Junior-Subordinated Capital Securities Markets

October 2023 Updates

The US Treasury bond market continued to trade lower after experiencing its weakest month of the year in September and scoring its 6th straight monthly decline which sent yields up to their highest levels since before the Great Financial Crisis. The Fed's no cut rate decision was greatly anticipated by month end, and it came with some conversation about how beneficial the rise in "term premium" has been for the Fed's hawkish objectives. There is no "dots" report for this Fed meeting but expect more emphasis on the "higher for longer" messaging to come in December dots if the summer's message is to have any legs. The spread between UST2yr notes and UST10yr notes further de-inverted this month (after closing the 2nd quarter at its lows of -107) by another 32bps to -16bps – note that the average slope of the US Treasury 2s-10s yield curve has been 113bps since Dec-1999 with a high of +281bps (and a low of -107). The 30yr bond closed the month yielding 5.09% (39bps higher) and the 10yr note closed yielding 4.90% (33bps higher). Real rates on the front end of the treasury curve (e.g., UST 5yr TIPS) fell by 5bps (to 2.34%); the 5yr implied breakeven inflation rate (i.e., the difference in yields between the 5yr UST and the 5yr Treasury Inflation Protected Security) rose by 13bps to close at 2.38%. Last month we emphasized the Fed must deal with a very challenging conflict between ongoing excess fiscal spending not being aligned with the Fed's urgent disinflationary goal. The effect of massive fiscal excess, zooming treasury debt costs and quantitative tightening may lead to a "fiscal fit" causing even higher real rates on the treasury term structure. Mounting US Treasury debt costs (now over $1trillion, annually) are gaining headlines and bond market's voice may create the discourse needed to compel congress to control its fiscal excess. The Fed has paused now since the end of July and as the term of no change lengthens the Fed's policy card won't be as important in swaying the bond market's bet on the economy while supply will continue to weigh on the "term premium". Equity prices are beginning to get the attention of the bond market's term premium. The VIX (i.e., Chicago Board Options Exchange Volatility Index) chopped up and down over the month closing only 4.1% higher at 18.14 as the S&P 500 slipped 2.23% to 4194.

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) fell 1.24% to close yielding 9.38% (45bps higher).
- Global bank credit (measured by ICE BofA ***e0ba*** index) fell 1.01% to close yielding 6.47% (26bps higher).
- The BBB rated 5-10yr corporate sector (measured by ICE BofA ***c6a4*** index) fell 1.75% to close yielding 6.70% (35bps higher).

Review of Market Structure:

The market for **hybrids** or **global junior-subordinated capital securities** (*i.e.,* "**Jsubs**") 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 Jsubs comprise two sub-sets that represent a broad group of hybrids, 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 <u>not</u> 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 $322 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 hybrids ***(cdlr)*** sums to $132 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 $447 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*) @ 44% *of i0cs***

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

✞ The *p0p1* fell 3.27% this month to close yielding 7.71% (+64bps)

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* fell 1.39% this month to close yielding 7.78% (+35bps)

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 1.93% this month to close yielding 8.82% (+38bps)

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 4.67% this month to close yielding 9.84% (+83bps)

Overall, the ICE BofA All US Capital Securities Index (***i0cs***) fell 3.02% this month to close yielding 8.29%, which was 58bps higher than last month's closing yield and a spread of +332bps over comparable US Treasury securities (33bps 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 0.34% this month to close yielding an 9.07%, which was 21bps higher than last month and a spread of +402bps over comparable US Treasury securities (10bps tighter).

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	76	-37	257	143	338	225
Stdev	120	102	49	27	64	37
Monthend	**179**	**36**	**326**	**183**	**370**	**227**
Spread Scores:						
(monthend-ave)/stdev	0.86	0.72	1.41	1.48	0.50	0.05
Δ from Last Month	0.39	0.36	0.55	0.70	0.05	-0.19

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 0.39 standard deviations; **the $25par sector is *max-fair valued* (leaning toward undervalued) with a Spread Score of 0.86 standard deviations from average**. The Absolute Spread Score for the institutional $1,000par preferred securities sector ("NoCos") widened by 0.55 standard deviations; **NoCos are *mid-undervalued* with a Spread Score of 1.41 standard deviations from average**. The Absolute Spread Score for the CoCo sector widened 0.05 standard deviations; **CoCos are *mid-fair valued* with a Spread Score of 0.50 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 $4.61 to $75.95 and the yield-to-worst rose by 89bps to 7.83% this month as bond market volatility continued to be in excess of equity volatility. There was no relevant issuance in the retail sector during October. The two largest $25par passive ETFs (iShares Preferred and Income ETF, PFF; and Invesco Preferred ETF, PGX), had about $52million of combined net money outflow this month. The overall retail $25par sector closed the month down 5.36% on a year-to-date basis. This month's Estimated Price Risk to Average Current Yield is the lowest (i.e., most positive) that it has been since we have been following the measure. This is because the current yield is now 47bps greater than the average current yield for the past 3 credit cycles, so if we experience a regression to the mean current yield over the next 12 months it would imply a 12.78% price gain. There is always a Fed cycle associated with the credit cycle, but no cycle is exactly like prior cycles because economic factors that cause credit spread differences change. Given that spreads in retail preferreds are 0.86 standard deviations wide of average, it appears that most of the higher yields in the retail market are explained by further elevated US treasury yields more than credit concerns.

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%**	4.91%	2.46%	
PCE DEFY	1.48%	0.59%	1.86%	**1.31%**	3.40%	2.09%	
Real UST10yr	1.50%	1.05%	0.88%	**1.14%**	1.51%	0.37%	
$25Coupon	6.64%	6.46%	6.05%	**6.38%**	5.45%	-0.93%	
$25Price	$94.06	$98.66	$93.09	**$95.27**	$75.95	-$19.32	
$25Current Yield	7.06%	6.55%	6.50%	**6.70%**	7.18%	0.47%	
Mdur Worst	9.52	10.44	10.95	**10.30**	11.86	1.56	
CY Spread vs. T10yr	4.08%	4.91%	3.76%	**4.25%**	2.27%	-1.98%	
Source: Bloomberg; ICE BofA Bond Indices						5.60%	Est. Price Risk to AveCY
				Comprehensive Risk Est.		12.78%	**Est. Price Risk + CY**
				Recapture Rate (yrs.)		-0.78	Est. Price Risk / CY
					Memo:	-2.52%	Total Return YTD

The current yield of the retail sector closed the month at 7.18%, which was approximately 47bps higher 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 227bps which is 198bps less than the average spread of the last three credit cycle bottoms as retail preferred yields are high but spread is being "squeezed" by UST yields being quite 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 $75.95 this month and $19.32 lower than the average price of the prior bottoms, which means that there is significantly 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 0.47% current yield decrease to 6.70% (the average current yield of the prior bottoms) is an estimated 5.60% price increase using the current modified duration of 11.86; then adding back a current book yield (assuming a 12month path) of 7.18% makes the *Comprehensive Risk Estimate* for returns in the retail sector positive at 12.78%. The assumed recapture rate with income has flipped to be negative which means that there is no longer an assumed loss to this measure because the market yield is higher than the average highest yields of the prior credit cycles. Overall, yields in the retail sector appear to be undervalued but spreads are max-fair valued.

Performance Memo: Total Return ~ p0p4 -5.36%:

No sector in the retail sleeve performed positively. The 3 least negatively performing sectors (using GICS Sub-industries) of p0p4 this month were Trading Companies & Distributors (-1.17%), Single Family REITS (-1.27%), and Specialized Finance (-1.40%).

The 3 most negatively underperforming sectors of p0p4 this month were REIT Operating Companies (-17.20%), Office Service & Supplies (-11.42%), and Alternative Telecom Carriers (-10.40%).

Year-to-date, below investment grade (BIG) $25pars have underperformed investment grade (IG) retail paper by 5.44%, which is 330bps worse than last month.

$1,000par Institutional Preferred Securities Sector

The $1,000 par institutional sector of the preferred securities market fell $1.95, and yields-to-worst rose 41bps to 8.48% 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%**	4.91%	2.43%	
PCE DEFY	1.17%	0.59%	1.86%	**1.21%**	3.40%	2.19%	
Real UST10yr	1.77%	1.16%	0.88%	**1.27%**	1.51%	0.24%	
Coupon	6.77%	6.43%	5.88%	**6.36%**	5.29%	-1.07%	
Price	$103.96	$99.62	$97.23	**$100.27**	$87.94	-$12.33	
Current Yield	6.51%	6.45%	6.05%	**6.34%**	6.02%	-0.32%	
Mdur Worst	5.90	5.23	4.64	**5.26**	3.98	-1.28	
CY Spread vs. T10yr	3.57%	4.70%	3.31%	**3.86%**	1.11%	-2.76%	
Source: Bloomberg; ICE BofA Bond Indices						-1.28%	Est. Price Risk to AveCY
				Comprehensive Risk Est.		4.73%	**Est. Price Risk + CY**
				Recapture Rate (yrs.)		0.21	Est. Price Risk / CY
					Memo:	0.99%	Total Return YTD

The current yield of the institutional preferred sector closed the month at 6.02%, which was 14bps higher than last month. The $87.94 price of the NoCo sector is $12.33 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 32bps less than the 6.34% average current yield at the bottom of the last three credit cycles. The implication of a 0.32% current yield increase to 6.34% (the average current yield of the prior bottoms) is an estimated 1.28% price decline using the modified duration of 3.98; then adding back a current book yield (assuming a 12month path) of 6.02% makes the *Comprehensive Risk Estimate* for the NoCo sector equal to a 4.73% horizon return to accept the risk, which is 66bps more than last month. It would take 0.21yrs to recapture this capital loss estimate with book income. We consider the NoCo sector to be a mid-undervalued sector.

<u>Performance Memos: Total Return ~ cips -1.62%; hips -1.93%:</u>

The primary performing (least negative) sectors (using GICS Sub-industries) of <u>investment grade NoCos</u> (**cips**) this month were Specialized Finance (-0.74%), Consumer Finance (-0.76%) and Industrials (-0.80%).

The primary (most negative) underperforming sectors of <u>investment grade NoCos</u> were Regional Banks (-3.57%), Investment Banking & Brokerage (-3.29%), and Asset Management & Custody (-3.08%).

The primary performing sectors (using GICS Sub-industries) of <u>below investment grade NoCos</u> (hips) this month were Broadline Retail (+2.02%), Property & Casualty (0.66%), Independent Power Producers (+0.41%).

The primary underperforming sectors of <u>below investment grade NoCos</u> were Regional Banks (-6.85%), Consumer Finance (-5.64%) and Broadcasting (-5.02%).

Year-to-date, below investment grade (BIG) $1000pars underperformed investment grade (IG) institutional paper by 3.05%, which was 26bps worse than last month.

<u>Contingent Capital Securities Sector</u>

The CoCo sector fell $0.81 to $88.39 as yields-to-worst rose 21bps to 9.07% 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%**	4.91%	2.36%	
PCE DEFY	1.48%	0.59%	1.86%	**1.31%**	3.40%	2.09%	
Real UST10yr	1.53%	1.16%	1.02%	**1.24%**	1.51%	0.27%	
Coupon	7.63%	6.40%	6.78%	**6.94%**	6.26%	-0.68%	
Price	$105.04	$89.12	$96.21	**$96.79**	$88.50	-$8.29	
Current Yield	7.26%	7.18%	7.05%	**7.16%**	7.07%	-0.09%	
Mdur Worst	4.76	5.30	3.95	**4.67**	2.48	-2.19	
CY Spread vs. T10yr	4.25%	5.43%	4.17%	**4.62%**	2.16%	-2.45%	
Source: Bloomberg; ICE BofA Bond Indices						-0.22%	Est. Price Risk to AveCY
				Comprehensive Risk Est.		6.85%	**Est. Price Risk + CY**
				Recapture Rate (yrs.)		0.03	Est. Price Risk / CY
					Memo:	-6.18%	Total Return YTD

The current yield of the CoCo sector closed the month at 7.07%, which was 6bps higher than last month and 9bps less than the average current yield at the bottom of the last three credit cycles (i.e., 7.16%). The average CoCo price of $88.50 is still lower than all 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 a 0.09% current yield increase to 7.16% (the average current yield of the prior bottoms) is an estimated 0.22% price decline using the modified duration of 2.48; then adding back the current book yield (assuming a 12month path) of 7.07% makes the *Comprehensive Risk Estimate* for return in the CoCo sector 6.85%. The recapture rate of the estimated capital risk is less than one month for CoCos.

Mitsubishi UFJ Financial (Baa3/BB+/BB+) issued a $750 million 8.20% AT1 fixed-to-refixed CoCo security this month – the deal was well received and was the first Japanese bank to issue a CoCo.

Performance Memos: Total Return ~ cdlr -0.34%:

The primary performing sectors of the CoCo benchmark (cdlr) by country (as CoCos are primarily diversified banks) were Germany (+1.52%), Denmark (+1.07%) and Norway (+0.94%).

The primary underperforming country sectors of the CoCo benchmark (cdlr) were Israel (-4.49%), Columbia (-3.26%) and Netherlands (-1.07%).

Outlook:

There was no October Fed meeting, but the bond market was certainly expecting the Fed would be more hawkish than dovish in its narrative given the UST10yr run at 5% toward the end of the month. We know now that the Fed paused in its meeting last week. In the press conference Chairman Powell said, "*The question we're asking is: Should we hike more? Slowing down is giving us, I think, a better sense of how much more we need to do, if we need to do more*." The bond market cheered this narrative with a strong rally as it came into this Fed meeting being oversold in a declining trend that had lasted 4 standards longer than average. Also, economists at Goldman Sachs economists raised their forecast for the "terminal fed funds" rate, which they define as the Federal Reserve's equilibrium rate of interest (i.e., a funds rate that is neither productive nor unproductive), from a range of 3%-3.25% to 3.5%-3.75% -- the Fed currently has their "terminal rate" shown on its dot plot as the Longer Term federal funds rate of 2.50%. We expect the Fed to "manage the dots" again in December by pushing them up for 2025 (from a median of 3.875%) and 2026 (from a median of 2.875%) to be flatter compared to 2024's median of 5.125%. Longer term, Goldman's view aligns with this upward dot drift and aligns with our view that the Fed will not be inclined to cut rates before the election. The implication is a persistently range bound bond market and elevated rates which traders seem to not want to accept. Eventually, we expect the Fed will win the "higher for longer" battle with the UST10yr note and perhaps even do a twist to buy 2yr notes and sell 10yr notes from its balance sheet because rate hikes in an election year would also be unpopular with the Biden Administration and Powell certainly doesn't want a policy mistake like 2018. The fact that the Fed's reverse repo in coming out of the money markets and draining currency from the non-bank financial system could also cause the financial system to clog somewhat – one way to resolve this (and not expand the balance sheet) is to allow (or incentivize) the "term premium" to be more permanent instead of a trading flash like it was in September-October – in other words, by fostering a more attractive and permanent "term premium", more investors will demand the "premium" and buy 10yr notes and bonds rather than demanding repo in the money market and eliminate the need for the Fed's reverse repo facility. The endless supply of US treasuries from $2 trillion deficits only adds to the technical pressures on the US government debt clearing system so the narratives will soon shift away from the Fed's policy rate to the functional fundamentals of supply, refunding and inflation, in addition to the massive annual federal budget interest expense (i.e., more than $1 trillion, annually). Raising the terminal rate, like Goldman predicts, may just be a way for the Fed to permanently instill a more core real federal funds rate that has a more core disinflationary impact.

Bottomline to outlook:

- **We are less cautious on fixed-for-life hybrids** (predominantly concentrated in the $25par sector) now that they are (and continue to be) in a cushion zone like they're in now (i.e., above 6.70% current yield). The 1999 type tax-loss selling appears to be more concentrated in the regional banks than a broad sector sale at this point – time will tell.
- **Ongoing equity complacency has abated somewhat but may still elevate more** as real rates and zooming US government borrowing costs gain more headlines and impel fiscal limitations.

- **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. 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 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)	11.86	7.83	2.38	3.29	0.28
NoCos (stb8)	3.98	8.53	2.38	3.58	0.90
CoCos (cdlr)	2.48	9.08	2.38	3.82	1.54
More Sr. Fins (e0ba)	4.52	6.50	2.38	2.73	0.60

Source: Bloomberg; ICE BofA Bond Indices

- Hybrid yield inflation coverages are generous at 3.29x to 3.82x 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.

In relation to positioning:

- 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 offer 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	3.98	2.48	6.06	3.82
Yield-to-Worst	8.53	9.08	6.52	9.48
Inflation[1] Adjustment	2.38	2.38	2.38	2.38
Real Yields	6.15	6.70	4.14	7.10
Default[2] Adjustment	-0.49	-0.49	-0.05	-2.72
YTW, net, net adj.	**5.66**	**6.21**	**4.09**	**4.38**
Composite Rating	*BBB2*	*BB1*	*BBB1*	*B1*
Last Month End:	Hybrids		Corporates	
	Preferreds	CoCos	IG Corps	BIG Corps
YTW, net, net adj.	5.33	6.12	3.84	3.97
Change from Last	☆ 0.33	☆ 0.09	☆ 0.25	☆ 0.41

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 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 and perhaps even get a little help from the Fed who appears very sanguine about help from the "term premium".

- 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 (now un-inverting but still negative) 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 still reasonably 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, but this will be challenging in an election year.
- The structural "pull toward par" discounts should reward hybrid investors who take advantage of today's lower prices and wider than average spreads. Indeed, large sectors of the hybrid markets are not "fixed income", but rather "fixed-to-refixed income".

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