Junior-Subordinated Capital Securities Markets

May 2020 Updates

The Coronavirus (COVID-19) still weighed heavily on the global economy in May despite asset prices making a V-shaped recovery – for this, we can thank the central banks. The total number of people who have filed for jobless claims peaked in May after its moon shot from March, but at 21 million people, the number of claims is still over 3.6x higher than before the pandemic. But the virus statistics are improving in the US with the hospitalization rate from COVID-19 dropping by 57% in May. For markets, May was record month for bond issuance and there was plenty of equity cheer as the palliative aid programs continued to boost financial assets faster than they are benefiting the real economy for now. The 30yr US Treasury bond closed the month yielding 1.41% (11bps higher). The US Treasury 10yr note closed the month yielding 0.65% (3bps lower). The yield differential between these two longer US Treasury terms closed at 76bps (29bps steeper on the year). The S&P 500 gained 4.53% during May as another vote of confidence in the Fed's historic policy response. So, despite the recession's arrival and recent social unrest, equity prices and credit prices are looking well ahead into the expansion.

Before we discuss the performance 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) rose 4.70% to close yielding 7.09% (97bps lower).
- Global bank credit (measured by ICE BofA ***e0ba*** index) rose 1.51% to close yielding 2.05% (39bps lower).

- The BBB rated 5-10yr corporate sector (measured by ICE BofA ***c6a4*** index) rose 2.78% to close yielding 2.87% (42bps 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 $303 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 $138 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 $449 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 consolidate into 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* rose 1.01% this month to close yielding 2.88%
     - Headcount grew by 9; face value grew by $9.1bil.
2. **ICE BofA US Capital Securities Index (*c0cs*) @ 25% of *i0cs***
   - Comprised of dated IG $1,000par hybrids (no US AT1)
     - The *c0cs* rose 2.22% this month to close yielding 3.88%
     - Headcount grew by 1; and face value declined by $2.0bil.

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* rose 5.42% this month to close yielding 5.35%
     - Headcount and face value unchanged.
4. **ICE BofA High Yield Fixed Rate Preferred Index (*p0hy*) @ 25% of *i0cs***
   - Comprised of BIG $1,000par US AT1 and BIG $25par
     - The *p0hy* rose 2.31% this month to close yielding 5.00%
     - Headcount grew by 4; face value grew by $1.8bil.

Overall, the BofA All US Capital Securities Index (***i0cs***) rose 1.90% in May to close yielding 3.80%, which was 65bps lower than last month's closing yield and a spread of +311bps over comparable US Treasury securities (66bps tighter).

Contingent Capital Securities

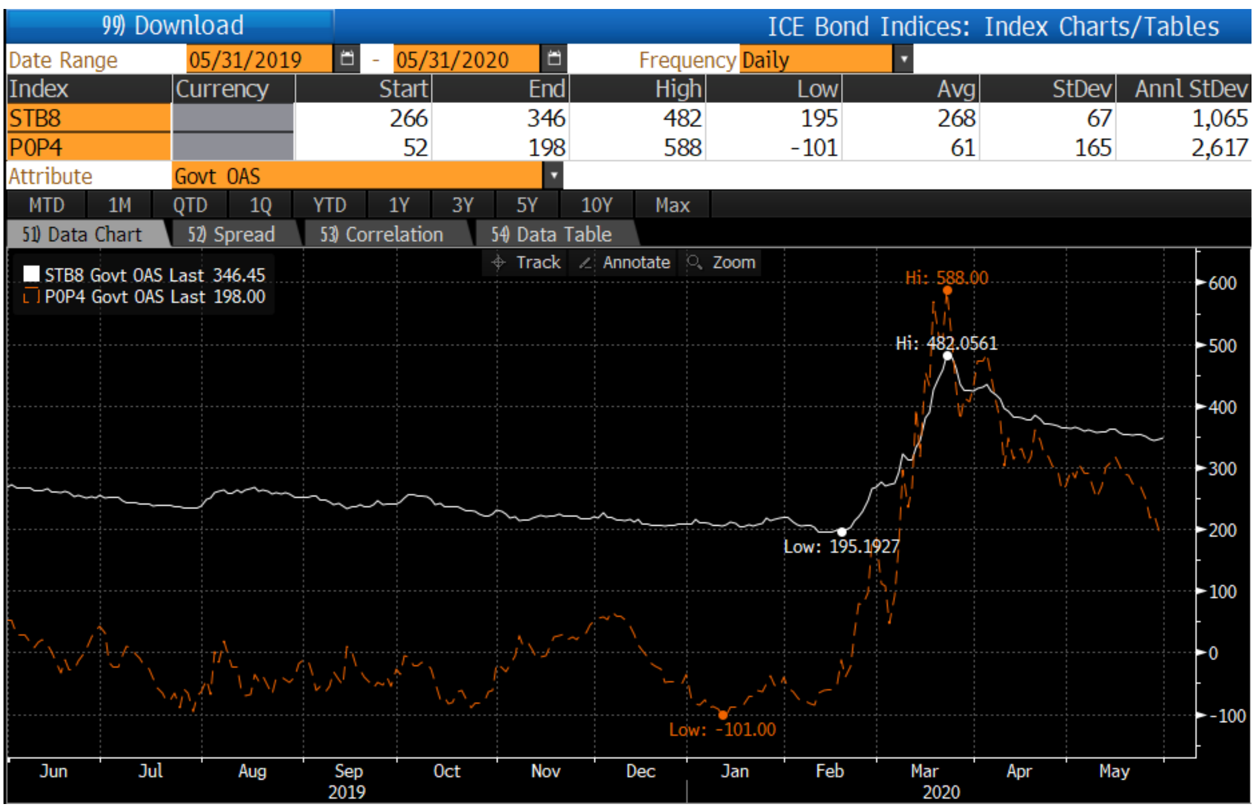
A **"contingent capital security"** (i.e., a "CoCo") represents a capital security issued through indenture typically within the context of a "going-concern" type regulatory regime for banking, which would reorganize a potentially insolvent bank through the contracts of its capital before falling into 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 62% of the mature master multi-currency benchmark (*coco*). 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***) rose 7.72% this month to close yielding 5.37%, which was 90bps lower than last month and a spread of +476bps over comparable US Treasury securities (83bps tighter).

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

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

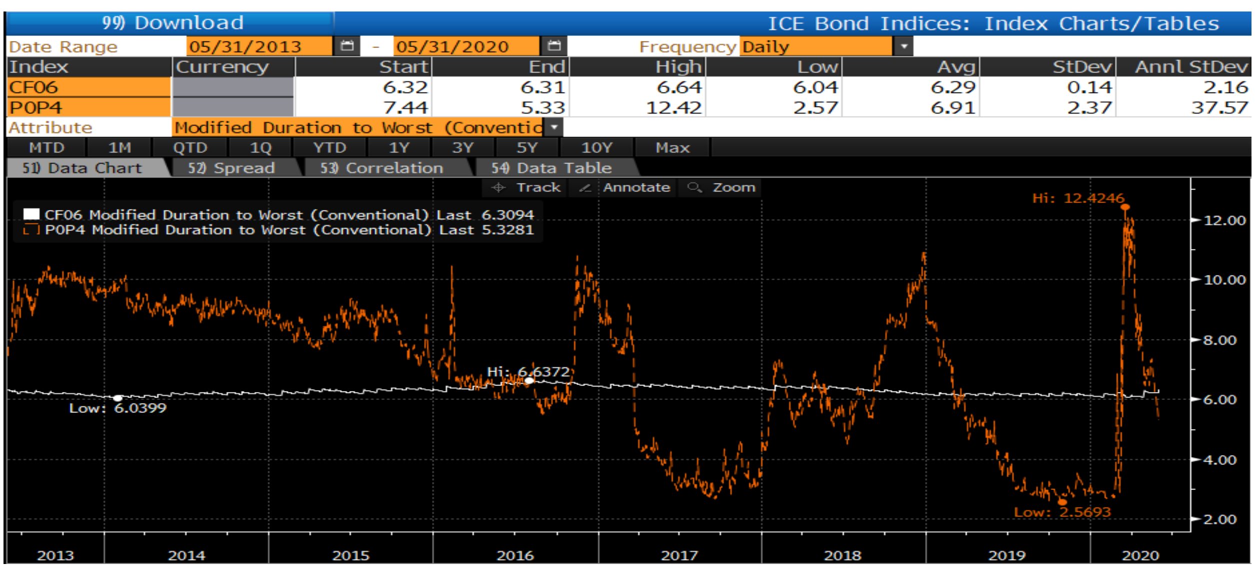
The retail preferred securities sector rose $1.09 this month and was significantly aided by the continued strength in equities and a favorably received IPO market that helped lift prices in secondary paper. The graph below shows the spread in the $25par market (i.e., p0p4) over the past year compared 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

The graph shows the market's collapse in March as the +588bp spread at the high and the 156bp rally the second half of March. This month, the rally continued with a further bull tightener of 162bps for the retail sector. This move (-0.56 standard deviations measured over the last 7 years) tightened up the retail sector to push spreads further below the institutional sector, which is normal given the retail sector's negative convexity. Despite the big move, there is still plenty of room to tighten as the retail market is still priced 0.82 standard deviations wide of its average spread over the last 7yrs.

We view modified duration of the *p0p4* benchmark to be a contra-indicator of value due to the benchmark's usual 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 more often than overweight in some of our funds. As spreads tighten in retail paper, we expect the $25par market's relative value to slip more compared to its institutional counterpart (i.e., NoCos).

$1,000par Institutional Preferred Securities Sector

The $1,000 par institutional sector of the preferred securities market rose $1.31 in May. The NoCo sector has recovered over 71% of its yield break this year, and yields are now marginally lower than average. 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 recession which markets are quickly looking beyond. At the end of the month, NoCo spreads to comparable treasuries closed 18bps tighter (+346) which was a 0.41

standard deviation move tighter. Though NoCos had a big move up this month, they are still positioned 2.0 standard deviations wide of their average spread to treasuries over the past 7yrs. The story in NoCo paper this month was new issuance helping to drive spreads tighter – so much new issance that is requires a list:

1. QBE Insurance 5.875% Jr-sub (Baa2/BBB-) +551
2. Bank of NY 4.70% AT1 (Baa1/BBB) +436
3. CMS Energy 4.75% Jr-sub AT1 (Baa3/BBB-) + 412
4. Comerica 5.625% AT1 (Baa2/BB+) +529
5. Markel 6.0% Jr-sub (Ba1/BB+) +566
6. Truist Financial 4.95% AT1 (Baa2/BBB-) +460
7. Huntington Bancshares 5.625% AT1 (Baa3/BB+) +495
8. Citizen's Financial Group 5.65% AT1 (nr/BB+) +531
9. Bank of Nova Scotia 4.90% (Baa3/BBB-) +455

Issuance was all well received and trading above par, but not before some minor indigestion for a few days. US bank AT1 paper is pricing off 5yr constant UST yields rather than off LIBOR swaps, which gives the belly of the UST curve for the reset rather than the uncertainty of 3mo.-LIBOR. Importantly, the combination of generally 5% area current yields and wide reset spread makes IPOs for NoCos in this market quite compelling. For example, the last time Charles Schwab came to market was in October 2016 when dividends were 75bps lower and spreads 166bps tigher and the last time Huntington Bancshares came to market was March 2016 when dividends were 8bps higher, but spreads were 207bps tighter.

<u>Contingent Capital Securities Sector</u>

The CoCo sector closed $2.70 higher this month against the backdrop of a fiscal spending hopes in Europe that developing quite well. 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 trended 3bps tighter this month. Fears have eased that regulators will recommend that European banks pass AT1 dividends (like they are on common dividends), though the thought still gets some discussion in European Parliament. We do not expect any negative surprises on AT1 dividends (i.e., being blanketed along with common dividends) because that would unnecessarily and arbitrarily eliminate AT1 payments when capital is more than adequate and payment triggers are already well designed into the instruments. We believe that the risk of banks being encouraged by September to extend this no-pay period on common stock beyond October is still elevated, but supportive policies can improve the outlook. The European Central Bank's recent decision to increase its pandemic emergency purchase program (PEPP) by €600 billion (to €1.35 trillion) will certainly help stimulate the Eurozone over the next year. By the end of May, CoCos were 1.7

standard deviations wide of their average spread to comparable treasuries since the end of 2016.

Outlook:

The spread of COVID-19 and the initial policy of needed social distancing in the US has caused the most severe impact to the US economy since the Great Depression. Policy responses appear to be constructive as localities reopen helping to lift US markets even despite social unrest. Resurging riots and looting are violently disrupting our privileges to peaceably protest, march and petition local governments for just grievances. Both challenges are certainly precarious and add considerations to our evolving outlook. As the year progresses, debates leading into the 2020 general elections should (hopefully) clearly frame core social grievances and other platforms with redress and solutions which will surely help further mold the 2021 market outlook.

My base philosophy when considering the macro trend to our market (learned during my early years as an analyst at Ford Financial), is to think things through to an extreme -- not because I necessarily believe that we are destined to that extreme, but because the direction of travel has varied implications if we head that way. Therefore, what are the rates and credit implications of moving toward an extreme and how bad can bad be if we get there? If the worst outcome is acceptable (irrespective of probabilities), then we take the journey – if not, then we pause (i.e., do nothing) or go the other way. In the credit markets, the choices are either to take the journey (buy credit); pause (in cash) or go the other way (buy Treasuries). Of course, asset allocators have more choices to buy different directions – like equity or gold.

The political stakes to American ideals seem higher than any other time during my career. It is essential, therefore, to think through some of these political trends as they develop to weigh (candidly) what the direction of travel means for credit and interest rates – this will indeed be an evolutionary process likely full of surprises. The politicization of the COVID-19 response (e.g., debates over abridges of 1st Amendment rights) and the unrelated riots that disrupted our freedom to assemble and petition very important grievances are two ongoing surprises. COVID-19 is an acute problem that should resolve itself while the social unrest is a chronic symptom of deeper issues that need thoughtful long term core redress – yet, irrespective varying views on the politics and policy of both, each weigh immediately on the macro view. The spread of COVID-19 is likely to be a resurging alarm in the media, though reports from doctors are that this novel virus is mutating into a tolerable and more manageable virus as it jumps from host to host -- this report is plausible because a virus (like the mob), wants to keep its host alive so it too can survive. Mutations combined with healthy immune systems can help to explain why a "natural immunity" can happen. Yet, Congress will still be pushing forward the $3 trillion HEROS Act that the US Treasury bond market may have to absorb in some form; and at a time when the economy is reawakening (e.g. last Friday's surprise good news on non-farm payrolls). When the government bond market feels a weakness (like an economy more resilient than anticipated, yet still satiated with forceful spending desires) it will push on it to invoke the Fed to do something – like control the yield curve. So, now more than ever the Fed does indeed need to be innovative and adroit on timing and countervailing force.

As we said last month, innovation is the thematic curiosity of the Fed as "*The Fed is prepared to engage in an open-ended period of policy innovation to support the years it's going to take the economy to dig out.*" Innovation means doing something new. For the Fed, something new is yield curve control which can help a potentially overloaded US Treasury market manage funding (and refunding) demands while containing the yield pressure. The extreme is that the debt burden gets so large in the process of sustaining the next expansion that desired inflation (from the success of the original policies) pressures up Treasury interest expense so much that it overwhelms an insufficient tax base to service it -- this is when "helicopter money" could happen. Modern Monetary Theory says that a fiat currency system can never default because the country will simply print more currency (i.e., inflate the currency) to repay the debt.

The "years" the Fed expects to pass before the economy is back to ground level is concerning given the fiscal road to ever more debt, which means a destination to IRS appetites that could eventually become insatiable at state and federal levels. Importantly, this craving is probably best satisfied by expanding the economy to inflate the tax base in a Keynesian fashion, rather than by taking more taxes from an economy that has already shrunk and will "take years to recover". So, the risks to significant expansion of US government debt are going to be ignored for now because politicians on both sides are incentivized do whatever it takes to restart local economies at different speeds together – the one constant is warp speed on US government spending. Moreover, we are witnessing not only a super-Keynesian response in action, but also a likely double-down proposal of supply-side economics through additional tax cuts to turbo charge the recovery. Irrespective of tax cut battles, further deregulation (and targeted tax incentives) are likely to focus on home grown manufacturing advances which are needed to foster growth in the middle class (i.e., enabling more people to join the middle class through growth in labor demands which can push more people up the income ladder). The recent social unrest is partially symptomatic of advances in labor not reaching deep enough or not having enough breadth, among other things. The relevance here is not necessarily to ponder political problems, but to figure out what the path of travel will be when elected officials seek the remedies. Enter COVID-19 (again) and the economic epiphany that spread with it, that is, the revelation that the US is overdependent on China for essential supplies related to healthcare and technology. The confluence of curing essential import dependency risk with the labor needs of Americans conjoins the demands of two megatrends with an opportunity to define the next expansion as more broadly inclusive -- a truly "Home-Grown" economic paradigm.

So, the extreme outcome to future politics and policy should follow a road to inflation, inflation, and inflation potentially ending in "helicopter money" someday. COVID-19 and social unrest are combining to make this outlook more probable irrespective of how America chooses to proceed (e.g., via capitalism or socialism) or who wins the next US Presidential Election or what party controls Congress. The elections will determine the speed of travel, but not the path of travel to free currency. Interest rates along the yield curve should go higher while the Fed anchors its short-term rate at zero-bound for the "*years it's going to take the economy to dig out.*" Yield curve controls from the Fed should decelerate the rise in longer term rates, but not prevent the rise –not when the goal is recovery and inflation. Above average spreads in hybrid capital securities should trend tighter as the yield curve steepens from the home-grown expansion being a product of money creation, fiscal excess, and wage growth. Equity markets should rise more, but not without some indigestion. In conclusion, we will take the journey and buy credit, that is, hybrid credit which has structures that can reset yields higher as US Treasury rates move higher. For now, the total rate of return implication to this expected journey is constructive given the breadth of the prospective money creation; and its likely delivery to an increasingly broader base of people taking pride in the home-grown ride – that is, provided the ride is peaceful and unabridged.

Justice, Tranquility and Welfare be to all,

Phil Jacoby
CIO, Spectrum Asset Management
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