

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

### **August 2019 Updates**

The bond market zoomed higher in August, following the Fed's "insurance cut" and President Trump's higher tariff penalties on China. Yields on US Treasury bonds collapsed for one of the biggest drops (or biggest UST bond rallies) since the European sovereign debt crisis 8yrs ago. The 30yr US Treasury bond closed the month yielding 1.96% (56bps lower; and 104bps lower since the end of 2015, the time of the Fed's first move up on its target funds rate). The US Treasury 10yr note closed the month yielding 1.51% (51bps lower; and 76bps lower since the end of 2015). The yield differential between these two longer US Treasury terms closed at 45bps (12bps steeper on the year). The equity markets, while inclined to feel comforted by the blarney of dovish central banks, were jolted by increasing trade war amperage between the US and China – the S&P 500 closed the month down 1.8% at 2927.

The Jackson Hole 2019 Economic Symposium entitled, "Challenges for Monetary Policy", was the key event this month which stirred ideas for central banking tools beyond policy rates. US Fed Chairman Jerome Powell's speech was the main event. He stated, "*low inflation seems to be the problem of this era, not high inflation.*" In prior discussions, Chairman Powell has said, "*the lack of inflation is the greatest challenge of our time.*" There is no question that challenges for monetary policy are keyed on combating deflation because every road to deflation has warning signs of "low inflation" (and "lack of inflation") along the way. This reinforces the need to start assessing the probability of the nuclear option to eradicate deflation – "helicopter money". In our view, this weapon is no longer a theory but an actual gun – the question is: When does a central bank put a bullet in the chamber? We are likely to hear more about helicopter money (and ways to distribute it) over the next few years. In the meantime,

Chairman Powell is concerned for risks of a global slowdown stemming from Germany and China in addition to added frictions from Brexit, Hong Kong and Italy. Indeed, US policy appears to be increasingly responsive to global conditions rather than limited to local conditions such as high consumer confidence, strong home sales and robust wage growth. He recognized that solid US data has been supported by *“the anticipated path of policy”* and that the Fed will *“act as appropriate to sustain the expansion.”* We interpret these words as being supportive of additional rate cuts because by acknowledging that the economy is in a good place largely due to *“anticipated policy”*, the Fed is effectively acquiescing to the market’s lead by guiding markets to be confident that the Fed should cut rates. Interestingly, Chairman Powell also said that the Fed does not see *“unsustainable borrowing, financial booms or other excesses.”* Consequently, and in the absence of excess, these words appear to be setting the stage for more balance sheet moves such as an operation twist – for example, buying T-Bills in no current position in and selling its positions in 10s & 30s (more on this later). While Jackson Hole did not reveal revelations, it did throw a broad net over the challenges to global growth and tout the Fed’s determination to independently respond.

Beyond Jackson Hole, the relentless pressure on sovereign rates and the expanding mass of negative interest rates present longer-term dilemmas for the sustained health of the global financial system. For now, negative rates are being lauded as needed. For example, incoming ECB Chairman Christine Lagarde believes that conditions in Europe would have been worse off had it not been for the benefit of negative rates. While this may be true for now, negative rates are not sustainable and contrary to what President Trump tweets about the competition...:

*“Our Federal Reserve cannot mentally keep up with our competition – other countries. At the G-7 in France, all the other leaders were giddy about how low their interest costs have gone. Germany is actually getting paid to borrow money – ZERO INTEREST PLUS! No Clue Fed!”*

...this is certainly not the kind of “competition” the US should seek to keep up with in the long run. But for now, negative rates do provide fodder for pithy tweets. Though, the situation being characterized as “zero interest plus” by the president can be more accurately characterized as “zero interest minus” (i.e., negative).

Negative interest rates are a sign of monetary policy failure and the resultant relentless US dollar demand is symptomatic of the dysfunction. A negative policy rate to a financial system is like inflammation to a body system—both indicate unhealthy stress conditions, and both will eventually kill the system if the upstream cause is not remedied. Fortunately for the US, recent research on this chronic condition from the regional Federal Reserve Banks of San Francisco and Kansas City warn of the dangers of negative interest rates. Consequently, the term structure of US interest rates is not likely to go negative despite fanning headlines to suggest negative rates are unavoidable. For example, former Federal Reserve Chairman Alan Greenspan, “sees no barriers to prevent negative treasury yields” and he believes that “zero has no meaning”. In our view, “zero” has a significant meaning – zero means no pulse to capitalism, which means no expected return on investment and consequently, no incentives to invest (or lend), which means no incentives to innovate (or borrow), which means a liquidity freeze. So, if zero means no pulse, then negative means deflation defibrillation – that is, an electric shock with a current of free currency (i.e., “helicopter money”). Helicopter money is liquidity in vapor form and (emergency) anti-freeze to a sovereign debt backed financial system. But in the meantime, rates are apt to stay low for a while longer as the global financial system’s inflammatory symptoms continue to be diagnosed and medicated very (very) slowly, but hopefully timely enough (and effectively enough) to avoid emergency measures (more on this later too).

Before we discuss performance in the junior subordinated sectors this month, let’s look at performance in some of the more senior corporate credit sectors 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 0.39% to close yielding 5.80% (22bps lower).
- Financial credit (measured by ICE Bank of America Merrill Lynch's **cf06** index) rose 2.59% to close yielding 2.78% (38bps lower).
- The BBB rated 5-10yr corporate sector (measured by ICE Bank of America Merrill Lynch's **c6a4** index) rose 2.38% to close yielding 3.06% (35bps 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 \$295.6 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 \$211.2 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 \$506.8 billion universe of fixed-rate junior-subordinated capital securities with preferred securities (measured by *i0cs*) 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* benchmark that combines the retail and institutional sectors of preferred securities are:

1. **ICE BofAML Fixed Rate Preferred Index (*p0p1*) @ 44% of *i0cs***
  - Comprised of IG \$25par and IG \$1,000par US AT1

- ❖ The *pOp1* rose 0.72% this month to close yielding 2.38%
- ❖ The rebalancing this month cut headcount by 3, and face value by \$1.6 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 0.70% this month to close yielding 3.72%
  - ❖ The rebalancing increased headcount by 1, but face value declined by \$800 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 1.62% this month to close yielding 4.03%
  - ❖ The rebalancing cut headcount by 1 and face value by 2.0 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 0.62% this month to close yielding 5.31%
  - ❖ The rebalancing had no impact on headcount, but face value increased by \$1.4 billion.

Overall, the BofAML All US Capital Securities Index (*i0cs*) rose 0.97% in August to close yielding 3.31%, which was 8bps higher than last month's closing yield and a spread of +176bps over comparable US Treasury securities (46bps wider). The yield impact from the rebalancing increased the yield-to-worst by 3bps to 3.34%.

**Contingent Capital Securities**

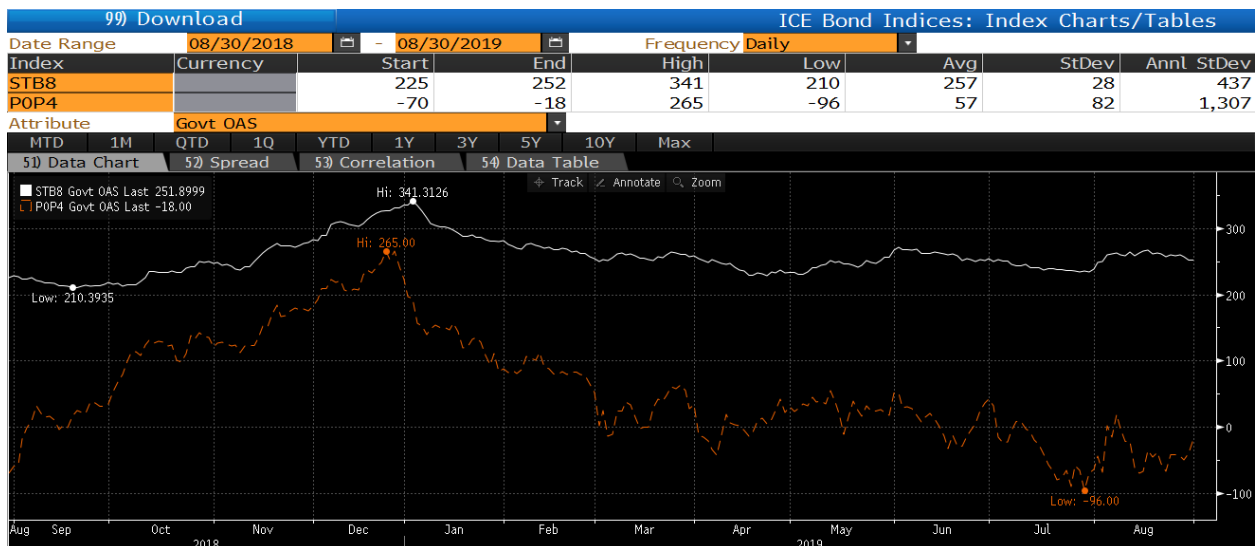
The ICE BofAML Large Cap Contingent Capital Index (*cocl*) rose 0.43% to close yielding 4.67%, which was 19bps lower than last month. The rebalancing this month removed 3 issues from the head count and face value declined by \$2.9 billion. The impact from the rebalancing increased the yield-to-worst by 1bp to 4.68%. 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 6 cents 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.



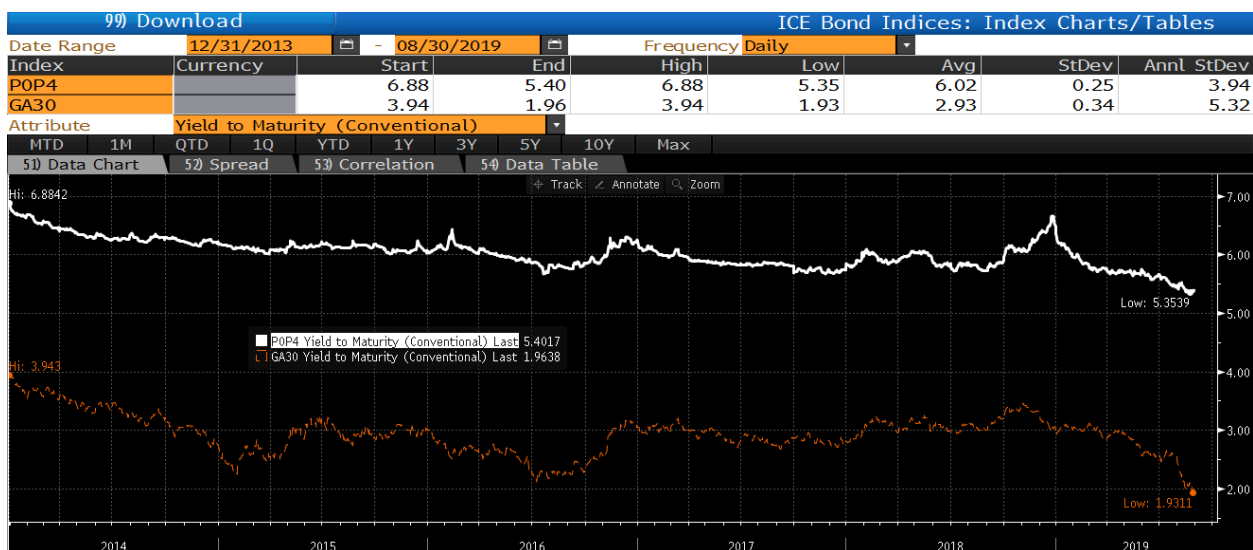
Source: Bloomberg

## ICE BofAML Core Plus Fixed Rate Preferred Securities Index (POP4)

noCos (STB8)

Option adjusted spreads in the overall retail sector improved in August by swinging a wide range and closing less negative than July. Much of the swing was related to the 100pt sine wave pattern of equities and the 52bp widening was the result of the significant rally in US Treasury securities. The passive preferred securities ETFs experienced steady inflows again in August. In fact, the progression since the 1<sup>st</sup> quarter has been essentially a 45° ray to where accumulated inflows this year have now completely recaptured all of what was lost in the last three months of 2018. If this linear progression in share count pace continues, then Invesco PowerShares (PGX) should breakout to record highs in October and IShares (PFF) should breakout to record highs in December.

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

noCos (STB8)

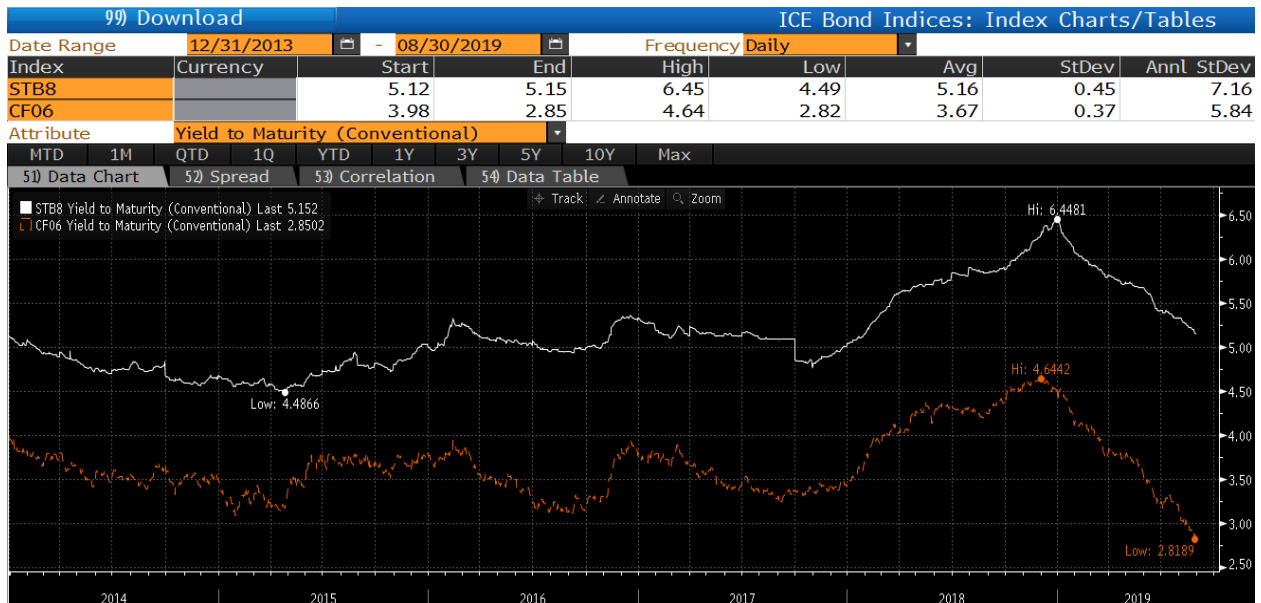
ICE BofAML Current 30-Year US Treasury Index (GA30)

Given yields are at all-time lows in the retail sector; and that 22% of the retail \$25par p0p4 benchmark (i.e., the specific benchmark of PGX) is callable at any time, we expect a significant jump in refunding activity through the rest of the year. This jump condition type risk to income is exacerbated by the benchmark being overpriced with the weighted average yield of this callable sleeve trading at negative yields – in other words, if this currently callable sleeve were called tomorrow there could be a weighted average price loss of over 2% on a significant sleeve of benchmark securities. There appears to be a lot of faith priced into a belief that companies will delay, linger and wait on refinancing and of course if they do, then these negative yields could accrue income beyond breakeven money market returns. But, as the weighted average coupon of this callable bucket is 6.02% and the average refunding rate is 5.10%, it appears that corporate treasurers will act sooner than later rather than wait on redemptions. The implication of this accelerated call risk (besides some potential price loss), is that SEC yields in the passive preferred ETFs are facing as much as 20bp annualized income haircut as we wait for the next rate cut from the Fed.

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

The \$1,000 par institutional sector of the preferred securities rose \$0.81 this month, which was 75 cents more than the retail sector. We again highlight this NoCo sector for relative value within preferred securities as there is less in-the-money call option resistance for the institutional sector and 266bps of additional spread compared to retail preferred securities.

NoCo paper compared to senior paper also stands out. The chart below shows the yield-to-worst of NoCos (i.e., stb8) vs. US financials, 5-10yr (i.e., cf06) since 2013:

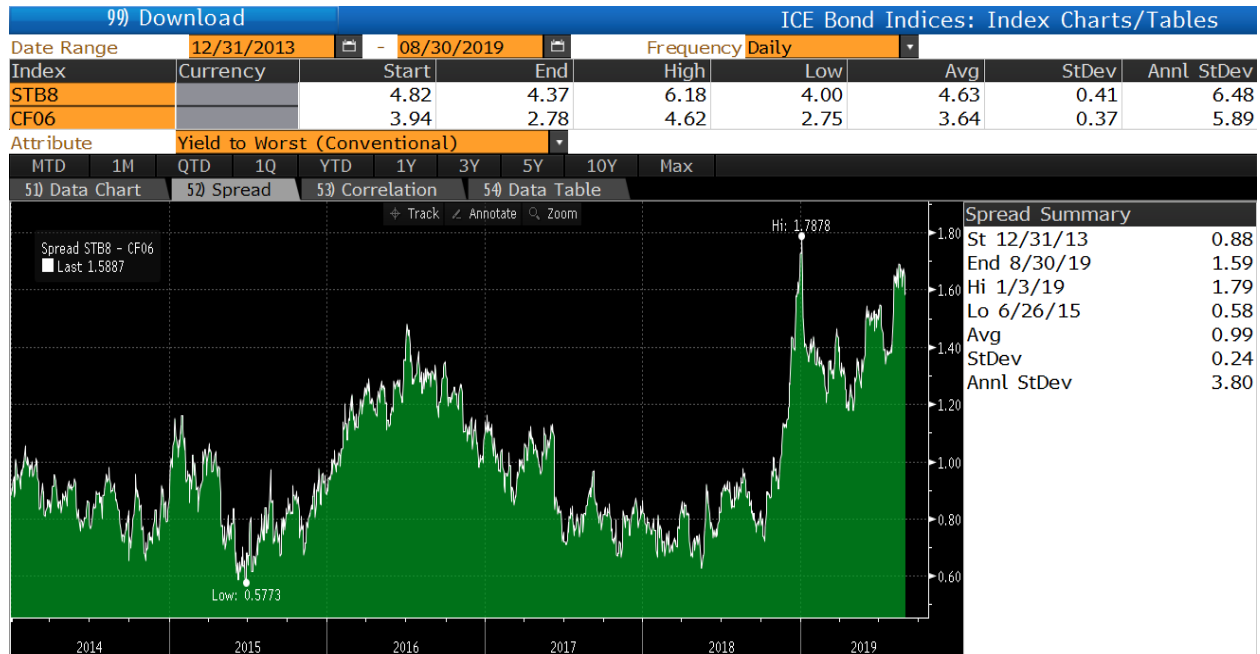


Source: Bloomberg

noCos (STB8)

ICE BofAML 5-10 Year US Financial Index (CF06)

Yields on NoCos have declined (like just about everything else too) and are now average for the cycle while 5-10yr US financials have dropped to new lows, which is remarkable given that in 2015 the federal funds rate was zero, yet senior yields then were higher. Indeed, the yield environment in senior fixed income sleeves is becoming so compressed (repressed) that more and more pundits are suggesting that the US could be impelled into negative rates. The graph below shows relative spreads in NoCo's compared to senior financials, which are just about as wide as they have been since the taper tantrum.



Source: Bloomberg

noCos (STB8)

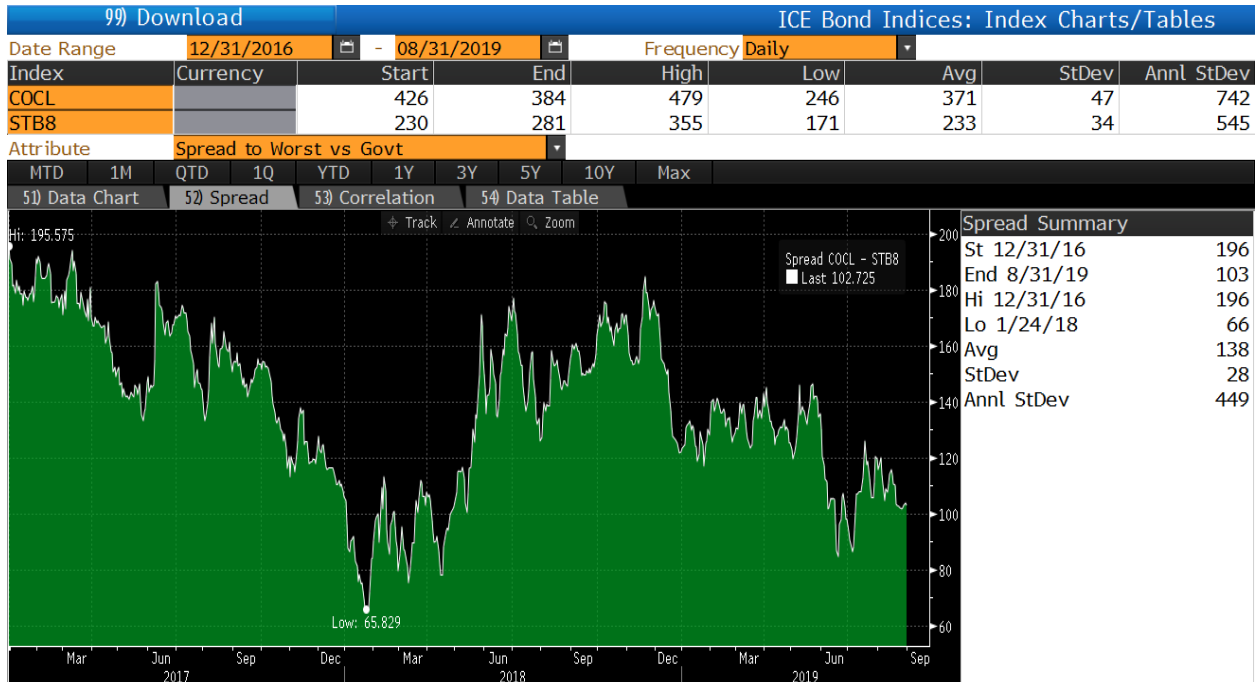
ICE BofAML 5-10 Year US Financial Index (CF06)

In other words, the statistics suggest allowance for 2.5 standard deviations of spread tightening for NoCos (i.e., 60bps) relative to senior financials before the relative value of NoCo paper to senior paper becomes average. In an investment environment plagued by yield scarcity and fears of ever more scarcity, the NoCo sector is cheap and can augment absolute and relative portfolio yields – this spread trade has improved further this month.

### Contingent Capital Securities Sector

The CoCo sector declined 10 cents this month against the backdrop of exhaustingly weak European bank equity shares that made new lows winding the clock back to valuations

equivalent to those during The Crash of 1987 (which I am old enough to remember). The graph below shows the spreads in CoCos (i.e., cocl) relative to the spreads in NoCos (i.e., stb8) since 2016 – note that we do not include prior history because CoCos were improved in 2016 after the Pillar-2 capital stack was redefined, thus reducing payment trigger risk for CoCos:



Source: Bloomberg

noCos (STB8)

ICE BofAML Large Cap Contingent Capital Index (COCL)

The spread differential between CoCos and NoCos tightened 16bps this month, which brings the differential 1.25 standard deviations lower than the average differential of 138bps since 2016. The overarching yield grab has helped CoCo performance improve despite dismal equity performance. European growth continues to be sluggish and we expect that the Fed’s recent

rate reduction to help compel the Governing Council to favor Eurozone rate cuts too. We also expect the ECB to provide forward guidance that it will renew quantitative easing with more corporate bond purchases soon. This means that Christine Lagarde should take the driver's seat of the ECB with her foot on the gas.

**Outlook:**

Now that the "insurance cut" is on the books and Jackson Hole has passed, we look forward to the Fed's next meeting, its ensuing actions and any forward guidance that may be included. We expect another 25bp cut in the target funds rate in September and guidance for more before year end. We also expect that the Fed offer some guidance about further use of balance sheet tools continue the current expansion sustain needed inflation. The Fed may start buying US Treasury bills soon by selling notes (and bonds) to twist the yield curve steeper; and perhaps even implement net new purchases if the trade wars elevate and risks to the global outlook become too unbalanced. Unfortunately, the Fed has become politicized to where it is driven to outwardly argue its actions as proof of its independence. That notwithstanding, the Fed does indeed have barriers available to prevent negative interest rates in US markets. We bring this up not because we believe that negative US interest rates are probable (they are not), but because talking heads profess that there are no barriers to prevent negative rates from happening. This is not true because there are tools in place to build more than adequate protections – and perhaps innovations (or new laws) that can further enhance them. To do this, there needs to be fiscal partnership (preferably, without taxation) and perhaps even further enabling legislation because just printing more debt (and currency to pay for it) has always brought with it the eventual desires to reverse the actions with quantitative tightening -- and this balance sheet reduction that did not go well the past year. So, "something has to give" such as a new Treasury product targeted to meet the national inflation objectives – unfortunately, like with TARP, politics will likely allow things are likely to get worse before they can get better. The irony is that getting worse (again) is the side effect of making things better

since the Sub-Prime Crisis, which in part, is why yields are vastly low and negative around the developed world and manifesting deflation risk as the “greatest challenge of our time”.

Deflation is not our base case outlook (see below), but low rates and a likely digression to more deflation fear is our evolved base case – this is precisely why the Fed is firmly committed “to continuing the length of the current expansion”. Oddly, politicians and investors appear sanguine about negative rates and have sought to justify why negative rates are OK when they are not OK but debilitating and indicative of a future emergency. Unfortunately, politics are expedient and dismissive of hidden infections until throbbing ultimately starts and then becomes too painful to tolerate – only then do emergency measures happen and the politicians that allowed problem(or created the problem) in the first place then get their names forever memorialized on the new legislation crafted to fix the problems – like The Dodd Frank Act.

In the US, emergency measures do require congressional action and it is plausible that helicopter money becomes the subject of expanded US policy. Helicopter money is free money, after all, and its distribution could be as “simple” as a Federal Reserve balance sheet swap with the US Treasury by a new act of Congress – “The US Helicopter Money Funding Act”. Here, we postulate that the Fed could exchange UST bills from its balance sheet (if owned) for trillions of newly minted US perpetual treasury bonds created by Treasury and issued exclusively with the Fed (for the Fed) under the new helicopter money program. These US Treasury “perpetual helicopter bonds” would never have to be repaid by Treasury and would provide an accounting placeholder for the Fed’s balance sheet to stay whole with an asset on exchange for the T-bills – this keeps the Federal Reserve Demand Notes (i.e., liabilities of the Fed), or the actual currency that was originally created to buy the US T-bills, outstanding and effectively “helicoptered” in circulation. This currency, which used to be bonded with T-Bills (that had to be repaid), would become oxidized and bonded with nothing (that needs to be repaid) effectively becoming a free radical looking for covalent bonds with real assets – thus creating demand pull inflation on goods and services. The US Treasury would just keep on

borrowing and perhaps some of the new debt would be bought with the oxidized currency or new currency could be created – business as usual. Helicopter money is in the spirit of Modern Monetary Theory. It has a cost, but the “full faith and credit” of the US government and its capitalist financial system prevails as interest rates normalize to positive numbers. Therefore, it is true that the US would never need to default on its debt – it would simply print more of its own currency to reprice its debt and use perpetual helicopter bonds to germ up needed inflation. Treasury Secretary Munchin’s thinks 50-100yr bonds could work, but helicopter money would work better because it is permanent (and the price can be controlled by the Fed). Additionally, the yield curve as we know it would not change and a new Operation Twist could get the process started with existing balance sheet assets. Afterall, the Fed would need to start buying all those T-bills today so it can swap them out tomorrow. So, do keep this helicopter money scenario in the back of your minds as we hear more (and more) about increased policy flexibilities and unlimited new tools. In the meantime, there is probably going to be a continued grind toward zero rates in the US (with corrections along the way) as being symptomatic of the broader global stress from ineffective tools already in place. Consequently, we are asking syndicates for coupon floors on fixed-to-floating deals (equivalent to the IPO spread) to protect our clients from negative interest rates, but our requests are being dismissed. If US rates do go negative, an eventual “US Helicopter Money Funding Act” is plausible and could keep liquidity flowing and capitalism growing – both helping to make “US dollar funding great again!”

Phil Jacoby  
CIO, Spectrum Asset Management  
September 9, 2019

  
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