Junior-Subordinated Capital Securities Markets

October 2019 Updates

The bond market continued its rally on the heels of last month's rate cut and some weaker economic data, but then retreated as global risks appeared to be shifting to the upside. The Fed again delivered on its 3rd insurance cut and then signaled that it is likely done cutting more unless inflation declines. The 30yr US Treasury bond closed the month yielding 2.18% (6bps higher; and 83bps 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 1.69% (1bp higher; and 58bps lower since the end of 2015). The yield differential between these two longer US Treasury terms closed at 49bps (16bps steeper on the year). Contrary to bond prices, the S&P 500 closed 2.04% higher in October (at 3038; a new monthly high) and was aided by a supportive earnings season, Fed action and constructive trade signals. Fed Chairman Jerome Powell emphasized that the odds of more rate hikes are slim by stating, "we would need to see a really significant move up in inflation that's persistent before we even consider raising rates."

The bond markets are beginning to recalibrate their perceptions on interest rates within the context of the central bank's slipping desires and abilities to keep rates low – in particular, real interest rates on the longer end of the US and European yield curves. Last month, we wrote about the technical challenges that the dealer community faces in funding markets. This month we are beginning to see sovereign markets re-price yields marginally higher on the longer end even as the Fed and the ECB stand committed to keep short-term rates "low for longer" (noting that "longer" is not forever). Central banks can control the front end of the yield curve with policy rate moves, but they have limited power to control the back end of the yield curve without (skillfully) using the infinite force of currency creation on its balance sheet. The Fed insists that the new long-term UST-bill purchase program (and renewed balance sheet growth) is not quantitative easing (QE) because it "would not take duration out of the market" – this duration litmus to define QE is not only arbitrary, but also dysfunctional because buying long bonds (to boost liquidity, a first order effect) does not take duration "out" of the market, but instead, it injects duration into the market. This is because duration *increases* when interest rates *decline.* Indeed, declining (and negative) rates have been the standardized (manipulated) second order effect of QE experiments. A third order effect has been the rising yields that follow once the buying stops (or is anticipated to stop) because a QE success means a bit more inflation; after all, growth engendered inflation is the goal of QE. Indeed, quantitative easing has become so normalized in the post Lehman era that it has become part of the bond market's genetic code.

But genes do not define destiny – as much as a genetic determinist would like you to think so. The fact is that signals from the environment determine how genes get expressed (this is the science of epigenetics). Up until now, the inability of central banks to create a sustained inflationary environment has caused the bond market's DNA to express lower yields (and even negative yields). But, the systemic environment "above the genes" is changing and so too will the bond market's gene expression. Therefore, QE is simply not a DNA blueprint for rates to go determinatively lower or negative because when the environment changes so too will its gene expression – we will discuss these changes in our 2019 Outlook.

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 0.23% to close yielding 5.80% (8bps lower).

- Global bank credit (measured by ICE Bank of America Merrill Lynch's ***e0ba*** index) rose 0.71% to close yielding 2.59% (13bps lower).
- The BBB rated 5-10yr corporate sector (measured by ICE Bank of America Merrill Lynch's ***c6a4*** index) rose 0.92% to close yielding 3.06% (12bps 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 $299.2 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 $221.9 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 $521.1 billion universe of fixed-rate junior-subordinated capital securities with preferred securities (measured by ***iocs***) being a 57% subset and contingent capital securities (measured by ***cocl)*** being 43% 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 *p0p1* rose 0.73% this month to close yielding 2.22%
     - ❖ The rebalancing this month increased headcount by 1; and boosted face value by $1 billion

2. **ICE BofAML US Capital Securities Index (*c0cs*) @ 26% of *i0cs***
   - Comprised of dated IG $1,000par hybrids (no US AT1)
     - ❖ The *c0cs* rose 1.35% this month to close yielding 3.83%
     - ❖ The rebalancing cut headcount by 1; and reduced face value by $1billion.
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 1.40 % this month to close yielding 5.00%
     - ❖ The rebalancing increased headcount by 1; and face value by $750 million.
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 0.99% this month to close yielding 3.09%
     - ❖ The rebalancing increased headcount by 2; and face value by $795 million

Overall, the BofAML All US Capital Securities Index (***i0cs***) rose 1.00% in October to close yielding 3.03%, which was 24bps lower than last month's closing yield and a spread of +146bps over comparable US Treasury securities (16bps tighter). The yield impact from the rebalancing increased the yield-to-worst by 2bps to 3.05%.

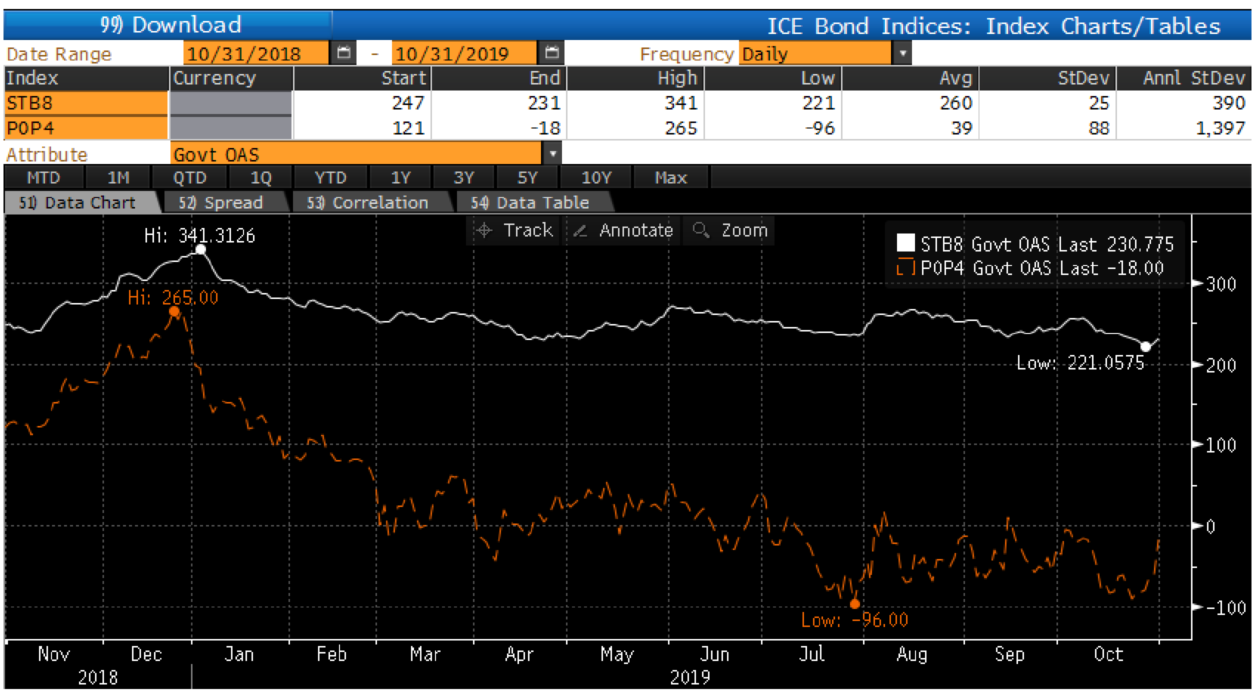
Contingent Capital Securities

The ICE BofAML Large Cap Contingent Capital Index (***cocl***) rose 1.52% to close yielding 4.35%, which was 24bps lower than last month. The rebalancing this month added 1 issue to the head count and face value grew by $1.5 billion. The impact from the rebalancing increased the yield-to-worst by 2bps to 4.37%. 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

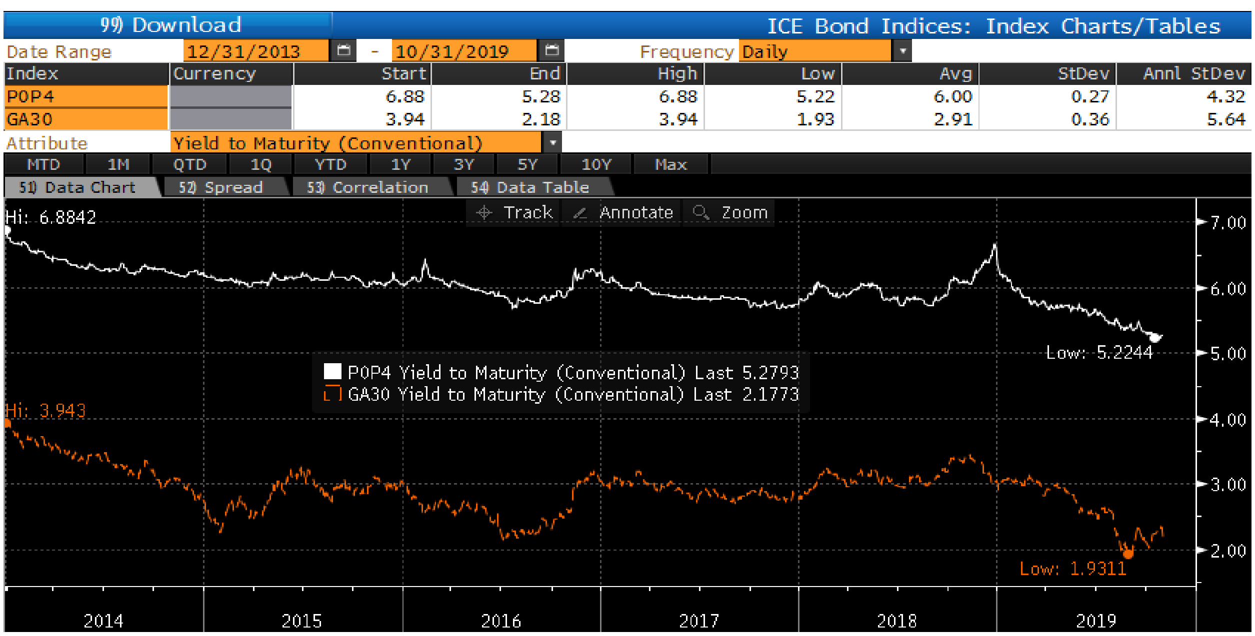
The retail preferred securities sector rose 13 cents this month. The graph below shows spread in the $25par market (i.e., p0p4) over the past year compared to the spread in the $1,000 par institutional preferred securities market (stb8), which as a group we'll refer to as "NoCos" to distinguish $1,000 preferred securities from $1,000par contingent capital securities risks.



Source: Bloomberg

Option adjusted spreads in the overall retail sector oscillated (like they have since June) in 100bp range again this month – the low end of the range was -96bps (more negative) and the upper end of the range was -6bps (less negative), which was the sector's closing spread. The continued low rates environment offered more opportunities for issuers to fund cheaply. The headcount of the retail benchmark grew this month and was highlighted by Aegon, Northern Trust and JPMorgan fixed-for-life preferred securities. 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, which it has done. We also said that iShares (PFF) could break out to record highs in December – it appears that iShares should recoup all of its share count lost in 2018's blow-off, but it will probably end up about 4% shy of its record share count set in 2017 – perhaps if the fund takes a timeout from its structural rebalancing (aimed at being completed this month), it can make new highs.

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:

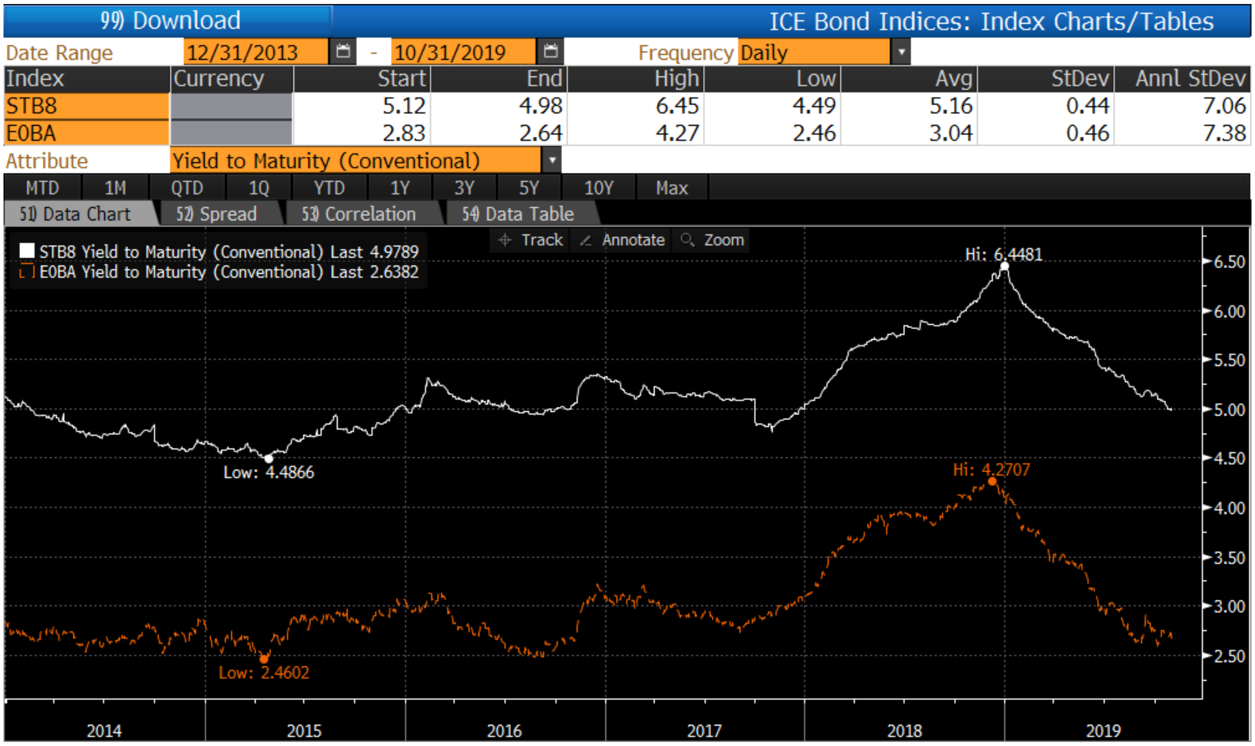


Source: Bloomberg

Given yields are at all-time lows in the retail sector; and that 16% 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 13% over the next year – in other words, 29% 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 1yr callable bucket is 6.07% and the average refunding rate is 4.90%, it appears that corporate treasurers will act quickly over the course of this quarter. 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 a 20bp annualized income haircut if the call waves crashes on shore. The Fed has indicated that it is done cutting rates for a while unless some unexpected risks arise to threaten the current expansion. This lowers the odds of a better refunding window becoming available this year and increases the odds of an active 4th quarter calendar in the retail market. If longer rates drift higher, this could also increase the risk of "pocket sales" in the retail market in order to realize tax losses on the more current (i.e., lower) coupon pocket in $25pars come December.

$1,000par Institutional Preferred Securities Sector

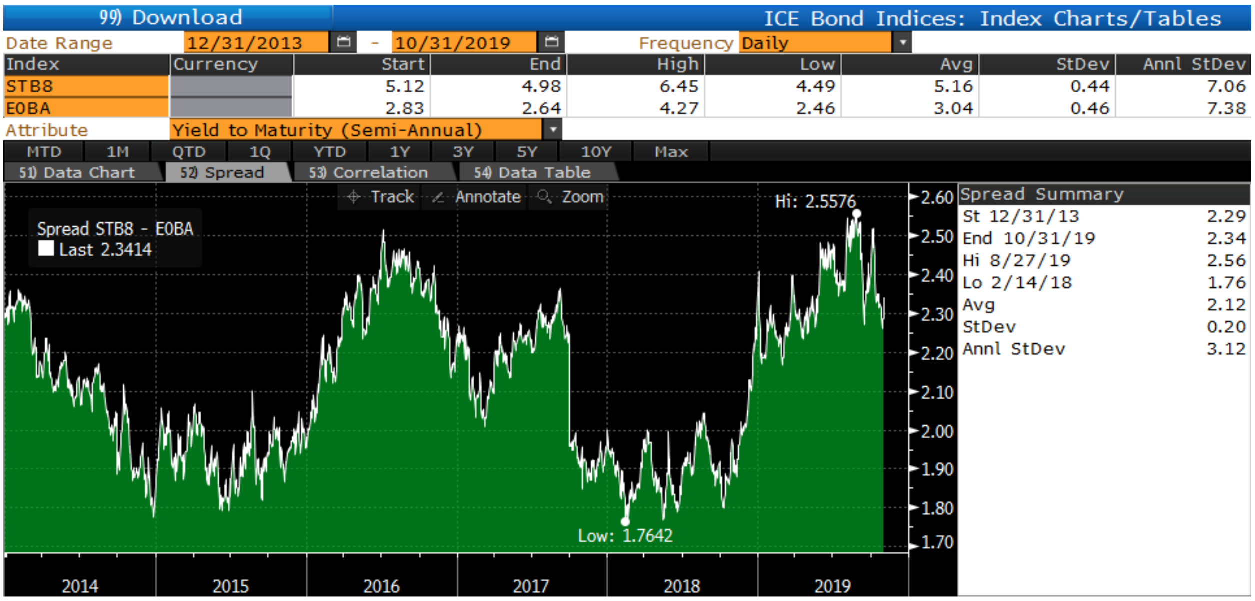
The $1,000 par institutional sector of the preferred securities market rose $1.09 this month. We continue to highlight this NoCo sector for relative value within preferred securities as there is less in-the-money call option resistance for the institutional sector and 249bps of additional spread compared to retail preferred securities. NoCo paper compared to more senior global bank paper also stands out. The chart below shows the yield-to-worst of NoCos (i.e., stb8) vs. Eurodollar Banking Index (i.e., e0ba) since 2013:



Source: Bloomberg

Yields on NoCos continued to fade lower, with yields on senior paper going lower too, but quite as NoCos as institutional preferred securities have tightened more. Yields on institutional preferred securities are 0.41 standard deviations below average for the period compared to more senior global bank paper that is 0.87 standard deviation below average. Issuance was thin for NoCos in October with just 1 deal coming to market worth considering, AERCap Holdings 5.875% junior sub debt due in 2079. A slowing IPO market for $1,000par NoCos due to limited refunding technical should aid the grind to lower yields, primarily from spread compression.

The additional spread available in NoCos sets the sector up well on relative value and compliments our constructive credit view for global financials. The graph below shows relative spreads in NoCos compared to more senior euro-dollar bank credit, which tightened by 6bps this month due to the marginally stronger rally for NoCos this month. Relative value spreads for NoCos are still above average and are roughly equivalent to the yield differentials available in 2014 & 2017.

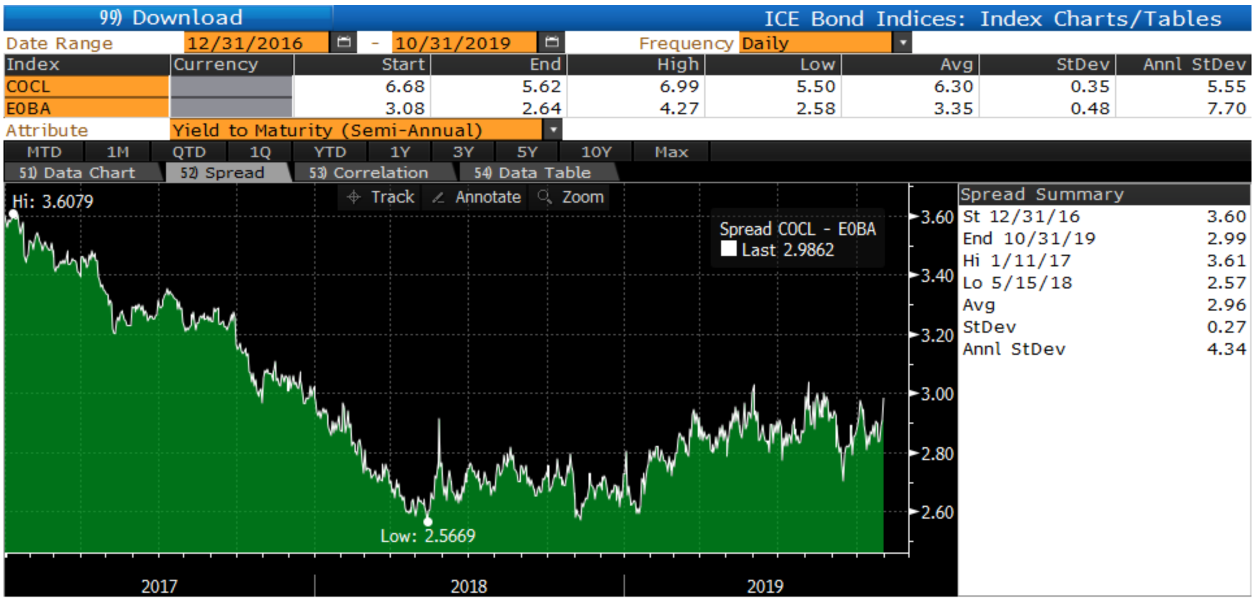


Source: Bloomberg

In other words, the statistics suggest allowance for 1.1 standard deviations of spread tightening for NoCos (i.e., 22bps) relative to more senior financials before the relative value benefit of NoCo 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 or modest bull/bear tightener.

<u>Contingent Capital Securities Sector</u>

The CoCo sector rallied $1.06 this month against the backdrop of a changing of the guard as the European Central Bank and better equity prices for the European bank sector. The graph below shows the spreads in CoCos (i.e., cocl) relative to the spreads in euro-dollar bank credit that is not CoCo (i.e., e0ba) 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 risks for CoCos:



Source: Bloomberg

The spread differential between CoCos and more senior euro-dollar bank credit widened 12bps this month, which brings the differential 0.1 standard deviations above the average differential of 296bps since 2016. European growth continues to be sluggish. There is a growing awareness that monetary policy benefits to the economy have reached their limits and as outgoing Chairman Mario Draghi stated, "*it is high time for the fiscal policy to take charge*". Incoming ECB President, Cristine Lagarde is not being confronted with an immediate crisis (i.e., the sovereign debt crisis) like Mario Draghi was but she does face an immediate challenge – that is, staying accommodative enough to sustain some inflation confidence while fostering a consensus for a coordinated era of fiscal expansion. Otherwise, the ECB may run out of bonds to buy -- but then, there can be more tools (i.e., new rules to address new problems) that can effectively forgive the ECB's assets back to its sovereigns (e.g., 100yr maturity extensions) along the same lines as the capital commitment rules that were followed to buy the bonds. Afterall, central banks don't necessarily need capital because they can create it with currency, "confidence" and inflation.

Outlook:

There is little doubt that any central bank can create inflation if it truly desires. The questions would be: 1) how much disruption would it cause in the process? and 2) would inflation be the cause or the effect of the disruption? We certainly cannot tell whether any central bank would be forced to helicopter money at this point as we are far from this problem, but bond markets will certainly anticipate this if the plausible were to become probable. In the meantime, the core backdrop is that financial physics are weighing on the Fed and it decided to re-engage QE by purchasing US Treasury bills – the implication of this should lower US rates on the front end and marginally push rates higher on the back end of the yield curve; while negative rates in Europe and Japan force overall global interest rates to remain low for longer, but not necessarily negative forever. Generally, this should bode well for junior subordination in financials because economic volatility should be suppressed by liquidity surpluses and growth should be supported by consumers enjoying full employment. The ECB crowding out private investors from non-financials again should make the higher yields of junior subordinated financials increasingly desirable as they were in 2017.

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November 8, 2019

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