

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

### **September 2019 Updates**

The bond market corrected swiftly to start the month only to steadily retrace much of its decline during the Fed meeting week which delivered another well anticipated 25bps rate cut. The 30yr US Treasury bond closed the month yielding 2.12% (15bps higher; and 89bps 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 1.68% (17bps higher; and 59bps lower since the end of 2015). The yield differential between these two longer US Treasury terms closed at 44bps (11bps steeper on the year). Contrary to bond prices, the equity market was aided by supportive economic data for most of the month as the S&P 500 closed up 1.7% in September at 2977. Indeed, Fed Chairman Jerome Powell reiterated that the US economy "is in a good place" and despite a backdrop of escalating trade wars, stocks continued to be remarkably resilient as the Fed praised strength in labor markets and the household sector as primary reasons for the economy's solid performance.

The Fed meeting this month was certainly a highlight, though the outcome or rate cut was rather well anticipated. This was the second cut in the target funds rate this year and was explained as more insurance and a further "modest adjustment" with parallels drawn to the successful adjustments in 1995 and 1998 that led to sustained expansions. Additionally, Fed Chairman Powell assured markets that "if the economy does turn down, then a more extensive sequence of rate cuts could be appropriate." The 25bp cut in the target funds range (1 ¾%-2%) and a marginally deeper (30bp) cut in the interest on excess reserves (IOER @ 1.80%) was viewed as a "step to help keep the US economy strong in the face of notable developments".

The Fed began paying interest on excess reserves 11 years ago as a policy response to manage the massive increase in excess reserves that would stem from quantitative easing (QE). As the Fed expanded its balance sheet through 3 series of QE, excess reserves mushroomed from just \$20 billion in 2008 to approximately \$2.7 trillion by 2014 – since then, balance sheet reductions have cut excess reserves to about \$1.4 trillion. But if reserves are still in “excess”, then why has there been pressure in funding markets that forced the Fed to do a series of repo operations to inject reserves into the system (much like the “old days”). The answer is that excess reserves do not have the same “simple” systemic meaning as they used to have now that liquidity rules are calling on banks to hoard their cash reserves to meet multiple stress-test requirements.

Central bank balance sheets around the globe are increasingly inter-connected with FX-funding differentials that make positive domestic yield curve slopes a virtual necessity for sovereign funding by global investors such as pensions and insurance companies. Cross-currency funded yield curve slopes can create a complicated technical to funding, hedging and distribution efficiency that is likely to require adjustments to prospective central bank policy tools. For example, the last time the US Treasury 10yr yield was this low (2016) the 1yr forward FX hedge from US dollars to euros cost about 1% -- this meant that a Eurozone insurance company could buy a 10yr US Treasury note at 1.68% and earn 68bps after the 1yr forward currency risk was hedged. Today, this currency hedge costs about 2.1%, so the same US Treasury investment would lose 42bps over the next year, net of the hedge – this is still less bad than the -57bp “de-yield” (i.e., negative yield) on the German 10yr bund, but is still a guaranteed book loss, all else being equal (which, of course, it never is). So, for the European investor in this example either short-term “risk-free” rates in the US are too high or the US Treasury 10yr yield is too low – or some combination of both. Either way, the US term structure needs to steepen in order to attract carry-sensitive euro hedged investors or the bund curve needs to shift up – until this happens, the US treasury market will have limited global demand and dealer balance sheets will become burdened to take down and clear over \$13 trillion of treasury paper over the next four

years with little (if any) help from non-US investors. The dealer community having to bid, borrow and carry significantly more US treasury inventory puts a giant bid into short-term funding markets where cash liquidity is becoming scarce due to term structure side effects created by central banks.

In 2016 for example, excess reserves were \$2.4 trillion and FX-funding spreads were positive (US domestic funding spreads were positive too) – today, excess reserves are effectively zero (or the Fed would not have had to do repos) and FX-funding spreads of 10yr US treasuries are negative (US domestic funding spreads are negative too. The Fed has raised policy rates too high and was forced to admit it by intervening in the repo markets this month for the first time since 2008. Given that the Fed “has no intention to invert the yield curve”, something must change along the slope. This is an important reason why the Fed is cutting rates which helps to rebalance the FX-swap funding markets with some relief from the pressures of global negative rate policies which challenge the Fed. In effect, Europe and Japan are weighing on Governor Powell’s more traditional game plan and “contesting” the Fed’s sovereignty – as if President Trump’s tweets weren’t enough pressure on its independence (we don’t necessarily condone President Trump’s tweet bullying, but the president’s desire to lower rates makes systemic sense at the moment). The Fed’s secondary move would be a yield curve twist through the mass of its balance sheet by selling UST10yrs (and bonds) to buy freshly issued UST-bills from Treasury. Indeed, if the Fed wants to improve UST auctions for the trillions upon trillions of prospective deficit spending needs, it will be forced to fix the negative FX-funding carry (i.e., impel a positive slope to the US yield curve) so dealers can put the bonds away around the globe and not be forced to squeeze reserves that are hoarded as the cheapest way to meet demanding regulatory requirements. Credit spread in the process should tighten as this trend to lower front-end rates for longer presses onward with renewed corporate bond buying coming from the European Central Bank, in particular (which is another flashback to 2016).

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 0.32% to close yielding 5.82% (5bps lower).
- Financial credit (measured by ICE Bank of America Merrill Lynch's **cf06** index) declined 0.55% to close yielding 2.90% (11bps higher).
- The BBB rated 5-10yr corporate sector (measured by ICE Bank of America Merrill Lynch's **c6a4** index) declined 0.33% to close yielding 3.16% (8bps higher).

**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 \$297.7 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 \$218.1 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 \$515.8 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*) @ 43% of *i0cs***

- Comprised of IG \$25par and IG \$1,000par US AT1
  - ❖ The *p0p1* rose 0.66% this month to close yielding 2.27%
  - ❖ The rebalancing this month cut headcount by 4; and reduced face value by \$0.1 billion

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

- Comprised of dated IG \$1,000par hybrids (no US AT1)
  - ❖ The *c0cs* rose 0.42% this month to close yielding 3.99%
  - ❖ The rebalancing cut headcount by 1; and reduced face value by \$1.2 billion.

**3. 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 0.92% this month to close yielding 5.16%
  - ❖ The rebalancing had no impact on headcount or face value.

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

- Comprised of BIG \$1,000par US AT1 and BIG \$25par
  - ❖ The *p0hy* rose 0.89% this month to close yielding 3.39%
  - ❖ The rebalancing increased headcount by 4; face value grew by \$3.5 billion

Overall, the BofAML All US Capital Securities Index (*i0cs*) rose 0.66% in September to close yielding 3.17%, which was 17bps lower than last month's closing yield and a spread of +154bps over comparable US Treasury securities (26bps tighter). The yield impact from the rebalancing increased the yield-to-worst by 9bps to 3.26%.

**Contingent Capital Securities**

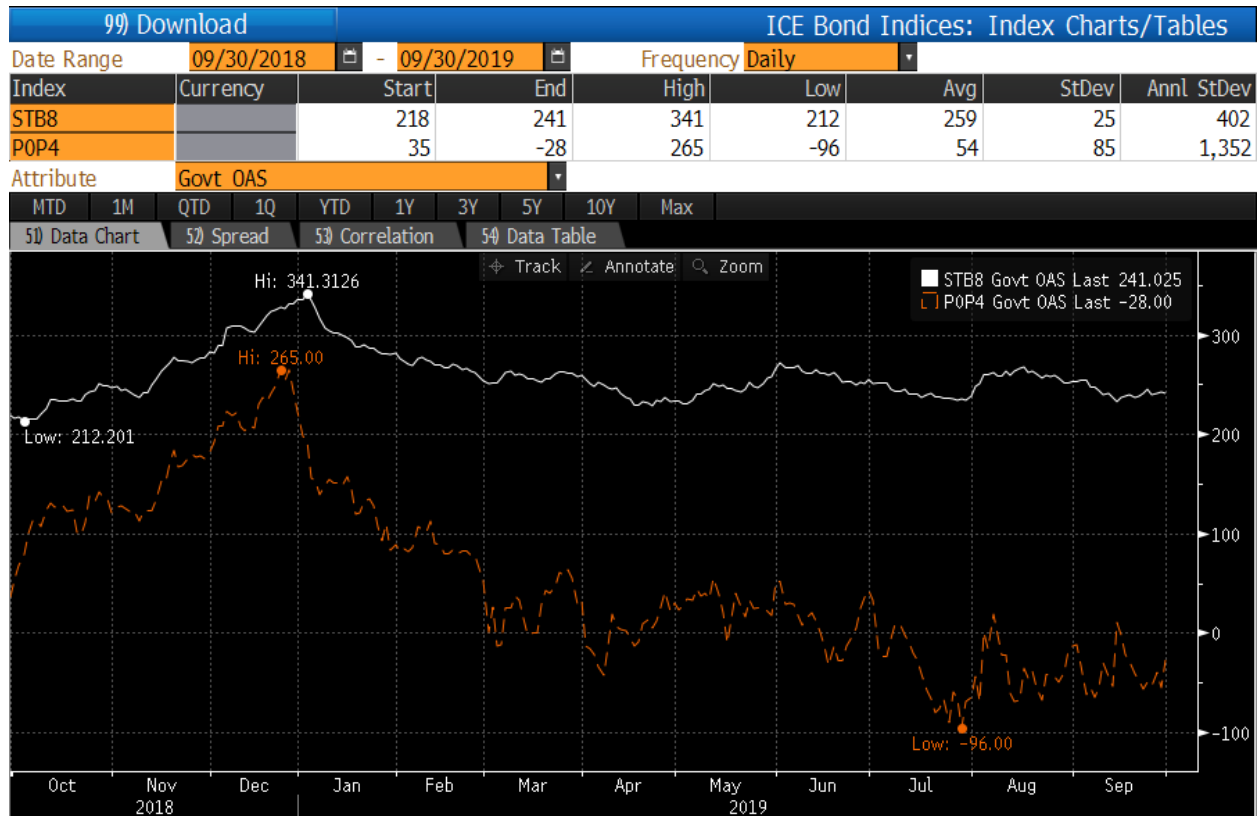
The ICE BofAML Large Cap Contingent Capital Index (*cocl*) rose 1.23% to close yielding 4.53%, which was 15bps lower than last month. The rebalancing this month added 8 issues to the head count and face value grew by \$7.3 billion. The impact from the rebalancing increased the

yield-to-worst by 6bps to 4.59%. 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 21 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.

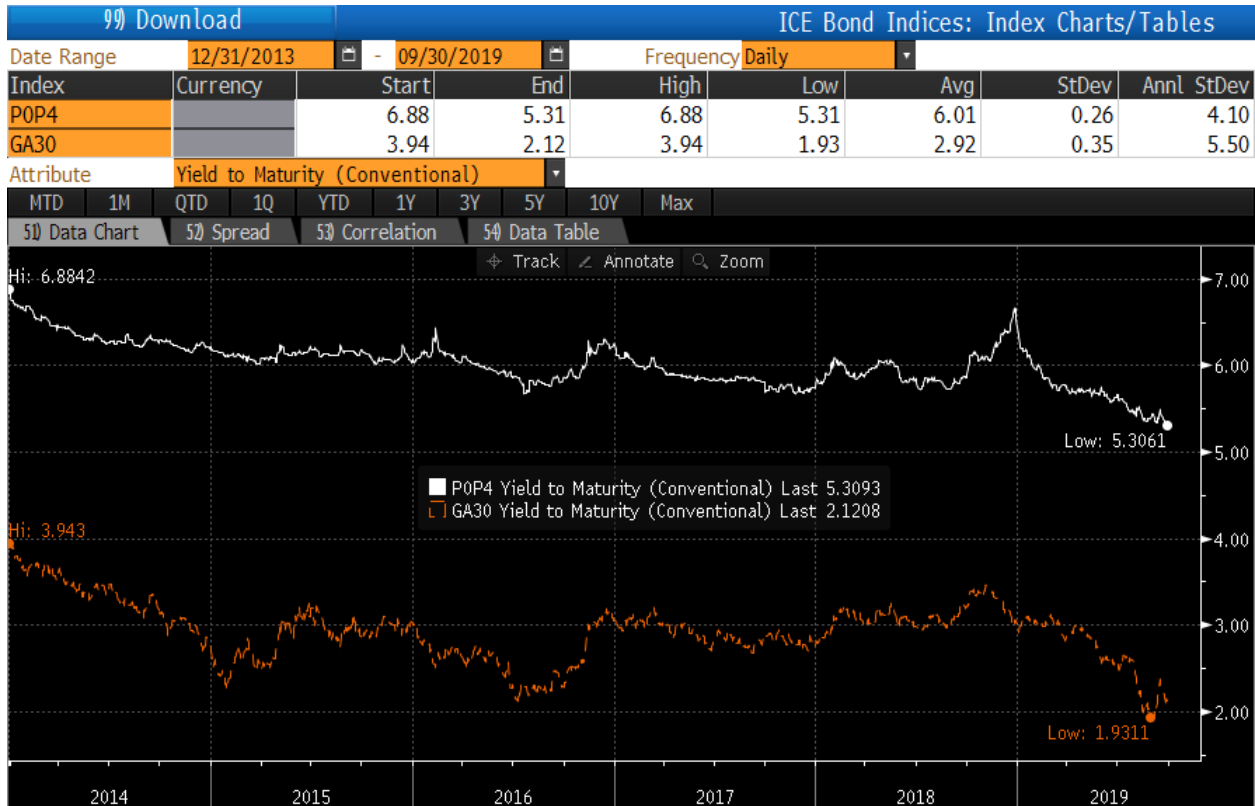


Source: Bloomberg

Option adjusted spreads in the overall retail sector whipped in a 75bps range in September closing 10bps more negative at -28bps to treasuries as the negative convexity and 5pt premium to the sector continues to weigh on its relative value. Even though September was a strong issuance month with 9 IPOs in \$25par, the benchmark still lost 3 net issues from its head count – this illustrates the call risk (we speak of) which we are constantly seeking to mitigate in our retail sleeves. The passive preferred securities ETFs experienced inflows this month, but the pace slowed. Last month we noted that Invesco PowerShares (PGX) could break out to record highs in October and IShares (PFF) could break out to record highs in December – it appears that PowerShares (PGX) is on track to do that.



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; and that 21% 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 next year. This jump condition call risk to income is exacerbated by the benchmark's callability increasing by another 12% over the next year – in other words, 33% of the p0p4 benchmark is callable within 1yr. There still appears to be a lot of faith priced into a belief that companies will delay 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 5.0%, it appears that corporate treasurers will act sooner than later rather than wait on redemptions – we certainly saw them move on refunding activities this month. 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 20bps annualized income haircut as we wait for a third rate cut from the Fed. A yield curve twist move by the Fed would likely cause a correction in the retail sector given the combination of high prices and negative spreads.

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

The \$1,000 par institutional sector of the preferred securities market rose \$0.13 this month. We continue to 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

Yields on NoCos continued to fade lower, but not as much as the drop in senior paper. Yields on institutional preferred securities, though average for the cycle, are well above average based on relative value compared to 5-10yr US financials. The yield environment corrected a bit last month in the senior sector, but we expect the grind to lower and lower yields to continue, which should bode well for additional spread performance in NoCos given our constructive credit views for global financials. Issuance was robust this month in both the long dated junior subordinated debt sleeve and the preferred stock sleeve of NoCos – TransCanada, Duke Energy and Citigroup were three notable issuers. The graph below shows relative spreads in NoCos compared to senior financials, which tightened in a bit this month due to the correction in seniors and the rally in junior subordination. Nonetheless, relative value spreads for NoCos still outpace the peaks of 2016, which marked the nominal highs in absolute US treasury spreads for both sectors this cycle.



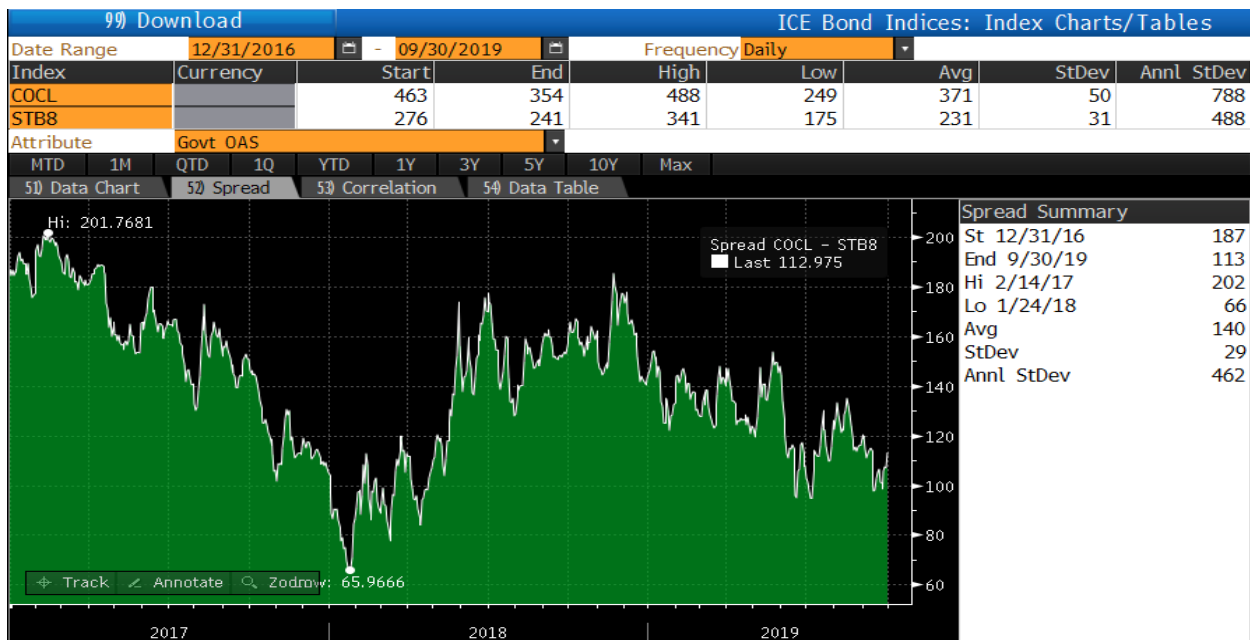
Source: Bloomberg

In other words, the statistics suggest allowance for 2.2 standard deviations of spread tightening for NoCos (i.e., 66bps) 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 in the path of more ECB buying more corporates, the NoCo sector is cheap and can augment both yield and spread while leaving potential for capital appreciation in a bull tightener.

### Contingent Capital Securities Sector

The CoCo sector rallied 75 cents this month against the backdrop of supportive policy news coming from the European Central Bank – primarily rate tiering and resumed bond buying. 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

The spread differential between CoCos and NoCos widened by 10bps this month in favor of CoCos, which brings the differential 0.93 standard deviations below than the average

differential of 140bps since 2016. European growth continues to be sluggish. Chairman Draghi (whose term is up this month) said that *“it is high time for the fiscal policy to take charge”*. The ECB (through Chairman Draghi’s comments) appears somewhat frustrated that fiscal and structural reforms are inadequate; and that the ECB has done just about all it can at this point. In fact, the ECB appears to want interest rates to go up, but it’s concerned that they cannot at this point. According to Chairman Draghi, *“monetary policy will continue to do its job...if fiscal and structural policies also play a role in parallel – and more so than we see today...the side effects of monetary policy will be less and the return to higher rates of interest will be faster.”* Comments like this helped to lift European bank stocks a bit in September (helping to support CoCo performance) as a slog to higher rates would likely help expectations for better bank earnings – especially if inflation expectations would normalize a shift up in the euro curve in the process.

**Outlook:**

We expect the Fed to offer guidance at its next meeting (October 30<sup>th</sup>) about further use of balance sheet tools in order to continue the length of current expansion and sustain needed inflation. The Fed should start buying US Treasury bills (before yearend) and characterize it as a “permanent repo facility” rather than quantitative easing even though the balance sheet would expand in the process. Additionally, the Fed could sell notes (and bonds) to twist the yield curve steeper by using the sale proceeds to buy T-bills with no net change to the balance sheet. The FX-funded yield curve for US treasuries should steepen, in our opinion, through a process of messaging the plan and then implementing the plan with “policy tools”. There is also opportunity for an unofficial “fiscal partnership” that guides more US treasury issuance to an increasingly cheaper front end as the Fed pushes its inventory of longer bonds to the secondary market in a twist. This too could create a “barbell issuance” opportunity for Treasury Secretary Munchin to get a meaningful new sleeve of ultra- long-term bonds done while the Fed’s “twisting” with shorter maturities (than ultra-longs) and rates are still low. Whatever the

scenario, the core backdrop is that financial physics are weighing on the Fed and it's likely to shift its policy soon – the implication of evolving policy would be to lower US rates more on the front and marginally push US rates higher on the back end; while negative rates in Europe and Japan force overall global interest rates to remain low for longer, yet. Generally, this should bode well for junior subordination in financials because economic volatility would be suppressed, growth would be supported, financial industry leverage is low and operating risk profiles are improved. The ECB crowding out private investors from non-financials again would make financials (especially junior subordinated financials given their wider spreads) increasingly desirable as the Fed seeks (or is forced by markets) to make “US dollar funding great again”.

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