Junior-Subordinated Capital Securities Markets

January 2020 Updates

Junior subordinated capital securities started the new year on a fast track as equity continued its linear ascent through the first three weeks of January before getting weighed down by the Coronavirus. The 30yr US Treasury bond closed the month yielding 2.01% (37bps lower; and 100bps 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 1.52% (39bps lower; and 74bps lower since the end of 2015). The yield differential between these two longer US Treasury terms closed at 49bps (2bps steeper on the year). The US treasury bond market discounted Coronavirus related growth concerns earlier and with more urgency than equity markets did, but the S&P500 eventually accumulated enough treasury friction to reverse its rally – but not before setting another record of 3330. By the end of the month, the S&P500 closed at 3226, which was 0.16% lower than where it started the year. Credit markets were fearless to start the year as new issuance was grabbed almost at any price which pulled yields lower as treasury yields plummeted to signal slower growth.

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) was unchanged to close yielding 5.55% (14bps higher).
- Global bank credit (measured by ICE Bank of America Merrill Lynch's ***e0ba*** index) rose 1.63% to close yielding 2.28% (29bps lower).

- The BBB rated 5-10yr corporate sector (measured by ICE Bank of America Merrill Lynch's ***c6a4*** index) rose 2.17% to close yielding 2.73% (33bps 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 US Dollar Contingent Capital Index (***cdlr***).

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 USD Contingent Capital Index of US dollar denominated junior-subordinated capital securities ***(cdlr)*** represents $137 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 would not fall into a receivership after the bail-in. These two benchmarks combine for a $437 billion universe of fixed-rate junior-subordinated capital securities with preferred securities (measured by ***iocs***) being a 69% subset and contingent capital securities (measured by ***cdlr)*** being a 31% subset of the total global USD 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 rated 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 0.83% this month to close yielding 1.99%
     - ❖ The rebalancing this month cut headcount by 2; face value by -$3.3bil.
2. **ICE BofAML US Capital Securities Index (*c0cs*) @ 26% of *i0cs***
   - Comprised of dated IG $1,000par hybrids (no US AT1)
     - ❖ The *c0cs* rose 1.52% this month to close yielding 3.58%

- ❖ The rebalancing increased headcount by 2; face value by +$1.9bil.

3. **ICE BofAML High-Yield Capital Securities Index (*h0cs*) @ 6% of *i0cs***

- o <u>Comprised of BIG $1,000par legacy Tier1 and BIG $1,000par hybrids</u>
  - ❖ The *h0cs* rose 1.94% this month to close yielding 4.59%
  - ❖ The rebalancing did not change headcount; or face value

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

- o <u>Comprised of BIG $1,000par US AT1 and BIG $25par</u>
  - ❖ The *p0hy* rose 1.40% this month to close yielding 2.86%
  - ❖ The rebalancing increased headcount by 3; face value by +$1.6bil.

Overall, the BofAML All US Capital Securities Index (***i0cs***) rose 1.21% in January to close yielding 2.78%, which was 27bps lower than last month's closing yield and a spread of +139bps over comparable US Treasury securities (6bps wider). The yield impact from the rebalancing cut the yield-to-worst by 1bp to 2.77%.

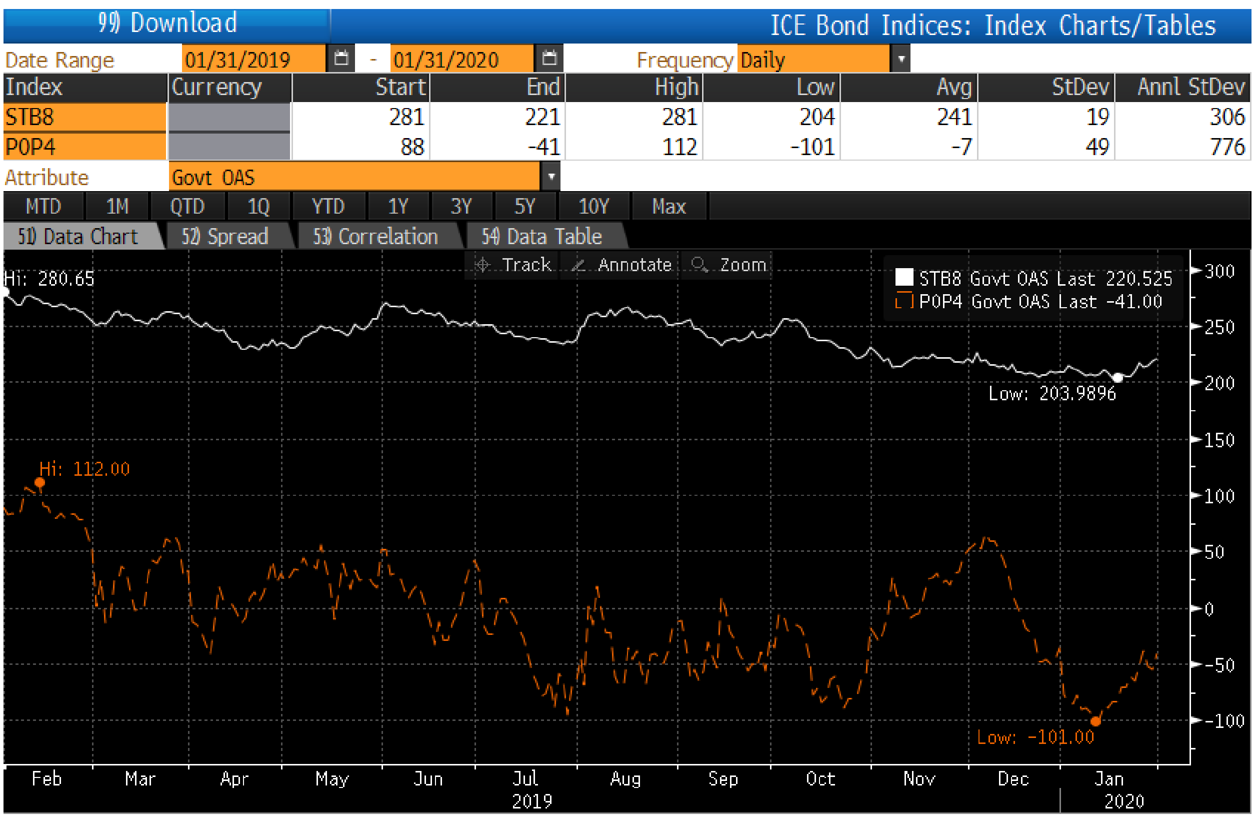
<u>Contingent Capital Securities</u>

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 a potentially insolvent bank through the contracts of its capital before falling into a conservatorship proceeding. 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). The ICE BofAML USD Contingent Capital Index (***cdlr***) is a new benchmark launched in January and is comprised of US dollar denominated constituents (exclusively), which represent 61% of the mature master multi-currency benchmark (*cocl*). We will utilize the new USD benchmark (*cdlr*) this month as it more meaningfully reflects the contingent capital currency types held in our portfolios. The ICE BofAML USD Contingent Capital Index (***cdlr***) rose 1.59% this month to close yielding 4.15%, which was 28bps lower than last month. The benchmark rebalancing cut the head count by 1, which reduced face value by $1.0 billion. The impact from the rebalancing reduced the yield-to-worst by 1bp to 4.14%.

Implications of Market Activity:

$25par Retail Preferred Securities Sector

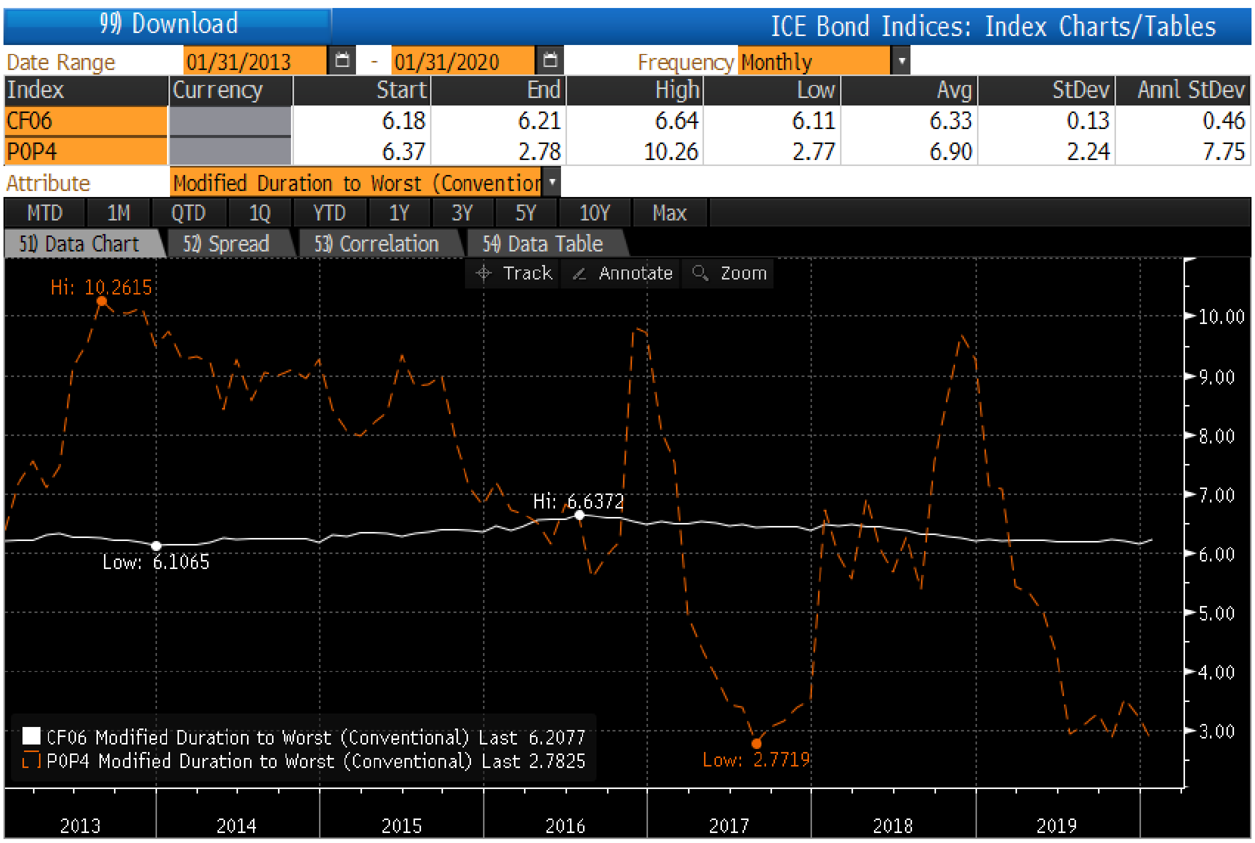
The retail preferred securities sector rose $0.81 this month. The graph below shows spread in the $25par market (i.e., p0p4) over the past year compared to the spread in the $1,000 par institutional preferred securities market (stb8), which as a group we'll refer to as "NoCos" to distinguish $1,000 preferred securities from $1,000par contingent capital securities risks.



Source: Bloomberg

Option adjusted spreads in the retail sector have tightened by 50bps to start the year, but then widened by 50bps to end the month unchanged as yields plummeted on treasury notes. We see only selected values in the retail preferred securities given relentless overvalued spreads and trending lower coupons from rolling redemptions.

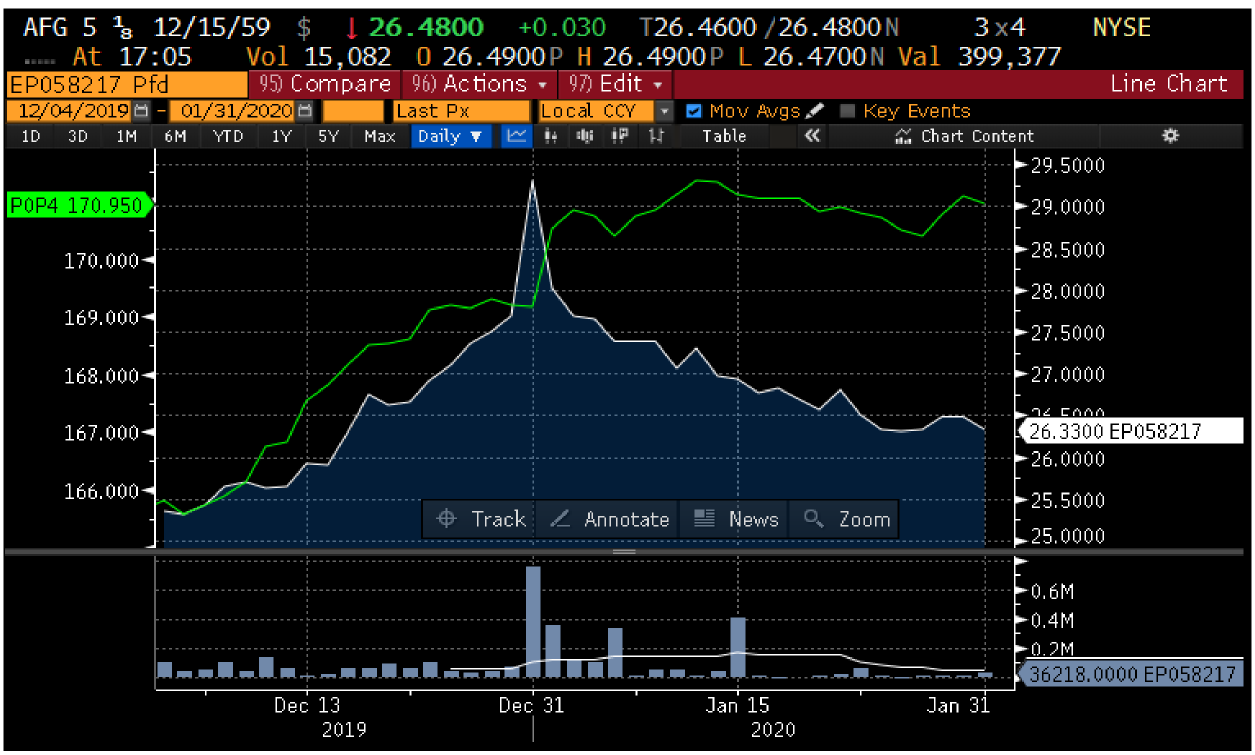
We view modified duration of the *p0p4* benchmark to be a contra-indicator of value due to the benchmark's negative convexity. In other words, the higher the modified duration the more absolute value there is to the sector – conversely, when duration is the lowest, price risk is the highest if yields revert higher. The chart below illustrates the modified duration of the retail sector measured by *p0p4* vs. the 5-10yr US financial sector measured by *cf06* as a baseline:



Source: Bloomberg

Looking back, 2019 was a lot like 2017 from not only a spread tightening perspective (and stellar performance), but also from an overall market mood – both years were relentless melt-ups in equities which played through into an exhaustive credit rally. Indeed, cash inflows were welcomed of course, but cash was coming in (during both years) as fast as it could be put to work making cash a notable "detractor" from positive performance against the (always) fully invested benchmarks. In the graph, note the very similar duration slopes and travel ranges in 2017 compared to 2019 -- we know that history doesn't necessarily repeat itself, but it often rhymes – and from start to finish these two years do seem poetic. Now, this year follows another rally to a low (high risk indicator) position for $25par duration (the Jan20 close = 2.78) and the benchmark coupon is 43bps lower than the last time duration was this low (Aug-17).

By the way, here's the price graph on American Financial Group 5.125% (AFGC pfd) that we discussed last month as having been "oddly" overbought at yearend:

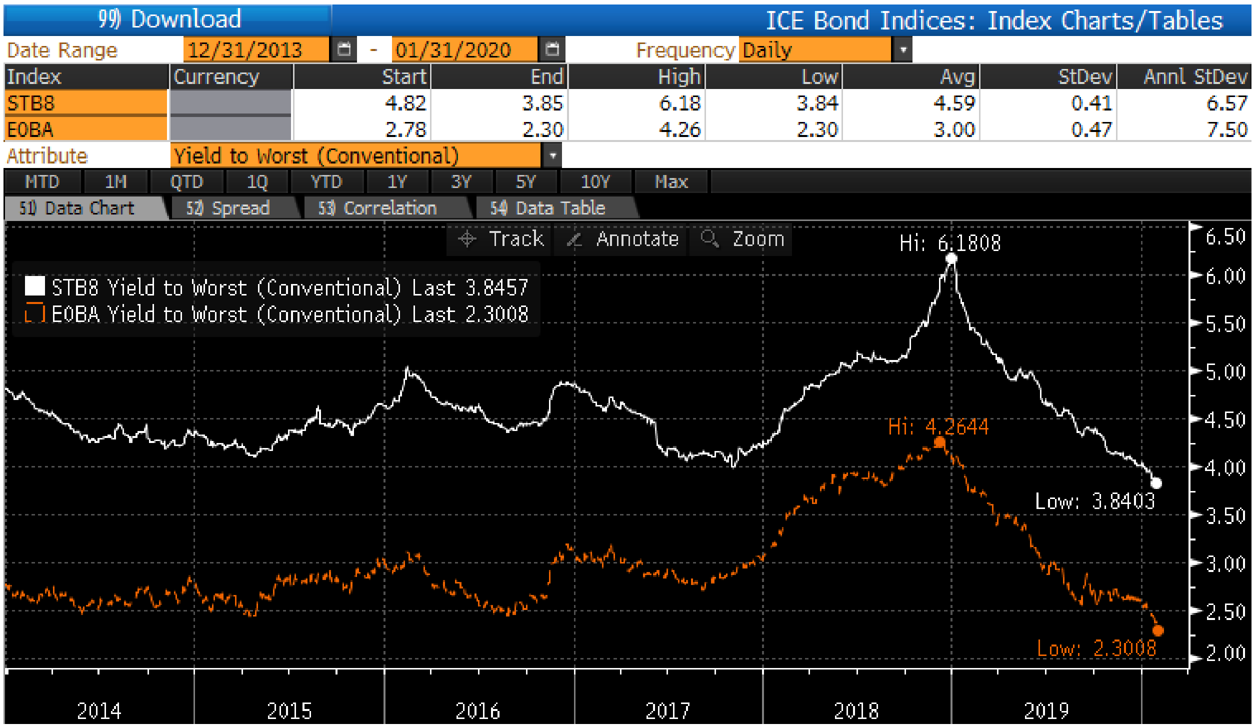


Source: Bloomberg

The graph compares AGFC pfd to the *p0p4* benchmark price, of which AGFC became a component member at yearend. Besides our concerns discussed last month on absolute price, does the behavior follow through on relative price this month support "best execution" practices on absolute price last month? Well, you be the judge. Our broader concern is that incessant cash flows into the passive retail preferred ETF sector are forcing overall benchmark prices to be collectively overbought almost at any price because Authorized Participants don't necessarily care about price if they are confident that the ETF will pay virtually any price at month end. The ETFs after all, are the "benchmarks" – so, if a constituent price goes down as a result of execution practices driving it up (to get the size they need), then the ETF rationale is "that's just the market". Of course, but what is driving the market? Passive investing does not mean that its inherent "passivity" has no market impact in feeding it growth – quite the contrary; and its growth can create technical bubbles in the retail sector like the one being expanded again this year. Indeed, having an active manager and other preferred sectors for risk diversity appears more important now than ever given the continuing trend to lower coupons, premium prices seemingly mischievous market moves during rebalancings.

$1,000par Institutional Preferred Securities Sector

The $1,000 par institutional sector of the preferred securities market rose $1.00 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 259bps 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:

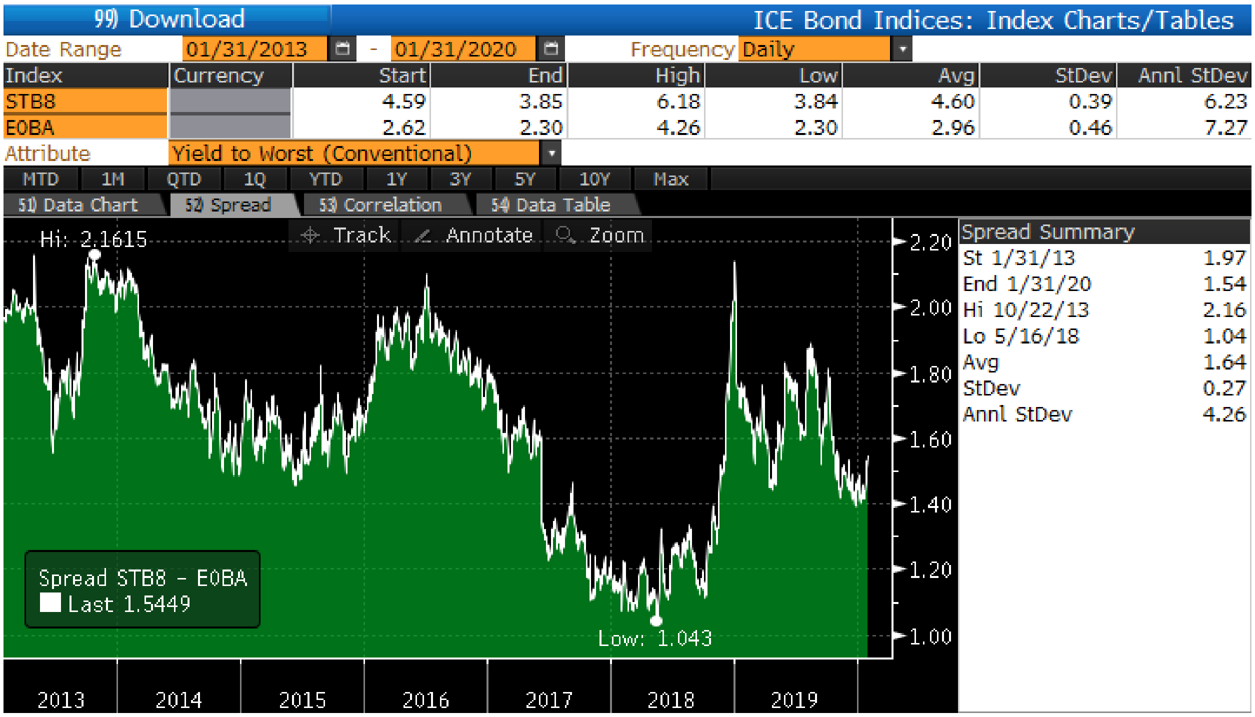


Source: Bloomberg

We look back to 2013 to include three intra-cycle shocks to yield and spread: 1) the end of the Taper Tantrum (2013), 2) the end of the commodity implosion and high yield market bust (2016) and 3) the end of the market's revolt to the Fed's overshoot on rates (2018). Indeed, the remarkable reversal that started in 2019 has broken through a sturdy floor or what had been repeated yield resistance over the years on NoCos of 4%. That resistance was again tested at the end of last year and by January's end the once sturdy NoCo yield floor was convincingly shattered -- interestingly, the once sturdy Eurodollar Bank Index floor of 2.5% was also broken.

New issuance drove secondary pricing higher in a "take at any price" investor mentality with syndicate this month. Of course, syndicate works for the issuer (i.e., not the investor) so there is a standard game of starting cheap in the initial marketing phase to build a significantly oversubscribed book; followed by predictably tighter guidance (e.g., 25bps tighter) as the book builds to show the issuer that orders are dropping as the price guidance tightens – at least, that's the typical cascade. Ultimately, when the deal price is determined, calls are made to confirm order levels and allocations are subsequently made based on the size of the book at pricing (among other things). If the new deal is hugely oversubscribed, then allocations can be "brutally" thin compared to your book order. This month, for the first time I can remember, a preferred IPO (for Bank of America, by Bank of America) was ***re-launched*** after having been pushed significantly tighter as the book built. But, because nobody dropped at any stage of the marketing period, Bank of America basically pulled the deal and started over at an even higher price – in other words, it was "re-launched" because the market that day was in a buying frenzy. Typically, when nobody drops (which is not all that unusual), allocations are severe (some folks have gotten none) because the orders significantly out-size the deal size. But this time , in the process of checking to confirm orders at 4.375% only to find investors still reluctant to cut back, Bank of America decided to pull their deal and re-launch at 4.30%. The appropriate process would have been to simply reduce allocations on what had evolved to be a "great deal" @ 4 3/8% on a day when investors literally could not buy enough of anything – we dropped on the re-launch out of principle. Investor complicity is anecdotal of not only the "food fight" to get invested these days, but also the velocity of performance chasing during the first three weeks of January. In fact, just the day before JPMorgan and CitiGroup had priced similar preferred stock deals at 4.60% and 4.70%, respectively.

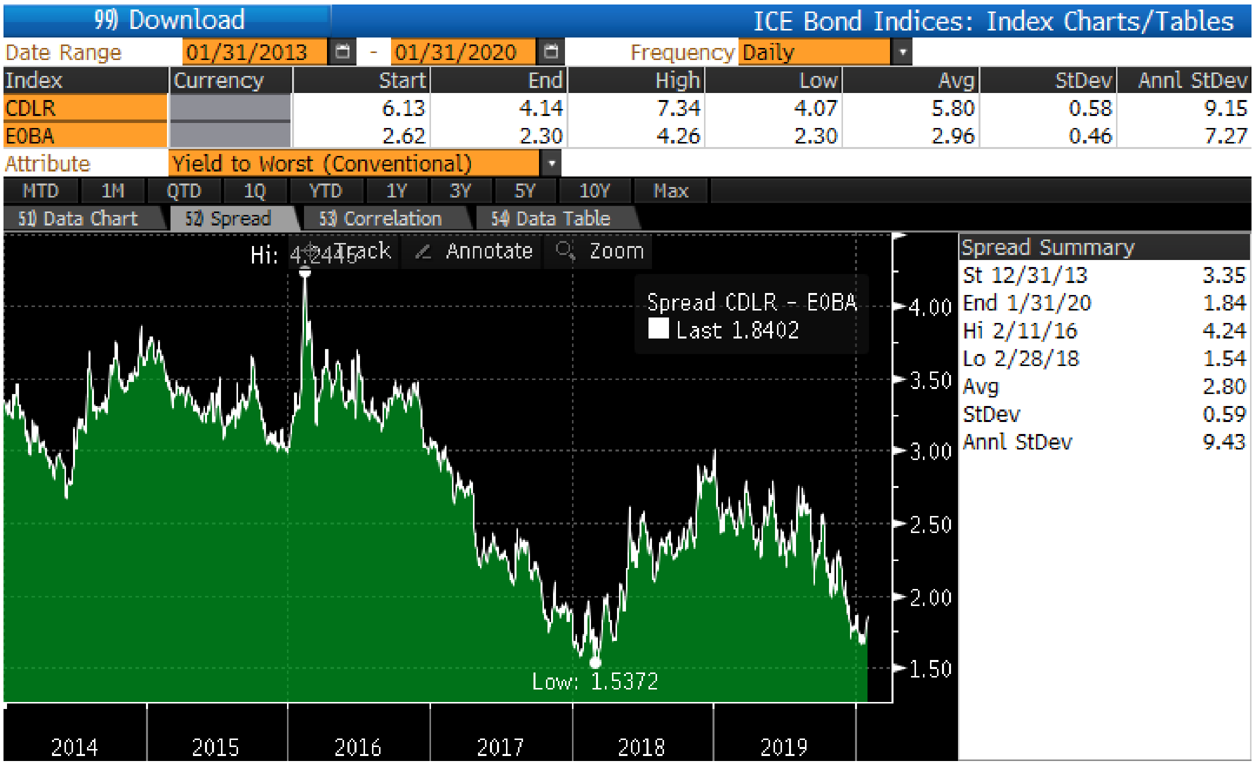
The graph below shows the NoCo sector (*stb8*) spread relative to the Eurodollar Banking Index (*e0ba*) spread since the Taper Tantrum. The differential widened by 7bps by the end of January and ended 10bps tighter than average for the 7yr sample period. There is still some statistical field to cover (almost 2 standard deviations of tightening) for the relative value of NoCos to match the down-in-capital structure tights marked in 2018.



Source: Bloomberg

Contingent Capital Securities Sector

The CoCo sector rallied $1.15 this month even against the backdrop of a 5.5% pullback in the European bank sector. The graph below shows the spreads in CoCos (i.e., *cdlr*) relative to the spreads measured in eurodollar 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

After starting the month by moving 20bps tighter, the spread differential between CoCos and more senior euro-dollar banks tightened by 1bp this month – this brings the relative value differential just ½ standard deviation from matching the tights of 2018. We this spread compression for CoCos as justified and mainly supported by the sector's regulated improvements on non-payment risk, evolved product acceptance and improved credit fundamentals since 2016. These have helped excess spread between CoCo paper and NoCo paper to tighten significantly to just 30bps, which is 2 ¼ standard deviations below average over the past 3 years. Though still positive, the relative value opportunity in CoCos compared to the AT1 paper of US banks is not what it used to be – yet, the higher relative yield available from contingent capital still attracts new buyers (like many French insurance companies).

Outlook:

The so-called "insurance cuts" from the Fed last summer were aided by a key shift in active Fed policy to purchase US Treasury Bills until at least sometime into the 2nd quarter. This policy action was a watershed and certainly needed at the time to repair dysfunction in the repo market. Since the Fed announcement on October 11th, stocks had been on a linear progression upwards until late January and spreads have zoomed tighter. In fact, since we authored our 2020 Outlook in mid-November, CoCo spreads had moved 55bps tighter at one point this month – recall that we are looking for 85bps tighter during the year. There is no question that January has been a fast start to the year. The Fed's insurance cuts are proving to be supportive and its plan to keep buying T-bills into the second quarter should continue fostering financial expansion -- and shallow corrections that are quickly bought. So, while under macro medication, financial conditions can advance against weakened friction, thus allowing junior subordinated credit to stay in a forward accruing motion. Indeed, as hard as it may be to buy into record low yields, they are even lower (and at record lows too) the higher up the capital structure you go.

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