SPECTRUM
Asset Management

Junior-Subordinated Capital Securities Markets

February 2020 Updates

The Coronavirus (COVID-19) has indeed reached the United States and has caused a major health scare alert that rattled markets this month. After starting the new year on a fast track along with record highs for equities, the rally in junior subordinated capital securities ended abruptly amidst a record blow-off in equities and flight-to-safety in US treasuries. The correction in capital securities was particularly severe in the retail sector, but the institutional sector also declined, but not by as much (more on this below). The 30yr US Treasury bond closed the month yielding 1.66% (35bps lower; and 135bps 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 1.13% (39bps lower; and 113bps lower since the end of 2015). The yield differential between these two longer US Treasury terms closed at 55bps (8bps steeper on the year). The swoon in stocks at the end of the month was the biggest weekly decline for the S&P500 (-11.5%) since the TARP vote (-18.2%; Oct-08) during the time of the Lehman collapse. By the end of the month, the S&P500 closed at 2954, which was 8.56% lower than where it started the year. Credit markets were mixed in absolute performance as the significant decline in treasury yields supported prices on more senior corporate paper, but the equity route impelled spreads wide enough in junior subordinated paper to cause price declines despite the massive rally in treasury prices – for example, the retail preferred market went down (-3.7%) by about as much as the 10yr US treasury sector went up (+3.6%).

Before we discuss more performance in the junior subordinated sectors this month, let's look at performance in some of the more senior corporate credit sectors for comparative reference points on returns and yield changes (before the month-end rebalancings):

- The junk market (measured by the ICE BofA High Yield ***h0a0*** index) declined 1.55% to close yielding 6.19% (57bps higher).
- Global bank credit (measured by ICE BofA ***e0ba*** index) rose 0.85% to close yielding 2.13% (17bps lower).
- The BBB rated 5-10yr corporate sector (measured by ICE BofA ***c6a4*** index) rose 0.99% to close yielding 2.62% (14bps 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 BofA indexes: 1) The ICE BofA US All Capital Securities Index (***i0cs***) and 2) The ICE BofA 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 $305 billion (face amount) of investment grade and below investment grade instruments in both the retail

$25par market (41%) and the institutional $1,000par market (59%). The USD Contingent Capital Index of US dollar denominated junior-subordinated capital securities ***(cdlr)*** represents $139 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 $444 billion universe of fixed-rate junior-subordinated capital securities with preferred securities (measured by ***iocs***) being a 68% subset and contingent capital securities (measured by ***cdlr)*** being a 32% 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 BofA Fixed Rate Preferred Index (*p0p1*) @ 44% *of i0cs***
   - Comprised of IG $25par and IG $1,000par US AT1
     - The *p0p1* fell 2.67% this month to close yielding 3.78%
     - The rebalancing grew head count by 2; face value by $2.0bil.

2. **ICE BofA US Capital Securities Index (*c0cs*) @ 26% of *i0cs***
    - Comprised of dated IG $1,000par hybrids (no US AT1)
        - The *c0cs* fell 0.18% this month to close yielding 3.65%
        - The rebalancing grew head count by 1; face value by $0.8bil.
3. **ICE BofA High-Yield Capital Securities Index (*h0cs*) @ 6% of *i0cs***
    - Comprised of BIG $1,000par legacy Tier1 and BIG $1,000par hybrids
        - The *h0cs* fell 1.00% this month to close yielding 4.70%
        - The rebalancing grew head count by 2; face value by $1.6bil.
4. **ICE BofA High Yield Fixed Rate Preferred Index (*p0hy*) @ 24% of *i0cs***
    - Comprised of BIG $1,000par US AT1 and BIG $25par
        - The *p0hy* fell 3.74% this month to close yielding 5.19%
        - The rebalancing grew head count by 1; face value by $0.3bil.

Overall, the BofA All US Capital Securities Index (***i0cs***) fell 2.14% in February to close yielding 4.13%, which was 135bps higher than last month's closing yield and a spread of +299bps over comparable US Treasury securities (159bps wider). The yield impact from the rebalancing improved the yield-to-worst by 3bps to 4.16%.

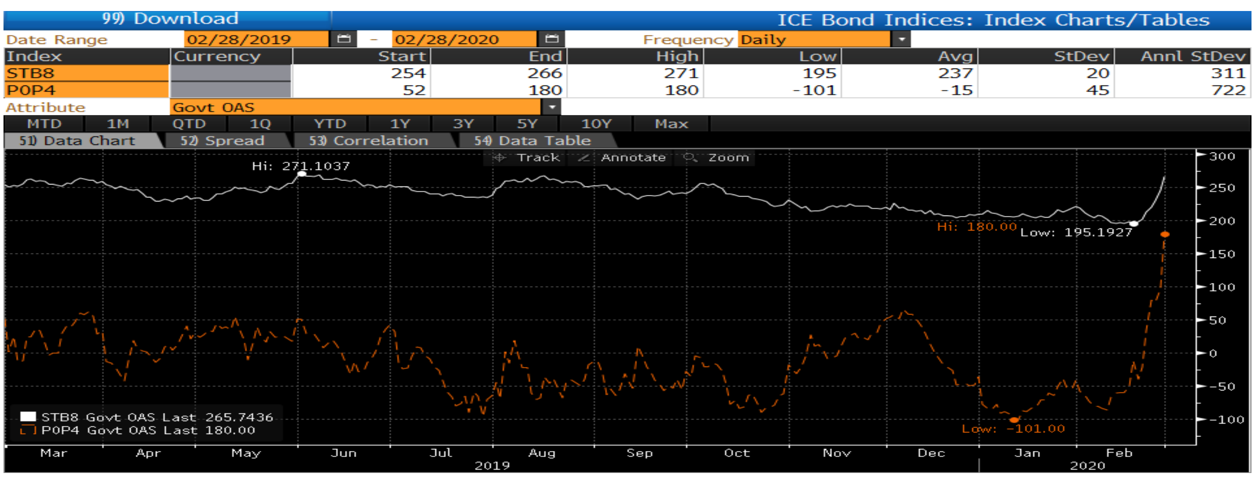
Contingent Capital Securities

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 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 BofA 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 BofA USD Contingent Capital Index (***cdlr***) fell 1.62% this month to close yielding 4.62%, which was 48bps higher than last month. The benchmark rebalancing grew head count by 1, which increased face value by $1.9 billion. The impact from the rebalancing improved the yield-to-worst by 4bp to 4.66%.

<u>Implications of Market Activity</u>:

<u>$25par Retail Preferred Securities Sector</u>

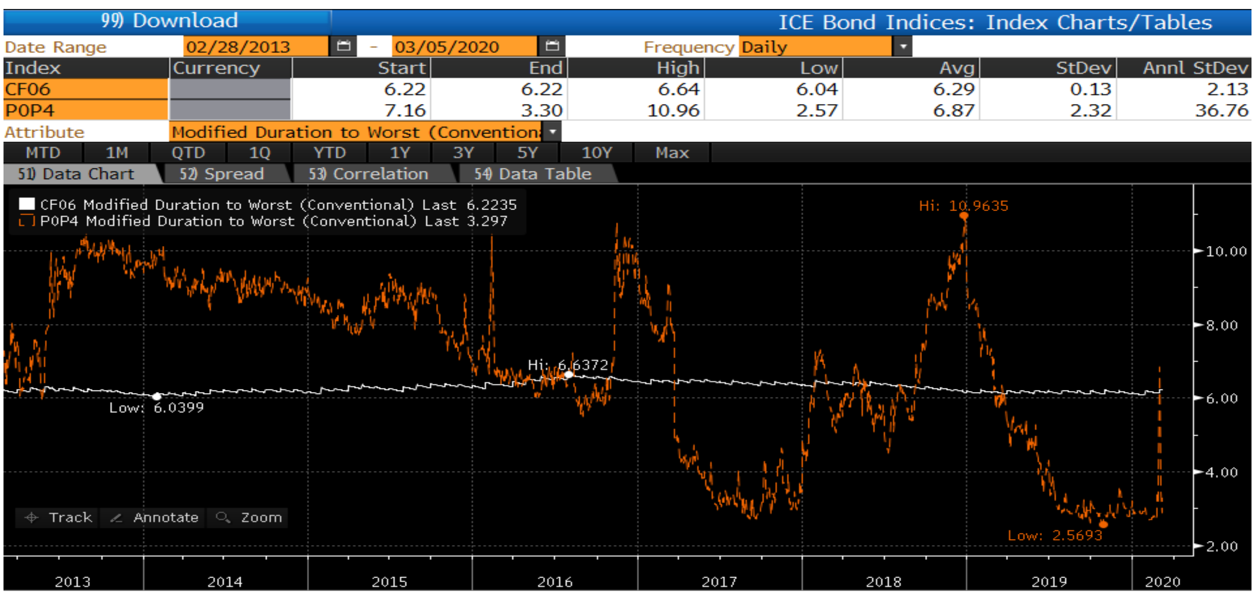
The retail preferred securities sector plummeted $4.53 this month. The graph below shows spread in the $25par market (i.e., p0p4) over the past year compared to the spread in the $1,000 par institutional preferred securities market (stb8), which as a group we'll refer to as "NoCos" to distinguish $1,000 preferred securities from $1,000par contingent capital securities risks.



Source: Bloomberg

After tightening as much as 50bps to start the year, option adjusted spreads in the retail sector zoomed 221bps wider this month. A sudden move of this magnitude through a combination of price declines in $25pars and price increases in treasuries was virtually unprecedented. Indeed, we have been underweight retail paper in our funds because of the sector's persistent overvaluation and lower coupon trendline skewing risk significantly to the downside. Security selection and active management are essential elements to achieve improved risk-adjusted returns over being simply passive in retail preferred securities.

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 effective duration of the retail sector measured by *p0p4* vs. the 5-10yr US financial sector measured by *cf06* as a baseline:

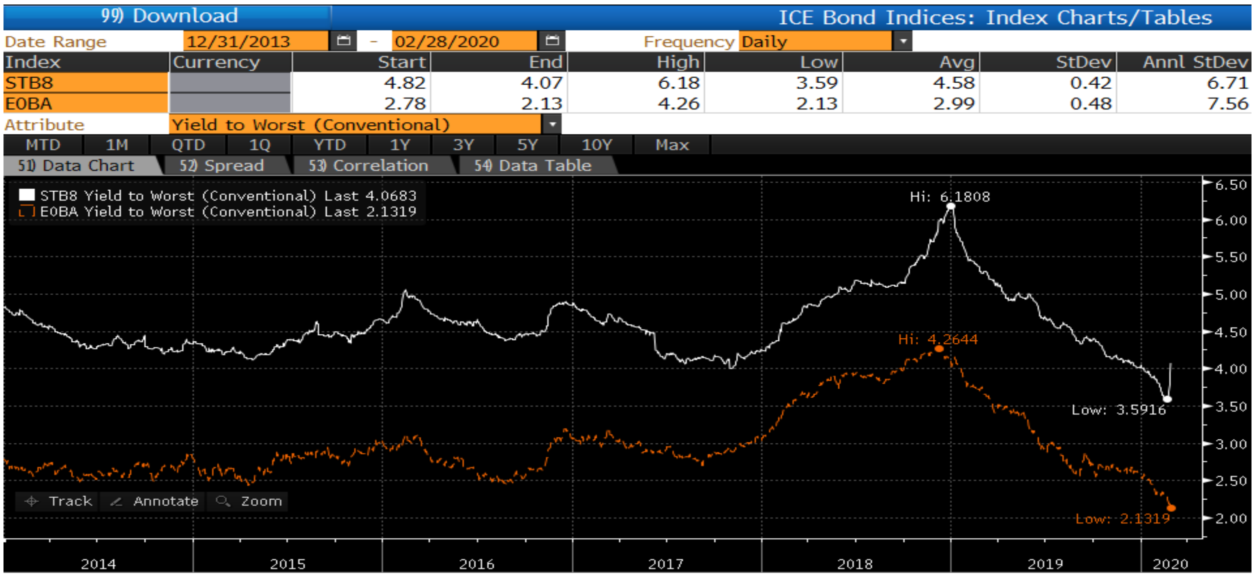


Source: Bloomberg

Looking back at historical behaviors, 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 witnessed relentless equity gains, which played through into an exhaustive credit rally as volatility plummeted. In both years, cash inflows were constant (welcomed of course), but cash was coming in almost faster than it could be put to work – this made cash a notable "detractor" from positive performance against the (always) fully invested benchmarks. The graph (above) illustrates very similar duration slopes and absolute ranges in 2017 compared to 2019 – both years were double digit return years. Every other year since 2015 has been an up/down sequence for the price component of the $25par market with the even years being negative – of course, this is not even an association, but the annual rhythmic pattern of being over-bought over-sold over-bought over-sold and now over-bought again appears to be on beat for a repeat in 2020. The move tighter in January ties in the beat with a chorus of over-bought duration and negative spreads that were flushed out this month by the correction in equities. The underperformance of the retail sector was more positively correlated to the equity sell-off than was the institutional sector because retail spreads were negative and $25par prices are negatively convex with most having over-priced call options. By the end of the month, the retail sector was fairly valued which compelled us to buy more. We expect the more recent retracement to marginal value to become better value again as this COVID-19 pandemic-of-panic takes a pervasive swing worse in the US this month.

$1,000par Institutional Preferred Securities Sector

The $1,000 par institutional sector of the preferred securities market fell $1.30 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. 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:



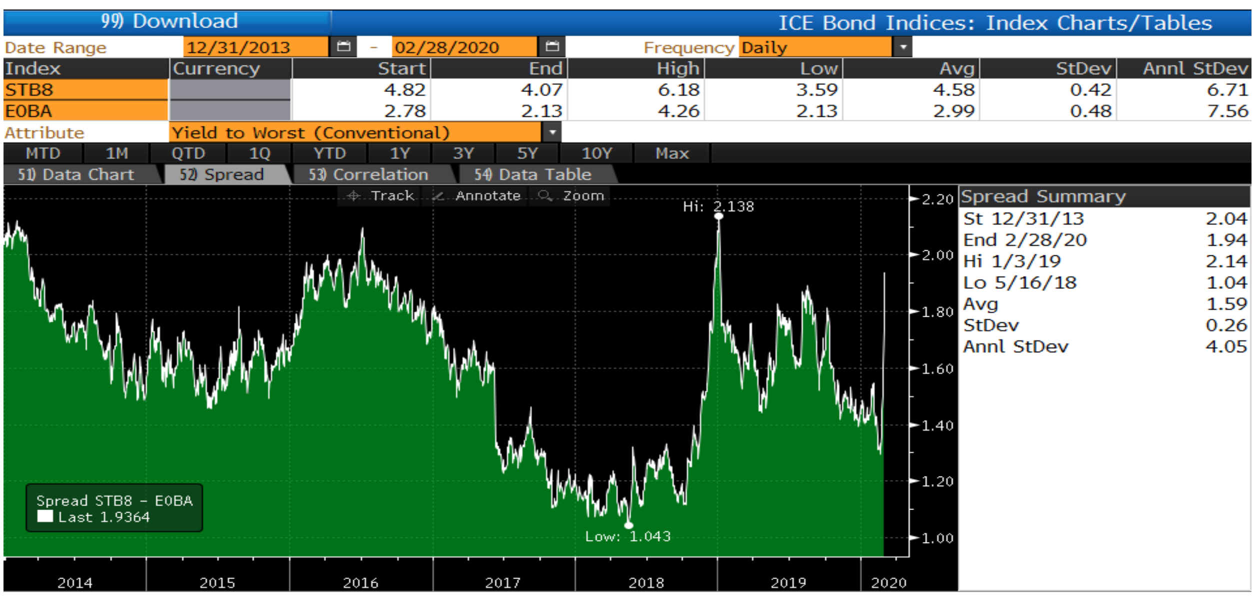
Source: Bloomberg

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 (oil) 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 4% floor or what had been repeated yield resistance over the years on NoCos. That resistance was again tested at the end of last year and by January's end the once sturdy NoCo yield floor was convincingly collapsed by the weight of the coronavirus contagion of confusion (more on this later).

This month the yield-to-worst on NoCos spiked back above 4% primarily because bank stocks have declined by 15% since their highs in December. But the depth of the treasury move in the opposite direction is putting an absolute floor on the price declines in NoCos – basically, there is no problem with non-performing loans, but there is a problem with virus panic sending the US treasury bond market into its biggest fear trade since the Lehman collapse. The mood change is bi-polar mania from nobody dropping from the initial launch on the Bank of America 4.30% preferred stock deal last month to nobody thinking US rates will ever be above zero before they ever get there. The emotional fears evident in markets are just as viral as the virus itself --

which is transitory. The economic impact will be transitory too (just like H1N1 was in 2010), but the headlines and media coverage of global quarantine responses and recession plausibility only temporarily delays the pervasive hunt for global (positive) yields.

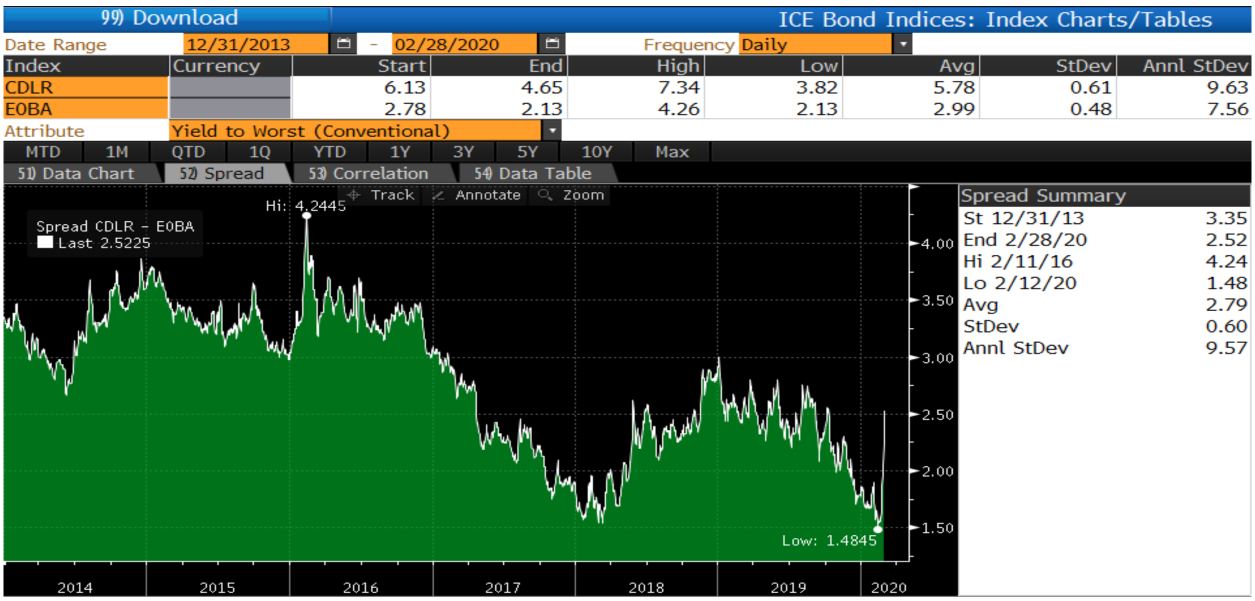
The graph below shows the NoCo sector (*stb8*) spread relative to the Eurodollar Banking Index (*e0ba*) spread since the Taper Tantrum. The yield differential widened 40bps by the end of February and ended the month 35bps wider than average for the 7yr sample period. There had still been some statistical 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 at the start of the month – and as you can see, NoCos made a move down field by tightening 25bps (i.e., about 1 stdev.) before being driven back up by 65bps. The move wider in NoCos relative to more senior paper positions NoCos back to "uncommon" relative value territory.



Source: Bloomberg

<u>Contingent Capital Securities Sector</u>

The CoCo sector fell $2.35 this month against the backdrop of a 7.9% decline in the European bank sector this month. Like other areas of the equity markets, European bank stocks went up (i.e., 11.6%) before they went down (i.e., 17.5%) during this extraordinarily volatile month. 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 36bps tighter, the spread differential between CoCos and more senior euro-dollar banks zoomed 104bps wider to close the month yielding 252bps more than the global bank bond benchmark. The relative value in CoCos is high, but not necessarily "uncommon" (as is the case with NoCos) only because the CoCo market went through a period of regulatory uncertainty on capital rules in (and before) 2016 – of course, this Pillar-2 uncertainty was fixed positively for CoCos which helped to usher in a de-risked era for CoCos to accelerate their relative tightening from the exceptional spreads prior more restrictive capital rules. The relative spreads for CoCos ended February as cheap as many advantageous entry points were last year.

Outlook:

We mentioned last month that 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. Given the coronavirus panic, it is unlikely that the Fed can pull back on this policy action especially as markets are demanding more policy support. Indeed, the surprise inter-meeting 50bps cut in the Federal Funds rate was beacon of worry that was last flared during the sub-prime crisis – but, it (really) is different this time. The equity market is not broken, but it had been extraordinarily exuberant since the Fed's move to purchase T-bills last October. The COVID-19 friction is slowing the global economies in unison. The virus's arrival in the US makes is expected to thwart consumer spending which has been the primary engine of growth among other things that are next to impossible to accurately predict – except that fanned panic and divisive politics should no doubt make everyday living more chaotic and stressful.

The extraordinary moves up in the US treasury markets are a core economic symptom of the coronavirus. The immune system of global central banks is significantly compromised by their helplessness at this juncture. Markets have become so accustomed to repeated policy vaccinations every time risk assets raise a fever that they have become antibiotic resistant – in other words, the drugs don't work anymore. No medical supplies as policy tools is the bond market's symptomatic fear in that, what used to cure the market ills won't work anymore. The US Fed is running out of policy drugs and like for the coronavirus, its needs to develop a new vaccine.

In Fed Chairman Powell's own words to the Senate Banking Committee, "*low rates are not really a choice anymore, they are a fact of reality*." Indeed, "*the lack of inflation is the greatest challenge of our time.*" So, the Fed certainly knows that it has less room to cut rates to combat the next economic illness than it has had in the past. It has not only pledged to sustain inflation above 2%, but also to continue the length of the current expansion – this explains the urgency of the intermeeting rate cut given the sudden deterioration in financial conditions though despite this usual prescription, the markets have not improved! This is primarily because dual eventual demand & supply side shocks are certain to cause a high fever, but nobody knows how high the temperature will ultimately go. So, markets are adjusting as fast as the virus is spreading.

As technical as these adjustments seem, they are uncomfortable and symptomatic of a deeper fundamental question – does the Fed have enough policy space to be able to support the economy? The US treasury market is professing "no"! As a result, junior subordinated credit spreads are significantly wider (IG corporate credit spreads widened too, but not as much) as the treasury bond market screams in "pain". The medicine cried for is "fiscal response!" – a new drug the current expansion hasn't received yet. This should happen, but the problem is that this new drug needs to be activated by a global panic pandemic first, before the politicians have enough "foresight" (while looking backwards) to see the growth risk – especially in Europe.

The important thing to remember is that viruses are parasites that need a living cell to survive and an exposed healthy immune system can contain most of them, especially the coronavirus. We are not minimizing life, but some statistical comparators can help to ease some of the fears: death by the COVID-19 risk factor (currently about 3.5% or 3,460 globally) is factorially less than the annual number of deaths from zinc and iron deficiencies. The US Center for Disease Control estimates that there are currently 34 million flu illnesses this season (which officially ends after April) and approximately 20,000 deaths have occurred in the US from flu already this season – and this even with the cross protection of over 174 million doses of flu vaccine in distribution. The earlier H1N1 flu pandemic was declared as over in August 2010 by the World Health Organization -- but, not before about 0.005% of the world's population (about 365,000 people) died from its complications. Clearly, the COVID-19 pandemic pales in comparison to the H1N1 virus and to illness from the "common" flu this season. So how and why has such fear been stoked and driven into its own viral market pandemic this year -- well, I'll leave the potential answers for you to decide. Indeed, I never thought that I'd be talking about a global virus pandemic as a preferred securities manager, but macro elements to what drives our animal spirits (and de-spirits) to buy and sell simply cannot be ignored.

The COVID-19 virus will be contained as others have been in the past; the human condition will survive and those exposed will be stronger once they've recovered. The long-term health of the global economy though will continue to be chronically inflamed not only by central bank policy tools that need to be re-ordered, but also by fiscal authorities that seek to do nothing (for now). From a functional standpoint, a silver lining to the coronavirus is enlightened concern now that the inter-twinned dependencies of the global economy are exposed – so are the limitations of negative interest rates. More quantitative easing and more fiscal spending are the logical next steps and anything with yield (and spread) should be bought – many junior subordinated capital securities are cheap again. Finally, the last time we had a treasury bond move like this, financial bankruptcy fear was the pandemic – this time it's just fear of a suspect and peculiar virus.

But, let's all wash our hands and be safe!

Phil Jacoby
CIO, Spectrum Asset Management
March 6, 2020

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