Junior-Subordinated Capital Securities Markets

June 2023 Updates

The US Treasury bond market was a bit heavy in June, but credit prices rose helping to tighten spreads. The Fed paused on its rate hikes in June but signaled that there are still more hikes to come. It also hiked the expected policy rate for the next 2yrs by a bit more too – this anchored a market narrative that short-term policy rates will stay higher for longer. Consequently, the spread between UST2yr notes and UST10yr notes revisited the depths of inversion (i.e., -107bps) reached just before Silicon Valley Bank went under last quarter, but the overall market mood was far more constructive this month and leaned into a soft landing for the US economy despite the most widely expected recession to come in decades. The 30yr bond closed the month yielding 3.86% (unchanged) and the 10yr note closed yielding 3.84% (20bps higher). Real rates on the front end of the treasury curve (e.g., UST 5yr TIPS) rose by 30bps (to 1.98%); the 5yr implied breakeven inflation rate (i.e., the difference in yields between the 5yr UST and the 5yr Treasury Inflation Protected Security) rose 4bps to close at 2.19%. The bond market is thinking the Fed will push up more on rates and the process will win the inflation battle as real rates are rising and breakeven inflation rates implied by US treasuries remain low, but time will tell as the fiscal backdrop of continued government excess spending is ongoing. The VIX (i.e., Chicago Board Options Exchange Volatility Index) fell 4.3pts 13.6 (the lows of 2019) as the S&P 500 rose to 4450, up 270 points, which is just 7% off the record high.

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

- The junk market (measured by the ICE BofA High Yield ***h0a0*** index) rose 1.63% to close yielding 8.55% (28bps lower).

- Global bank credit (measured by ICE BofA ***e0ba*** index) was unchanged to close yielding 5.71% (17bps higher).
- The BBB rated 5-10yr corporate sector (measured by ICE BofA ***c6a4*** index) rose 0.06% to close yielding 5.73% (6bps 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 $328 billion (face amount) of investment grade and below investment grade instruments in both the retail $25par market (35%) and the institutional $1,000par market (65%). The USD

Contingent Capital Index of US dollar denominated junior-subordinated capital securities ***(cdlr)*** represents $136 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 $463 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.

<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***
   - <u>Comprised of IG $25par and IG $1,000par (incl. US AT1)</u>
     - The *p0p1* rose 1.00% this month to close yielding 6.69% (-20bps)

2) **ICE BofA US Capital Securities Index (*c0cs*) @ 24% of *i0cs***

○ Comprised of dated IG $1,000par dated hybrids (excl. US AT1)

- The *c0cs* rose 0.45% this month to close yielding 6.93% (+9bps)

3) **ICE BofA High-Yield Capital Securities Index (*h0c*s) @ 6% of *i0cs***

○ Comprised of BIG $1,000par legacy Tier1 and BIG $1,000par hybrids

- The *h0cs* rose 0.02% this month to close yielding 7.98% (-25bps)

4) **ICE BofA High Yield Fixed Rate Pfd Index (*p0hy*) @ 25% of i*0cs***

○ Comprised of BIG $25par and BIG 1,000par (incl. US AT1)

- The *p0hy* rose 1.78% this month to close yielding 8.58% (-26bps)

Overall, the ICE BofA All US Capital Securities Index (***i0cs***) rose 0.99% this month to close yielding 7.33%, which was 13bps lower than last month's closing yield and a spread of +329bps over comparable US Treasury securities (30bp 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 56% 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***) rose 1.46% this month to close yielding an

8.50%, which was 11bps lower than last month and a spread of +453bps over comparable US Treasury securities (18bps lower).

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 of historical default in a ***Real Yield Matrix*** that compares hybrids, investment grade corporates and high yield bonds. Finally, we show data on prior credit cycles for each sector 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. Each signal is intended to be independently supplementary to foster a more balanced value assessment for each sector.

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	486	205	660	472
Low	-178	-267	176	60	223	143
Range	766	518	310	145	437	329
Average	72	-41	255	142	337	225
Stdev	121	103	49	27	65	38
Monthend	136	6	300	170	391	261
Spread Scores:						
(monthend-ave)/stdev	0.53	0.46	0.92	1.04	0.83	0.95
Δ from Last Month	-0.34	-0.26	-0.39	-0.19	-0.60	-0.68

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*

Here, we look at option adjusted spread (OAS) to haircut spread to comparable US Treasuries for interest rate volatility and time to expiry. The way we interpret the above option adjusted spread table is by the statistical positioning of the *Spread Scores* where, **zero** = "*fair value*", **+/-**

1stdev. = "*undervalued*"/ "*overvalued*", respectively and **+/- 2stdevs** = "*very undervalued*"/ "*very overvalued*", respectively.

Spread performance for hybrids this month was positive for all three sectors with CoCo spread performance tightening the most (i.e., -60bps). The Absolute Spread Score on retail paper tightened by 0.34 standard deviations; **the $25par sector is somewhat *undervalued* with a Spread Score of 0.53 standard deviations from average**. The Absolute Spread Score for the institutional $1,000par preferred securities sector ("NoCos") tightened by 0.39 standard deviations; **NoCos are the most *undervalued* with a Spread Score of 0.92 standard deviations from average**. The Absolute Spread Score for the CoCo sector tightened by 0.60 standard deviations; **CoCos are *undervalued* with a Spread Score of 0.83 standard deviations from average**. Note that these statistical positionings provide an absolute and relative view on some historical spread, which can be further complimented with some cycle perspectives from the Comprehensive Risk Estimates below.

<u>Implications of Market Activity</u>:

<u>$25par Retail Preferred Securities Sector</u>

The retail preferred securities sector measured by *p0p4* rose $0.66 to $83.07 in a further risk on move that followed last month's more sanguine view on the regional banking stresses. The largest passive $25par ETF, iShares Preferred and Income ETF (i.e., $13.05billion; pff), had about $84 million of net money inflow this month. The overall retail $25par sector closed June 5.09% higher than its 2022 close. At the end of last year, our Comprehensive Risk Estimate was deeply positive (i.e., 8.90%), which meant that over the next 12mos., the return potential was 8.90% even if the sector's current yield retraced to 6.70% or the average of the last three credit cycle bottoms. This month's Comprehensive Risk Estimate from the three prior credit cycles is a bit less positive the last month's 5.61% (the highest of the year) due to the sector's modest price gain in this month which marked down the estimate to 4.51% -- still seemingly quite generous.

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%**	3.81%	1.36%	
PCE DEFY	1.48%	0.59%	1.86%	**1.31%**	3.80%	2.49%	
Real UST10yr	1.50%	1.05%	0.88%	**1.14%**	0.01%	-1.13%	
$25Coupon	6.64%	6.46%	6.05%	**6.38%**	5.46%	-0.92%	
$25Price	$94.06	$98.66	$93.09	**$95.27**	$83.90	-$11.37	
$25Current Yield	7.06%	6.55%	6.50%	**6.70%**	6.51%	-0.19%	
Mdur Worst	9.52	10.44	10.95	**10.30**	11.81	1.51	
CY Spread vs. T10yr	4.08%	4.91%	3.76%	**4.25%**	2.70%	-1.55%	
Source: Bloomberg; ICE BofA Bond Indices						-2.00%	Est. Price Risk to AveCY
				Comprehensive Risk Est.		4.51%	**Est. Price Risk + CY**
				Recapture Rate (yrs.)		0.31	Est. Price Risk / CY
					Memo:	5.09%	Total Return YTD

The current yield of the retail sector closed the month at 6.51%, which was 4bps lower than last month and 19bps lower than the average current yield at the bottom of the last three credit cycles. The current yield spread to the 10yr US Treasury note is 270bps which is 155bps less than the average spread of the last three credit cycle bottoms as retail preferred yields are still high but spread is being squeezed by UST yields being high, as well -- a gauge to yields being high is the discount price to the sector. The rebalanced dollar price of the retail sector is $83.90 this month and $11.37 lower than the average of the prior bottoms, which means that there is more convexity to the retail market during this cycle than there was during the prior cycles even though yields were higher. The implication of a 0.19% current yield increase to 6.70% (the average current yield of the prior bottoms) is an estimated 2.00% price decrease using the current modified duration of 11.81; then adding back a current book yield (assuming a 12month path) of 6.51% makes the *Comprehensive Risk Estimate* for returns in the retail sector positive at 4.51%. The income recapture rate of the illustrated price loss is 0.31yrs because the market yield is higher than the illustrated price risk indicating the retail sector has more opportunity than risk.

Performance Memos (p0p4 +1.42%):

The primary contributors to the p0p4 performance this month were Regional Banks (+0.28%), Office REITS (0.20%) and Wireless Communications (+0.07%).

The primary detractors to p0p4 performance this month were Electric Utilities (-0.02%), Diversified Financial Services (-0.01%), and Diversified Chemicals (-0.01%).

Year-to-date, below investment grade (BIG) $25pars have underperformed investment grade (IG) retail paper by 5.36%.

$1,000par Institutional Preferred Securities Sector

The $1,000 par institutional sector of the preferred securities market lifted $0.20 but yields were unchanged at to 7.66% this month. The following table illustrates the institutional preferred securities sector's three prior credit cycles compared to closing valuations 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%**	3.81%	1.33%	
PCE DEFY	1.17%	0.59%	1.86%	**1.21%**	3.80%	2.59%	
Real UST10yr	1.77%	1.16%	0.88%	**1.27%**	0.01%	-1.26%	
Coupon	6.77%	6.43%	5.88%	**6.36%**	5.22%	-1.14%	
Price	$103.96	$99.62	$97.23	**$100.27**	$90.87	-$9.40	
Current Yield	6.51%	6.45%	6.05%	**6.34%**	5.74%	-0.59%	
Mdur Worst	5.90	5.23	4.64	**5.26**	3.97	-1.29	
CY Spread vs. T10yr	3.57%	4.70%	3.31%	**3.86%**	1.93%	-1.93%	
						-2.36%	Est. Price Risk to AveCY
				Comprehensive Risk Est.		3.39%	Est. Price Risk + CY
				Recapture Rate (yrs.)		0.41	Est. Price Risk / CY
					Memo:	1.86%	Total Return YTD

Source: Bloomberg; ICE BofA Bond Indices

The current yield of the institutional preferred sector closed the month at 5.74%, which was 3bps higher than last month. The $90.87 price of the NoCo sector is $9.40less than the average price over the last three credit cycles – the implication of the discount is an embedded **"pull toward par"** and time ages and the prospect of higher coupon resets approach becoming available. The current yield of the sector edged up to be 59bps less than the 6.34% average current yield at the bottom of the last three credit cycles. The implication of a 0.59% current yield increase to 6.34% (the average current yield of the prior bottoms) is an estimated 2.36% price decline using the modified duration of 3.97; then adding back a current book yield (assuming a 12month path) of 5.74% makes the *Comprehensive Risk Estimate* for the NoCo sector equal to a 3.39% horizon return to accept the risk, which is 19bps higher than last month. It would take 0.41yrs to recapture this capital loss estimate with book income. The NoCo sector continues to be in a cushioned valuation position.

Performance Memos (cips +0.67%; hips +0.80%):

The primary contributors to investment grade NoCo (cips) performance this month were Custody Banks (+0.72%), Diversified Financial Services (+0.39%) and Regional Banks (+0.06%).

The primary detractors from investment grade NoCo performance were Brokerage (-0.04%), Property & Casualty (-0.01%) and Reinsurance (-0.01%).

The primary contributors to below investment grade NoCo (hips) performance this month were Diversified Banks (+0.39%), Oil & Gas (+0.12%) and Broadcasting (+0.11%).

The primary detractors from below investment grade NoCo performance were Retail (-0.34%), Utilities (-0.01%) and no other sector performed negatively.

Year-to-date, below investment grade (BIG) $1000pars underperformed investment grade (IG) institutional paper by 4.45%.

Contingent Capital Securities Sector

The CoCo sector rose $0.80 this month to $89.31 as the sector continues to recover from the sudden blowoff suffered from the collapse of confidence in Credit Suisse last quarter. There is ongoing talk of European regulatory surveys on how the sector can be improved so as to not create such systemic shock in a bail-in but we see no reason to change CoCo structure because bail-in has proven to work a few times. Indeed, each bail-in can be a little different from the last and each regulatory regime that receives a failed bank is going to protect its depositors (and perhaps even voters) as responsibly as possible through the bail-in benefits of the capital priorities – and they might even change the rules as regulators do to get what regulators want.

The following table illustrates the contingent capital securities sector's three prior credit cycles compared to closing valuations this month:

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%**	3.81%	1.26%	
PCE DEFY	1.48%	0.59%	1.86%	**1.31%**	3.80%	2.49%	
Real UST10yr	1.53%	1.16%	1.02%	**1.24%**	0.01%	-1.23%	
Coupon	7.63%	6.40%	6.78%	**6.94%**	6.22%	-0.72%	
Price	$105.04	$89.12	$96.21	**$96.79**	$89.31	-$7.48	
Current Yield	7.26%	7.18%	7.05%	**7.16%**	6.96%	-0.20%	
Mdur Worst	4.76	5.30	3.95	**4.67**	2.57	-2.10	
CY Spread vs. T10yr	4.25%	5.43%	4.17%	**4.62%**	3.15%	-1.46%	
Source: Bloomberg; ICE BofA Bond Indices						-0.51%	Est. Price Risk to AveCY
				Comprehensive Risk Est.		6.45%	**Est. Price Risk + CY**
				Recapture Rate (yrs.)		0.07	Est. Price Risk / CY
					Memo:	-7.64%	Total Return YTD

The current yield of the CoCo sector closed the month at 6.96%, which was 7bps lower than last month and 20bps less than the average current yield at the bottom of the last three credit cycles (i.e., 7.16%). The CoCo price average of $89.31 is lower than 2 of the last 3 three cycles, which (like the other hybrid sectors) highlights that the term structure of interest rates (i.e., high real US Treasury yields) being the primary reason for discounted prices – the implication of the discount is an embedded **"pull toward par"** and time ages and the prospect of higher coupon resets approach becoming available. The implication of an 0.20% current yield increase to 7.16% (the average current yield of the prior bottoms) is an estimated 0.51% price decline using the modified duration of 2.57; then adding back the current book yield (assuming a 12month path) of 6.96% makes the *Comprehensive Risk Estimate* for return in the CoCo sector 6.45%. The recapture rate of the estimated capital risk is less than one month for CoCos.

Performance Memos (cdlr +1.46%):

The primary contributors to CoCo performance by country (as CoCos are primarily diversified banks) were United Kingdom (0.32%), France (0.31%) and Switzerland (0.23%).

The primary detractors from CoCo performance were Denmark (-0.01%); there were no other negatively performing countries.

Outlook:

After ten sequential moves higher, the Fed decided not to raise rates at its June meeting. The language of the FOMC statement was changed to strongly suggest that there will be another hike coming and the Dot Plot suggests that two more hikes may be coming based on the median target funds rate for 2023 jumping 50bps to 5.625% (note that the distribution for this median still implies more risk of a lower policy rate than a higher policy rate by 2:1). The Fed is not only the master moneychanger, but also the master messenger -- **the key message from the June meeting was policy should be "higher for longer"**. Indeed, the hawkish intent of elevating the dots over the next two years was to persuade markets that the Fed is serious about keeping rates elevated for an extended period so lag effects from market adjustments can do the inflation fighting in advance; and as markets fight in advance, the action messaged may never be needed. So, the debate that follows the meeting is not as much over how high the federal funds rate will go, but how long they will stay at where they end up; and how fast they will ease the funds rate back down when inflation declines to acceptable levels – we confident that inflation will indeed wane giving the Fed what the Fed wants but it will likely take until next year before markets and the Fed are convinced.

Here is a review of what we said in December (we highlight where we are or where we should be heading from here):

- Three key questions remain for Fed policy on federal funds:
    1. How high?

        Answer: 4.75% - 5.00%

        Risk: 5.25% - 5.50%
    2. How fast?

Answer: by March 2023

Risk: by June 2023

3. How long?

Answer: hold for 1yr =
March 2024

Risk: hold for 6 months = December 2023

It is a good bet that Powell will go up at least one more time because the gap between the lower bound of target funds rate (5.0%) and the core personal consumption deflator (4.6%) is 40bps and a move up in rates is a sure way to widen the gap now that it is in a downward trend – a more positive real federal funds rate is more insurance to create the needed friction to slow demand to foster desired disinflation.

Main takeaways:

- The Fed has achieved its goal by inverting the gap to a positive real funds rate equivalent to prior peaks of its hiking cycles.
- Rate hikes could be done for this cycle but a very hawkish tone and a shift up in the June dots for the next two years is a likely signal of one more hike in July and rates staying higher for longer.

Why the rate hikes matter:

- The Fed knows that inflation should be trending down and that either another rise in the funds rate or a further fall in the core PCE will widen the gap more. The next PCE report is on July 28th and the next FOMC decision is on July 26th so there is plenty of time (opportunity) for the data to either support a stop, pause or another insurance hike to further widen the gap.
- The rate hikes and resultant yield curve inversion make the lower duration fixed-to-refixed sectors generally more attractive than higher duration fixed-forever sectors, and the stronger rally in retail paper compared to institutional paper (i.e., IG retail

outperforming IG NoCos by 3.23% this year) is keeping institutional paper in a better value position when considering the lower duration of NoCos.

Even if the Fed is not done raising rates, most of the market's job should be complete. The Fed's ongoing balance sheet reductions are the backstories creating friction to aggregate demand while the rate hikes are getting all the headlines. June was the 12th straight month of declines in the producer price index, so the balance sheet reduction's lagged effects are gaining momentum. Indeed, even though Chairman Powell says, *"It will be appropriate to cut rates at such time as inflation is coming down really significantly and we're talking about a couple of years out",* bond markets (i.e., hybrids) should rally in advance of that cut which means they should be in a rally trend during the extended period when the Fed has "stopped" (which is either now or beginning next month most likely). There are attractive yields available in hybrid preferred securities which offer significant yield advantages to corporate bonds, shown here:

	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)	11.81	6.67	2.19	3.04	0.26
NoCos (stb8)	3.97	7.70	2.19	3.51	0.89
CoCos (cdlr)	2.57	8.55	2.19	3.90	1.52
More Sr. Fins (e0ba)	4.82	5.72	2.19	2.61	0.54

Source: Bloomberg; ICE BofA Bond Indices

With hybrid yields up and inflation breakevens rising by 4bps this month, inflation coverages are quite robust at 3.04x to 3.90x for junior subordination. The contingent convertible sector (CoCos) is the winner on *Inflation Coverage* and risk adjusted coverage when factoring in duration. The NoCo sector wins the silver medal again on both scores. The retail sector measures up too, but one must accept more duration risk in a mostly "fixed-forever" structure to retail paper to get the coverage.

Bottomline:

- **Now is the time to be buying junior subordination in quality financials** despite money market returns appearing so attractive because by the time these short rates come down, prices on term spread product should have already made a good move higher.
- **Lock in the total returns now while there is some time and attraction** as headlines focus on rates or Powell's dilemma of a June being becoming an extended "pause" turned stop or a just "skip" in rate hikes.
- **Bank drawdowns on the Bank Term Funding Program flatlined this month** which indicates some deposit stress and willingness to hold the losses and allow them to age away to maturity over the next few years.
- **There is good value in the junior subordinated sectors based on discounted prices** in the retail sector and unique total return prospects for fixed-to-refixed structures that should **"pull toward par"** in the institutional sectors.

In Closing:

Maintaining a core portfolio defense in positioning structure, liquidity and credit concentrations are our three primary investment objectives this year. Real yields are quite attractive in hybrids and even more so when we consider subtracting estimated historical credit default risks from real yields. Below we assess a more comprehensive view of real yields net of inflation and net of estimated 10yr average default in a *Real Yield Matrix* to double risk adjusted yield comparisons in hybrids, investment grade corporates and below investment grade corporates (i.e., junk bonds):

Real Yield Matrix	Hybrids		Corporates	
	Preferreds	CoCos	IG Corps	BIG Corps
Bloomberg Index	*cips+hips*	*cdlr*	*c6c0*	*h0a0*
Mod.Duration	3.97	2.57	6.21	3.94
Yield-to-Worst	7.70	8.55	5.51	8.56
Inflation[1] Adjustment	2.19	2.19	2.19	2.19
Real Yields	5.51	6.36	3.32	6.37
Default[2] Adjustment	-0.44	-0.44	-0.04	-2.57
YTW, net, net adj.	**5.07**	**5.92**	**3.28**	**3.80**
Composite Rating	*BBB2*	*BB1*	*BBB1*	*B1*
Last Month End:	Hybrids		Corporates	
	Preferreds	CoCos	IG Corps	BIG Corps
YTW, net, net adj.	5.45	6.40	3.26	4.16
Change from Last	☆ -0.38	☆ -0.48	☆ 0.02	☆ -0.36

Source: Bloomberg; ICE BofA Bond Indices

[1] *Inflation assuption based on the UST5yr breakeven inflation rate*
[2] *Sprectrum's 10yr annual default study through 2021 adjusted for est. SIVB & CS*

Hybrids offer the most positive double-net real yield opportunity in credit. As the Fed is very likely to be no more than 1 step away from a full stop on rate hikes, the elevated real yields in US treasuries will likely persist well into 2024. Hybrid yields will probably stay elevated for some time though, especially given the high likelihood of recession next year from the consistently (deeply) inverted yield curve and net deposit outflow from the banking system. Consequently, the window of opportunities in Hybrids should be available for some time as volatility is likely to elevate somewhat from current complacent levels in equity. In a year when we don't expect duration to be a major contributor to institutional performance, the income accretion component of Hybrids (especially those with QDI) looks compelling compared to core corporates and high yield -- especially net of longer run average default risks. Over the longer term, rate cuts to offer insurance of a shallow recession and the structural "pull toward par" discounts should reward hybrid investors who take advantage of today's lower prices and relatively wide spreads.

Phil Jacoby
CIO, Spectrum Asset Management
July 17, 2023