Junior-Subordinated Capital Securities Markets

April 2019 Updates

There was very little change in the tone of markets over the course of April. The March FOMC Minutes were released early in the March and confirmed that the Fed will be data dependent and patient in making another move (either way) on the target federal funds rate. The US treasury bond market eased back modestly taking a breather from the demand surge last month from mortgage convexity hedger (i.e., buyers). The 30yr US Treasury bond closed the month yielding 2.94% (12bps higher MTD; and 7bps lower since the end of 2015, which was the time of Fed's 1st move on rates). The US Treasury 10yr note closed yielding 2.51% (10bps higher MTD; and 24bps higher since the end of 2015) -- the yield curve differential between the two longer US Treasury terms closed April at 43bps (10bps steeper on the year). The rates pause and confirming signals of disappointment on inflation gave equites a boost of confidence that the Fed will not be raising rates any time soon. The S&P 500 closed the month gaining 3.9% to 2946.

The Fed's message coming out of the meeting last month was a strong pivot from being decidedly hawkish just last October to be convincingly dovish. Chairman Powell voiced concern that inflation is not advancing to the Fed's desired 2% goal by professing that having downward pressure on inflation is one of the major challenges of our time. Most members marked down their projections for GDP growth this year, as well as their expectations for inflation. There was still some general belief that inflation, though muted, would rise above the committee's 2% "happy zone" over the next two years. The best way to achieve this goal, it seems, is to hold rates steady and patiently wait for the economy to play through and for labor markets to bid up wages as work for utilization improves.

Potential balance sheet actions are on the table. We sense a frustration from the Fed that the economic winds are not behaving according to "normal" Phillips Curve standards and that usual tacking angles to sail up wind are ineffective because the winds are shifting. As a result, the Fed appears wide of course and ready to start its balance sheet engine if a dead calm arrives. In keeping with preparedness, the Fed is ending its treasury balance sheet reductions by the 4th quarter; it will then add up to $20 billion per month of reinvestments in treasuries funded with agency & mortgage run-off. This is a subtle but important shift. More conversations from Fed members on shortening the Fed's balance sheet duration are likely this summer. Simply buying 3mo-TBills with mortgage & agency run-off would shorten the balance sheet duration, but only slightly. Indeed, if the Fed were to sell UST bonds and buy UST-Bills it could stir up the atmosphere enough to create (at least) a sea breeze. As the Fed has said it has no intention of inverting the treasury yield curve and every intention to delay its next move on target funds, a balance sheet action beyond autopilot reinvestments appears plausible against the backdrop of an approaching re-funding wave and maturing global expansion.

Before we discuss performance in capital securities this month, let's look at performance in some other credit markets for reference points on returns and yield changes before the month-end rebalancings:

- The junk market (measured by the ICE Bank of America Merrill Lynch High Yield ***h0a0*** index) rose 1.40% to close yielding 6.16% (32bps lower).
- Financial credit (measured by ICE Bank of America Merrill Lynch's ***cf06*** index) rose 0.77% to close yielding 3.65% (9bps lower).
- The BBB rated 5-10yr corporate sector (measured by ICE Bank of America Merrill Lynch's ***c6a4*** index) rose 0.94% to close yielding 3.90% (11bps lower).

Review of Market Structure:

The market for **global junior-subordinated capital securities** (*i.e.,* "**Jsubs**") is comprised of:

1. Preferred Securities, and
2. Contingent Capital Securities

Each sector is evolving 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 Bank of America Merrill Lynch indexes: 1) The ICE BofA Merrill Lynch US All Capital Securities Index (***i0cs***) and 2) The ICE BofA Merrill Lynch Large Cap Contingent Capital Index (***cocl***).

Our litmus test for junior-subordinated capital securities 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 $297.9 billion (face amount) of investment grade and below investment grade instruments in both the retail $25par market (43%) and the institutional $1,000par market (57%). The Contingent Capital (***cocl***) benchmark of junior-subordinated capital securities represents $215.5 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 does not fall into a receivership. These two benchmarks combine for a $513.4 billion universe of fixed-rate junior-subordinated capital securities with preferred securities (measured by ***iocs***) being a 58% subset and contingent capital securities (measured by ***cocl)*** being 42% subset of the total global 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* preferred securities benchmark are:

1. **ICE BofAML Fixed Rate Preferred Index (*p0p1*) @ 43% *of i0cs***
    - Comprised of IG $25par and IG $1,000par US AT1
        - The *p0p1* rose 1.11% this month to close yielding 3.52%
        - The rebalancing this month increased headcount by 2, and face value by $1.4 billion
2. **ICE BofAML High Yield Fixed Rate Preferred Index (*p0hy*) @ 23% of *i0cs***
    - Comprised of BIG $1,000par US AT1 and BIG $25par
        - The *p0hy* rose 1.61% this month to close yielding 4.08%
        - The rebalancing increased had minimal impact on face value
3. **ICE BofAML US Capital Securities Index (*c0cs*) @ 28% of *i0cs***
    - Comprised of dated IG $1,000par hybrids (no US AT1)
        - The *c0cs* rose 1.44% this month to close yielding 4.71%
        - The rebalancing increased headcount by 3 and face value by $3.4 billion
4. **ICE BofAML High-Yield Capital Securities Index (*h0cs*) @ 6% of *i0cs***

- Comprised of BIG $1,000par legacy Tier1 and BIG $1,000par hybrids
  - The *h0cs* rose 1.94% this month to close yielding 5.86%
  - The rebalancing had no impact on headcount or face value

Overall, the BofAML All US Capital Securities Index (***i0cs***) rose 1.36% in April to close yielding 4.11%, which was 22bps lower than last month's closing yield and a spread of +179bps over comparable US Treasury securities – this was 15bps lower than last month. The yield impact from the rebalancing increased the yield-to-worst by 9bps to 4.20%.

Contingent Capital Securities

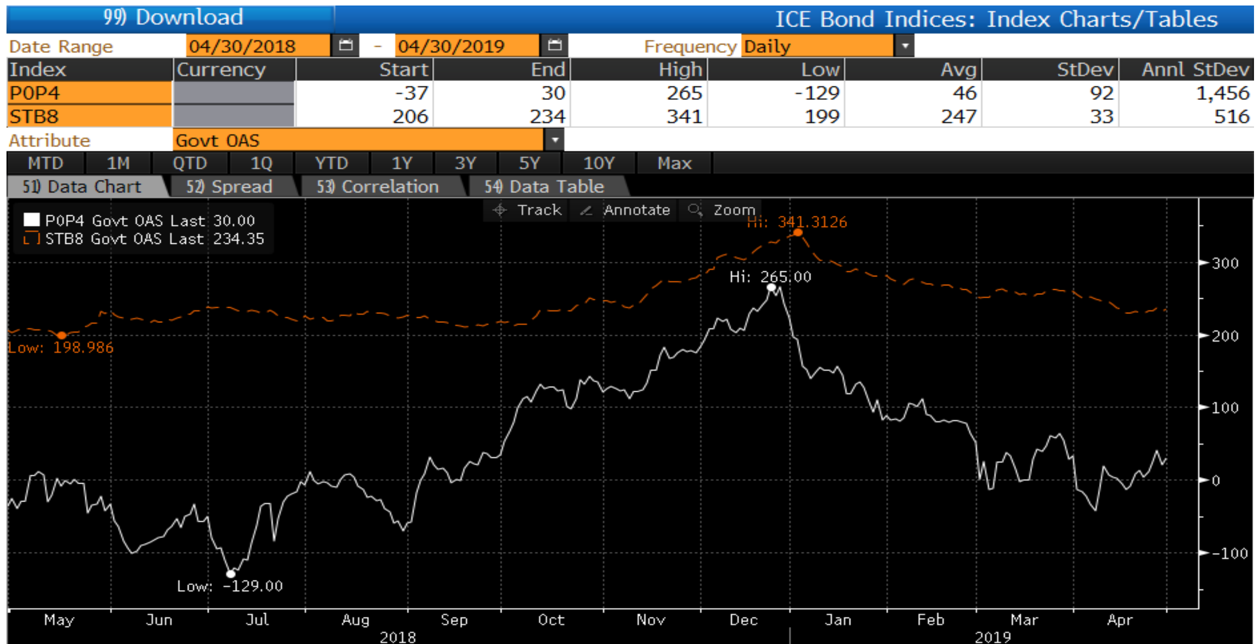
The ICE BofAML Large Cap Contingent Capital Index (***cocl***) rose 2.25% to close yielding 5.11%, which was 53bps lower than last month. The rebalancing this month cut head count by 1 and face value by $1.3 billion. The impact from the rebalancing increased the yield-to-worst by 6bps to 5.17%. A **"contingent 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 an insolvent bank through the contracts of its capital before falling into any conservatorship. 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 core capital).

Implications of Market Activity:

$25par Retail Preferred Securities Sector

The retail preferred securities sector pushed $0.73 higher this month continuing its remarkable streak this year. The move appears to be losing momentum though as spreads offer little (if

any) advantage to US treasury securities. The graph below shows spread in the $25par market (i.e., p0p4) over the past year compared to the spread in the $1,000 par institutional preferred securities market (stb8), which as a group we'll refer to as "NoCos" to distinguish $1,000 preferred securities from $1,000par contingent capital securities risks.



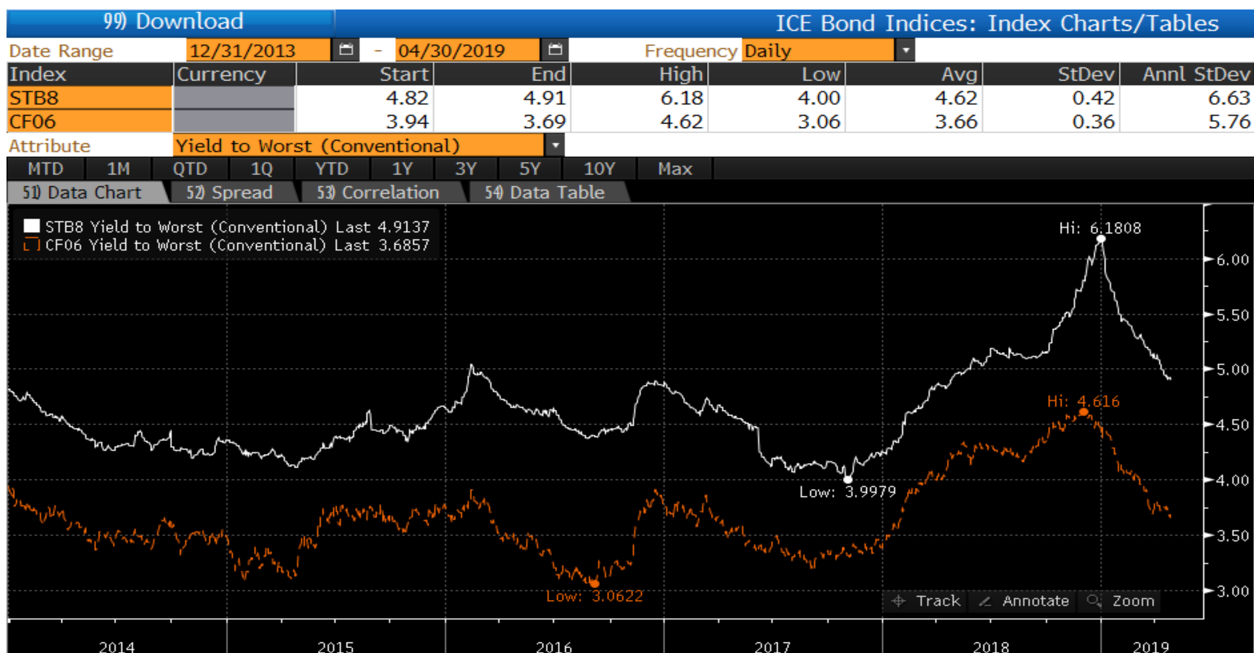
Source: Bloomberg

Though option adjusted spreads are quite low for the benchmark (and negative at times), they can stay low for extended periods – especially when equity prices are consistently rising and long-term interest rates are stable. That notwithstanding, it is more important now for investors to be extra selective in picking retail $25 par market exposure because call option risks can be pervasive during periods of compressed yields and flattening yield curve trends. A sense of complacency toward capital call risks can lead to over-pricings when the primary focus is on income without considering the premium being paid to earn it. The rebalancings in the passive preferred ETF markets have enabled market sweeps that over-pay leading to negative yield-to-worst possibilities if call dates are exercise over the course of the year. The resurgence

of IPO activity in the retail market due to the price surge (i.e., recovery) augments the refunding risks to the sector as it implies cheap spreads to issuers. The new issue market priced (Baa3/BB+) Key Corp preferred stock at 5 5/8%, (ba2/BB) Energy Transfer pipeline preferred stock at 7.60% and (Baa2/BBB) NextEra junior subordinated debt at 5.65%. Retail appetite for income has been notable in our SMA platforms and in the passive preferred ETF share counts.

$1,000par Institutional Preferred Securities Sector

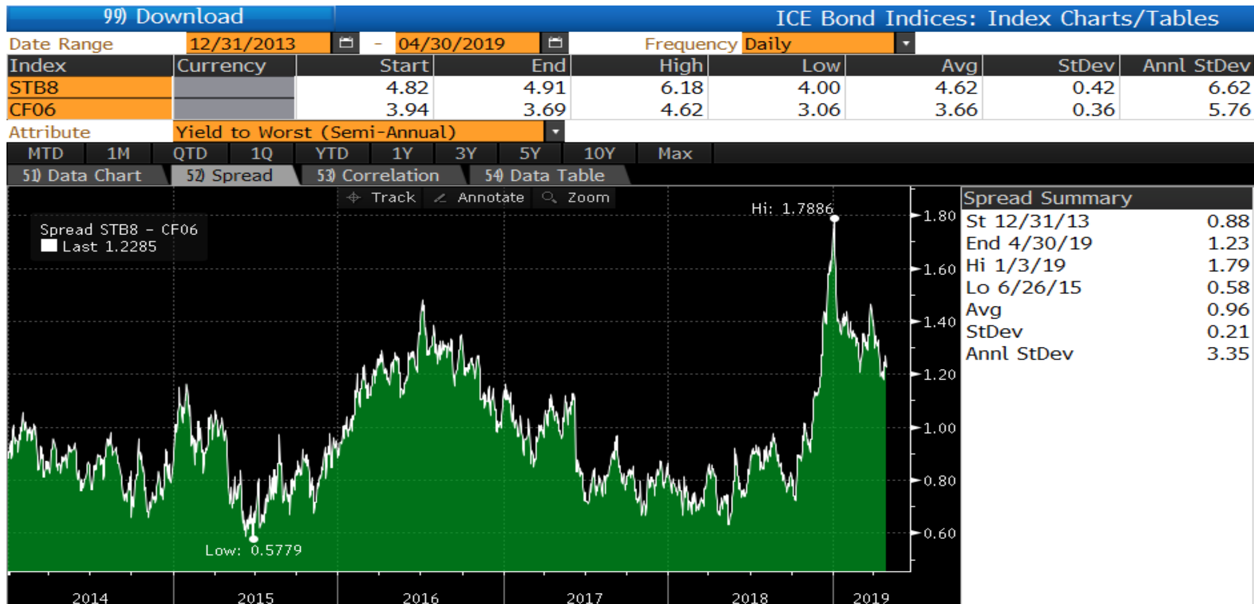
The $1,000 par institutional sector of the preferred securities rose by $1.24 this month, which was 51 cents more than the rise in the retail sector. The chart below shows the yield-to-worst of NoCos (i.e., stb8) vs. US Financials, 5-10yr (i.e., cf06) since the end of the treasury market's Taper Tantrum (Dec-2013):



Source: Bloomberg

Yields on NoCos are still positioned higher than they were at the end of the taper tantrum and just below their yields during the 1Q16 peak in credit spreads. US treasury 10yr note yields

have retraced their yields to where they were during the 1st quarter of 2018, which was the tights in spreads for this cycle, but NoCo yields remain 70bps higher. Moreover, relative spreads in NoCo's compared to senior financials remain as cheap as they were during 2016 as the chart below shows:



Source: Bloomberg

Institutional preferred securities are charting to be a better relative value for income in the absolute and on spreads when compared to their retail $25 par counterparts. Though NoCo subordination spreads have retraced much of last year's move wider, they are still over 1 standard deviation higher than average for the sample period since the taper tantrum.

Contingent Capital Securities Sector

The CoCo sector rose $1.77 this month against the backdrop of an 8.0% rise in European bank equity shares, which marks a month end closing high this year for the group. The graph below

shows the spreads in CoCos (i.e., cocl) relative to the spreads in NoCos (i.e., stb8) over the past 2yrs:

Source: Bloomberg

The spread differential is 23bps tighter this month compared to last month, which brings the spread differentials between the benchmarks marginally more than 1.0 standard deviation tighter than average. There were no new CoCos issued is US dollars this month which, together with the equity rally, helped to drive prices higher. Growth in Europe has been sluggish and the consensus view for policy rates to lift above zero by the end of next year appears at risk of being delayed. ECB Chairman, Mario Draghi, has assured markets that the Governing Council stands ready to adjust all of its instruments to ensure (yes, “ensure”) that inflation continues to move towards 2% inflation in a sustained manner.

Outlook:

Financial condition measures continue to improve as the Fed Minutes confirmed the view last month that policy rates would be static for an extended period with the next move being down.

This should foster opportunity for the US economy to regain some momentum. Continued surgent treasury supply along with Fed balance sheet tools should aid the Fed, if desired, in steepening the treasury yield curve comfortably away from being inverted in the belly.

- We expect the credit environment to be constructive as the Fed remains supportive of growth with no intention to invert the yield curve.
- A combination of tighter spreads and only modestly higher longer-term US Treasury rates and high income should combine for a positive total rate of return for junior subordinated capital securities -- more so prospectively for institutional preferred securities product because nominal yields and spreads are higher.
- The retail $25 par market appears overvalued. We expect the retail sector to come under some pressure as a modest bear steepener develops this summer and risk of an equity correction amidst summertime complacency that can accompany stellar financial condition measures.
- NoCos are especially attractive in the relative and CoCos, though tighter this month, are still expected to do well because of yield, low duration, and a slowing issuance calendar.

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