Junior-Subordinated Capital Securities Markets

August 2020 Updates

The Coronavirus pandemic is still plaguing the human condition but not the market condition. August was certainly another good month for hybrid securities, but not so good for US Treasury securities – in particular, treasury duration. Yields in junior subordination declined and spreads tightened, and long-term yields of US Treasuries rose. The Fed reaffirmed its commitment to keep interest rates low and introduced a new policy named "Flexible Average Inflation Targeting" ("FAIT") that intends to "run the economy hot". Real rates on the front end of the curve continued to plummet deeper into negative territory while the gold rally took a breather after making record highs earlier in the month. The 30yr US Treasury bond closed the month yielding 1.46% (26bps higher). The US Treasury 10yr note closed the month yielding 0.68% (15bps lower). The yield differential between these two longer US Treasury terms closed at 78bps (12bps more than last month; 30bps steeper on the year). The S&P500 had a steady price move up over 7.00% in August and the VIX (i.e., Chicago Board Options Exchange Volatility Index), after crossing under its 200day moving average last month, drifting down to a low (21.51) since March before lifting a bit after the Fed news. Equity has bought into policy goals for a US recovery and volatility compression implies little risk of a paradigm shift in US politics -- just yet. However, risk of US election chaos is growing as contested elections up and down the tickets in over a dozen states are likely to happen because of mass mail-in balloting.

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 0.98% to close yielding 5.35% (11bps lower).
- Global bank credit (measured by ICE BofA ***e0ba*** index) declined 0.25% to close yielding 1.48% (2bps lower).
- The BBB rated 5-10yr corporate sector (measured by ICE BofA ***c6a4*** index) rose 0.07% to close yielding 2.15% (1bp higher).

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 has evolved with unique technical, structural, and fundamental features that are discussed and updated below:

Global junior subordinated capital securities (sometimes called “hybrids”) 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 hybrids 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 $324 billion (face amount) of investment grade and below investment grade instruments in both the retail

$25par market (40%) and the institutional $1,000par market (60%). The USD Contingent Capital Index of US dollar denominated junior-subordinated capital securities ***(cdlr)*** represents $140 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 $455 billion universe of fixed-rate junior-subordinated USD 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*) @ 45% *of i0cs***
    - Comprised of IG $25par and IG $1,000par US AT1
        - The *p0p1* rose 1.57% this month to close yielding 1.77% (-31bps)
        - Headcount was +1, face value unchanged

2. **ICE BofA US Capital Securities Index (*c0cs*) @ 23% of *i0cs***
    - Comprised of dated IG $1,000par hybrids (no US AT1)
        - The *c0cs* rose 1.36% this month to close yielding 3.10% (-14bps)
        - Headcount was +2; face value grew by $3.3 billion
3. **ICE BofA High-Yield Capital Securities Index (*h0cs*) @ 7% of *i0cs***
    - Comprised of BIG $1,000par legacy Tier1 and BIG $1,000par hybrids
        - The *h0cs* rose 1.93% this month to close yielding 4.32% (-14bps)
        - Headcount unchanged; 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 2.58% this month to close yielding 4.32% (-29bps)
        - Headcount was +3; face value grew by $1.6 billion

Overall, the BofA All US Capital Securities Index (***i0cs***) rose 1.78% in August to close yielding 2.88%, which was 24bps lower than last month's closing yield and a spread of +231bps over comparable US Treasury securities (31bps 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 60% 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 2.63% this month to close yielding 4.24%, which was 43bps lower than last month and a spread of +351bps over comparable US Treasury securities (38bps tighter).

Snapshot of Junior Subordinated Spread Sector Moves:

	(a)	(b)	(a)	(b)	(a)	(b)
Last 7yrs	**Retail**	**Retail**	**NoCo**	**NoCo**	**CoCo**	**CoCo**
Jr-Subs	***Absolute**	****Relative**	***Absolute**	****Relative**	***Absolute**	****Relative**
High	588	251	482	202	660	421
Low	-178	-267	175	56	223	143
Range	766	518	307	146	437	278
Average	93	-32	262	140	386	263
Stdev	124	106	45	23	74	52
Monthend	105	-4	284	175	372	263
Sector Spread Score[1]	**0.18**		**1.01**		**-0.09**	

1: Sector Spread Score = {[Monthend(a)-Ave(a)]/Stdev(a)+[Monthend(b)-Ave(b)]/Stdev(b)}/2

	Monthend statistical position to average per unit of standard deviation					
***Absolute**	0.10		0.49		-0.19	
****Relative**		0.26		1.52		0.00

** Absolute = Option Adjusted US Government Spread*

*** Relative = spread to global financials measured by e0ba ICE Bond Index*

Source: Bloomberg, ICE Bond Indices

Implications of Market Activity:

$25par Retail Preferred Securities Sector

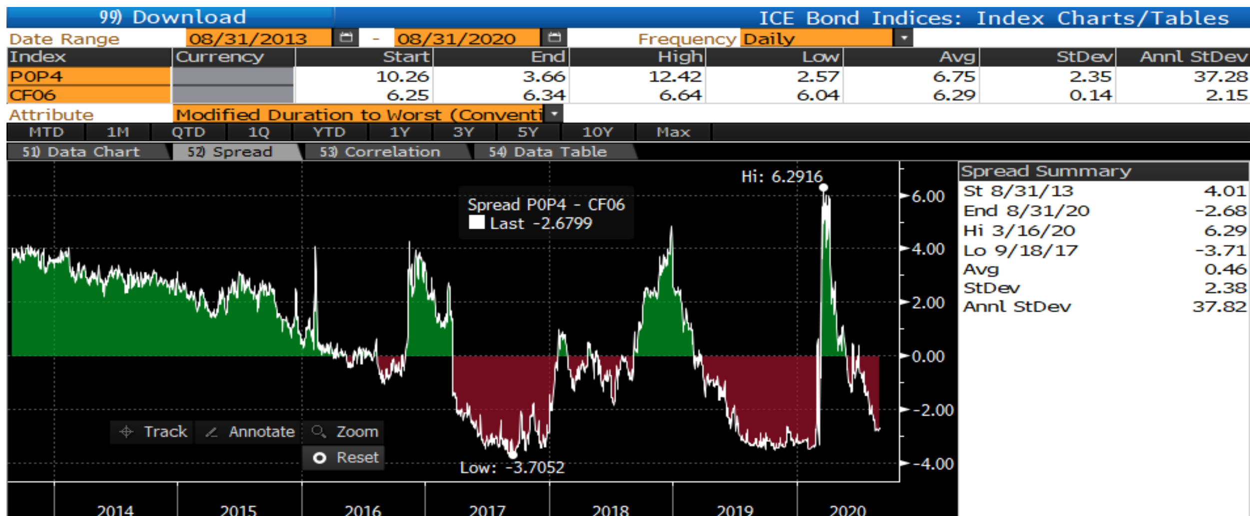
The retail preferred securities sector rose $2.02 this month aided by buoyant equity prices, better treasury prices and an attractive spread positioning to start the month (see last month's report). The graph below shows the spread in the $25par market (i.e., p0p4) over the past year compared to the 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 (CoCo) risks:

Source: Bloomberg

After the retail market's collapse in March (shown by the 698bp vertical overall), it rallied almost 450bps tighter up to the day before the Fed's meeting early last June -- only to be disappointed by a dismal economic outlook voiced by Chairman Powell during the press conference that followed. The correction last June provided an interim buying opportunity in retail paper that has trended the sector tighter along the lines of the equity rally this summer.

The $25par market tightened by 29bps to an OAS of 105 by month's end. This move leaves the retail sector with considerably less spread (+105) than was available earlier this summer. Over a longer perspective (i.e., the last 7yrs), the $25par market closed August spread roughly at average value or 0.10 standard deviations more than the average option adjusted spread of 93bps, but still 0.26 standard deviations in excess of the average spread over more senior financials.

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:



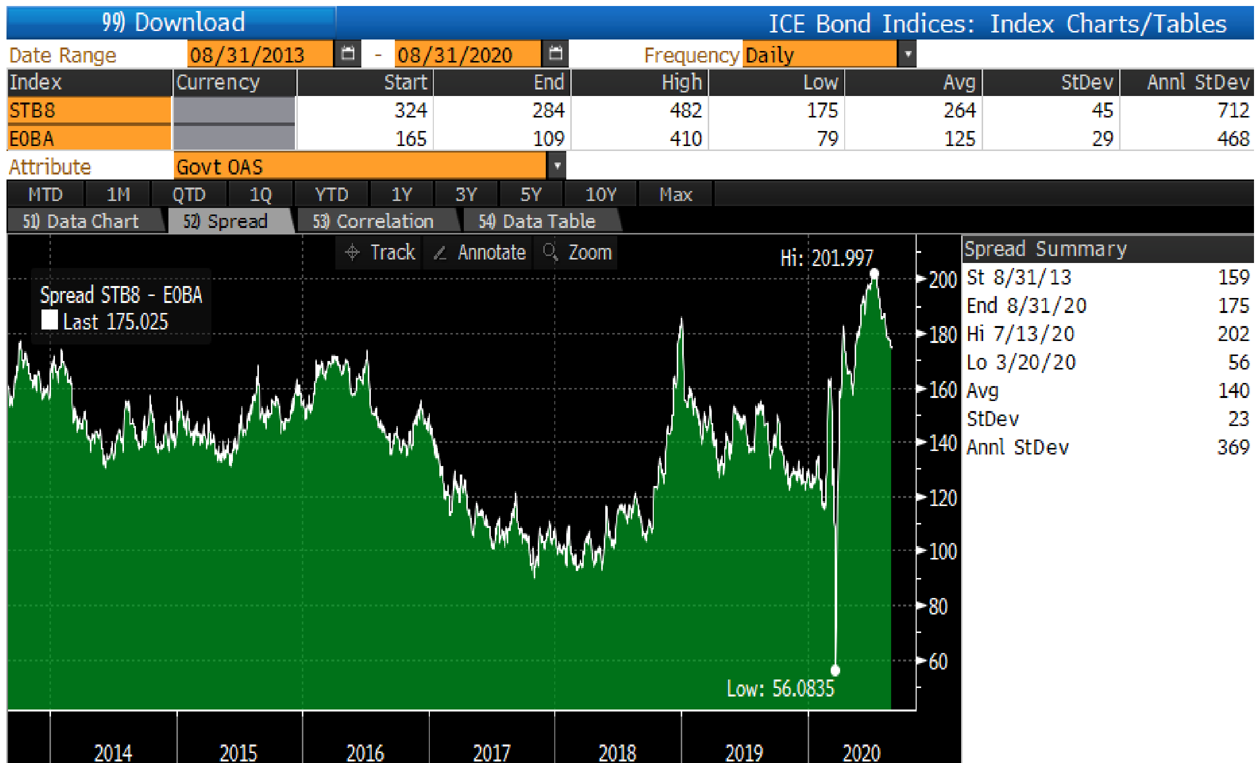
Source: Bloomberg

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. As spreads tighten in retail paper, the $25par market's relative value tends to slip more compared to its institutional counterpart (i.e., NoCos). This month, the retail sector's

modified duration dropped 0.45yrs further under parity compared to bullet financials, which flags more risk than is implied by the 3.66yr duration to worst of the retail sector.

$1,000par Institutional Preferred Securities Sector

The $1,000 par institutional sector of the preferred securities market rose $1.45 in August. The NoCo sector has recovered all its yield break this year and finished the month at new (record) 7yr lows (i.e., lower than the prior record set in February). But relative values still look attractive because more senior financials have rallied even lower and tighter. The chart below shows the yield-to-worst of spread of NoCos (i.e., *stb8*) vs. Eurodollar Banking Index spread (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 this year we have the COVID-19 recession which markets seem to be are looking beyond thanks to the Fed, primarily. At the end of the month, NoCo spreads to comparable treasuries closed 18bps tighter (+284), which was 0.40 standard deviations tighter on the month. This move was 8bps more than the move tighter in more senior financials this month – NoCos have room to further tighten because at +175 to senior financials, spreads in NoCos are 1.52 standard deviations better than average; and 0.49 standard deviations better than average to comparable treasury OAS.

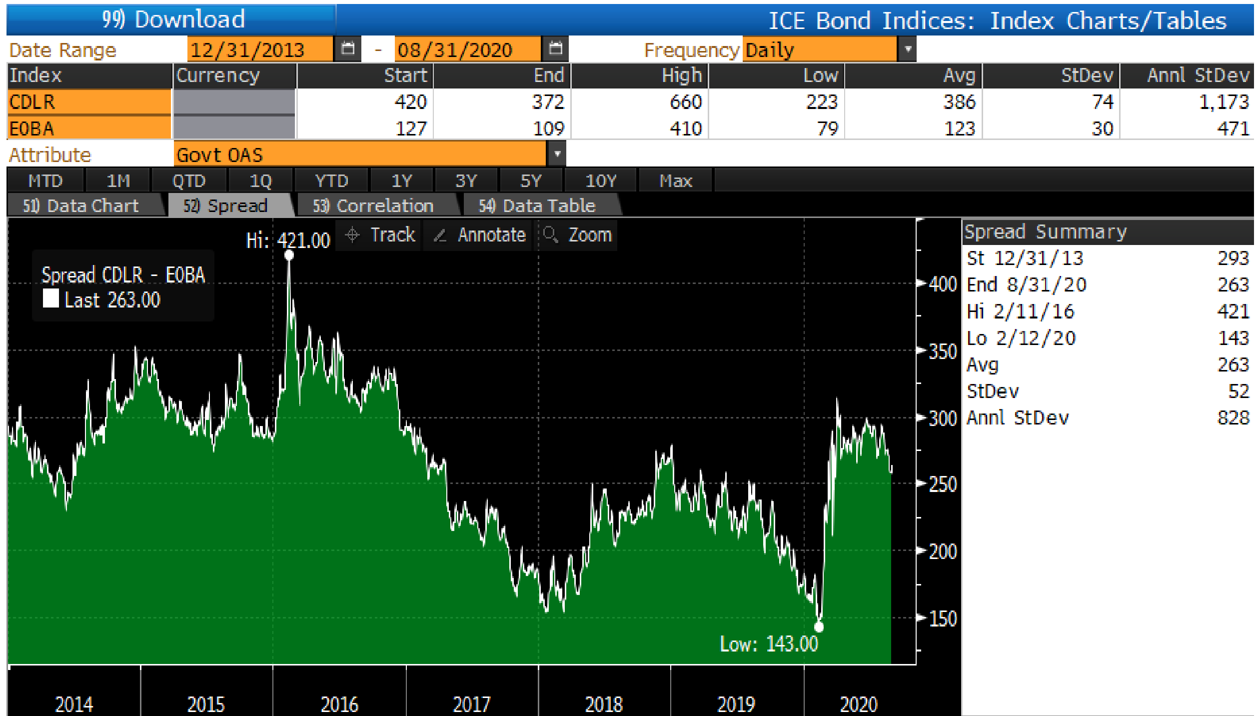
Lower yields lead to continued momentum in new issuance this month. Notables are:

1. Huntington Bancshares 4.45% perpetual preferred stock AT1 (Baa3/BB+) +405
2. Equitable Holdings 4.95% perpetual preferred stock (Ba1/BBB-) +474
3. Prudential Financial 3.70% jr. sub debt due 2050 (Baa3/BB+) +303

Issuance was all well received and closed the month trading above par. NoCo paper is pricing off 5yr and 10yr constant maturity UST yields rather than off LIBOR swaps, which gives the belly of the UST curve for the future income reset rather than the uncertainty of 3mo.LIBOR (or some similar rate). Importantly, the combination of 4.5% area current yields and wide reset spreads almost equivalent to the coupons continues to make IPOs for NoCos quite compelling.

Contingent Capital Securities Sector

The CoCo sector closed $2.19 higher this month as European bank equity channeled sideways and the bund and US treasury curves steepened. 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 the benchmark's inception (Dec-13) – note that 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 moved 31bps tighter this month and continues to be even wider than levels in 2016 when Pillar-2 capital was redefined in support of CoCos. The relative value opportunity in contingent tightened to be average by month end compared to the last 6yrs running (i.e., the benchmark's inception). A full sail of European Central Bank pandemic emergency purchase program (PEPP) and heavy fiscal spending continues to add confidence to the down in capital structure play in CoCos. By the end of August, CoCos were 38bps tighter, but 0.19 standard deviations less than their average spread to comparable treasuries and equal to their average spread to more senior financials since inception of the USD CoCo benchmark.

Lower yields also compelled some new USD issuance in August highlighted by:

1. Credit Suisse 5.25% CoCo AT1 (Ba2/BB-) +489
2. Barclays 6.125% CoCo AT1 (Ba2/B+) +587

Outlook:

The additional fiscal stimulus to help the economy recover from COVID-19 has a $2 trillion bid-offer spread in Congress: the Democrats propose $3 trillion of additional stimulus and the Republicans counter to propose $1 trillion – with other policy aspects to the bills compelling both sides to agree to disagree and do nothing. The US national debt stands at $26.7 trillion which is $1 trillion more than the combined national debt of China, Japan, Germany, and the UK; but in terms of US budgeted fiscal speed, $1 trillion is just 1 year of excess spending. Politicians talk casually of spending $1 trillion as though it's just another big number even though it's an exponentially enormous number -- for some perspective on just how exponential, consider: if one were to stack $100 bills flat on top of one another (say, face up), $1 million would stack 40 inches high; $1 billion would stack over 2 ¼ times as high as the Empire State Building ; and $1 trillion would stack over 630 miles high (or about ½ the distance between New York City and Miami). Incidentally. the $26.7 trillion US national debt would stack to over 2.1x the diameter of Earth.

Central banks, having continuous amalgamated printing presses, pronounce their tools to be "unlimited". But the curtailments to "unlimited" are in the monetary mechanisms which (for now) require buying limited supplies of financial assets like government bonds, mortgages, corporates and even equity ETFs. Corporate balance sheets (i.e., liabilities) are not limitless – so, the price of financial friction gets expressed as negative interest rates and expanded P/E multiples with little sustained growth or inflation. Worse still, the process germinates a systemic wealth and income gap because the currency gets predominantly absorbed by financial liabilities rather than by productive hard assets and services that sustain value and opportunity to expand a thriving working class. So, the Fed strives to be "innovative" as income inequality becomes acknowledged through Fed speak as problematic. Indeed, Chairman Powell's Jackson Hole speech this month that introduced "flexible average inflation targeting"

was vague yet telling – vague because "average" is undefined and telling because inflation is the goal rather than the risk. Rates in the US will likely stay low on the front end for years until the Fed "innovates" the inflation it wants – this is apt to put a persistent steepening bias on the yield curve especially as real rates currently are deeply negative. The "innovation" the Fed speaks of will probably come in how currency expansion gets distributed away from its balance sheet rather than on its balance sheet. There's a potential sea change for the dollar's monetary mechanism that could give the Fed what it wants (inflation) and politicians what they want (power) – it's called a US Digital Dollar. Ultimately, a digital dollar (i.e., legal tender blockchain) could replace paper money and make any process of distributing "helicopter money" more like pinpoint target shooting directly to the projects that need it most – like sustainable farming, renewable energy or Medicare. A "digit trail" would be the new "money trail" and if it sounds Orwellian, it may be. But it doesn't have to be if premised on freedoms and a more perfect union. Any move to digital dollars would hopefully be a process of monetary evolution rather than revolution.

The revolution is now, but it's in US politics rather than monetary theory. Specifically, the Democrat party has formed a coalition with Bernie Sander's calling it the "Biden-Sanders Unity Task Force". The Democrat party's socialist embrace is no longer "fringe" as new progressive younger members are gaining influence. Democrats and Republicans are miles apart on policy and the elections couldn't be soon enough – the people will decide which way to go as there is no longer a center. As President Obama famously said, "Elections have consequences" -- this election will surely have consequences, but we are not sure what kind just yet. Indeed, the political vitriol in America is boiling over. Anarchy (far beyond anything resembling peaceful assemblies) and propaganda are expanding which brings George Orwell's dystopian society into view. The elections are probably going to very contentious and outcomes contested in many states making electoral vote certifications for president impossible for days, weeks and even months if lawsuits follow as they did in 2000. The difference is that this election will be

contentious up and down the state and local tickets too, not just the presidential ticket because both parties have vastly different visions for the republic. We expect there to be increasing market volatility leading up to, though and beyond the November US election that could extend into 2021. The Fed continuously buying $80 billion per month will be welcomed liquidity advances, but if the 2000 election is any lesson, the path forward for tighter credit spreads is likely to be interrupted by an election correction first.

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