Junior-Subordinated Capital Securities Markets

November 2019 Updates

The bond market ended largely unchanged, but volatile on the heels of the 3rd rate cut this year and equities continued to reach new highs. The 30yr US Treasury bond closed the month yielding 2.21% (3bps higher; and 80bps 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 1.79% (10bps higher; and 48bps lower since the end of 2015). The yield differential between these two longer US Treasury terms closed at 42bps (9bps steeper on the year). Contrary to bond prices, the S&P 500 closed 3.40% higher in November (at 3141; a new monthly high) and was aided by a generally supportive tone to a preliminary trade deal and supportive economic news. Equity valuations appear fearless after the Fed has virtually guaranteed a long hiatus on rate hikes by saying that it desires a meaningful rise to inflation before moving up on rates again – of course, the flip side of this is that persistent accommodation should elevate risk assets because of the increased (global) liquidity flow.

Last month we said that the bond markets are recalibrating their perceptions on interest rates within the context of the central bank's decreasing desires and abilities to keep rates low – in particular, real interest rates on the longer end of the curve could rise if fiscal policies play larger roles than they have in the past. Basically, monetary policy has limits and negative rates are symptomatic of them, after all, QE is limited only by the supply of financial assets that can be bought and, importantly, it's not a determinative blueprint for rates to go only lower. The US is ten years into its expansion, yet the Fed was forced by markets to restart QE again (with T-Bill purchases) in large part because most of the free world is captive to $11.3 trillion of chronic negative rates. A negative rate regime is a state tax on capital and it's not life supportive. Just as any living cell set between a culture of nutrients and toxins will always migrate toward nutrients, so too will capital. Negative rates are not nutrient dense but rather, they are toxic. Negative rates decay capital formation just as toxins suck electrons from healthy cells and cause inflammation. The ECB cut rates to negative in 2014 and since then the European bank group (measured by sx7e) is down 31%, yet US banks (measured by bkx) are up 62%. We believe that policy makers are beginning to realize that this protracted "clinical trial" on the economic effects of negative rates is proving that negative rates are not only associated with weakness, but they cause weakness because they impede the profit motives to progress. So, policy makers will be forced to change; and that change will redirect the signals to the market environment toward Modern Monetary Theories of endless debt funded by endless currency (i.e., inflation). Change is most likely coming to fiscal policies – basically, selling more debt to compete with expected returns on equity and in the process, increased real current rates of return on (ever) expanding global sovereign debt formation. Japan, in fact, is a first mover on fiscal expansion with Prime Minster Shinzo Abe's recent announcement to boost government spending by roughly 26 trillion yen (or about $240 billion). We believe the ultimate move to higher rates will take years, not months. There is also the likelihood that things in Europe, for example, will need to get worse before there is collective will to make them better. Germany's adherence to its "zero black" fiscal policy is an example of how existing rules require a recession to happen before added fiscal stimulus can happen.

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 0.27% to close yielding 5.79% (9bps lower).
- Global bank credit (measured by ICE Bank of America Merrill Lynch's ***e0ba*** index) rose 0.12% to close yielding 2.62% (2bps higher).

- The BBB rated 5-10yr corporate sector (measured by ICE Bank of America Merrill Lynch's ***c6a4*** index) rose 0.04% to close yielding 3.10% (2bps 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 $303 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 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 $524 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* 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* declined 0.27% this month to close yielding 2.91%
        - The rebalancing this month increased headcount by 6; and boosted face value by $2.85 billion
2. **ICE BofAML US Capital Securities Index (*c0cs*) @ 25% of *i0cs***
    - Comprised of dated IG $1,000par hybrids (no US AT1)

- ❖ The *c0cs* rose 0.57% this month to close yielding 3.82%
- ❖ The rebalancing did not change headcount; or face value.

3. **ICE BofAML High-Yield Capital Securities Index (*h0c*s) @ 6% of *i0cs***

- o <u>Comprised of BIG $1,000par legacy Tier1 and BIG $1,000par hybrids</u>
  - ❖ The *h0cs* rose 0.31% this month to close yielding 4.96%
  - ❖ The rebalancing did not change headcount; or face value

4. ICE BofAML High Yield Fixed Rate Preferred Index (*p0hy*) @ 25% of *i0cs*

- o <u>Comprised of BIG $1,000par US AT1 and BIG $25par</u>
  - ❖ The *p0hy* declined 0.22% this month to close yielding 3.81%
  - ❖ The rebalancing increased headcount by 4; and face value by $950 million

Overall, the BofAML All US Capital Securities Index (***i0cs***) rose 0.01% in November to close yielding 3.49%, which was 44bps higher than last month's closing yield and a spread of +180bps over comparable US Treasury securities (33bps wider). The yield impact from the rebalancing increased the yield-to-worst by 5bps to 3.54%.

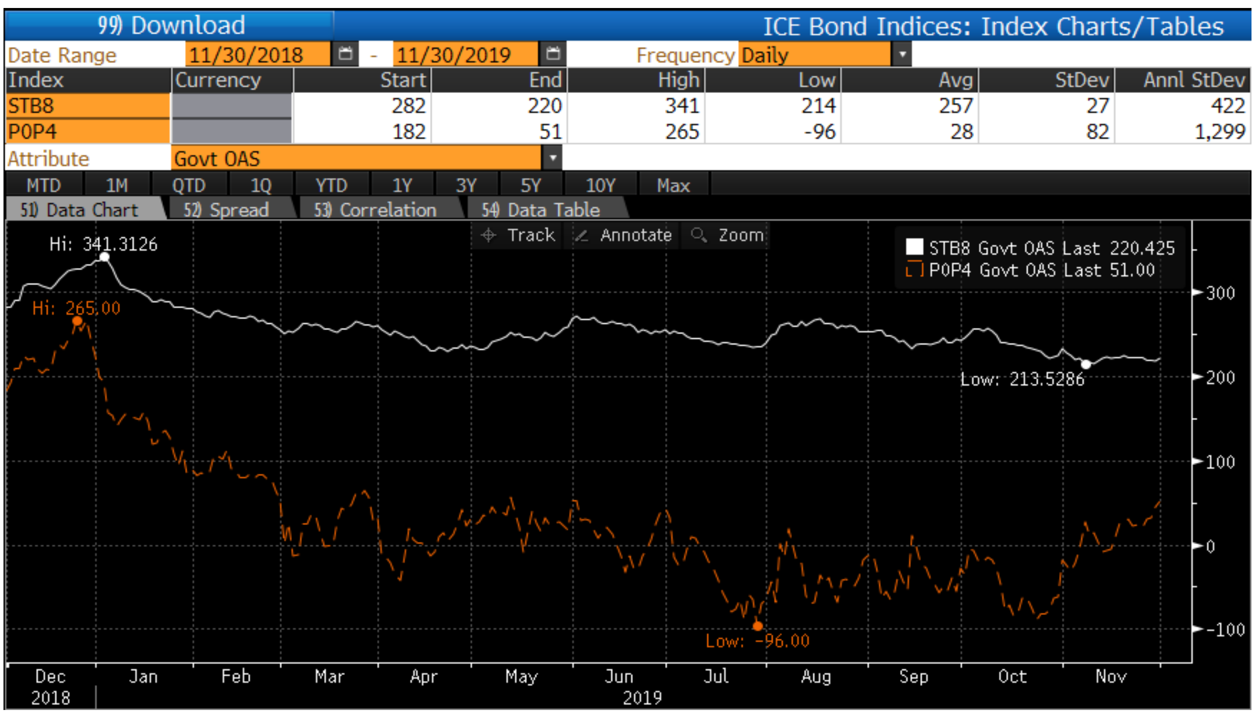
<u>Contingent Capital Securities</u>

The ICE BofAML Large Cap Contingent Capital Index (***cocl***) rose 1.18% to close yielding 4.14%, which was 24bps lower than last month. The rebalancing this month added 3 issues to head count, but face value declined by $739 million. The impact from the rebalancing lowered the yield-to-worst by 3bps to 4.11%. A **"contingent capital security"** (i.e., a "CoCo") represents a capital security issued through indenture typically within the context of a "<u>going-concern</u>" 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 declined $1.53 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.

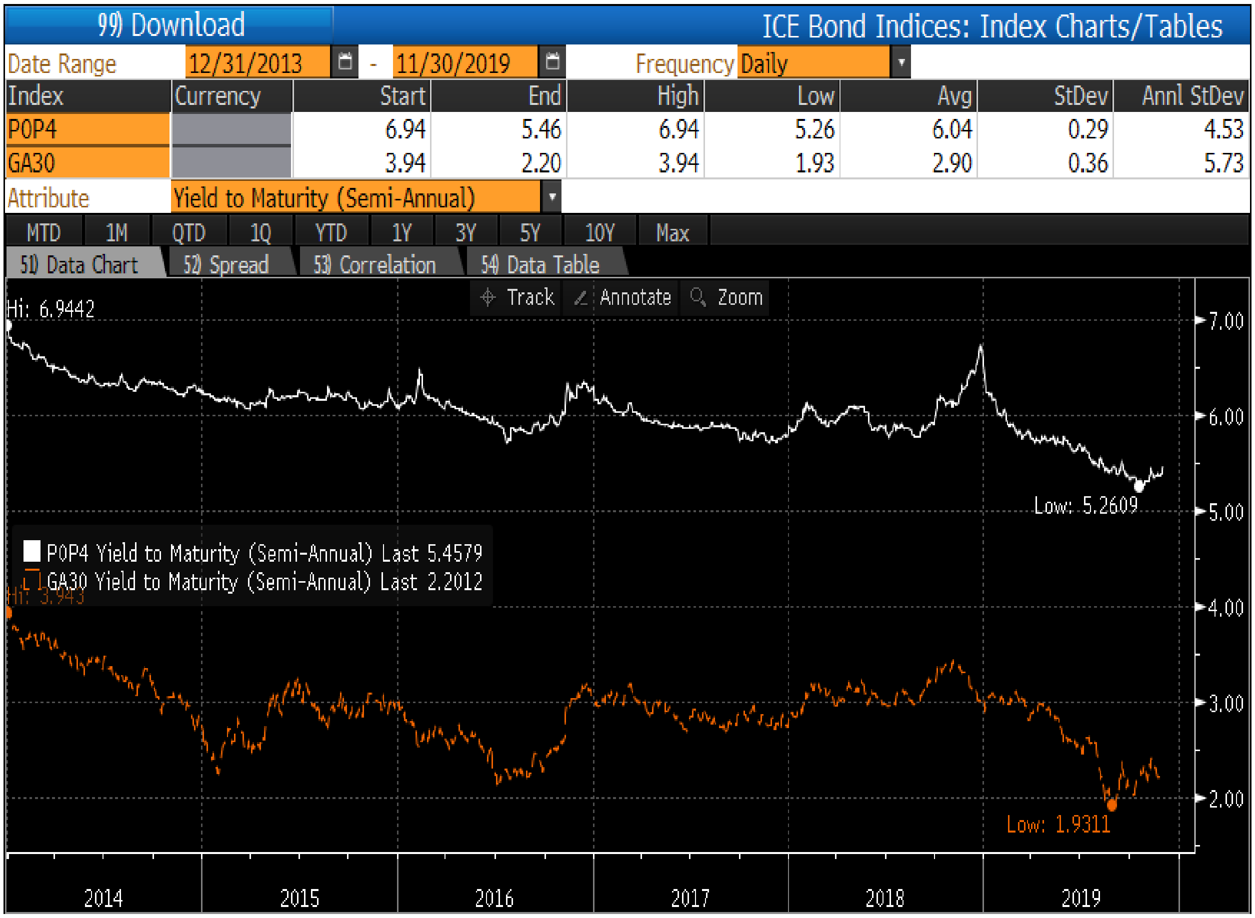


Index	Currency	Start	End	High	Low	Avg	StDev	Annl StDev
STB8		282	220	341	214	257	27	422
P0P4		182	51	265	-96	28	82	1,299

Source: Bloomberg

Option adjusted spreads in the overall retail sector have widened by 140bps in a little over a month bringing the OAS to +51 or the highest since last May. We have been ringing the overvalued bell on the sector for a while, so we are not surprised to see this correction while the NoCo sector has risen. A spread change of this magnitude seems alarming, but the price change has only been -1.98%, which means that the effective duration of the change is only 1.40 years. The relevance of this low impact measure is that most of the benchmark decline is from high coupon paper being either called or repriced to more fair money market returns. We've mentioned before that the sector is subject to high call risk – the recent blowout in OAS is the product of that risk which will gradually lead to a higher duration sector as the coupon of the benchmark declines. The headcount of the retail benchmarks grew by 10 this month with about $4billion of new issuance – names such as JPMorgan Chase, Public Storage, Allstate and First Republic Bank all came with issues offering less than 4.875%. As this trend continues the duration risk to the retail sector will increase. Last month we noted that Invesco PowerShares (PGX) broke out to record highs and it did it again in November. The iShares Preferred and Income ETF (PFF) has another 2% to gain in share count before it recovers all its withdrawals from 2018 and another 5% more to reset a record. Recaptured flows into passive retail preferred ETFs appear to be outpacing inflows into the open mutual fund sector.

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:



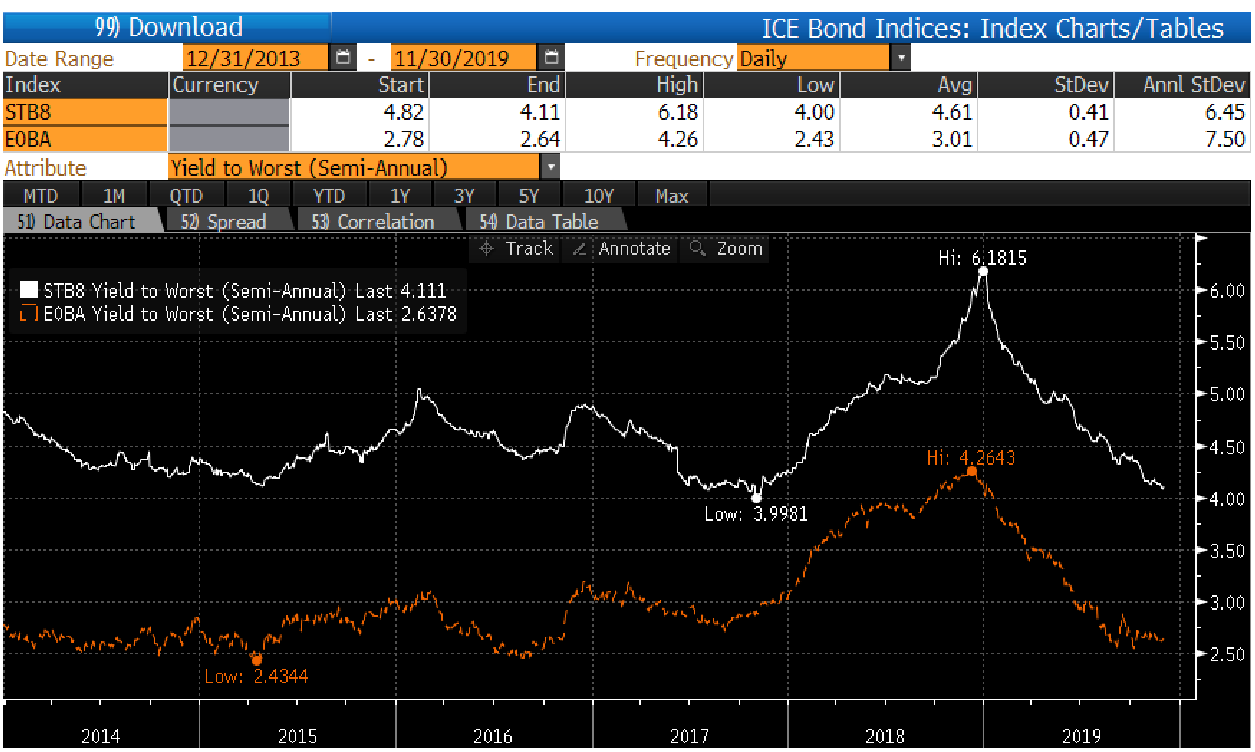
Source: Bloomberg

Given yields close to 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 11% over the next year – in other words, 27% of the p0p4 benchmark is callable within 1yr. The significant rise in OAS spreads from October has repriced the call risk more fairly, but the sub-5% financing rates in the sector makes the economics of refunding options very attractive, still. The weighted average coupon of this 1yr callable bucket declined 21bps this month to 5.88% and we estimate the average refunding rate to be 4.75%, so it is evident that corporate treasurers are in action –

we expect refunding activity to continue. 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 20bps annualized income haircut if the call waves crash on shore. The Fed has indicated that it is done cutting rates until inflation rises meaningfully and persistently above 2%. This lowers the odds waiting for a better refunding gift from the Fed and increases the odds of more activity into next year given more than a 100bps of expense savings available at current prices.

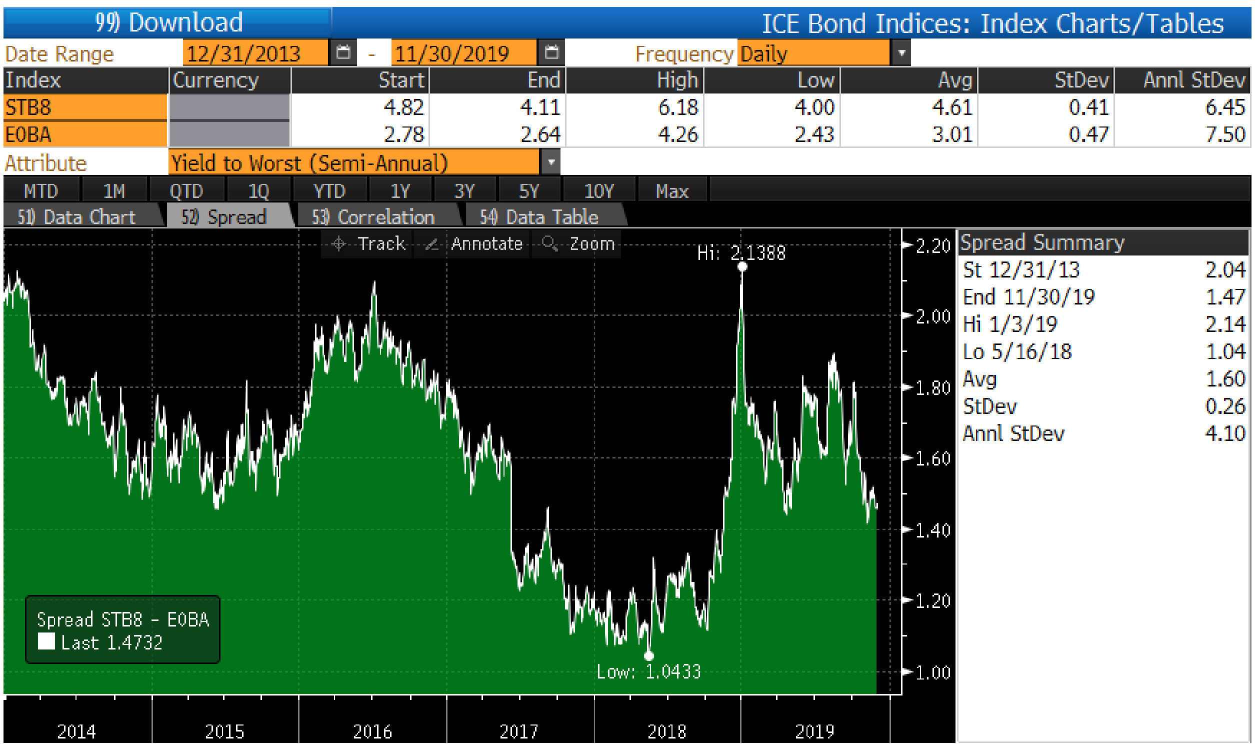
$1,000par Institutional Preferred Securities Sector

The $1,000 par institutional sector of the preferred securities market rose $0.28 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 sideways which means the junior subordinated sector is compressing into more senior paper. Yields on institutional preferred securities are almost at their absolute lows and are in line with the path to triple lows in senior paper. Low yields are fostering issuance opportunities in the NoCo sector, but issuance has been more prevalent in the retail sector due to more refunding opportunities. Despite low yields there is still relative spread available in NoCos compared to more senior global financials as shown in the graph below:

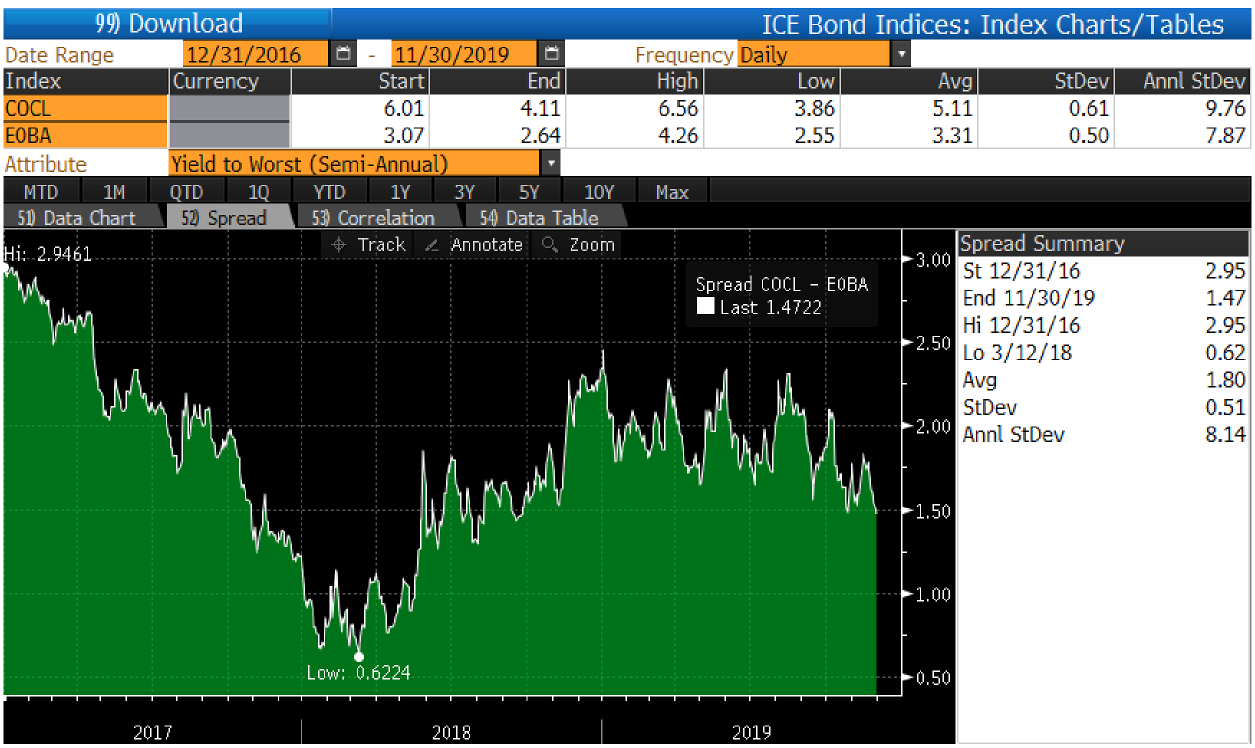


Source: Bloomberg

Relative value spreads for NoCos are just below average and have compressed quickly from being roughly equivalent to the differentials available in 2014 & 2017. 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 likely to tighten more against its more senior financial alternatives.

Contingent Capital Securities Sector

The CoCo sector rallied $0.72 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 tightened 30bps this month, which brings the differential 0.6 standard deviations below average since

2016. The European bank sector is up over 8% on the year and up 21% from its lows set back in August. Credit continues to perform for the European banking sector and two new CoCo deals were done this month – SEB 5.125% and DNBNO 4.875% were both adequately received. The ECB minutes released this month called for unity among members as they addressed frustrations over the banks differing opinions on policy – primarily pertaining to the success of negative rates and the need for more QE. There appears to be a more realistic tone developing on the ECB's economic outlook as being weaker and inflation goals being out of reach. This is indicative of what will likely be more demands for fiscal response next year. The ECB's next meeting (this week) will be Christine Lagarde's first meeting as president. We do not expect any new ideas from the ECB just yet.

Outlook:

We are advancing through the beginning of another coordinated global QE cycle with the same market responses so far as we have had in prior cycles – responses such as a US equity melt-up from global capital demanding upside that is unavailable to negative interest rate catchments and tighter credit spreads as central banks scoop up debt with fresh currency to expand their balance sheets. We expect lower US rates on the front end and marginally higher on the back end of the US yield curve; while negative rates in Europe and Japan force overall global interest rates to remain low for longer, but not necessarily negative forever.

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