Junior-Subordinated Capital Securities Markets

March 2020 Updates

The Coronavirus (COVID-19) has crushed the global economy. At this point, we all know that the physical, emotional and economic costs of the pandemic are enormous and growing. As each day passes, we are increasingly confident that coordinated global efforts to social distance will ameliorate COVID-19's surge to stay within control of treatment capacities. There is no question that the human condition will survive this invisible enemy, but the economic toll to get there will be extraordinary. Consequently, risk assets (and "risk free" assets) have dramatically repriced and this process will be ongoing as new economic paradigms emerge from our collective behavioral response to fear. Indeed, record blow-offs in equity valuations and credit spreads defined March's madness. The US treasury bond market zoomed like a rocket launch, but then developed operating problems that were very unusual for a moon shot – "Houston, we have a problem." Even the US treasury market became illiquid. Ultimately, central banks fired almost every bazooka imaginable, policymakers loosened regulatory governors and governments freewheeled trillions in palliative aid. By the end of the month, markets began to feel some pain relief. The 30yr US Treasury bond closed the month yielding 1.35% (31bps lower). The US Treasury 10yr note closed the month yielding 0.70% (43bps lower). The yield differential between these two longer US Treasury terms closed at 65bps (18bps steeper on the year). At one point during the month, the swoon in stocks had reversed the 51% gain posted in the S&P 500 over the last 3 years of the Trump administration. But as historic policy responses mounted, the S&P 500 recovered from its lows to finish the month at 2585, which was down 12.5% or 20% lower than its peak made just six weeks earlier. But in the process, credit markets were crushed across the capital structure. The credit curve dislocated from term logic as funds sold anything they could to meet the redemption demands of liquidating investors in shock over travel bans and quarantines that put a slam stop to almost half of the globe's commercial exchange. So, after trading through 3 prior dramatic re-pricings (i.e., 2011, 2016 & 2018) that each triangulated back to prior bottoms, this time it's different – a recession has arrived.

Before we discuss the performance implosion in Spectrum's junior subordinated sectors this month, let's look at performance in some of the more senior corporate credit sectors for comparative references on returns and yield changes (note that any rebalancings this month for the ICE Data Indices were postponed due to the market disruption):

- The junk market (measured by the ICE BofA High Yield ***h0a0*** index) declined 11.76% to close yielding 9.06% (280bps higher).
- Global bank credit (measured by ICE BofA ***e0ba*** index) declined 4.68% to close yielding 3.19% (105bps higher).
- The BBB rated 5-10yr corporate sector (measured by ICE BofA ***c6a4*** index) declined 10.56% to close yielding 4.39% (177bps higher).

<u>Review of Market Structure:</u>

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 <u>sub-sets</u> 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 <u>two core characteristics</u>:

1) any non-payment of distributions would <u>not</u> 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 $302 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 $441 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.

<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 rated preferred securities are:

1. **ICE BofA Fixed Rate Preferred Index (*p0p1*) @ 43% *of i0cs***
    - Comprised of IG $25par and IG $1,000par US AT1
        - The *p0p1* fell 7.09% this month to close yielding 5.47%
        - Head fell by 4; face value declined by $2.2bil.
2. **ICE BofA US Capital Securities Index (*c0cs*) @ 26% of *i0cs***
    - Comprised of dated IG $1,000par hybrids (no US AT1)
        - The *c0cs* fell 10.72% this month to close yielding 5.08%
        - Head count and face value unchanged.
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 22.70% this month to close yielding 6.99%
        - Head count and face value unchanged.
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 13.59% this month to close yielding 7.51%
        - Head count fell by 1; face value declined $0.9bil.

Overall, the BofA All US Capital Securities Index (***i0cs***) fell 10.61% in March to close yielding 5.90%, which was 174bps higher than last month's closing yield and a spread of +502bps over comparable US Treasury securities (201bps wider).

Contingent Capital Securities

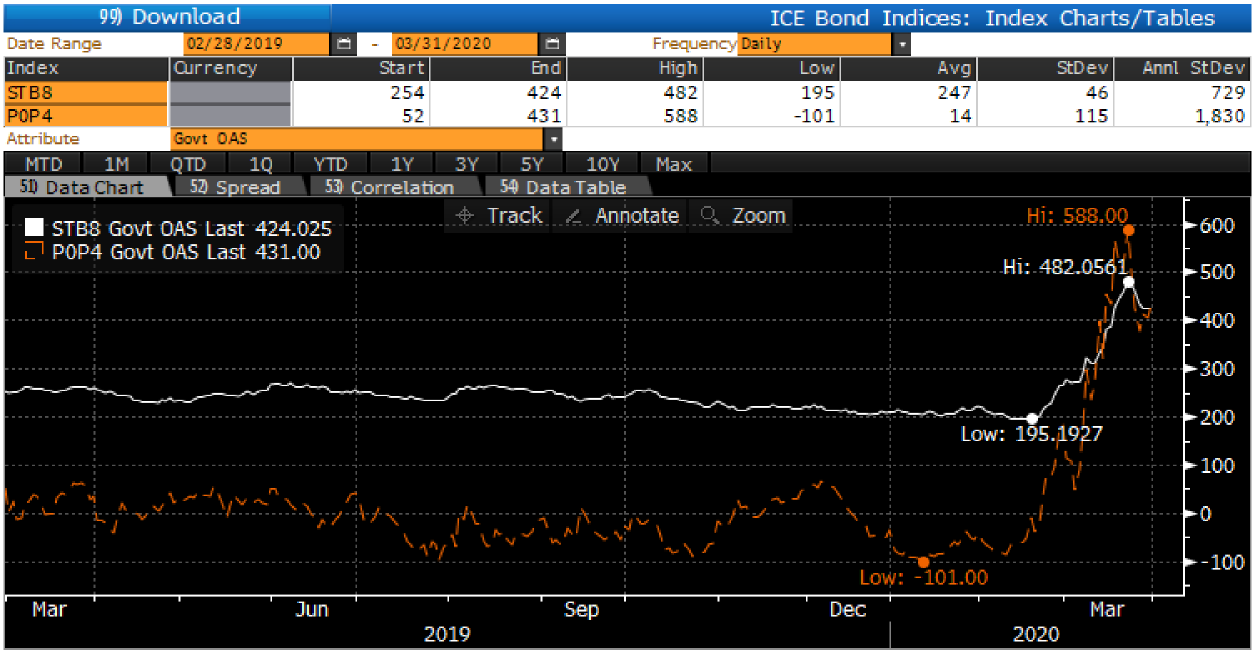
A **"contingent capital security"** (i.e., a "CoCo") represents a capital security issued through indenture typically within the context of a "going-concern" type regulatory regime for banking, which would reorganize a potentially insolvent bank through the contracts of its capital before falling into 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 13.23% this month to close yielding 6.20%, which was 154bps higher than last month.

Implications of Market Activity:

$25par Retail Preferred Securities Sector

The retail preferred securities sector fell $9.42 this month after significantly recovering from a deeper flash crash within a crash. The price decline blew spreads out to levels not seen since the Great Recession of 2008-2009. The graph below shows the 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 we call "NoCos" to distinguish $1,000 preferred securities from

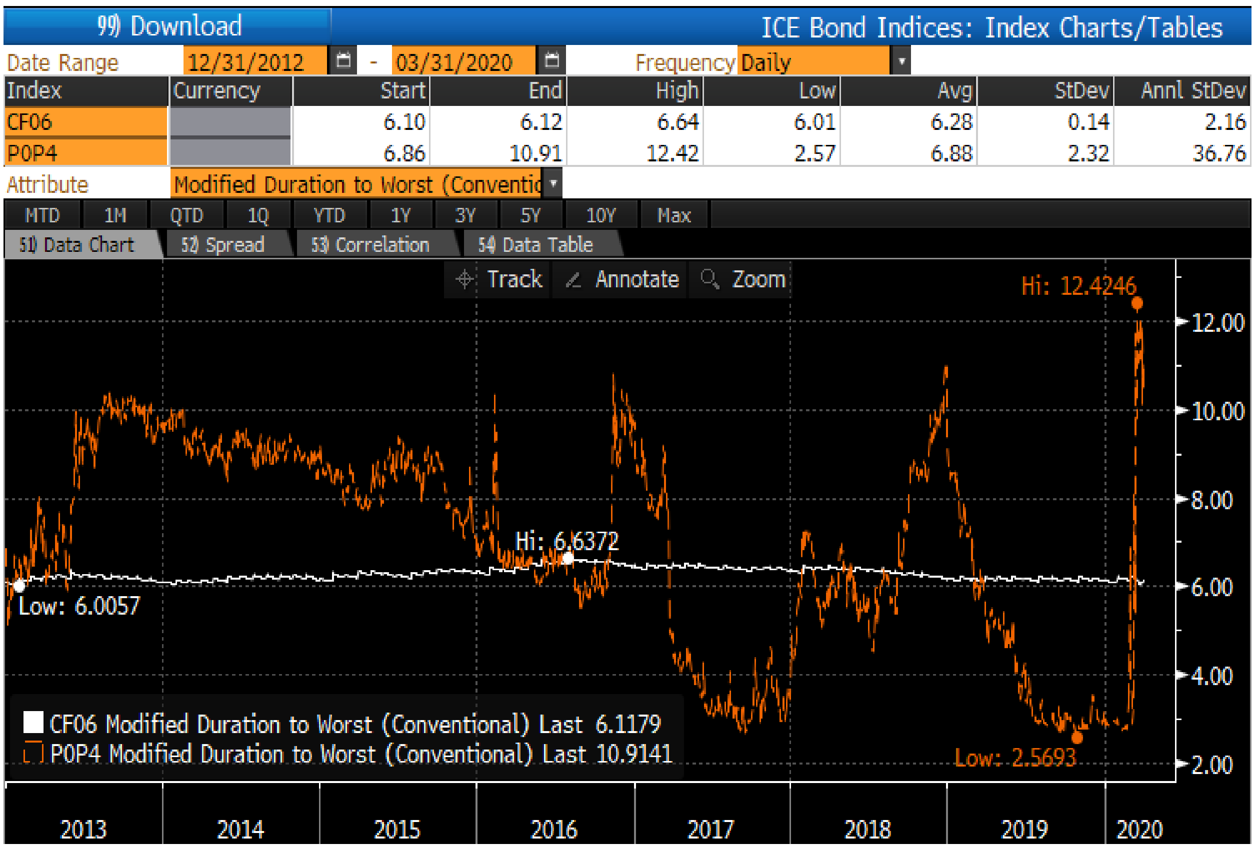
$1,000par contingent capital securities risks.



Source: Bloomberg

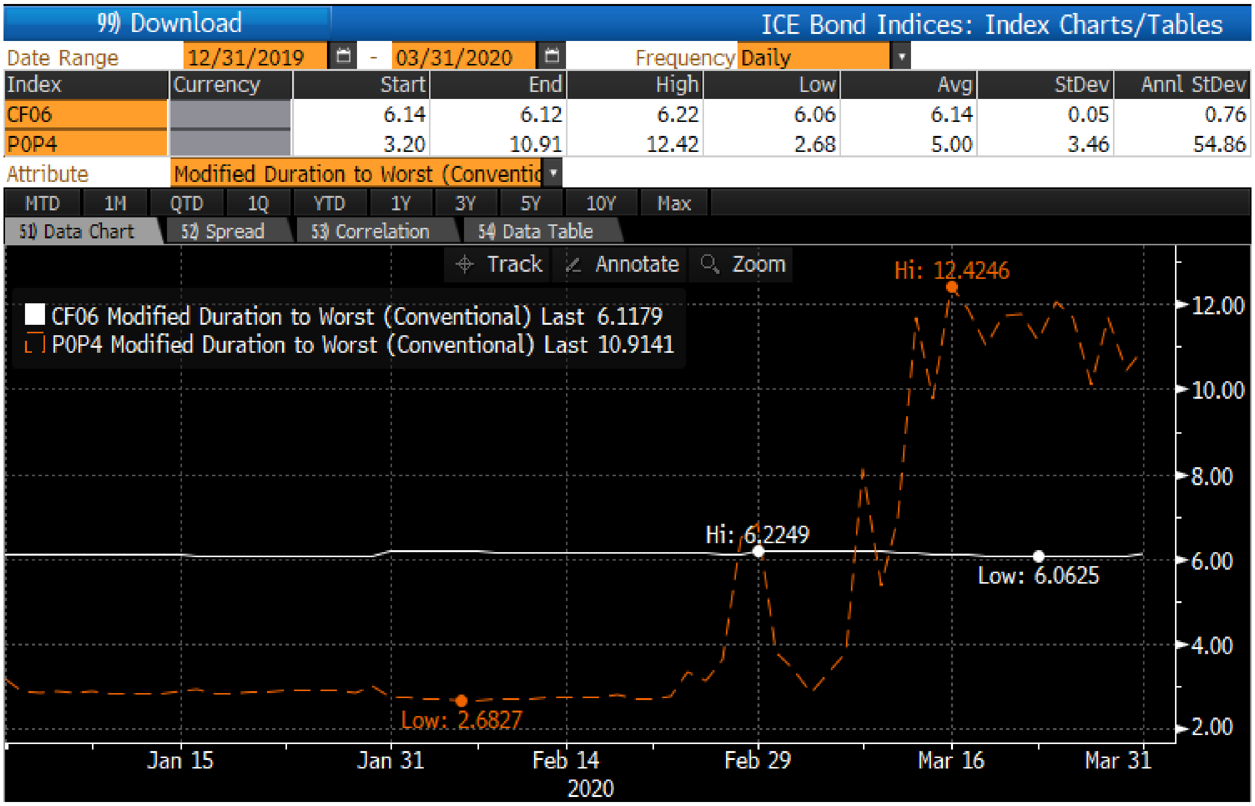
After tightening to 101bps through treasuries earlier this year, the retail market weakened in February and then virtually collapsed in March – but not without a fight. The sector tightened 133bps to start the month, but then concerns in the oil patch sparked a 3day treasury bond rally that stepped the 30yr bond yield down 70bps to an all-time closing low of 1%. Over the weekend of March 8th , production negotiations fell apart between Saudi Arabia and Russia which, against the backdrop of accelerating coronavirus concerns, sent the $25par market into a historic 7day tailspin totaling a 26pt decline (31pts from its peak in January) – the spread in the $25par benchmark vaulted 541bps higher over a two week run and broke through the NoCo spread for the first time in over 7years. A combination of Fed policy bazookas and the $2.2 trillion CARES Act helped to ease market fears and ignite a significant retracement of deeper losses by month end.

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

When duration of the $25par market is below the duration of the ICE BofA 5-10yr US Financial Index (cf06) negative convexity slows potential price progression and OAS spreads can become overvalued – which is primarily why we have been underweight the retail sector for some time in our funds. This month, we take a zoom shot of duration behavior for both benchmarks:

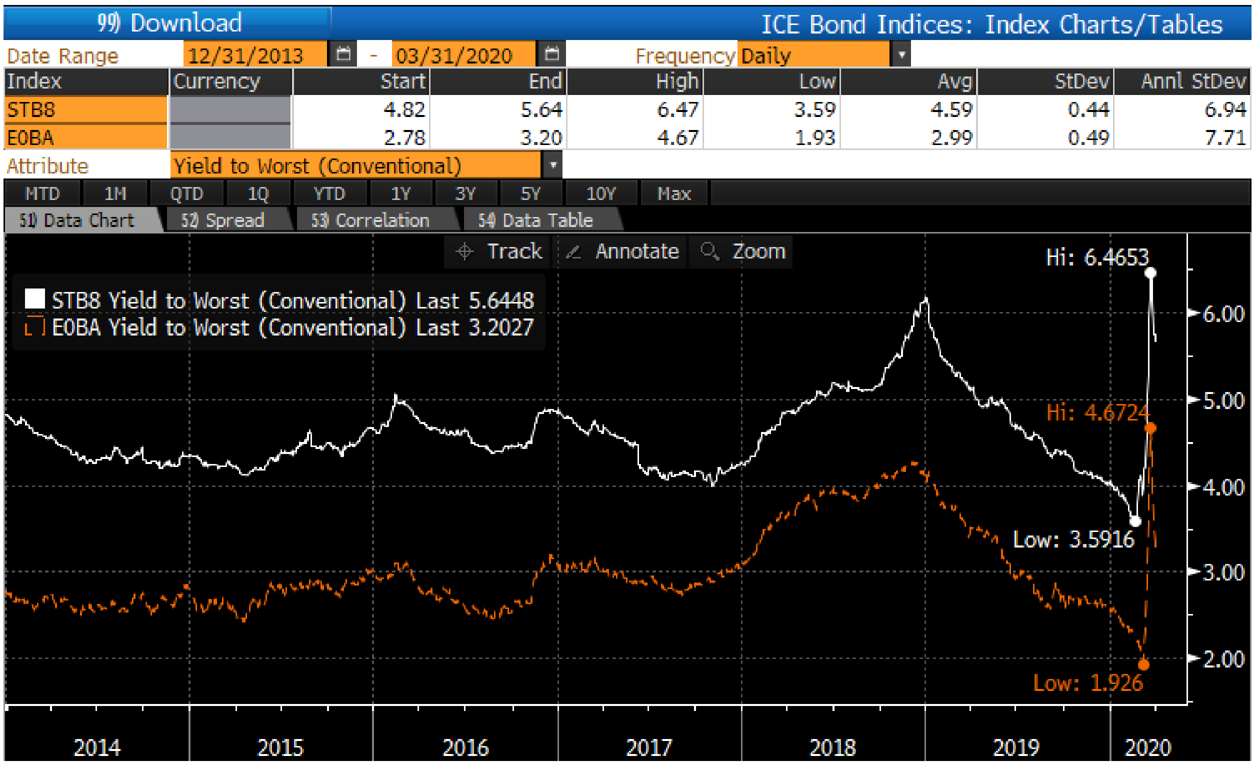


The modified duration of the retail $25par market was zooming higher as fast as the price of the benchmark was falling in March. This significant repricing flagged by double digit modified duration leaves the retail sector with an unusual value trifecta of 1) discount price ($92.17), 2) high yield (6.80%) and 3) generous spread (431bps). Basically, the yield clock has been wound back to the Taper Tantrum (2013) and the spread clock the summer of 2009.

$1,000par Institutional Preferred Securities Sector

The $1,000 par institutional sector of the preferred securities market fell $12.55 this month after being down as much as 22pts. The NoCo sector has certainly gotten cheaper in the absolute, as has everything other credit class. Interestingly, the relative spreads in NoCos compared to the more senior financials stayed relatively contained because nothing was immune from the blow-off this month and the problem wasn't Wall Street it was Main Street.

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) -- and now we have the COVID-19 end to the expansion. The recent remarkable rally that started in 2019 and carried into this year broke through a sturdy 4% floor, but abruptly reversed to discount the economic uncertainties of the coronavirus lockdowns. Notice the breadth of the move for both asset classes in just 3 weeks this month has returned the yields to levels available in 2018 when US treasury rates were 170bps higher, which means that spreads in NoCo paper are outstanding vs. treasuries that yield next to nothing. At the end of the month, NoCo spreads to treasuries (+424) were 75bps higher than 2018 (and 2016) and 4 standard deviations wide of their 257bp average over the last 7years. We note also that the OAS for more senior financials (measured here by e0ba) are 5 standard deviations wide of average for the same period, which illustrates the dislocation of credit markets and opportunities up and down the capital structure.

<u>Contingent Capital Securities Sector</u>

The CoCo sector closed $14.83 lower this month against the backdrop of a 35.5% decline in the European bank sector this 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

The relative spread differential between CoCos and more senior financials was volatile and traded within an 88bp range this month as payment fears on European AT1 heightened when the European Central Bank recommended that EU banks should "refrain from making dividend distributions and performing share buy-backs aimed at remunerating shareholders during the period of COVID-19 related economic shock." After Rabobank eliminated it payments on a common equity tier1 Certificate issue that looks like an AT1 issue (but is not), the bank made no mention of CoCo payments being passed. The next day, Andrea Enira, the ECB Supervisory Board chairman, stated that "the ECB had no plans to order banks to suspend interest payments on their hybrid debt instruments such as AT1 or tier2 securities." This certainly makes sense as it would completely tarnish the fundamental facts that European banks have adequately passed years of stress tests with replenished CET1 capital, improved asset quality and have sufficient liquidity to manage economic stress with existing capital levels. Delaying payments on common equity is a core source of current period capital preservation and future period payments can always be accelerated when earnings improve (and longer term, the irony to change is bank earnings likely will improve in the next recovery). Over the course of March, CoCo securities widened 69bps relative to more senior bonds for a 299bp advantage at month end. CoCo spreads relative to US treasuries closed at 573bps or 2.6 standard deviations wider than average over the 7yr period.

Outlook:

The arrival of COVID-19 in the US has caused the most severe impact to the US economy since the Great Depression as virtually the entire country is under some form of operating limit, lock-down and social distancing. Consumer spending, which has been the primary growth engine to the economy, has plummeted and unemployment is soaring. The combination of central bank policy initiatives or "bazookas" and fiscal responses like the $2.2 trillion CARES Act should help pull the economy up while core operations are down. There is even more fiscal spending planned. Ultimately, we expect a phase-in process in certain regions that are less impacted and then for the hotspots to be opened with some sort of behavioral guidance in May. There does appear to be hope with certain treatment modalities but ultimately, only the process of achieving natural herd immunity will contain the virus – and this is the point: COVID-19 had never been in the human population before, which is why it's so contagious and compromising. Basically, human immune systems had no prior memory of what this virus was so there was no experience written genetic code to contain it. Therefore, new code needs to be written individually for each member of the herd to beat it down – this take some time and exposure. Once this happens, the herd becomes naturally immune until the next mutation happens (and it will), but it's now well prepared to fight a familiar enemy. Every flu season, we have mutations of prior viruses, but the mutations have recognizable proteins that can trigger our immunity into action before the parasite replicates enough to compromise its healthy host -- this is precisely why we know that the human condition will survive COVID-19. Improved COVID-19 testing should help to identify who has immunity and who doesn't and allow more informed risk management when next year's flu season arrives. Though warmer weather to come will naturally flatten the curve this spring & summer, this year's elections are apt to be complicated another wave of infections playing into the process. But by this time, COVID-19 should be more akin to the "ordinary" flu as much of the herd will have experienced the enemy before thus preventing a surge (despite what the media is likely to fan) and allowing the medical community (which will be prepared this time) to effectively treat those that need special attention.

We have no doubt that the global economy will prosper again, but the path to prosperity will be burdened as the economic implication of surviving the coronavirus is a plethora of public and private debt -- the blessing of survival leaves a burden of debt. The US national debt for example, just zoomed up 10% in one month with the CARES Act – yes, most of it was needed, but it weighs an enormous burden of debt refinancing for generations. Interest rates are low now, but low for longer does not mean low forever. Just as too much commercial paper weighed on GE almost twenty years ago, so too should trillions of frontend curve funded US treasury debt from the corona-contraction. The paradigm shift to more US production and control of vital manufacturing of technology, pharmaceuticals and defense equipment will be good for the US economy and wage growth and finally give the Fed what the Fed wants – sustained inflation. It seems like rates should be low for longer, but the fundamental paradigm shifts from globalization to localization are inflationary. What is "low" anyway – it's rather subjective; we believe a 3% US treasury 10yr yield is still "low". The process of resurgent growth should reduce equity volatility, and this should bode well for spreads to tighten as we climb out of the corona-hole. Uniquely, the junior subordinated capital securities market has a core structural attribute enabling fixed rates to reset higher if inflation happens. Ironically, higher rates and a steeper yield curve should bode well for bank earnings too (and dividend growth) which can help to recover loan losses that are a natural cost to every recession. So, the outlook is certainly complicated with change, yet we are constructive about this change – especially within the context of quality financials and the value trifecta currently available in junior subordination.

Health be with you and yours.

Phil Jacoby
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