Junior-Subordinated Capital Securities Markets

July 2023 Updates

The US Treasury bond markets were heavy in July, but credit prices rose again to further tighten spreads in a UST vs. credit yield twist. The Fed moved again to hike the federal funds rate another 25bps (to 5.25%-5.50%) after a pause last month; and signaled that there are still more hikes to come, which is a similar message to that from its June meeting. The spread between UST2yr notes and UST10yr notes, which revisited the depths of inversion (i.e., -107bps) last month, de-inverted less negative by 14bps. The credit market's mood was quite constructive this month and continued tighter to lean into a softer landing for the US economy – this, despite the most widely anticipated recession to come in decades. The 30yr bond closed the month yielding 4.00% (14bps higher) and the 10yr note closed yielding 3.95% (11bps higher). Real rates on the front end of the treasury curve (e.g., UST 5yr TIPS) fell by 9bps (to 1.89%); the 5yr implied breakeven inflation rate (i.e., the difference in yields between the 5yr UST and the 5yr Treasury Inflation Protected Security) rose 8bps to close at 2.27%. The bond market is thinking the Fed will keep rates high for longer as the back end of the curve is beginning to give up hope of a quick reversal in policy and perhaps even a tolerance for the Fed not quite making its 2% inflation target in the long run. The ongoing fiscal backdrop of continued government excess spending is not aligned with the Fed's disinflationary goals though resultant rising real rates should slow the economy into a stagflationary boring mood rather than excite it the way fiscal stimulus has in the past – this would be a welcomed outcome from the Fed's policy perspective. The VIX (i.e., Chicago Board Options Exchange Volatility Index) chopped but closed unchanged at 13.6 (the lows of 2019) as the S&P 500 rose to 4489, up 39 points, which is just 6.2% off its 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 1.42% to close yielding 8.31% (26bps lower).
- Global bank credit (measured by ICE BofA ***e0ba*** index) rose 0.73% to close yielding 5.62% (10bps lower).
- The BBB rated 5-10yr corporate sector (measured by ICE BofA ***c6a4*** index) rose 0.73% to close yielding 5.68% (6bps 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 $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 $134 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 $462 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*) @ 45% *of i0cs***

o Comprised of IG $25par and IG $1,000par (incl. US AT1)

- The *p0p1* rose 1.39% this month to close yielding 6.55% (-10bps)

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

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

- The *c0cs* rose 1.05% this month to close yielding 6.85% (-16bps)

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

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

- The *h0cs* rose 1.06% this month to close yielding 8.07% (-10bps)

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

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

- The *p0hy* rose 2.79% this month to close yielding 8.64% (-24bps)

Overall, the ICE BofA All US Capital Securities Index (***i0cs***) rose 1.61% this month to close yielding 7.20%, which was 14bps lower than last month's closing yield and a spread of +302bps over comparable US Treasury securities (25bps 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).

<u>Discussion of Retail and Institutional Sectors:</u>

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 <u>not</u> 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	73	-40	255	142	338	225
Stdev	121	103	49	27	65	38
Monthend	**135**	**17**	**276**	**158**	**375**	**222**
Spread Scores:						
(monthend-ave)/stdev	0.51	0.55	0.43	0.59	0.57	-0.08
Δ from Last Month	-0.02	0.10	-0.49	-0.44	-0.26	-1.03

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 NoCo spread performance tightening the most (i.e., -24bps). The Absolute Spread Score on retail paper tightened by 0.02 standard deviations; **the $25par sector is somewhat *undervalued* with a Spread Score of 0.51 standard deviations from average**. The Absolute Spread Score for the institutional $1,000par preferred securities sector ("NoCos") tightened by 0.49 standard deviations; **NoCos are the most *undervalued* with a Spread Score of 0.43 standard deviations from average**. The Absolute Spread Score for the CoCo sector tightened by 0.26 standard deviations; **CoCos are *undervalued* with a Spread Score of 0.57 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.

Implications of Market Activity:

$25par Retail Preferred Securities Sector

The retail preferred securities sector measured by *p0p4* rose $0.52 to $84.42 in another risk on move that was fueled by the regional bank sector and below investment grade paper. The largest passive $25par ETF, iShares Preferred and Income ETF (i.e., $13.05billion; pff), had about $120 million of net money inflow this month. The overall retail $25par sector closed the month 5.97% higher year-to-date. 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 4.51% due to the sector's modest price gain in this month which marked down the estimate to 3.96% -- still, seemingly quite generous with a 165bp coverage to the 5yr breakeven inflation rate (2.31%).

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%**	3.95%	1.50%	
PCE DEFY	1.48%	0.59%	1.86%	**1.31%**	3.00%	1.69%	
Real UST10yr	1.50%	1.05%	0.88%	**1.14%**	0.95%	-0.19%	
$25Coupon	6.64%	6.46%	6.05%	**6.38%**	5.45%	-0.93%	
$25Price	$94.06	$98.66	$93.09	**$95.27**	$84.39	-$10.88	
$25Current Yield	7.06%	6.55%	6.50%	**6.70%**	6.46%	-0.24%	
Mdur Worst	9.52	10.44	10.95	**10.30**	12.00	1.70	
CY Spread vs. T10yr	4.08%	4.91%	3.76%	**4.25%**	2.51%	-1.74%	
Source: Bloomberg; ICE BofA Bond Indices						-2.50%	Est. Price Risk to AveCY
				Comprehensive Risk Est.		3.96%	**Est. Price Risk + CY**
				Recapture Rate (yrs.)		0.39	Est. Price Risk / CY
					Memo:	5.97%	Total Return YTD

The current yield of the retail sector closed the month at 6.46%, which was 5bps lower than last month and 24bps 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 251bps which is 174bps 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 $84.39 this month and $10.88 lower than the average price 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 0.24% current yield increase to 6.70% (the average current yield of the prior bottoms) is an estimated 2.50% price decrease using the current modified duration of 12.00; then adding back a current book yield (assuming a 12month path) of 6.46% makes the *Comprehensive Risk Estimate* for returns in the retail sector positive at 3.96%. The income recapture rate of the illustrated price loss is 0.39yrs because the

market yield is higher than the illustrated price risk indicating the retail sector has more opportunity than risk.

Performance Memos (p0p4 +0.84%):

The primary contributing sector returns (using GICS Sub-industries) of p0p4 this month were Diversified REITS (+8.06%), Office REITS (5.21%) and Renewable Energy (+5.10%).

The primary detracting sector returns of p0p4 this month were Integrated Telecom (-8.95%), Diversified Chemicals (-6.33%), and Apparel (-4.99%).

Year-to-date, below investment grade (BIG) $25pars have underperformed investment grade (IG) retail paper by 3.72%, which is 164bps better than last month.

$1,000par Institutional Preferred Securities Sector

The $1,000 par institutional sector of the preferred securities market lifted $1.35, and yields declined 23bps to 7.48% 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%**	3.95%	1.47%	
PCE DEFY	1.17%	0.59%	1.86%	**1.21%**	3.00%	1.79%	
Real UST10yr	1.77%	1.16%	0.88%	**1.27%**	0.95%	-0.32%	
Coupon	6.77%	6.43%	5.88%	**6.36%**	5.24%	-1.12%	
Price	$103.96	$99.62	$97.23	**$100.27**	$92.30	-$7.97	
Current Yield	6.51%	6.45%	6.05%	**6.34%**	5.68%	-0.66%	
Mdur Worst	5.90	5.23	4.64	**5.26**	3.91	-1.35	
CY Spread vs. T10yr	3.57%	4.70%	3.31%	**3.86%**	1.73%	-2.13%	
Source: Bloomberg; ICE BofA Bond Indices						-2.58%	Est. Price Risk to AveCY
				Comprehensive Risk Est.		3.09%	**Est. Price Risk + CY**
				Recapture Rate (yrs.)		0.46	Est. Price Risk / CY
					Memo:	3.97%	Total Return YTD

The current yield of the institutional preferred sector closed the month at 5.68%, which was 6bps lower than last month. The $92.30 price of the NoCo sector is $7.97 less 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 lower to be 66bps less than the 6.34% average current yield at the bottom of the last three credit cycles. The implication of a 0.66% current yield increase to 6.34% (the average current yield of the prior bottoms) is an estimated 2.58% price decline using the modified duration of 3.91; then adding back a current book yield (assuming a 12month path) of 5.68% makes the *Comprehensive Risk Estimate* for the NoCo sector equal to a 3.09% horizon return to accept the risk, which is 30bps less than last month. It would take 0.46yrs to recapture this capital loss estimate with book income. The NoCo sector continues to be in a cushioned valuation position.

Performance Memos (cips +1.80%; hips +2.70%):

The primary contributing sectors (using GICS Sub-industries) of investment grade NoCo (cips) performance this month were Investment Banking & Brokerage (+6.21%), Regional Banks (+4.72%) and Diversified Financial Services (2.92%).

The primary detracting sectors of investment grade NoCo performance (i.e., the least positive this month) were Multi-line Insurance (0.28%), Reinsurance (+0.31%), and Industrials (+0.63%).

The primary contributing sectors (using GICS Sub-industries) of below investment grade NoCo (hips) performance this month were Consumer Finance (6.36%), Trading & Distributors (5.97%) and Regional Banks (+4.57%).

The primary detracting sectors of below investment grade NoCo performance (i.e., mixed) were Broadline Retail (-1.47%), Broadcasting (+0.55%) and Wireless Telecomm (+0.67%)

Year-to-date, below investment grade (BIG) $1000pars underperformed investment grade (IG) institutional paper by 3.64%, which was 81bps better than last month.

Contingent Capital Securities Sector

The CoCo sector rose $2.17 this month to $91.48 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 in support of the financial system more than once. 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%**	3.95%	1.40%	
PCE DEFY	1.48%	0.59%	1.86%	**1.31%**	3.00%	1.69%	
Real UST10yr	1.53%	1.16%	1.02%	**1.24%**	0.95%	-0.29%	
Coupon	7.63%	6.40%	6.78%	**6.94%**	6.24%	-0.70%	
Price	$105.04	$89.12	$96.21	**$96.79**	$91.41	-$5.38	
Current Yield	7.26%	7.18%	7.05%	**7.16%**	6.83%	-0.34%	
Mdur Worst	4.76	5.30	3.95	**4.67**	2.61	-2.06	
CY Spread vs. T10yr	4.25%	5.43%	4.17%	**4.62%**	2.88%	-1.74%	
Source: Bloomberg; ICE BofA Bond Indices						-0.88%	Est. Price Risk to AveCY
				Comprehensive Risk Est.		5.94%	Est. Price Risk + CY
				Recapture Rate (yrs.)		0.13	Est. Price Risk / CY
					Memo:	-4.90%	Total Return YTD

The current yield of the CoCo sector closed the month at 6.83%, which was 13bps lower than last month and 34bps less than the average current yield at the bottom of the last three credit

cycles (i.e., 7.16%). The average CoCo price of $91.41 is still 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 0.34% current yield increase to 7.16% (the average current yield of the prior bottoms) is an estimated 0.88% price decline using the modified duration of 2.61; then adding back the current book yield (assuming a 12month path) of 6.83% makes the *Comprehensive Risk Estimate* for return in the CoCo sector 5.94%. The recapture rate of the estimated capital risk is less than one month for CoCos.

Performance Memos (cdlr +2.97%):

The primary contributing sectors (using GICS Sub-industries) of CoCo performance by country (as CoCos are primarily diversified banks) were Columbia (5.44%), Germany (3.91%) and France (3.84%).

The primary detracting country sectors of CoCo performance (i.e., the least positive this month) were Israel (+0.31%), China (0.34%) and Kuwait (0.79%).

Outlook:

After ten sequential moves higher and a pause in June, the Fed decided to raise rates at its meeting this month. The language of the FOMC statement was little changed to suggest that there could be another hike coming and the Dot Plot suggests that one more hike is in store before the year is done -- **the key message from the July meeting is still that policy rates should be "higher for longer"**.

- The hawkish intent of elevating the dots over the next two years is 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 of a Fed action; and as markets fight in real time, the messaged action may ultimately be unnecessary.

- **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 (and now, burgeoning US government debt financing costs) are getting the headlines.

- 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 in September most likely). The immediate problem is that the bond market is not convinced that the Fed has stopped, so it is getting cheaper under the weight of zooming borrowing needs and the Fed's balance sheet run-off.

- We recall, a few years ago, when Federal Reserve Vice Chairman for Supervision, Randal Quarles, said, "*It may be that there is a simple macro fact that the treasury market being so much larger than it was even a few years ago, much larger than it was a decade ago and now really much larger than it was even a few years ago, that the sheer volume there may have outpaced the ability of the private market infrastructure to support stress of any sort there.*" At the time (i.e., 2020), the US Treasury market was $21 trillion (with 0.50% T-bill rates; QE and a Fed ZIRP "Zero Interest Rates Policy) – today it is $26 trillion (with 5.50% T-bill rates; QT and a Fed BIRP "Burgeoning Interest Rates Policy"). This statement by Quarles was in support of the Fed using its balance sheet to manipulate rates with QE & ZIRP, but the opposite is true now with QT & BIRP.
    - It turns out that Quarles' insight was right, especially now that the private market has chosen to elevate real term structure rates under the influence of BIRP to make US Treasury borrowing costs more competitive with other credit – the process of a classic "crowding out" by the US Treasury is painful, but necessary to rein in government spending.

- The challenge **is that burgeoning rates are putting fiscal policy in a pickle** (i.e., basically neutering it) so, **fiscal policy cannot cut taxes (because deficits are too high) and it cannot spend more (because inflation is too high)** – so, what's left to foster growth?
    - Equity investors have become accustomed to **the Fed printing money to foster growth and fuel valuations higher, but inflation is too high, which currently puts monetary policy in a pickle too!**

- **<u>Timing</u> is everything** – currently, the UST market is getting a chance to price in real fundamental term structure risks while the Fed draws blood from the veins of the financial system -- and a time when the US government borrowing needs are materially raising the system's blood pressure with more supply! The Fitch downgrade of US sovereign debt essentially recognizes this stress.

<u>Bottomline to outlook:</u>

- Last month we said, ***"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*." Spreads did indeed move tighter again in July, but we do not think that one should have much fear of missing out as the underpinning of US treasury rates should stay elevated as the US Treasury market is finally beginning to feel the weight of inflation and the supply tsunami.
- **We are increasingly cautious on fixed-for-life hybrids** (predominantly concentrated in the $25par sector) because a 1999 type tax-loss selling scenario is percolating with unrealized equity gains potentially looking for a loss pair from preferreds closer to year end – time will tell.
- **Recent equity complacency is worrisome** as real rates and US borrowing costs gain more headlines and credit spreads go tighter in the face of Fitch's new tear in the sails of US government credit -- granted AAA to AA+ is not a big tear, but the more the wind blows the more this tear gets ripped open which could impel a sell-off in the equity market and widen credit spreads.
- **Nonetheless, there is good value in the junior subordinated fixed-to-refixed sectors based on discounted prices** and elevating forecast coupons with unique total return prospects can **"pull price toward par"** over the intermediate term, which could "fight the tape" even if real rates journey higher over the next few years.
- There are still 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)	12.00	6.60	2.31	2.86	0.24
NoCos (stb8)	3.91	7.50	2.31	3.25	0.83
CoCos (cdlr)	2.61	8.17	2.31	3.54	1.36
More Sr. Fins (e0ba)	4.84	5.64	2.31	2.45	0.51

Source: Bloomberg; ICE BofA Bond Indices

- With hybrid yields still quite elevated and inflation chopping and waning, hybrid yield inflation coverages are generous at 2.86x to 3.54x for junior subordination – shown above. 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.

In relation to positioning:

- Maintain a core portfolio income defense by positioning fixed-to-refixed structure (barbelling discounts with current coupon to protect leverage thresholds with the "pull toward par"), liquidity, and credit concentrations.
- Real hybrid yields are compelling and even more so when we consider subtracting estimated historical credit default risks from real yields – shown here in a *Real Yield Matrix*

Real Yield Matrix	Hybrids		Corporates	
	Preferreds	CoCos	IG Corps	BIG Corps
Bloomberg Index	*cips+hips*	*cdlr*	*c6c0*	*h0a0*
Mod.Duration	3.91	2.61	6.19	3.90
Yield-to-Worst	7.50	8.17	5.48	8.36
Inflation[1] Adjustment	2.31	2.31	2.31	2.31
Real Yields	5.19	5.86	3.17	6.05
Default[2] Adjustment	-0.44	-0.44	-0.04	-2.57
YTW, net, net adj.	4.75	5.42	3.13	3.48
Composite Rating	*BBB2*	*BB1*	*BBB1*	*B1*
Last Month End:	Hybrids		Corporates	
	Preferreds	CoCos	IG Corps	BIG Corps
YTW, net, net adj.	5.07	5.92	3.28	3.80
Change from Last	-0.32	-0.50	-0.15	-0.32

Source: Bloomberg; ICE BofA Bond Indices

- The recent spread tightening and price rallies in credit are evident by the Change from Last, but Hybrids still 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 deeply inverted yield curve and net deposit outflows from the banking system.
    - **Consequently, the window of opportunities in Hybrids should be available for some time as short-term volatility periods are likely to elevate somewhat from current complacent levels in equity.**
- Over the longer term, rate cuts to offer some insurance against a shallow recession (the risk of which is declining and switching sentiments to low growth instead) which would be politically pleasing if burgeoning US debt interest expenses increasingly populate the headlines; and the structural "pull toward par" discounts should reward hybrid investors who take advantage of today's lower prices and wider than average spreads.

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