Junior-Subordinated Capital Securities Markets

December 2019 Updates

Junior subordinated capital securities continued to attract buyers this month as the equity market rallied and US Treasury bond yields edged modestly higher. The 30yr US Treasury bond closed the month yielding 2.39% (18bps higher; and 68bps 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 1.92% (13bps higher; and 35bps lower since the end of 2015). The yield differential between these two longer US Treasury terms closed at 47bps (14bps steeper on the year). Contrary to UST market bond prices declining, the S&P 500 rose to mark new highs this month. The S&P500 closed at 3231, which was 2.9% higher this month and was aided by supportive developments on the trade deal with China. Credit markets were cheered with expectations for the Fed be entering a long holding pattern on rates – we talk more about this and its implications for junior subordinated capital securities in our 2020 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 2.09% to close yielding 5.37% (47bps lower).
- Global bank credit (measured by ICE Bank of America Merrill Lynch's ***e0ba*** index) rose 0.49% to close yielding 2.57% (7bps lower).
- The BBB rated 5-10yr corporate sector (measured by ICE Bank of America Merrill Lynch's ***c6a4*** index) rose 0.68% to close yielding 3.05% (8bps 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 $300 billion (face amount) of investment grade and below investment grade instruments in both the retail $25par market (45%) and the institutional $1,000par market (55%). 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 $521 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.

<u>Preferred Securities</u>

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 "<u>gone-concern</u>" 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*) @ 45% *of i0cs***
   - <u>Comprised of IG $25par and IG $1,000par US AT1</u>
      - The *p0p1* rose 1.53% this month to close yielding 2.09%
      - The rebalancing this month cut headcount by 2; no face value impact

2. ICE BofAML US Capital Securities Index (*c0cs*) @ 25% of *i0cs*
   - <u>Comprised of dated IG $1,000par hybrids (no US AT1)</u>
      - The *c0cs* rose 0.53% this month to close yielding 3.77%
      - The rebalancing increased headcount by 1; face value declined by $595 million.

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

- Comprised of BIG $1,000par legacy Tier1 and BIG $1,000par hybrids
    - The *h0cs* rose 0.1.77% this month to close yielding 4.77%
    - The rebalancing did not change 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 1.37% this month to close yielding 3.41%
        - The rebalancing cut headcount by 2; face value declined by $2.185 billion

Overall, the BofAML All US Capital Securities Index (***i0cs***) rose 1.24% in December to close yielding 3.01%, which was 53bps lower than last month's closing yield and a spread of +131bps over comparable US Treasury securities (52bps tighter). The yield impact from the rebalancing increased the yield-to-worst by 3bps to 3.04%.

Contingent Capital Securities

The ICE BofAML Large Cap Contingent Capital Index (***cocl***) rose 1.27% to close yielding 3.84%, which was 27bps lower than last month. The rebalancing this month did not impact head count, but face value declined by $1.3 billion. The impact from the rebalancing improved the yield-to-worst by 5bps to 3.09%. 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 declined $1.39 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.

99) Download — ICE Bond Indices: Index Charts/Tables

Date Range 12/31/2018 - 12/31/2019 Frequency Daily

Index	Currency	Start	End	High	Low	Avg	StDev	Annl StDev
STB8		336	210	341	204	249	24	381
P0P4		223	-36	223	-96	11	60	953

Attribute Govt OAS

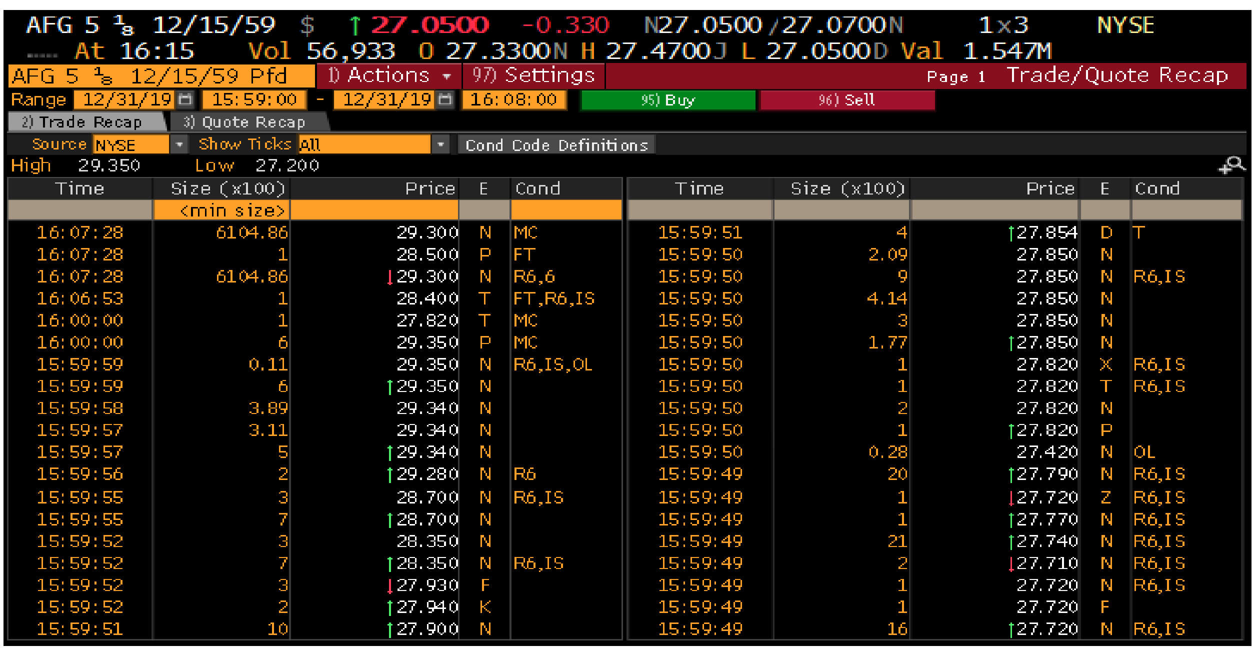
MTD 1M QTD 1Q YTD 1Y 3Y 5Y 10Y Max

51) Data Chart 52) Spread 53) Correlation 54) Data Table

Source: Bloomberg

Option adjusted spreads in the overall retail sector have tightened again to be less than zero to an OAS detracting 36bps from commensurate US Treasury yields. We continue to see only selected value in the retail preferred securities sector despite the relentless move to over-valued spreads and lower coupons from redemptions, which implies increasing prospective price risk. We've alerted that the sector is subject to high call risk – the sector's capitalization has declined by about $7billion since 2017 and its average coupon has decline by 0.46%, yet the dollar price has risen by about 6pts. Remember the blowout in 2018 when prices declined prices declined about 10pts by yearend? Well, by this yearend, the price of the p0p4 benchmark is 12pts higher and the coupon of the sector is 0.16% lower, which implies even more risk if another blowout happens. We believe that this is not fully appreciated by passive investors in the preferred securities markets as this space continues to gain market share and show signs of strain relative to its overall market share (roughly 20% of retail).

The clearest evidence of market strain (i.e., liquidity challenges) fostered by the passive preferred ETFs is the very peculiar market activity in some newly issued securities that are about to enter their benchmarks at month end. A prime example was American Financial Group 5.125% (AFGC pfd) this month, which was run up with market sweep orders that lifted series of odd-lots in the last minute of trading. This cascade inflated the price by $1.91 (i.e., up 7%) in just the last 60 seconds. Then, big size (610,486 shares) traded through (by exemption) probably at the "market-at-close" just 5 cents below (the inflated) market closing price ($29.35; "P ~ MC") on the NYSE-Arca. Here's the tape on the last 11 seconds:


AFG 5 1/8 12/15/59 $ ↑ 27.0500 -0.330 N27.0500 / 27.0700N 1x3 NYSE
At 16:15 Vol 56,933 O 27.3300N H 27.4700J L 27.0500D Val 1.547M
AFG 5 1/8 12/15/59 Pfd 1) Actions 97) Settings Page 1 Trade/Quote Recap
Range 12/31/19 15:59:00 - 12/31/19 16:08:00 95) Buy 96) Sell
2) Trade Recap 3) Quote Recap
Source NYSE Show Ticks All Cond Code Definitions
High 29.350 Low 27.200

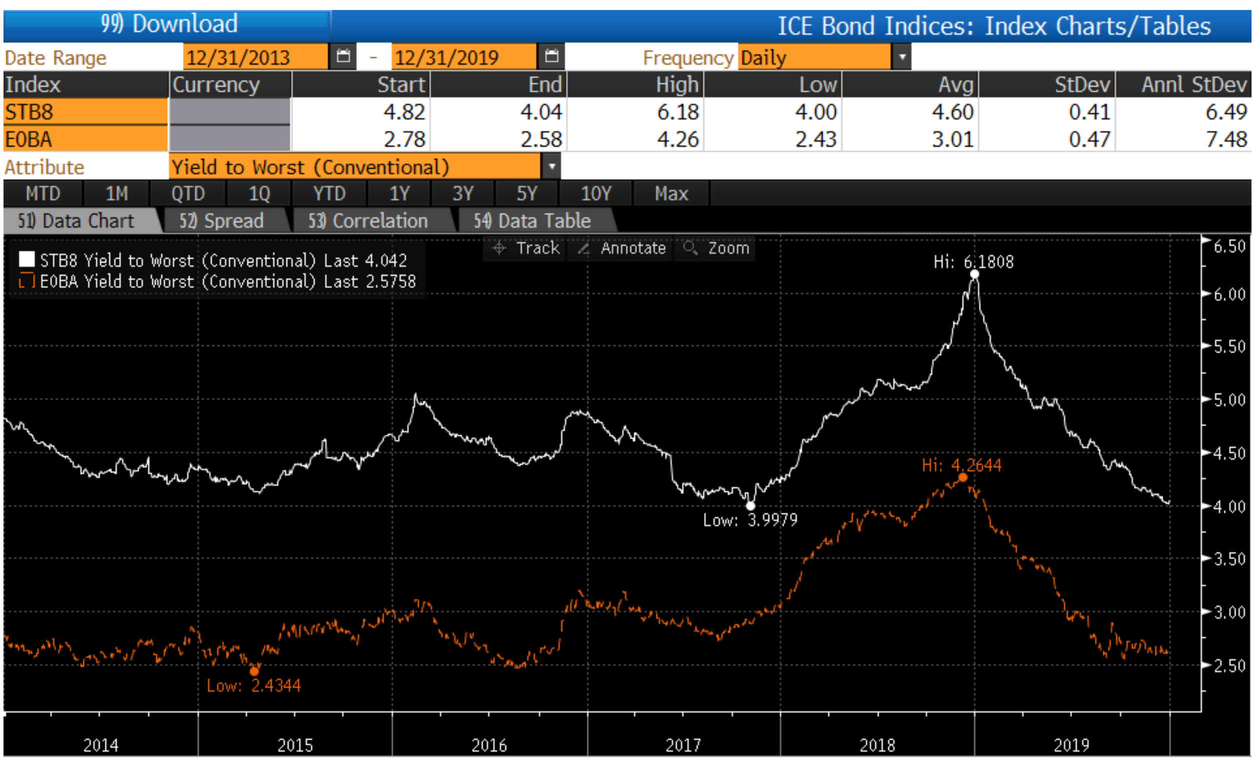
Time	Size (x100)	Price	E	Cond	Time	Size (x100)	Price	E	Cond
	<min size>								
16:07:28	6104.86	29.300	N	MC	15:59:51	4	↑27.854	D	T
16:07:28	1	28.500	P	FT	15:59:50	2.09	27.850	N	
16:07:28	6104.86	↓29.300	N	R6,6	15:59:50	9	27.850	N	R6,IS
16:06:53	1	28.400	T	FT,R6,IS	15:59:50	4.14	27.850	N	
16:00:00	1	27.820	T	MC	15:59:50	3	27.850	N	
16:00:00	6	29.350	P	MC	15:59:50	1.77	↑27.850	N	
15:59:59	0.11	29.350	N	R6,IS,OL	15:59:50	1	27.820	X	R6,IS
15:59:59	6	↑29.350	N		15:59:50	1	27.820	T	R6,IS
15:59:58	3.89	29.340	N		15:59:50	2	27.820	N	
15:59:57	3.11	29.340	N		15:59:50	1	↑27.820	P	
15:59:57	5	↑29.340	N		15:59:50	0.28	27.420	N	OL
15:59:56	2	↑29.280	N	R6	15:59:49	20	↑27.790	N	R6,IS
15:59:55	3	28.700	N	R6,IS	15:59:49	1	↓27.720	Z	R6,IS
15:59:55	7	↑28.700	N		15:59:49	1	↑27.770	N	R6,IS
15:59:52	3	28.350	N		15:59:49	21	↑27.740	N	R6,IS
15:59:52	7	↑28.350	N	R6,IS	15:59:49	2	↓27.710	N	R6,IS
15:59:52	3	↓27.930	F		15:59:49	1	27.720	N	R6,IS
15:59:52	2	↑27.940	K		15:59:49	1	27.720	F	
15:59:51	10	↑27.900	N		15:59:49	16	↑27.720	N	R6,IS

Blackrock's iShares Preferred & Income Fund ETF was the buyer:

Their print was subsequently reflected as the NYSE close ($29.30; "N-MC"). We understand a market order at a closing price, but the stock's market price behavior in advance of this print certainly appears to materially (and suddenly) benefit the seller and not Blackrock's ETF fund shareholders, regardless of any exemption to trading through. As you can see above (in red), the price of AFGC pfd is back down to $27.05 (i.e., 8% lower from PFF's print day before), which happened to also be the low on Dec-31st before the price took off that day. We note also note that Invesco's Preferred ETF (PGX) also bought AFGC pfd on Dec-31st, but they appear to have bought it during the market hours rather than the fully inflated closing price. This preferred security (i.e., AFGC pfd) represents just 0.15% of the entire pop4 index, so it's astounding how much a "passive" fund class will allow the share price of a prospective constituent to run up (in just seconds) in order to get benchmark representation when a small rebalancing is needed. The passive preferred fund sector, as a group, appears to be "acquiescing" to some market making activity that could be situationally interpreted as “painting the tape”. Or, maybe the funds aren’t looking the other way. Perhaps some are noting this peculiar market making activity to regulators; indeed, it would be prudent for their fund boards to question these types of movements and purchases within the context of required “best execution” discoveries.

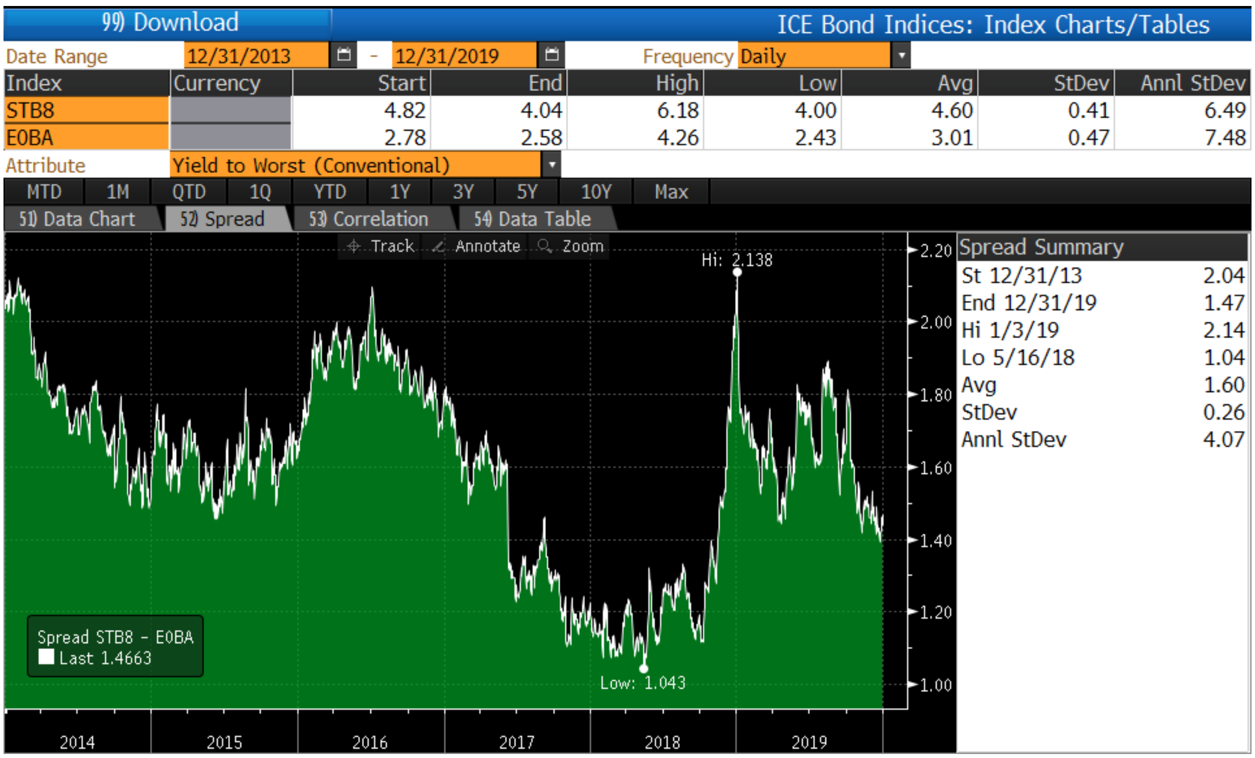
$1,000par Institutional Preferred Securities Sector

The $1,000 par institutional sector of the preferred securities market rose $0.25 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 246bps of additional spread compared to retail preferred securities. NoCo paper compared to more senior global bank paper still 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 grind lower, with yields on senior paper going sideways. Yields on institutional preferred securities are matching their absolute lows set in 2017 and are in line with the path to triple lows in senior paper. Despite low yields (as a global challenge), there is still relative spread available in NoCos compared to more senior global financials as shown in the graph below:

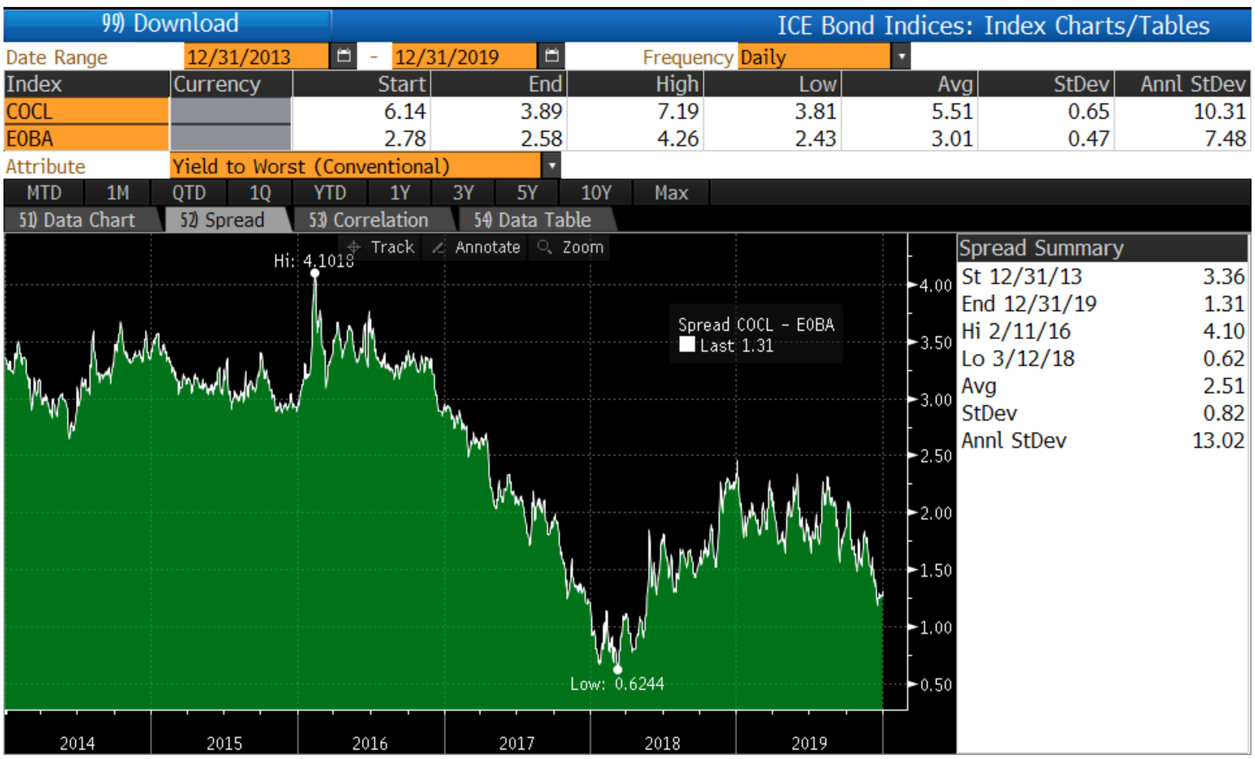


Source: Bloomberg

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 $0.82 this month against the backdrop of 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 16bps this month, which brings the differential less than 1 standard deviation from its all-time low.

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 in negative interest rate catchments. Rates are likely to stay low in 2020, but the yield curve should steepen (with the front end declining more) as quantitative easing is happening on both sides of the Atlantic.

We talk more about the junior subordinated capital securities sectors in our published 2020 Outlook.

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