SPECTRUM
Asset Management

Junior-Subordinated Capital Securities Markets

August 2023 Updates

The US Treasury bond markets were heavy again in August, especially on the shorter end and credit prices edged lower too without much change in spreads. The Fed's messaging on more rate hikes was mixed leaning into moderately hawkish according to our interpretation of the numerous board member comments throughout the month. Specifically, according to Chairman Powell in his short speech at Jackson Hole, "It is the Fed's job to bring inflation down to our 2% goal and we will do so….no change to target...period, full stop." The spread between UST2yr notes and UST10yr notes de-inverted more this month (after closing the 2nd quarter at its lows of -107) by another 16bps to -76bps – please note that the average month end slope of the US Treasury 2s-10s yield curve has been 113bps since Dec-1999 with a high of +281bps. The 30yr bond closed the month yielding 4.21% (21bps higher) and the 10yr note closed yielding 4.11% (16bps higher). Real rates on the front end of the treasury curve (e.g., UST 5yr TIPS) rose by 24bps (to 2.13%); the 5yr implied breakeven inflation rate (i.e., the difference in yields between the 5yr UST and the 5yr Treasury Inflation Protected Security) fell 11bps to close at 2.17%. The bond market continues to anticipate the Fed keeping rates elevated for longer as the back end of the curve is cheapening and real rates are rising, but the idea that the Fed may tolerate an inflation target higher than 2% was taken off the table at Jackson Hole. The implication of this is that more economic friction will be required to slow spending and labor growth and that will likely price equity lower over the near-term causing credit spreads to widen. A conflict that the Fed must deal with is that the ongoing fiscal backdrop of continued government excess spending is not aligned with the Fed's disinflationary goal. However, the effect of fiscal excess may lead to a "fiscal fit" causing even higher real rates on the term structure of treasuries if labor markets don't cool. This would result in a stagflationary economic environment and limited fiscal flexibility to foster growth the way politicians have conveniently become accustomed to campaigning. The VIX (i.e., Chicago Board Options Exchange Volatility Index) rose 17% during the month only to close unchanged at 13.6 (the lows of 2019) as the S&P 500 slipped 81pts to 4508, which is just 7.9% 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 0.29% to close yielding 8.38% (7bps lower).
- Global bank credit (measured by ICE BofA ***e0ba*** index) fell 0.38% to close yielding 5.78% (16bps higher).
- The BBB rated 5-10yr corporate sector (measured by ICE BofA ***c6a4*** index) fell 0.51% to close yielding 5.84% (16bps 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 $326 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 $133 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 $459 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* fell 1.20% this month to close yielding 6.88% (+33bps)

2) **ICE BofA US Capital Securities Index (*c0cs*) @ 23% of *i0cs***

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

- ✞ The *c0cs* fell 0.30% this month to close yielding 7.11% (+26bps)

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* fell 0.03% this month to close yielding 8.30% (+23bps)

4) **ICE BofA High Yield Fixed Rate Pfd Index (*p0hy*) @ 26% of i*0cs***

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

- ✞ The *p0hy* fell 0.09% this month to close yielding 8.70% (+6bps)

Overall, the ICE BofA All US Capital Securities Index (***i0cs***) fell 0.65% this month to close yielding 7.44%, which was 24bps higher than last month's closing yield and a spread of +314bps over comparable US Treasury securities (14bps wider).

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 57% 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 0.59% this month to close yielding an 8.45%, which was 29bps higher than last month and a spread of +412bps over comparable US Treasury securities (14bps higher).

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 <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.

<u>Snapshot of Junior Subordinated Spread Sector Moves vs. Global Financials:</u>

	p0p4	p0p4-e0ba	stb8	stb8-e0ba	cdlr	cdlr-e0ba
Capital Securities Spread Value Matrix	(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	486	205	660	472
Low	-178	-267	176	60	223	143
Range	766	518	310	145	437	329
Average	74	-39	256	143	338	225
Stdev	120	103	49	27	65	38
Monthend	150	26	289	165	356	232
Spread Scores:						
(monthend-ave)/stdev	0.63	0.63	0.67	0.81	0.28	0.18
Δ from Last Month	0.12	0.08	0.24	0.22	0.25	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*

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 negative for all three sectors with NoCo spread performance widening the most. The Absolute Spread Score on retail paper widened by 0.12 standard deviations; **the $25par sector is *undervalued* with a Spread Score of 0.63 standard deviations from average**. The Absolute Spread Score for the institutional $1,000par preferred securities sector ("NoCos") widened by 0.24 standard deviations; **NoCos are the most *undervalued* with a Spread Score of 0.67 standard deviations from average**. The Absolute Spread Score for the CoCo sector widened 0.25 standard deviations; **CoCos are somewhat *undervalued* with a Spread Score of 0.28 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* fell $1.68 to $82.71 as yields-to-worst rose by 21bps to 6.81% this month. There has been little issuance to note in the retail sector lately, except for a $600mm (A3/BBB/BBB+) Apollo Management 7.625% fixed-to-refixed deal junior subordinated debt deal this month, which we passed on due to the opacity of leveraged finance. There were two large redemptions in the sector, Goldman Sachs and Wells Fargo, totaling over $2.7billion, so the retail sector has been shrinking at the margin lately. The largest passive $25par ETF, iShares Preferred and Income ETF (PFF), had about $20million of net money outflow this month. The overall retail $25par sector closed the month 4.70% 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 could be 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%**	4.09%	1.64%	
PCE DEFY	1.48%	0.59%	1.86%	**1.31%**	3.00%	1.69%	
Real UST10yr	1.50%	1.05%	0.88%	**1.14%**	1.09%	-0.05%	
$25Coupon	6.64%	6.46%	6.05%	**6.38%**	5.46%	-0.92%	
$25Price	$94.06	$98.66	$93.09	**$95.27**	$82.81	-$12.46	
$25Current Yield	7.06%	6.55%	6.50%	**6.70%**	6.59%	-0.11%	
Mdur Worst	9.52	10.44	10.95	**10.30**	11.94	1.64	
CY Spread vs. T10yr	4.08%	4.91%	3.76%	**4.25%**	2.50%	-1.75%	
Source: Bloomberg; ICE BofA Bond Indices						-1.10%	Est. Price Risk to AveCY
				Comprehensive Risk Est.		5.49%	**Est. Price Risk + CY**
				Recapture Rate (yrs.)		0.17	Est. Price Risk / CY
					Memo:	4.70%	Total Return YTD

The current yield of the retail sector closed the month at 6.59%, which was 13bps higher than last month and 11bps 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 250bps which is 175bps 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 $82.81 this month and $12.46 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 0.11% current yield increase to 6.70% (the average current yield of the prior bottoms) is an estimated 1.10% price decrease using the current modified duration of 11.94; then adding back a current book yield (assuming a 12month path) of 6.59% makes the *Comprehensive Risk Estimate* for returns in the retail sector positive at 5.49%. The income recapture rate of the illustrated price loss is 0.179yrs because the market yield is higher than the illustrated price risk indicating the retail sector has more opportunity than risk.

Performance Memo: Total Return ~ p0p4 -1.20%:

The primary performing sectors (using GICS Sub-industries) of p0p4 this month were Wireless Telecom (+17.15%), integrated Telecom (3.59%) and Offices Services & Supplies (3.56%).

The primary underperforming sectors of p0p4 this month were Alternative Carriers (-10.47%), Renewable Electricity (-5.76%), and Diversified REITS (-3.92%).

Year-to-date, below investment grade (BIG) $25pars have underperformed investment grade (IG) retail paper by 2.29%, which is 143bps better than last month.

$1,000par Institutional Preferred Securities Sector

The $1,000 par institutional sector of the preferred securities market fell $0.84, and yields-to-worst rose 27bps to 7.77% 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%**	4.09%	1.61%	
PCE DEFY	1.17%	0.59%	1.86%	**1.21%**	3.00%	1.79%	
Real UST10yr	1.77%	1.16%	0.88%	**1.27%**	1.09%	-0.18%	
Coupon	6.77%	6.43%	5.88%	**6.36%**	5.26%	-1.10%	
Price	$103.96	$99.62	$97.23	**$100.27**	$91.41	-$8.86	
Current Yield	6.51%	6.45%	6.05%	**6.34%**	5.75%	-0.58%	
Mdur Worst	5.90	5.23	4.64	**5.26**	3.88	-1.38	
CY Spread vs. T10yr	3.57%	4.70%	3.31%	**3.86%**	1.66%	-2.20%	
Source: Bloomberg; ICE BofA Bond Indices						-2.26%	Est. Price Risk to AveCY
				Comprehensive Risk Est.		3.49%	**Est. Price Risk + CY**
				Recapture Rate (yrs.)		0.39	Est. Price Risk / CY
					Memo:	3.58%	Total Return YTD

The current yield of the institutional preferred sector closed the month at 5.75%, which was 7bps higher than last month. The $91.94 price of the NoCo sector is $8.86 less than the average price over the last three credit cycles – the implication of the discount is an embedded **"pull toward par"** as time ages and the prospect of higher coupon resets approach becoming available in less than 4yrs on average. The current yield of the sector is 58bps less than the 6.34% average current yield at the bottom of the last three credit cycles. The implication of a 0.58% current yield increase to 6.34% (the average current yield of the prior bottoms) is an estimated 2.26% price decline using the modified duration of 3.88; then adding back a current book yield (assuming a 12month path) of 5.75% makes the *Comprehensive Risk Estimate* for the NoCo sector equal to a 3.49% horizon return to accept the risk, which is 40bps more than last month. It would take 0.39yrs to recapture this capital loss estimate with book income. The NoCo sector continues to be in a cushioned valuation position.

Goldman Sachs (Ba1/BB+) issued a 7.50% AT1 perpetual fixed-to-refixed preferred stock this month – it essentially prefunded the $25par security it's calling in September (Wells Fargo did the same thing last month).

<u>Performance Memos: Total Return ~ cips -0.50%; hips -0.09%:</u>

The primary performing sectors (using GICS Sub-industries) of <u>investment grade NoCos</u> (cips) this month were Industrial Machinery (+2.11%), Specialized Finance (+1.10%) and Electric Utilities (0.65%).

The primary underperforming sectors of <u>investment grade NoCos</u> were Investment Banks & Brokerage (-2.00%), Reinsurance (-1.20%), and Regional Banks (-0.82%).

The primary performing sectors (using GICS Sub-industries) of <u>below investment grade NoCos</u> (hips) this month were Independent Power Producers (2.49%), Broadline Retail (2.35%) and Multi-Utilities (1.89%).

The primary underperforming sectors of <u>below investment grade NoCos</u> were Consumer Finance (-4.51%), Wireless Telecom (-1.53%) and Regional Banks (-0.80%)

Year-to-date, below investment grade (BIG) $1000pars underperformed investment grade (IG) institutional paper by 3.21%, which was 43bps better than last month.

<u>Contingent Capital Securities Sector</u>

The CoCo sector fell $1.06 to $90.35 as yields-to-worst rose 29bps to 8.45% this month. 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%**	4.09%	1.54%	
PCE DEFY	1.48%	0.59%	1.86%	**1.31%**	3.00%	1.69%	
Real UST10yr	1.53%	1.16%	1.02%	**1.24%**	1.09%	-0.15%	
Coupon	7.63%	6.40%	6.78%	**6.94%**	6.22%	-0.72%	
Price	$105.04	$89.12	$96.21	**$96.79**	$90.20	-$6.59	
Current Yield	7.26%	7.18%	7.05%	**7.16%**	6.90%	-0.27%	
Mdur Worst	4.76	5.30	3.95	**4.67**	2.59	-2.08	
CY Spread vs. T10yr	4.25%	5.43%	4.17%	**4.62%**	2.81%	-1.81%	
Source: Bloomberg; ICE BofA Bond Indices						-0.69%	Est. Price Risk to AveCY
				Comprehensive Risk Est.		6.20%	Est. Price Risk + CY
				Recapture Rate (yrs.)		0.10	Est. Price Risk / CY
					Memo:	-5.46%	Total Return YTD

The current yield of the CoCo sector closed the month at 6.90%, which was 7bps higher than last month and 27bps less than the average current yield at the bottom of the last three credit cycles (i.e., 7.16%). The average CoCo price of $90.22 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 in less than 3yrs on average. The implication of an 0.27% current yield increase to 7.16% (the average current yield of the prior bottoms) is an estimated 0.69% price decline using the modified duration of 2.59; then adding back the current book yield (assuming a 12month path) of 6.90% makes the *Comprehensive Risk Estimate* for return in the CoCo sector 6.20%. The recapture rate of the estimated capital risk is less than one month for CoCos.

BNP (Baa1/BB+) issued a $1.5billion 8.50% AT1 fixed-to-refixed CoCo security this month – it helped to further mitigate the concerns over subordination risks in the European AT1 space after the peculiar outcome in the Credit Suisse demise.

Performance Memos: Total Return ~ cdlr -0.59%:

The primary performing sectors of the CoCo benchmark (cdlr) by country (as CoCos are primarily diversified banks) were Kuwait (2.60%), Brazil (1.58%) and Turkey (1.12%).

The primary underperforming country sectors of the CoCo benchmark (cdlr) were Columbia (-2.93%), Germany (-1.83%) and the United Kingdom (-1.23%).

Outlook:

After another rate hike last month, the Fed had a break this month as it does every year with the primary news coming from its Jackson Hole conference. The minutes from the July meeting were released in August and they seemed to have a hawkish tone because it upgraded its description of economic activity as moving from “modest” to “moderate”. Given that the key message from the July meeting’s press conference was that policy rates should be “higher for longer”, the minutes affirmed that messaging by describing inflation as still “elevated” and jobs as still having “robust” gains.

- The hawkish intent of the elevated 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 which we expect will create accumulating friction to aggregate demand and burgeoning US government debt financing should become problematic to fiscal flexibilities (and get more 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 should be after one hike in the 4th quarter). The immediate problem is that the bond market is not convinced that the Fed has stopped, so US Treasury yields are elevating under the weight of zooming borrowing needs and the Fed's balance sheet run-off.

- We reiterate that 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 Fed has the <u>opposite intention</u> 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. We've referred to this process as potentially leading to a "fiscal fit" in the treasury market where a bear steepener happens first (to cause the recession that chokes inflation) followed by the bull steepener (to create the recovery through rate cuts).**

- Indeed, **burgeoning rates are putting fiscal policy into a pickle** because **fiscal policy cannot cut taxes because <u>deficits are too high</u> and it cannot spend more because**

inflation is too high – so, what's left for fiscal policy (i.e., campaign promises) to foster growth? The answer is **very little**.

- 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 or currency create in a pickle too!**
- **Timing is everything** – currently with the Fed running off its balance, the UST market is getting a chance to price in real fundamental term structure risks while the Fed pulls more and more currency out of circulation which increasingly draws down liquidity. The primary proof of waning liquidity is higher real rates on treasury inflation protected securities (TIPS), which are holding at over 2% on 5yr TIPS for the first time since 2006.

Bottomline to outlook:

- As spreads and yields move higher, there is little fear of missing out on attractive hybrid yields 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 relentless supply tsunami caused by endless $1trillion deficits.
- **We continue to be 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 NYSE listed preferred securities closer to year end – time will tell.
- **Ongoing equity complacency is worrisome** as real rates and zooming US government borrowing costs gain more headlines and impel fiscal limitations.
- **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 in variable rate sectors (discussed earlier), even if real rates were to go higher over the next few years, which would only mean more income from higher reset coupons.
- Today's high hybrid yields are attractive based on our Comprehensive Risk profiles which compels us to be **bullish on buying junior subordination in quality financials** despite money market yields being high too. Indeed, by the time short rates

do finally come down, prices on term spread product should have already made a good move higher in anticipation of that move**.**

- 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)	11.94	6.87	2.17	3.17	0.27
NoCos (stb8)	3.88	7.79	2.17	3.59	0.93
CoCos (cdlr)	2.59	8.53	2.17	3.93	1.52
More Sr. Fins (e0ba)	4.71	5.79	2.17	2.67	0.57

Source: Bloomberg; ICE BofA Bond Indices

- With hybrid yields still quite elevated and breakeven inflation rates chopping and waning, hybrid yield inflation coverages are generous at 3.17x to 3.93x 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" sector structure to get the coverage.

<u>In relation to positioning:</u>

- Maintain a defensive orientation by positioning fixed-to-refixed structures and barbelling these discounts with current coupon new issuance which embeds a "pull toward par" backstory to preserve capital and the potential for income growth.
- 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	3.88	2.59	6.15	3.86
Yield-to-Worst	7.79	8.53	5.65	8.47
Inflation[1] Adjustment	2.17	2.17	2.17	2.17
Real Yields	5.62	6.36	3.48	6.30
Default[2] Adjustment	-0.49	-0.49	-0.05	-2.72
YTW, net, net adj.	**5.13**	**5.87**	**3.43**	**3.58**
Composite Rating	*BBB2*	*BB1*	*BBB1*	*B1*
Last Month End:	**Hybrids**		**Corporates**	
	Preferreds	CoCos	IG Corps	BIG Corps
YTW, net, net adj.	4.70	5.37	3.12	3.33
Change from Last	☆ 0.43	☆ 0.50	☆ 0.31	☆ 0.25

Source: Bloomberg; ICE BofA Bond Indices

[1] *Inflation assuption based on the UST5yr breakeven inflation rate*
[2] *Sprectrum's 10yr annual default study through 2023 to date*

- The recent lift in yields shown by the Change from Last further supports Hybrids as offering 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 too, especially given the high likelihood of recession next year from the deeply inverted yield curve and net deposit outflows from the banking system that are the normal result of ongoing QT.
    - **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, eventual rate cuts to offer some insurance against an extended recession next year would be politically pleasing especially if burgeoning US debt

expenses populate the headlines; the structural "pull toward par" discounts should reward hybrid investors who take advantage of today's lower prices and wider than average spreads.

Phil Jacoby
CIO, Spectrum Asset Management
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