SPECTRUM
Asset Management

Junior-Subordinated Capital Securities Markets

May 2022 Updates

The fixed income markets opened May under the same pressure that plagued markets during April. Equity reached new lows by the middle of the month trading down 18.15% before staging a 6% rally into month end. Credit, in particular the retail preferred market, rallied along with the equity market as a modest rally in US Treasuries helped ally some of the more extreme fears about the Fed's hawkish resolve to combat zooming inflation. Just before the rally in the retail market, prices had corrected by 20% on the heels of what was the worst month in 25yrs for the $25par market. This month we had some major divergences in the price performance between hybrid sectors. For example, the below investment grade retail sector was up (+3.05%) by about as much as the below investment grade NoCo sector was down (-2.97%) – more on valuations later. Recession risks rose as the second run at the 1st quarter GDP measure reported 0.10% weaker than the advanced 1.4% contraction reported at the end of last month. The contraction helped to create a bit of a near term washout in US Treasury prices and rally in equity that helped higher grade credit but widened spreads down the capital structure and down the ratings scale – this accordion like spread widening is typical of credit cycles.

The 30yr bond closed May yielding 3.06% (11bps higher). The 10yr note closed yielding 2.84% (4bps lower) -- the yield differential between the two longer US treasuries steepened 15bps to +22bps. Real rates on the front end of the curve (e.g., UST 5yr TIPS) ended the month 26bps higher at -0.14%; the 5yr implied breakeven inflation rate (i.e., the difference in yields between the 5yr UST and the 5yr Treasury Inflation Protected Security) declined 39bps to close at 2.96%. The VIX (i.e., Chicago Board Options Exchange Volatility Index) declined 19% to 26.2 as the S&P 500 finished the month exactly unchanged at 4132, after being down as much as 5.6% this month which was down 18.7% from the record high (4797) set on the first day of the year.

Before we talk hybrids, the performance in some of the more senior corporate credit sectors for comparative references on returns and yield changes is shown below:

- The junk market (measured by the ICE BofA High Yield ***h0a0*** index) rose 0.25% to close yielding 7.02% (2bps lower).
- Global bank credit (measured by ICE BofA ***e0ba*** index) rose 0.87% to close yielding 3.93% (11bps lower).
- The BBB rated 5-10yr corporate sector (measured by ICE BofA ***c6a4*** index) rose 0.43% to close yielding 4.66% (2bps lower).

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 $352 billion (face amount) of investment grade and below investment grade instruments in both the retail $25par market (37%) and the institutional $1,000par market (63%). The USD Contingent Capital Index of US dollar denominated junior-subordinated capital securities ***(cdlr)*** represents $150 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 $502 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 1.71% this month to close yielding 5.48% (+2bps)

- ❖ Headcount was up 1; but face value fell $700 million

2. **ICE BofA US Capital Securities Index (*c0cs*) @ 24% of *i0cs***
   - o <u>Comprised of dated IG $1,000par dated hybrids (excl. US AT1)</u>
     - ❖ The *c0cs* fell 1.40% this month to close yielding 5.26% (+27bps)
     - ❖ Headcount was up 2; face value up $1.875billion
3. ***3.* ICE BofA High-Yield Capital Securities Index (*h0cs*) @ 5% of *i0cs***
   - o <u>Comprised of BIG $1,000par legacy Tier1 and BIG $1,000par hybrids</u>
     - ❖ The *h0cs* fell 2.40% this month to close yielding 6.36% (+43bps)
     - ❖ Headcount fell 1; face value fell $550 million
4. **ICE BofA High Yield Fixed Rate Preferred Index (*p0hy*) @ 27% of *i0cs***
   - o <u>Comprised of BIG $25par and BIG 1,000par (incl. US AT1)</u>
     - ❖ The *p0hy* rose 0.10% this month to close yielding 6.25% (+21bps)
     - ❖ Headcount was down 6; face value fell $3.617 billion

Overall, the ICE BofA All US Capital Securities Index (***i0cs***) rose 0.28% in May to close yielding 5.68%, which was 16bps higher than last month's closing yield and a spread of +288bps over comparable US Treasury securities (49bps wider).

<u>Contingent Capital Securities</u>

A **"contingent capital security"** (i.e., a "CoCo") represents a capital security issued through indenture typically within the context of a "<u>going-concern</u>" 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 62% 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***) gained 0.10% this month to close yielding 6.34%, which was 1bps lower from last month and a spread of +363bps over comparable US Treasury securities (2ps wider).

Discussion of Retail and Institutional Sectors:

We report on the retail and institutional sectors using statistical tables in a *Spread Value Matrix* to provide readers with data on absolute and relative spread positionings. The data samples are sourced from ICE BofA benchmarks starting in March 2017, which is when retail benchmark calculations on yield-to-worst for currently callable $25par preferred securities were improved to reflect actual yields, even if negative. We provide measures of inflation coverage in a *Purchasing Power Matrix*; and a table for yield-to-worst, net of inflation and historical default in a *Real Yield Matrix* that compares hybrids, investment grade corporates and high yield bonds. Finally for each sector, we show data on prior credit cycles to give you a *Comprehensive Risk Estimate* to the average bottom of the last 3 credit cycles (2013, 2016 and 2018) -- the rationale here is to illustrate risk measures relative to prior down credit cycles, but not necessarily an outlook to that direction. By following these tables monthly (and sometimes as “pop-outs” in flash reports), investors should gain consistent insights to assist in making more informed and supportive asset allocation decisions using junior subordinated capital securities.

Snapshot of Junior Subordinated Spread Sector Moves vs. Global Financials:

	p0p4	p0p4-e0ba	stb8	stb8-e0ba	cdlr	cdlr-e0ba
Capital Securities Spread Value Matrix	(a) Retail	(b) Retail	(a) NoCo	(b) NoCo	(a) CoCo	(b) 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	49	-57	242	135	325	219
Stdev	121	106	45	27	61	35
Monthend	168	42	286	160	333	207
Spread Scores:						
(monthend-ave)/stdev	0.98	0.93	0.98	0.93	0.13	-0.34
Δ from Last Month	-0.27	-0.28	0.62	1.22	0.10	0.26

Source: Bloomberg; ICE BofA Bond Indices

** Absolute = Option Adjusted US Government Spread; (current-ave)/stdev*

*** Relative = spread to global financials measured by e0ba ICE Bond Index; (current-ave)/stdev*

Spread performance was mixed this month for hybrids. The retail market tightened while both institutional sectors widened in the absolute (i.e., vs. USTs) and in the relative (i.e., vs. more senior bank paper). Notably, the relative spreads for NoCos widened by 1.22 standard deviations making the down in capital structure trade into NoCos the most attractive it has been all year at month end – though the spread did peak a bit higher before rallying the last week of May. The rally in intermediate USTs against the backdrop of the recovering equity prices helped the corporate sector outperform the NoCo & CoCo sectors – essentially, corporates up and hybrids down. Retail paper was very well behaved this month evidenced by the green lights on change from last month; and the red lights for NoCos evidenced their misbehavior – interestingly (coincidentally), the statistical spread positioning for retail and NoCos are identical. CoCos got a little cheaper in May.

Implications of Market Activity:

$25par Retail Preferred Securities Sector

The retail preferred securities sector measured by *p0p4* rallied $2.71 in May to $91.63, breaking the sector's streak of 4 straight monthly price declines. The retail sector (i.e., *p0p2; which we need to use to look back 12yrs or more*) had its largest price drawdown by early May since recovery from the Lehman Crisis – were it not for the COVID panic. As we said last month, April's decline in the *p0p2* was a -4.26 standard deviation move which left the sector cheaper in just 4 months than all the annual periods over the past 25yrs, except 2008 – and by the first week of May, the sector had gotten even cheaper (3pts cheaper) before it rallied up 6pts from May9th into month end. The following table illustrates the retail sector's 3 prior credit cycles compared to month end valuations:

Retail Pfds.	Valuation Implosions			Average		Diff. to	
Credit Cycle Bottoms >	2013	2016	2018	Prior Bottoms	Current	Average	
GA10	2.98%	1.64%	2.74%	**2.45%**	2.84%	0.39%	
PCE DEFY	1.48%	0.59%	1.86%	**1.31%**	6.30%	4.99%	
Real UST10yr	1.50%	1.05%	0.88%	**1.14%**	-3.46%	-4.60%	
$25Coupon	6.64%	6.46%	6.05%	**6.38%**	5.45%	-0.93%	
$25Price	$94.06	$98.66	$93.09	**$95.27**	$91.61	-$3.66	
$25Current Yield	7.06%	6.55%	6.50%	**6.70%**	5.95%	-0.75%	
Mdur Worst	9.52	10.44	10.95	**10.30**	10.90	0.60	
CY Spread vs. T10yr	4.08%	4.91%	3.76%	**4.25%**	3.11%	-1.14%	
Source: Bloomberg; ICE BofA Bond Indices						-7.70%	Est. Price Risk to AveCY
				Comprehensive Risk Est.		-1.75%	Est. Price Risk + CY
				Recapture Rate (yrs.)		1.29	Est. Price Risk / CY
					Memo:	-11.26%	Total Return YTD

The current yield of the retail sector closed May at 5.95%, which was 18bps lower than last month and 75bps lower than the average current yield at the bottom of the last three credit cycles. The current yield spread to the 10yr is 114bps less than the average of the last three credit cycle bottoms. The implication of a 0.75% yield increase to 6.70% (the average current yield of the prior bottoms) is an estimated 7.70% price decline using the average modified duration of 10.30; then adding back a current book yield (assuming a 12month path) of 5.95% makes the Comprehensive Risk Estimate for the retail sector negative again at -1.75% after being positive for the first time this year last month at 0.23%. It would take 1.29yrs to recapture this assumed capital loss with book income. We said last month that now that the comprehensive risk estimate indicates a positive return the retail sector looks like a fair value; and cheap enough (in the absolute) to potentially recapture the measured capital risk with high income in less than 1yr – but the rally this month (after watching the sector still get cheaper by May 9th) has flipped our fair value assessment back to more risk than value. For the record, on May 9th (when the retail market had bottomed at $85.26) the Comprehensive Risk Estimate was 3.29% and the recapture rate was 0.48yrs. Consequently, our fair value assessments when Comprehensive Risk Estimates are positive appear to be indicative of fair values based on the retail market's behavior in May. Indeed, it is not a perfect indicator but it does suggest tempered risk points to be a better buyer than seller -- let us remember this on prospective assessments as the Fed keeps squeezing the demand side of the economy with higher federal funds and less balance sheet support, especially as the real UST10yr yield is still deeply negative relative the PCE deflator.

$1,000par Institutional Preferred Securities Sector

The $1,000 par institutional sector of the preferred securities market fell $1.81 as yields rose by 37bps to 5.74% in May. The following table illustrates the institutional preferred securities sector's 3 prior credit cycles compared to closing valuations in this month:

Institutional Pfds.	Valuation Implosions			Average		Diff. to	
Credit Cycle Bottoms >	2013	2016	2018	Prior Bottoms	Current	Average	
GA10	2.94%	1.75%	2.74%	**2.48%**	2.84%	0.36%	
PCE DEFY	1.17%	0.59%	1.86%	**1.21%**	6.30%	5.09%	
Real UST10yr	1.77%	1.16%	0.88%	**1.27%**	-3.46%	-4.73%	
Coupon	6.77%	6.43%	5.88%	**6.36%**	5.18%	-1.18%	
Price	$103.96	$99.62	$97.23	**$100.27**	$95.62	-$4.65	
Current Yield	6.51%	6.45%	6.05%	**6.34%**	5.42%	-0.92%	
Mdur Worst	5.90	5.23	4.64	**5.26**	4.10	-1.16	
CY Spread vs. T10yr	3.57%	4.70%	3.31%	**3.86%**	2.58%	-1.28%	
Source: Bloomberg; ICE BofA Bond Indices						-3.78%	Est. Price Risk to AveCY
				Comprehensive Risk Est.		1.64%	Est. Price Risk + CY
				Recapture Rate (yrs.)		0.70	Est. Price Risk / CY
					Memo:	-9.35%	Total Return YTD

The current yield of the institutional preferred sector closed May at 5.42%, which was 9bps higher than last month and still 92bps lower than the average current yield at the bottom of the last three credit cycles. The current yield spread is 128bps lower than the average of the last three credit cycle bottoms. The implication of a 0.92% yield increase to 6.34% (the average current yield of the prior bottoms) is an estimated 3.78% price decline using the modified duration of 4.10; then adding back a current book yield (assuming a 12month path) of 5.33% makes the Comprehensive Risk Estimate for the NoCo sector equal to 1.64%. It would take 0.70rs to recapture this capital loss estimate with book income. The combination of higher yields and some spread widening has moved the NoCo sector into a more cushioned valuation this month (evidenced by the recapture rate of less than 1.00) and a more positive Comprehensive Risk Estimate than last month.

There was one notable NoCo issue placed this month:

1. $1.25 billion Munich Re 5.875% 10yr fixed-to-refixed 20yr subordinated debt (A2/nr) resettable at +398bps off the 5yr constant maturing US treasury yield.

The deal came right around the time that the tone to equity markets was improving which helped to lift these bonds to $104 by the end of the month – no doubt, Munich Re will be a NoCo bell weather bond for quite a while given its issuance timing and size. The bonds outperformed the general NoCo market by a little over 2pts.

Contingent Capital Securities Sector

The CoCo sector declined $0.42 as even as the European bank stocks recovered all their losses from the prior month. There were no new developments on the European Commission's call for advice on its review of macroprudential frameworks. The call was to the European Banking Authority (EBA), the European Systemic Risk Board (ESRB) and the European Central Bank (ECB). In the ECB's response, it suggests that the capital rules for CoCos be enhanced to provide for more "going-concern loss absorption" which means that coupon skipping risk, loss absorption risk, and less call likelihood are all possible for a new variety of CoCos. This is easier to imagine that it is practical because CoCos would be nothing more than equity without upside and would be subject to a potential complete loss as equity survives to benefit a recapitalized better bank. This would be very hard to sell fixed income investors because CoCos would in effect be subordinated to equity if CoCos are written to zero while equity survives a modest dilution to recapitalize a going concern. As we stated last month, it would be counterproductive for European regulators to sunset CoCo AT1 when the US banking system has a vibrant AT1 market of its own. Indeed, there would be complaints of competitive global advantages for shareholders of US banks over European banks. Time will tell and we will keep you updated on any developments – change is certain, especially in a complex regulatory system with many diverse constituent interests. It may be that a new era of legacy tier1 could evolve making for some potentially interesting values in CoCos.

The following table illustrates the contingent capital securities sector's 3 prior credit cycles compared to closing valuations in May:

CoCo Securities	Valuation Implosions			Average		Diff. to
Credit Cycle Bottoms >	2013	2016	2018	Prior Bottoms	Current	Average
GA10	3.01%	1.75%	2.88%	**2.55%**	2.84%	0.29%
PCE DEFY	1.48%	0.59%	1.86%	**1.31%**	6.30%	4.99%
Real UST10yr	1.53%	1.16%	1.02%	**1.24%**	-3.46%	-4.70%
Coupon	7.63%	6.40%	6.78%	**6.94%**	6.15%	-0.79%
Price	$105.04	$89.12	$96.21	**$96.79**	$95.62	-$1.17
Current Yield	7.26%	7.18%	7.05%	**7.16%**	6.43%	-0.73%
Mdur Worst	4.76	5.30	3.95	**4.67**	3.01	-1.66
CY Spread vs. T10yr	4.25%	5.43%	4.17%	**4.62%**	3.59%	-1.03%

Source: Bloomberg; ICE BofA Bond Indices

	-2.20%	Est. Price Risk to AveCY
Comprehensive Risk Est.	4.23%	**Est. Price Risk + CY**
Recapture Rate (yrs.)	0.34	Est. Price Risk / CY
Memo:	-9.08%	Total Return YTD

The current yield of the institutional preferred sector closed May at 6.43%, which was 2bps higher than April and 73bps lower than the average current yield at the bottom of the last three credit cycles. The current yield spread is 103bps lower than the average of the last three credit cycle bottoms. The implication of a 0.73% yield increase to 7.16% (the average current yield of the prior bottoms) is an estimated 2.20% price decline using the modified duration of 3.01; then adding back the current book yield (assuming a 12month path) of 6.43% makes the Comprehensive Risk Estimate for the NoCo sector 4.23% -- 15bps higher (i.e., lower risk) than last month. It would take 0.34yrs to recapture this assumed capital loss with book income. Since the Russian invasion of Ukraine, CoCo prices have underperformed NoCo prices even though NoCos have about 0.75yrs of additional duration risk. But this month, CoCos crossed back over NoCos to bottom $0.76 higher than NoCos which realigns the price behavior to what their lower duration differences suggest – that is, all else being equal there is less rates risk in CoCo duration than in NoCo duration.

Outlook:

The Fed meeting this month ended with a 50bps hike which was very well baked into the market. Chairman Powell in the press conference characterized the US economy as “*very strong*” and labor markets as “*extremely tight*”. As a result, the Fed believes that the economy is well prepared for hikes of 50bps at the "next couple of meetings", which means June & July. This would push the federal funds rate to 2% by the summer and put it spot on the 2022 median with three more meetings to go. If the Fed went another 25bps at each of the last 3 meetings after that, then it would have federal funds of 2.75% which would be an early arrival on the DOTS report median for 2023 and 2024. Yet, this would still be well below today's inflation rate of 6.3% measured by the PCE deflator (the Fed's preferred measure of inflation). Typically, the Fed does not stop raising the federal funds rate until it has crossed over the PCE deflator which suggests the Fed is a long way from pausing. That notwithstanding, the equity market got quite gleeful this month as fears of a recession brought hopes that the Fed would take a pause in September. We think the odds of that are very low because supply chain problems are still pervasive, and the labor markets are still quite strong – or "extremely tight". For now, the UST5yr break evens (i.e., the UST market's implied expectation for inflation over the next 5yrs) have corrected back down to the rising trend on the 200day moving average after peaking in March at 3.73%. Nonetheless as the Fed catches up with the market, we expect this breakeven to rise again given US policy is intentionally impairing US oil production which raises the cost on everything except darkness, sunlight and oxygen.

The following *Purchasing Power Matrix* helps us keep track of how attractive hybrids are relative to more senior financials in covering 5yr inflation breakeven with investment yields:

	A	B	C	D=B/C	E=D/A
Purchasing Power Matrix: Financials	Mdur	YTW%	5yrBE Inflation%	Inflation Coverage	Inflation Coverage/ Mdur
Retail $25par (p0p4)	10.90	5.49	2.96	1.86	0.17
NoCos (stb8)	4.10	5.77	2.96	1.95	0.48
CoCos (cdlr)	3.01	6.37	2.96	2.15	0.72
More Sr. Fins (e0ba)	5.10	3.96	2.96	1.34	0.26

Source: Bloomberg; ICE BofA Bond Indices

The contingent convertible sector (CoCos) is the winner on Inflation Coverage and risk adjusted coverage when factoring duration. The retail sector is back behind the NoCo sector for Inflation Coverage, after outpacing it last month. More senior financials can cover 5yr breakeven inflation too, but not by as much and institutional hybrids; CoCos & NoCos have better duration risk coverages, as well.

Defense continues to be our primary investment objective this year and positive real yields help us to make that play. Real yields are still getting increasingly attractive for most hybrids and even more so when we adjust historical default risks from real yields. Below we assess a more comprehensive view of real yields net of inflation and net of default in a *Real Yield Matrix* to double risk adjusted yield comparisons in hybrids and corporates:

Real Yield Matrix	Hybrids		Corporates	
	Preferreds	CoCos	IG Corps	BIG Corps
Bloomberg Index	*cips+hips*	*cdlr*	*c6c0*	*h0a0*
Mod.Duration	4.10	3.01	6.36	4.55
Yield-to-Worst	5.77	6.37	4.45	7.13
Inflation[1] Adjustment	2.96	2.96	2.96	2.96
Real Yields	2.81	3.41	1.49	4.17
Default[2] Adjustment	-0.11	-0.11	-0.04	-2.57
YTW, net, net adj.	**2.70**	**3.30**	**1.45**	**1.60**
Composite Rating	*BBB2*	*BB1*	*BBB1*	*B1*
Last Month End:	Hybrids		Corporates	
	Preferreds	CoCos	IG Corps	BIG Corps
YTW, net, net adj.	1.91	2.90	1.09	1.13
Change from Last	☆ 0.79	☆ 0.40	☆ 0.36	☆ 0.47

Source: Bloomberg; ICE BofA Bond Indices

[1] *Inflation assuption based on the UST5yr breakeven inflation rate*
[2] *Sprectrum's 10yr annual default study through 2020*

Hybrids offer the most positive double-net real yield opportunity in credit. The changes from April are noteworthy with NoCo yields moving up the most and CoCos now offering more than 3% YTW (i.e., 3.30%), net-net. The positive real yield opportunities that made hybrids worthy inflation combatants last month have made them more attractive this month – the climb is likely to be ongoing as the Fed begins reducing its balance sheet this month. The steepening yield curve is the second order effect on the UST curve for now as the first order effect was the fast and furious rise of the 2yr note and a commensurate flattening. The steeper 2s to 10s go (currently 27bps; 6bps wider than April), the more room the bond market is giving the Fed to manage a soft landing. We do not believe that any landing can happen without the equity market legitimately testing the risk of a recession looming – this would mean a test of 3800 on the S&P and some time spent trading below that level. The Fed intending to drain $523billion from market liquidity by the end of the year is the primary reason real yields are rising, the stock market is falling, and spreads are pressured to widen. It will take some time for central banks to realize that inflation has permanently elevated above targets (markets will get there first). The primary risk is that the Fed (and other central banks) feels compelled to push up hard on interest rates to create needed friction on consumption demand – combine this against the backdrop of an already a broken (and changing) global supply system and stagflation becomes more probable which could digress into recession becoming the goal -- just as inflation used to be the goal, but now is the enemy. Inflation expectations becoming unanchored would be the central bank's worst nightmare, so they will forcefully use all their tools to foster a more pleasant reality. But the ruling progressive dream of a zero-carbon electric universe makes any immediate meaningful policy relief on inflation impracticable. The implication of this entrenched trend is that hybrids should become increasingly attractive. We will keep following the Comprehensive Risk Estimates, Recapture Rates and double-net YTW for hybrids and update you on the changes – as we said earlier, these assessments appear to indicate some risk adjusted entry points worth making as we witnessed this month for the retail sector. Despite an overall stagflationary outlook that could still weigh on fixed income prices, the hybrid sectors can, nonetheless, offer a competitive playbook to help mitigate capital risks and improve cashflows when compared to other fixed income sectors.

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