result, retail prices are still quite elevated and are more recently supported by the bull flattener (and record equity prices) that is tightening spreads to treasuries and the relative value of retail paper to NoCos. Importantly, if we factor out the call options in retail and assume the low yield-to-calls are false and yield-to-perpetuity (or maturity) are more reflective of an anchored inflationary environment (and rising UST yields), then the amount of potential spread benefit (to tighten in a rising rate environment) is quite limited as the z-score of -1.42% reflects – this basically means that 98.58% of the price benefit of measured spread tightening may have already happened leaving income carry as the prospective primary contributor to total return from the retail sector.

Relevant new issuance in the retail sector this month were: 1) $1.3 billion of (Baa3/BBB-) Bank of America 4.25% fixed-for-perpetuity preferred stock and 2) $1.3 billion of (Baa3/BB+) Morgan Stanley 4.25% fixed-to-perpetuity preferred stock. Fixed rate non-refixing issuance continues to be the predominant issuance for retail product.

$1,000par Institutional Preferred Securities Sector

The $1,000 par institutional sector of the preferred securities market fell $0.95 in October. Relative values to more senior financials are just below average now as spreads on junior subordinated paper continue to tighten in more than on product up the capital structure. The chart below shows the option adjusted spread of NoCos (i.e., *stb8*: a custom weighted combination of ICE BofA's *cips* and *hips*) 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 within the broader economic cycle from 2013's QE-III to 2020's QE-IV: 1) the aftermath (2014) of the bottom of QE3's Taper

Tantrum (2013), 2) the commodity implosion and high yield (oil) market bust (2016) and 3) the market's revolt to the Fed's overshoot on rates (2018) – and now, the ongoing fear of and recovery from the COVID-19 pandemic and associated variants (2020+). NoCo spreads to comparable treasuries closed 5bps wider (+211). Relative to more senior financials, NoCos moved 2bps wider and have room to further tighten because at +136bps to senior financials, spreads for NoCos are -0.21 standard deviations less than average or 1.96 standard deviations off their tightest spread set in late 2017. We expect the yield compression on junior subordination to more senior credit to continue grinding tighter though there is likely to be some correction along the way from the excesses created by the Fed's massive balance sheet expansion and the uncertain risks that inflation will have to a rates policy lift-off next year now that the taper is underway. From an historical relative spread perspective, the position of the junior subordinated spread differential looks like where it was in late 2016 as credit climbed out of the commodities crisis – the similarities to the Fed lift-off cycle now appear aligned with the prior lift-off of 2015 into 2016 being the current day into 2022 especially if inflation turns out to be more entrenched than transitory. Nonetheless, we do not expect the Fed to raise the funds rate for some time after the taper is complete because the politics of the mid-term elections will keep the Fed biased toward dovishness (i.e., no move off the zero bound until after the elections) to save democrats from spoiling the equity party before the elections. The estimated probability of spread duration benefiting NoCo capital rose modestly from 40.89% to 51.63% this month as yields moving up nudged duration to decline.

Relevant new issuance is NoCos this month were: 1) $1.5 billion of (Baa1/BBB) US Bancorp 3.70% 5yr fixed-to-refixed preferred stock, 2) $1.0 billion of (Ba1/BB+) CitiGroup 4.15% 5yr fixed-to-refixed preferred stock, and 3) $1.0 billion of (Baa2/BB) SVB Financial 4.25% 5yr fixed-to-refixed preferred stock.

Contingent Capital Securities Sector

The CoCo sector fell $0. 85 this month under the weight of interest rate concerns on the belly of the yield curve (from an early lift-off) more than anything being credit related. European bank equities rallied 2.4% to new highs for the year to finish the month poised to move further above the momentum the sector had before the pandemic caused a slam stop last year. Basically, this year's rally in European banks has elevated the sector back up (i.e., 83% from last year's pandemic low) to the low breakout zones of the triple bottoms (excluding the pandemic which was well beyond cyclical) it posted in 2012 (the sovereign debt default), 2016 (the commodities crisis) and 2019 (the global growth squeeze from the Fed's overshoot).

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

Since the 2015-2016 high spreads reflected higher pre-Pillar-2 risks that weakened payment probabilities. But since then, Pillar-2 regulations have improved, core capital has expanded and loan quality has been stable -- which leads us to conclude that this data sample over-tests downside risks in CoCos. As we emphasized last month, there is an improved "normal" since 2016 for CoCo credits that not even the pandemic could break – the junior subordinated differential spike from the pandemic being lower than the spike in 2016 suggests that the market agrees. This month, the relative OAS differential between CoCos and more senior financials tightened by 4bps with a difference of 187bps in favor of CoCos as the senior sector tightened and the CoCo sector widened. The relative value opportunity in CoCos compared to more senior financials is below average, but still appears reasonable given how much credit spreads are compressed in other sectors. Despite the CoCo sector's spread score of -1.01 being the lowest of the three junior subordinated sectors, CoCos still provide 51bps of additional spread to NoCos (6bps less than last month) and 199bps of additional spread to retail preferred securities (20bps more than last month); and CoCos offer the highest absolute yields in additional tier-1 capital securities and the lowest of durations. Importantly, the incremental yield available in the sector reflects the second-best probability estimate of spread benefit at 34.30% (up from 20.02% in September), which is still multiple times higher than what we estimate is available for more senior financials (*e0ba*). The implication here is that the defensive down in capital structure play in CoCos can still defend the total return goal with income – especially as CoCo paper is turning out to effectively be virtual and expensive tier2 capital from a payment priority perspective as the regulatory stress from the pandemic declines.

Outlook:

The Fed Minutes released this month still affirms its policies as being **outcome based.** The Fed has two desired outcomes: 1) a significantly improved labor market, and 2) inflation maintaining a track above 2%. But there certainly has been mixed messages over inflation

views coming from the Fed since June (i.e., that it would move rates up sooner based on expectations not outcomes). As much as the Fed has been anchoring its inflation narrative as being “transitory”, it has reduced the frequency of using this word in its statements and discussions of late. The Minutes state “transitory” 4 times compared to 6 times in the each of the prior two meeting minutes. In the press conferences, Chairman Powell has used the word less frequently too and more recently, not at all. In fact, the minutes from the November meeting a few days ago qualifies “transitory” as being “expected” rather than effectively being certain. So, it seems that the Fed is giving itself some wiggle room to allow the supply-side bottleneck constraints to ease while the outlook for the economy remains dependent on the virus. Nobody knows exactly what full employment means (that’s intentional) so the current conflict between the dual mandate can stay at odds most likely for some time yet as the Fed waits to see if the supply side of the economy can clear to ease inflation next year and foster an extended dovish policy into 2023. In the meantime, the UST 2yr note is starting to build the runway that the Fed will need to lift-off and go wheels up on rates. Keep in mind that the Fed cannot lift-off without a long enough runway built by a generous positive spread between the UST 2yr note and the upper bound of federal funds. Construction on this runway project got underway this month (October) – we’ll discuss this more in our Outlook for 2022 coming soon.

All that said, we expect the fourth quarter to be rather choppy as markets adjust to the reality that the Fed will be tapering 30 billion from purchases before year end and should announce a continuation of its taper in December. As interest rates rise to adjust for more normalized real risks, hybrids can allow for income to rise over time given their coupon reset abilities to follow the expected rate rise in the belly of the curve over time. Hybrids are a sector that can offer quality credit, act as a cheap inflation hedge and book positive real rates of return rather than the negative real rates guaranteed by the entire TIPS curve and most intermediate corporates.

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