

Junior-Subordinated Capital Securities Markets

May 2019 Updates

There was a significant change in market tone during May as US Treasury bonds rallied and equity markets plunged. The primary impetus for the abrupt mood change was the FOMC minutes and rising trade tensions. The US Treasury bond rallied all month long and finished May quite over-bought. The 30yr US Treasury bond closed the month yielding 2.58% (36bps lower MTD; and 43bps lower since the end of 2015, which was the time of Fed's 1st move up on rates). The US Treasury 10yr note closed yielding 2.14% (36bps lower MTD; and 13bps lower since the end of 2015) -- the yield curve differential between the two longer US Treasury terms closed at 44bps (11bps steeper on the year). The equity market experienced one of its worse months of the expansion declining 6.6% (from its highs) to 2751 as trade tensions have evolved to a base case rather than a risk to global growth.

Chairman Powell recently repeated his concerns that the lack of inflation (i.e., risk of deflation) is one of the greatest challenges of our time. Indeed, the US Treasury bond market is a very bright student – but the traditional teaching role has reversed to where the market is teaching the Fed a lesson rather than the Fed teaching the market a lesson. The adage that the one (i.e., the market) should “never fight the Fed” has flipped to the Fed should “never fight the market”. Indeed, it's different this time. Short-term debt cycles that have driven prior expansions have ultimately fostered inflation that was controlled by boosting the cost of short-term money and therefore, reducing the demand for money, thus slowing marginal excess. This 10yr running recovery is increasingly challenged by interconnected global risks, unrestrained sovereign debt expansions and liquidity sensitivities. Quantitative Easing (QE) has been the primary response tool from central banks throughout the expansion, yet QE only medicates the illness without

curing it; and as the treatments wear off, secondary conditions such as corrections and bond rallies only call for more of the same treatments. Ultimately, QE only temporarily resolves liquidity voids created by debt destruction and central banks are coming to realize that they will probably never be able to “normalize” or meaningfully shrink their balance sheets; and that short-term interest rate policies risk not having the control they used to have because, among other things, machines are taking the place of humans and demographic shifts are permanent paradigms. In the longer run, excess debt in much of the developed world will need to be managed with adroit foresight that will likely only be clouded by political fog that is apt to get thicker before it lifts. Indeed, the newest theme is for the Fed is to guide markets to think of an “insurance” cut in rates, which is to say “we can blame our overshoot on politics” and, as such, regain the market’s confidence that policymakers still have prescient and counterbalancing vision on economies and markets – this would be a good thing and would restore the traditional teaching role as the Fed being in charge of the classroom.

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) declined 1.27% to close yielding 6.68% (50bps higher).
- Financial credit (measured by ICE Bank of America Merrill Lynch’s **cf06** index) rose 1.40% to close yielding 3.50% (19bps lower).
- The BBB rated 5-10yr corporate sector (measured by ICE Bank of America Merrill Lynch’s **c6a4** index) rose 1.22% to close yielding 3.76% (16bps 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 (***iocs***) 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 (***iocs***) benchmark of preferred securities represents \$295.3 billion (face amount) of investment grade and below investment grade instruments in both the retail \$25par market (44%) and the institutional \$1,000par market (56%). The Contingent Capital (***cocl***) benchmark of junior-subordinated capital securities represents \$212.7 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 \$508.0 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 0.50% this month to close yielding 3.53%
 - ❖ The rebalancing this month cut headcount by 5, and face value by \$3.0 billion

2. ICE BofAML High Yield Fixed Rate Preferred Index (*p0hy*) @ 24% of *i0cs*

- Comprised of BIG \$1,000par US AT1 and BIG \$25par
 - ❖ The *p0hy* fell 0.15% this month to close yielding 4.64%
 - ❖ The rebalancing increased headcount by 7, and face value by \$594 million

3. ICE BofAML US Capital Securities Index (*c0cs*) @ 27% of *i0cs*

- Comprised of dated IG \$1,000par hybrids (no US AT1)
 - ❖ The *c0cs* rose 0.52% this month to close yielding 4.74%
 - ❖ The rebalancing had no impact on headcount and minimal on face value

4. ICE BofAML High-Yield Capital Securities Index (*h0cs*) @ 5% of *i0cs*

- Comprised of BIG \$1,000par legacy Tier1 and BIG \$1,000par hybrids
 - ❖ The *h0cs* rose 0.15% this month to close yielding 5.84%
 - ❖ The rebalancing had no impact on headcount and reduced face value by \$196 million

Overall, the BofAML All US Capital Securities Index (*i0cs*) rose 0.33% in May to close yielding 4.25%, which was 5bps higher than last month's closing yield and a spread of +215bps over comparable US Treasury securities – this was 36bps higher than last month. The yield impact from the rebalancing increased the yield-to-worst by 3bps to 4.28%.

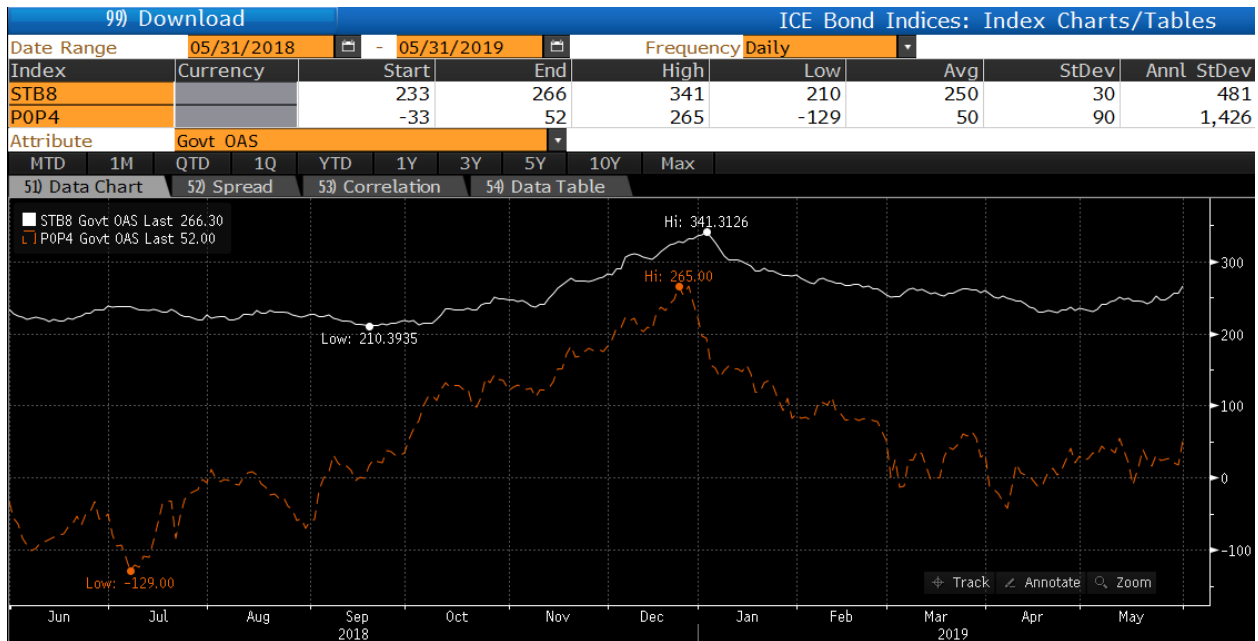
Contingent Capital Securities

The ICE BofAML Large Cap Contingent Capital Index (*cocl*) declined 1.22% to close yielding 5.48%, which was 31bps higher than last month. The rebalancing this month cut head count by 1 and face value by \$1.9 billion. The impact from the rebalancing increased the yield-to-worst by 5bps to 5.53%. 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 corrected (declined) \$0.22 this month. 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.



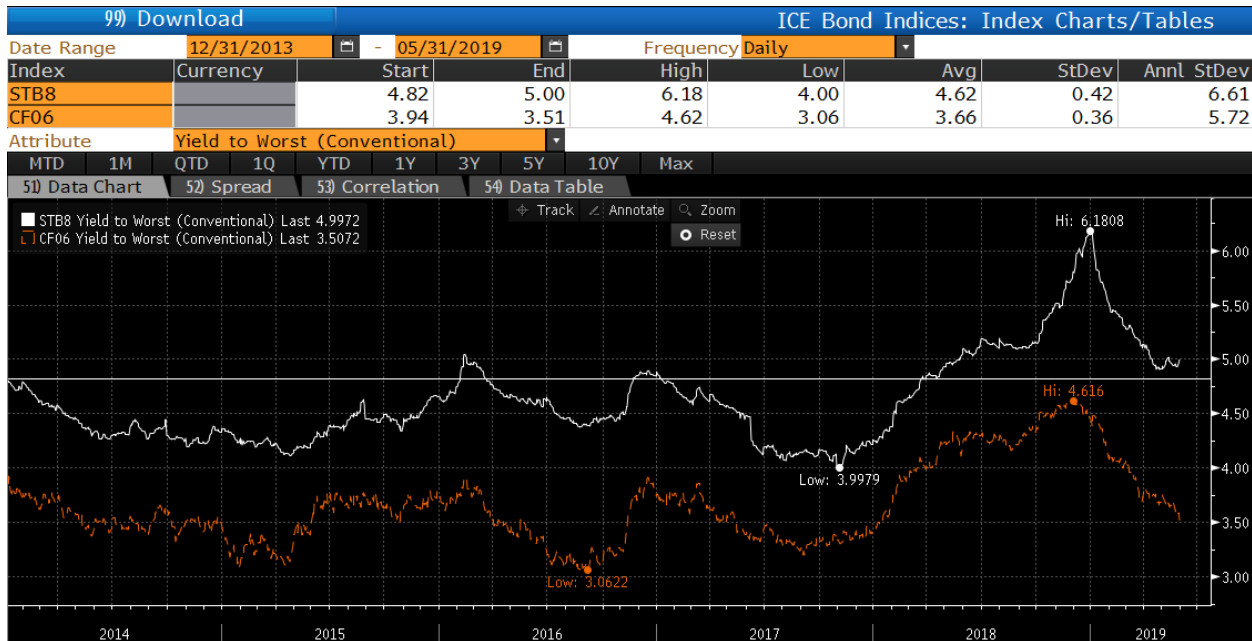
Source: Bloomberg

Option adjusted spreads are quite low for the benchmark (basically, zero to 50bps) and are likely to stay low for an extended period as the US Treasury market reprices the risks to the lack of inflation. For the time being, we do not expect an "insurance" reaction to come from the Fed until sometime this fall as markets digest continuing trade war tensions throughout the summer. Unremarkable spreads and negative convexity make it important 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 compressed yield curve trends. Nonetheless, fund flows into the passive ETF space continue to rise as repressed investors need

income. The ETF fund flows have recovered half of the pervasive outflows since last summer. The IPO market appears to be topping out as small below investment grade issuers dominated the activity in May, except for Ford Motor Company, which sold a 6.2% baby bond.

\$1,000par Institutional Preferred Securities Sector

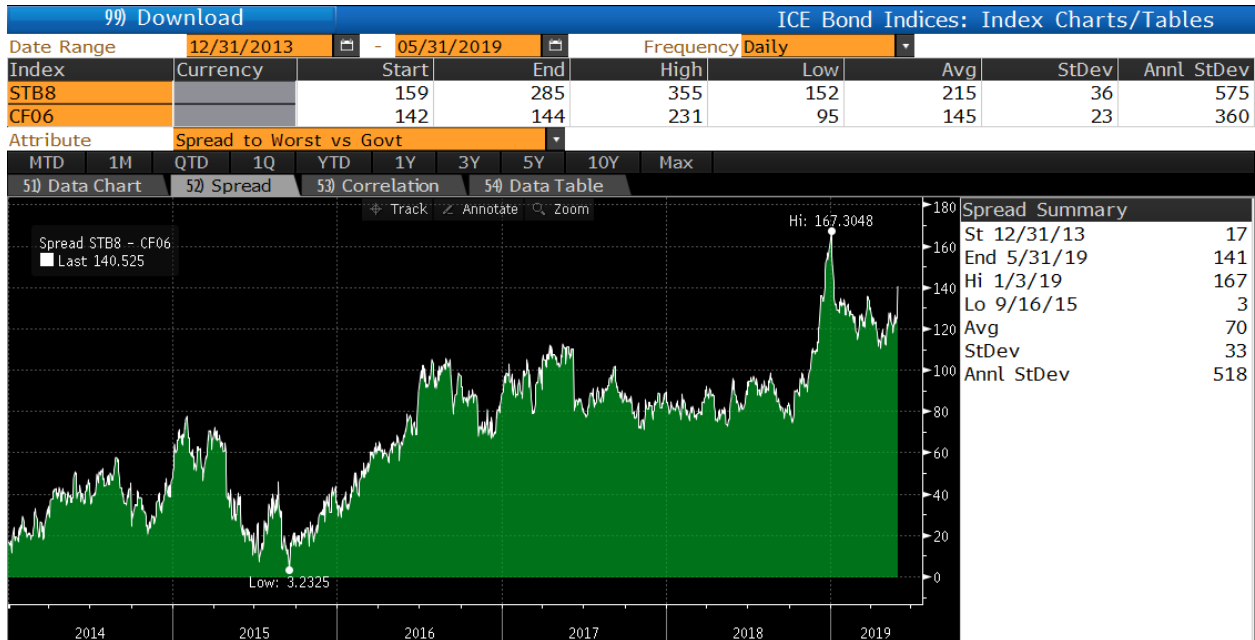
The \$1,000 par institutional sector of the preferred securities rose \$0.25 this month, which was just a few pennies more than the retail sector. The chart below shows the yield-to-worst of NoCos (i.e., stb8) vs. US Financials, 5-10yr (i.e., cf06) since the end of the treasury market’s Taper Tantrum (Dec-2013):



Source: Bloomberg

Yields on NoCos are still positioned higher than they were at the end of the taper tantrum and equivalent to their yields during the 1Q16 peak in credit spreads. US treasury 10yr note yields have declined to a point where absolute deflation fears would appear to be the next impetus for bonds to reprice – but this is unlikely at this point given the strength in wages, employment

and consumer confidence. The primary story for NoCo preferred securities is relative value compared to senior paper, which has compressed along with US Treasuries. Relative spreads in NoCo's compared to senior financials is 2.15 standard deviations higher than average as this correction in spreads has retraced much of the rally year-to-date as the chart below shows:

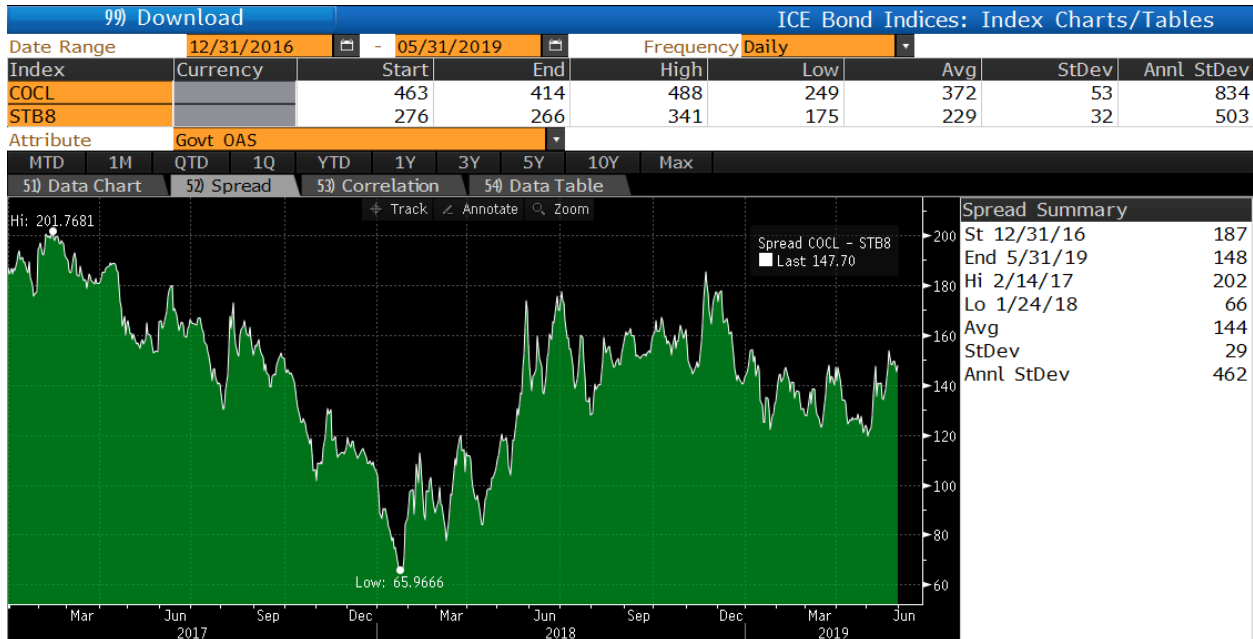


Source: Bloomberg

Institutional preferred securities are charting to be a better than average relative value compared to \$25par paper, as well. As a result, the NoCo sector has ample yield available to cushion a price retracement and more relative value available for spread tightening – in other words, NoCos are our favored risk/reward choice from a sector perspective in preferred securities.

Contingent Capital Securities Sector

The CoCo sector declined \$1.83 this month against the backdrop of a 14.3% correction that erased all the gains for the year in European bank equity shares. 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 between CoCos and NoCos widened considerably this month, which brings the differential 4bps above the average since 2016. There were no new CoCos issued in US dollars this month as the sector was challenged by the poor equity performance and a move closer to a retesting the bottom for a third time since 2012. Growth in Europe has been sluggish and the consensus view for policy rates to lift above zero by the end of next year appears increasingly at risk of being delayed. ECB Chairman, Mario Draghi, contends that “there’s no probability of deflation” and the European economic results “aren’t bad.”

Outlook:

Fed officials seem satisfied, at least according to the minutes, on the economy and the policy rate, despite the market's loud objections. Fed funds futures have gone from expecting one hike in December this year to discounting almost 3 cuts by the end of the year. It is unlikely that the Fed does anything but stand still through the end of August because: 1) the minutes showed balanced views on the policy rate and an upward skew, 2) the Jackson Hole 2019 Economic Symposium, "Challenges for Monetary Policy" is held the 3rd week of August, and 3) the average length of no action on rates after a series of rate hikes by the Fed is 8 months, which would bring us to the September meeting. The idea of an "insurance" cut may gain conviction by Fed members if financial conditions deteriorate, but equity markets would probably need to breach 2600 on the S&P 500 for that to happen. The Jackson Hole conference should be very robust and shape policy views on what tools will be used to restore inflation confidence beyond the federal funds policy rate. In the past, balance sheet tools have been useful in moving up inflation results and are likely to be repeated. This adds support to our base case that the Fed will start buying US Treasury Bills by selling notes (and bonds) to twist the yield curve; and perhaps even implement net new purchases to average down the duration of its balance sheet.

- We expect the credit environment to be constructive as the Fed remains supportive of growth with no intention of inverting the yield curve and should take action to steepen it.
- The combination of contained spreads, only modestly higher longer-term US Treasury rates and attractive relative values should combine for a positive total rate of return for junior subordinated capital securities this year -- more so for the institutional sector because nominal yields and spreads are higher than in the institutional sector.
- The retail \$25 par sector appears overvalued. We expect the retail paper to come under some pressure as a modest bear steepener develops this summer and risk of deeper equity correction amidst trade wars intensifies.

- NoCos are especially attractive in the relative; and CoCos, though wider this month, are expected to outperform because of yield, low duration, and a slowing issuance calendar.

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June 6, 2019

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