

## **Junior-Subordinated Capital Securities Markets**

### **July 2019 Updates**

The bond market consolidated in July trading off after the 4<sup>th</sup> of July holiday into a modest downtrend and then went sideways for the rest of the month in anticipation of the Fed meeting at month end. Despite an upward shift on the front end of the US Treasury yield curve, the “stubborn” inversion still prevails in the belly of the curve. The initial rates move lower in bonds and then a modest retrace followed by a two-week journey sideways ended one of the longest bond rallies since 2014. The 30yr US Treasury bond closed the month yielding 2.53% (unchanged; and 48bps lower since the end of 2015, which was the time of Fed’s first move up on rates). The US Treasury 10yr note closed yielding 2.02% (2bps lower MTD; and 25bps lower since the end of 2015). The yield differential between these two longer US Treasury terms closed at 51bps (18bps steeper on the year). The equity market continued to cheer a dovish Fed by setting new highs in July on constant tweet pressure on the Fed from President Trump to aggressively cut rates – the S&P 500 closed +1.3% at 2980.

Last month we stated that the Fed’s perturbation over the lack of inflation is becoming an economic enigma and that the concept of an “insurance cut” in rates was the Fed’s latest solution to the deflation risk. During July in advance of the Fed meeting, the European Central Bank signaled from its meeting that more accommodation is coming by September – it emphasized that rates are likely to trend to lower levels through the first half of next year. It also conceded that inflation is an enigma and that if the unexpected persistent weakness continues, then it would be “determined to act.” Remembering that last month Chairman Draghi said essentially that there are no limits to the tools the ECB can use and that tools would be specifically tailored weaponry for combat against the challenges we face, it does appear

much more likely that the ECB will pop the clutch to restart QE by the end of the year. In keeping with its determination to act, the ECB has set the necessary committee processes in motion to explore all options. The reports should provide Christine Lagarde, the incoming ECB Chairman, with a full arsenal of options to exercise upon her arrival next quarter – the operative word is “exercise.”

The Fed exercised some of its muscle this month by delivering its well telegraphed “insurance cut” by reducing the target funds rate by 25ps -- as expected (down to 2% on the lower bound). Despite the accommodative benefits, the market wants more as the futures market quickly discounted the cut to ask for another cut (totally 3 more rather than what would have been 2 more cuts) within the next year. President Trump wants more cuts too evidenced by quickly tweeting, “What the markets wanted to hear from Jay Powell and the Federal Reserve was that this was the beginning of a lengthy and aggressive rate-cutting cycle which would keep pace with China, the European Union and other countries around the world.” President Trump’s very public dissatisfaction with the Fed’s seeming token accommodation was preceded by a series of statements over the course of July critical of the Chairman Powell’s leadership:

- “Our most difficult problem is not our competitors, it’s the Federal Reserve...The Fed raised rates too soon, too often – and doesn’t have a clue.”
- “Because of the faulty thought process...our interest costs are much higher than other countries, when they should be lower. Fed: There is almost no inflation”
- “Q2 GDP up 2.1% not bad considering we have the very heavy weight of the Federal Reserve anchor wrapped around our neck. Almost no inflation. USA set to zoom!”
- “The EU and China will further lower interest rates and pump money into their systems making it much easier for their manufacturers to sell product. In the meantime, and with very low inflation, our Fed does nothing – and probably will do very little by comparison. Too bad!”

In the president's own words, just before the central bank's policy meeting at the end of the month, "I'm very disappointed in the Fed." There is no question that President Trump wanted a "large cut" and that 25bps was inadequate to him – and to the bond market. On the other hand, the president was seemingly satisfied that the Fed ended its balance sheet run-off, which the markets had earlier "complained" about as being too restrictive.

In the Fed's post meeting press conference, Chairman Powell emphasized that the committee was not viewing this cut as the beginning of a lengthy cutting cycle, but rather that the cut was a mid-cycle adjustment and that if the cut works to support the economy, then there could be more hikes coming. Clearly, the Fed needs to push back on the president's persistent pressure in order to affirm its independence. Chairman Powell cited the reasons for the cut as being due to "the implications of global developments...to insure against downside risks to the outlook from weak global growth and trade tensions ... as well as muted inflation pressures" and that "it will act as appropriate to sustain the expansion." Ultimately, market signals are more convincing to the Fed than tweets and retweets. We cannot ignore the vault higher in long bond prices in the days that followed the Fed decision even though it's next month's conversation. The Fed has adroitly signaled to the president that it will cut rates further if global growth weakens and trade tensions mount -- and it doesn't matter what might come first! In other words, Mr. President, keep fighting to negotiate a better trade deal, we will have your back and we will do all we can to prolong the expansion – clearly, the president saw the Fed's bet and raised the tariffs by 10% on China.

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 0.51% to close yielding 6.00% (6bps lower).

- Financial credit (measured by ICE Bank of America Merrill Lynch's **cf06** index) rose 0.43% to close yielding 3.13% (4bps lower).
- The BBB rated 5-10yr corporate sector (measured by ICE Bank of America Merrill Lynch's **c6a4** index) rose 0.66% to close yielding 3.39% (7bps 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 \$298.6 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 \$214.8 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 (**ioCs**) – 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 *ioCs* preferred securities benchmark are:

**1. ICE BofAML Fixed Rate Preferred Index (*p0p1*) @ 44% of *ioCs***

- Comprised of IG \$25par and IG \$1,000par US AT1
  - ❖ The *p0p1* rose 1.64% this month to close yielding 2.01%
  - ❖ The rebalancing this month increased headcount by 1, and face value by \$3.2 billion

**2. ICE BofAML High Yield Fixed Rate Preferred Index (*p0hy*) @ 23% of *ioCs***

- Comprised of BIG \$1,000par US AT1 and BIG \$25par
  - ❖ The *p0hy* rose 2.19% this month to close yielding 3.50%
  - ❖ The rebalancing cut headcount by 1 and face value by \$1.4 billion

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

- Comprised of dated IG \$1,000par hybrids (no US AT1)
  - ❖ The *c0cs* rose 1.36% this month to close yielding 4.24%
  - ❖ The rebalancing left headcount unchanged and face value down \$550 million.

**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 1.28% this month to close yielding 5.45%
  - ❖ The rebalancing had no impact on headcount or face value.

Overall, the BofAML All US Capital Securities Index (*i0cs*) rose 1.67% in July to close yielding 3.17%, which was 68bps lower than last month's closing yield and a spread of +125bps over comparable US Treasury securities (69bps lower). The yield impact from the rebalancing increased the yield-to-worst by 6bps to 3.23%.

**Contingent Capital Securities**

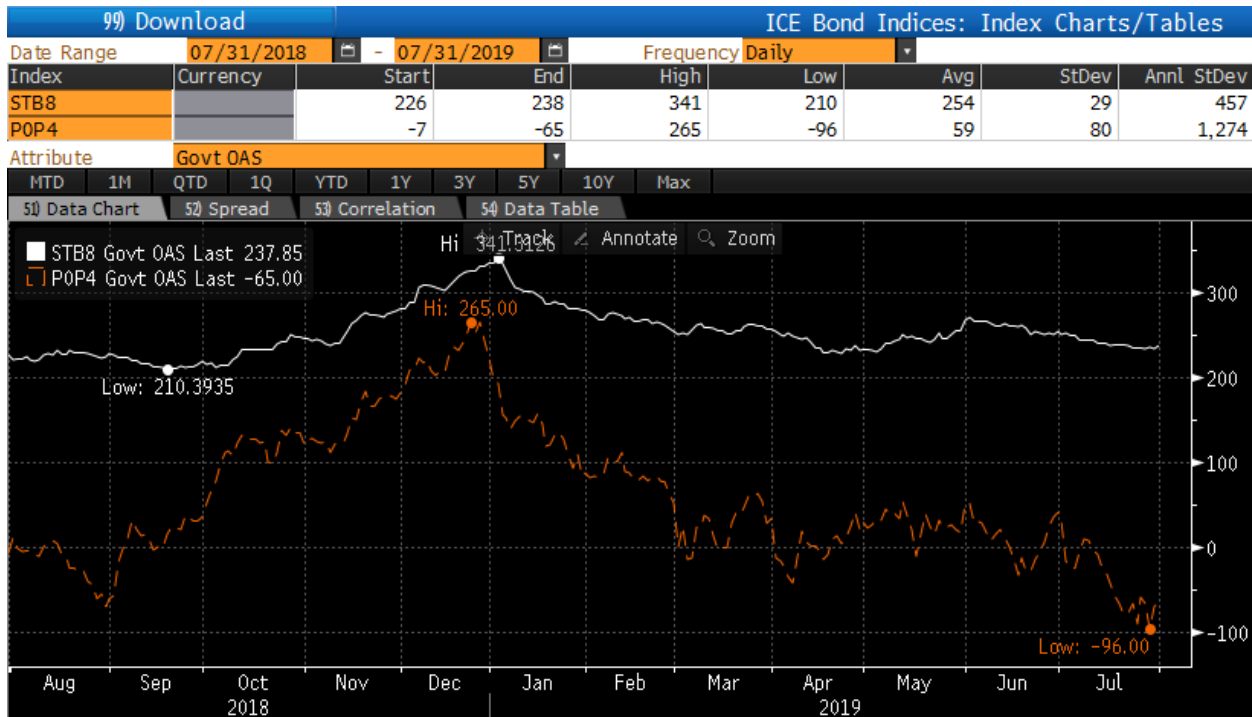
The ICE BofAML Large Cap Contingent Capital Index (*cocl*) rose 0.65% to close yielding 4.82%, which was 3bps higher than last month. The rebalancing this month added 2 issuers to the head count and face value increased by \$850million. The impact from the rebalancing increased the yield-to-worst by 4bps to 4.86%. 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 rose \$1.44 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 in the retail sector dipped deeper below zero in July with the insatiable yield grab amidst new equity highs this month and range bound US Treasury bond yields. The

passive preferred securities ETFs saw steady inflows in July and closed the month at the high share counts for the year. The money flows have recovered more than half of the total record outflows of last year while prices have almost fully recovered last year's entire blow-off. New equity highs and a month of constructive anticipation for more easing conditions from central banks have emboldened retail with a renewed sense of security for now. The graph below shows the yield-to-maturity in the \$25par sector (i.e., ignoring the call risks) in a long trend to lower yields since the end of the taper tantrum (2013) – this month marked another an all-time historic low running yield for the \$25par sector:



Source: Bloomberg

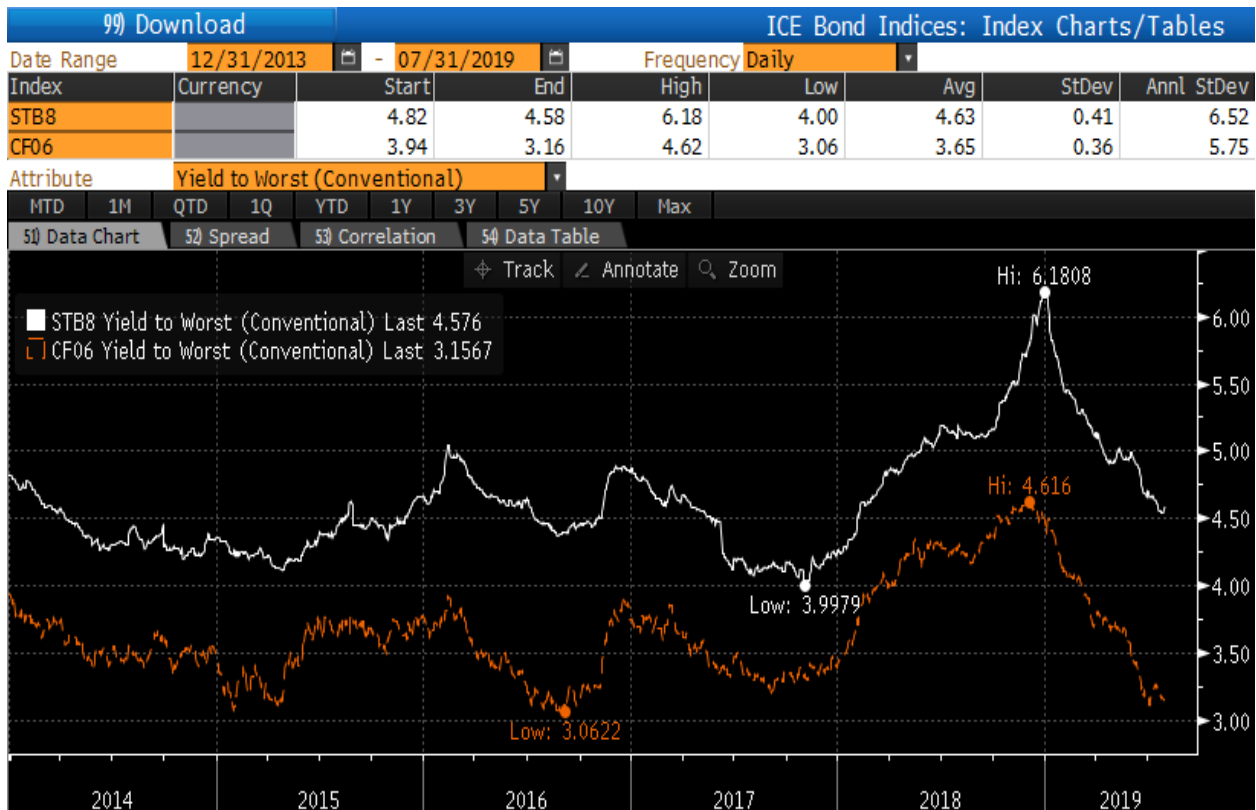
Given yields are at all-time lows in the retail sector, it is astounding to note that there were no new issues that would qualify for entry into the pOp4 benchmark in July. Note that 20% of the entire pop4 benchmark is currently callable with a par weighted coupon of 5.91%. Given the



entire benchmark is priced to a 5.48% YTM, it is plausible to be concerned about jump call conditions and price risks under negative YTW situations even more pervasive than during the 2017 cycle. Look again at the spread graph (page 7) of the institutional preferred securities (stb8) compared to retail paper (p0p4) and make your judgment on relative value given this sample of call risk in the retail and passive preferred securities ETF markets.

**\$1,000par Institutional Preferred Securities Sector**

The \$1,000 par institutional sector of the preferred securities rose \$0.87 this month, which was 57 cents less than the retail sector. We again highlight this sector for relative value with preferred securities classes as there is less in-the-money call option resistance for the institutional sector 303bps of additional spread. The chart below shows the yield-to-worst of NoCos (i.e., stb8) vs. US financials, 5-10yr (i.e., cf06) since 2013:



Source: Bloomberg

Yields on NoCos are still tracking through an above average yield zone (behind 2018) while 5-10yr US financials are revisiting their low yields for a 4<sup>th</sup> time in 6 years. The graph below shows relative spreads in NoCo's compared to senior financials is 2.0 standard deviations higher than average and still higher than differentials in 2016 when we had the wides in absolute spreads for the cycle. In other words, NoCo spread premiums are more attractive (still) relative to senior financials than they were when spreads were at their absolute wides in 2016.



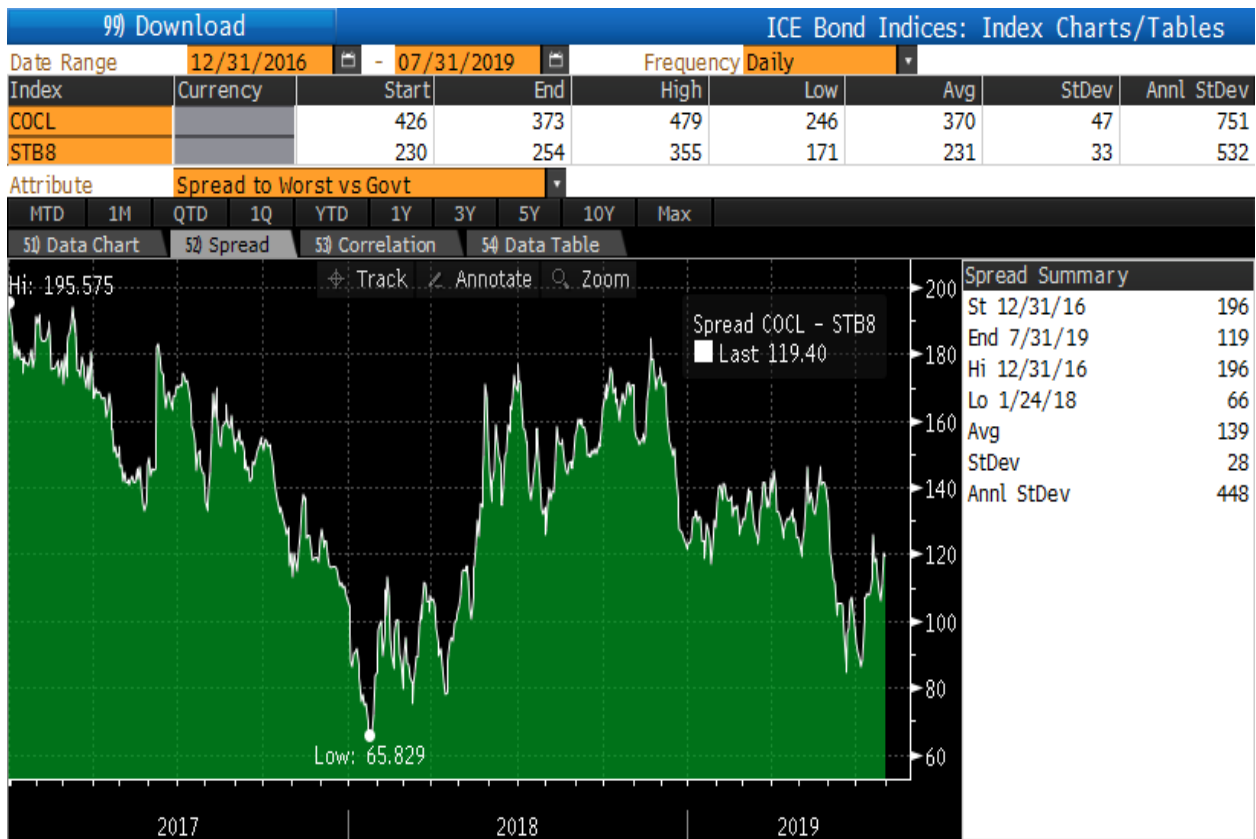
Source: Bloomberg

The trade here is to buy NoCos and sell senior financials as a play on yield compression in quality financials in anticipation of central banks adding more stimulus to prolong the expansion. So, if one may have missed some of the rates move or some of the benefit from

spread gains, institutional preferred securities can be a way to capture still attractive yield spread on the broader more senior benchmarks that have rallied closer to US treasuries.

**Contingent Capital Securities Sector**

The CoCo sector increased \$0.13 this month against the backdrop of exhaustingly weak European bank equity shares that showed some life to start the month, only to give back the gains by the end of the month. 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 21bps month, which brings the differential 20bps below the average differential since 2016. As European growth is sluggish,

we expect the Fed's rate cut to help compel the Governing Council to favor Eurozone rate cuts in September and QE by the end of the year. Indeed, ECB Chairman Mario Draghi appears to be conceding to deflation concerns by stating that policy may resort to more "strategic" measures, especially now that the entire bund curve is under zero percent. Christine Lagarde should be well equipped with multiple fresh policy studies when she takes the chair next quarter.

**Outlook:**

Now that the "insurance cut" is on the books, we now look forward to news coming from the Jackson Hole 2019 Economic Symposium entitled, "Challenges for Monetary Policy", held the 3<sup>rd</sup> week of August. There should indeed be plenty to talk about given the most recent bond move and equity correction since month end. The conference should help to shape policy views on what tools beyond federal funds should be used to restore sustainable inflation confidence. In the past, balance sheet tools have been useful in moving up inflation and similar tools are likely to be implemented again to sustain the current expansion – after all, the Fed, in our view, has the president's economic policy back despite tweets that suggest repeated disappointments. The Fed may start buying US Treasury bills by selling notes (and bonds) to twist the yield curve steeper; and perhaps even implement net new purchases if the trade wars get too involved and risks to the global outlook become too unbalanced.

- 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 more immediate actions to steepen it soon.
- The combination of contained spreads, modestly higher longer-term US Treasury rates (if more QE comes) and attractive relative yield values should combine for a positive total rate of return for junior subordinated capital securities over the rolling periods, but market corrections can be healthy in clearing shorter term excess.

- The retail \$25 par sector appears to show excess in being even more fully valued than last month and needs a strong bull steepener on the front end to benefit spreads if prices are to be sustained at these levels.
- NoCos are especially attractive in the relative; and CoCos appear to be a fair value.

Phil Jacoby  
CIO, Spectrum Asset Management  
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