Junior-Subordinated Capital Securities Markets

September 2020 Updates

Credit ran a modest correction in September with the hybrid markets slipping the most as US Treasury securities marginally improved. Yields in junior subordination rose and spreads widened in a modest risk-off mood. The Fed reaffirmed its commitment to keep interest rates low in discussing its new policy named "Flexible Average Inflation Targeting" ("FAIT") that intends to sustain inflation above 2% by allowing the economy to "run hot" for an extended period. Real rates on the front end of the curve (e.g. UST 5yr TIPS) turned up this month as nominal rates went mostly sideways while the gold rally continued its summer long correction. The 30yr US Treasury bond closed the month yielding 1.45% (1bp lower). The US Treasury 10yr note closed the month yielding 0.68% (2bps lower). The yield differential between these two longer US Treasury terms closed at 77bps (1bp less than last month; 29bps steeper on the year). The S&P500 slipped 3.92% in September and the VIX (i.e., Chicago Board Options Exchange Volatility Index) closed essentially unchanged (26.37) after jumping earlier in the month. Equity continues to show little concern that there could be a fundamental paradigm shift in US politics this year. Risk of US election outcomes being uncertain for days, weeks or even months after Election Day because of mail-in balloting is real.

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) declined 1.04% to close yielding 5.70% (33bps higher).

- Global bank credit (measured by ICE BofA ***e0ba*** index) declined 0.42% to close yielding 1.58% (8bps higher).
- The BBB rated 5-10yr corporate sector (measured by ICE BofA ***c6a4*** index) declined 0.19% to close yielding 2.22% (5bp 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 $326 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

$141 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 $468 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*) @ 44% *of i0cs***
   - Comprised of IG $25par and IG $1,000par US AT1
     - The *p0p1* declined 0.92% this month to close yielding 2.54% (+76bps)
     - Headcount was +2, face value increased by $1.0 billion
2. **ICE BofA US Capital Securities Index (*c0cs*) @ 25% of *i0cs***
   - Comprised of dated IG $1,000par hybrids (no US AT1)

- ❖ The *c0cs* declined 0.38% this month to close yielding 3.19% (+7bps)
- ❖ Headcount was unchanged; face value grew by $1.7 billion

3. **ICE BofA High-Yield Capital Securities Index (*h0c*s) @ 5% of *i0cs***

- o Comprised of BIG $1,000par legacy Tier1 and BIG $1,000par hybrids
    - ❖ The *h0cs* declined 1.29% this month to close yielding 4.51% (+17bps)
    - ❖ Headcount was -9; face value declined by $5.7 billion

4. ICE BofA High Yield Fixed Rate Preferred Index (*p0hy*) @ 26% of *i0cs*

- o Comprised of BIG $1,000par US AT1 and BIG $25par
    - ❖ The *p0hy* declined 0.93% this month to close yielding 4.39% (+4bps)
    - ❖ Headcount was +10; face value grew by $5.6 billion

Overall, the BofA All US Capital Securities Index (***i0cs***) declined 0.80% in September to close yielding 3.28%, which was 37bps higher than last month's closing yield and a spread of +264bps over comparable US Treasury securities (30bps 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 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***) declined 0.69% this month to close yielding 4.54%, which was 26bps higher than last month and a spread of +368bps over comparable US Treasury securities (13bps wider).

<u>Snapshot of Junior Subordinated Spread Sector Moves:</u>

	(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	92	-32	264	140	386	263
Stdev	123	105	45	23	73	52
Monthend	185	64	284	188	403	282
Sector Spread Score¹	0.84		1.27		0.30	
Last Month's Score¹	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	0.76		0.44		0.23	
**Relative		0.91		2.09		0.37

** Absolute = Option Adjusted US Government Spread*

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

Source: Bloomberg, ICE Bond Indices

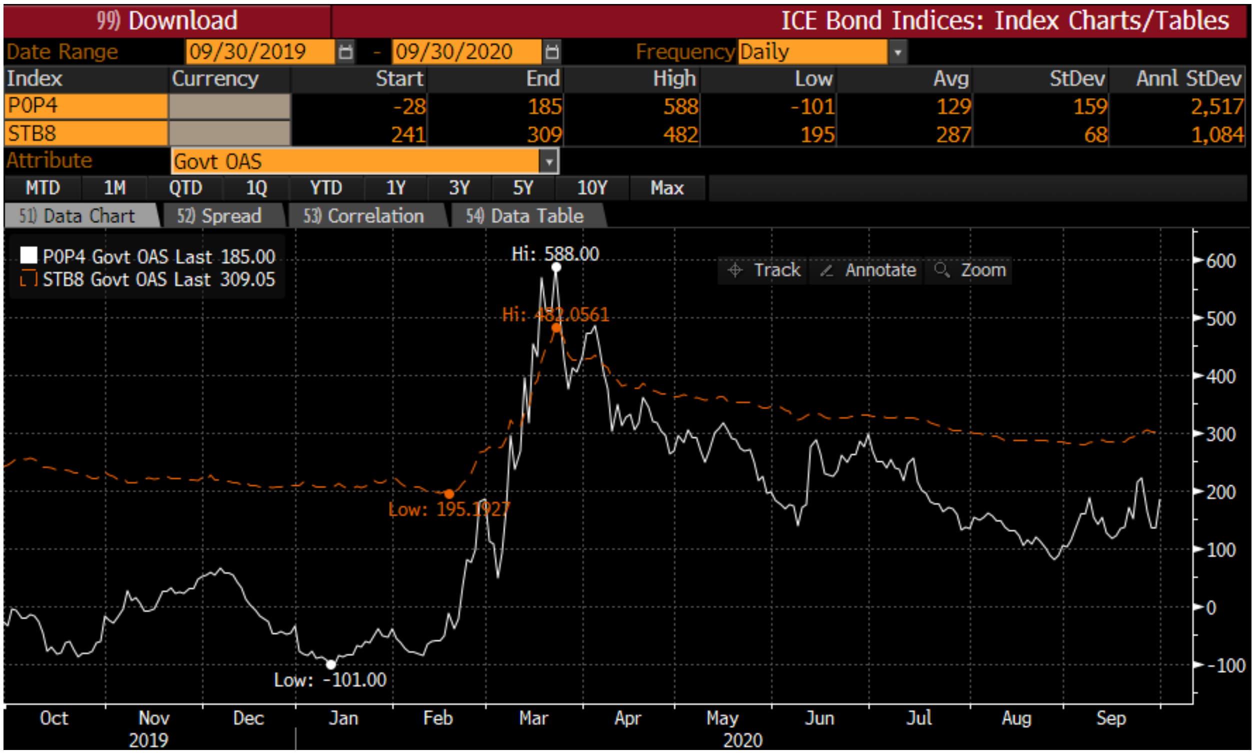
<u>Implications of Market Activity</u>:

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

The retail preferred securities sector fell $1.17 this month as spreads widened under the pressure of strong new issuance which broke under the 4% level for the first time in 70yrs (e.g.

Southern California Edison redeemed a long standing series of preferred stocks including its 4.08% series issued in 1950). The yield path that has journeyed below 4% this year includes the strongest two consecutive quarters for the retail sector since the bounce after the Lehman Crisis – interestingly, the price blow-off that set up this year's rally was the worst sell-off since the Lehman Crisis. But, yields are certainly different this time as the average coupon of the sector today is 5.6% compared to 7.2% more than 10yrs ago – the implication of the continuing refunding trend with ever low coupons is that the duration risk of the sector is increasing the lower yields go (e.g., a 4yr increase since 2010), yet the upside is limited not only by standard 5yr call options, but also by low absolute yields (e.g. a 3.875% coupon for PSA) running into a wall of growing fiscal excess (a topic to discuss in our 2021 outlook). The relative value doesn't always score well for the IPOs because the froth of excess demand and the sector being "sold" (for new issue credit) and not "bought" (for relative value) can cloud over zealous pricings compared to outstanding issues – that's happened with the CapitalOne 4.625% IPO that lost about 5% of its value within two weeks to align with a similar $25par secondary issue trading almost 20bps cheaper.

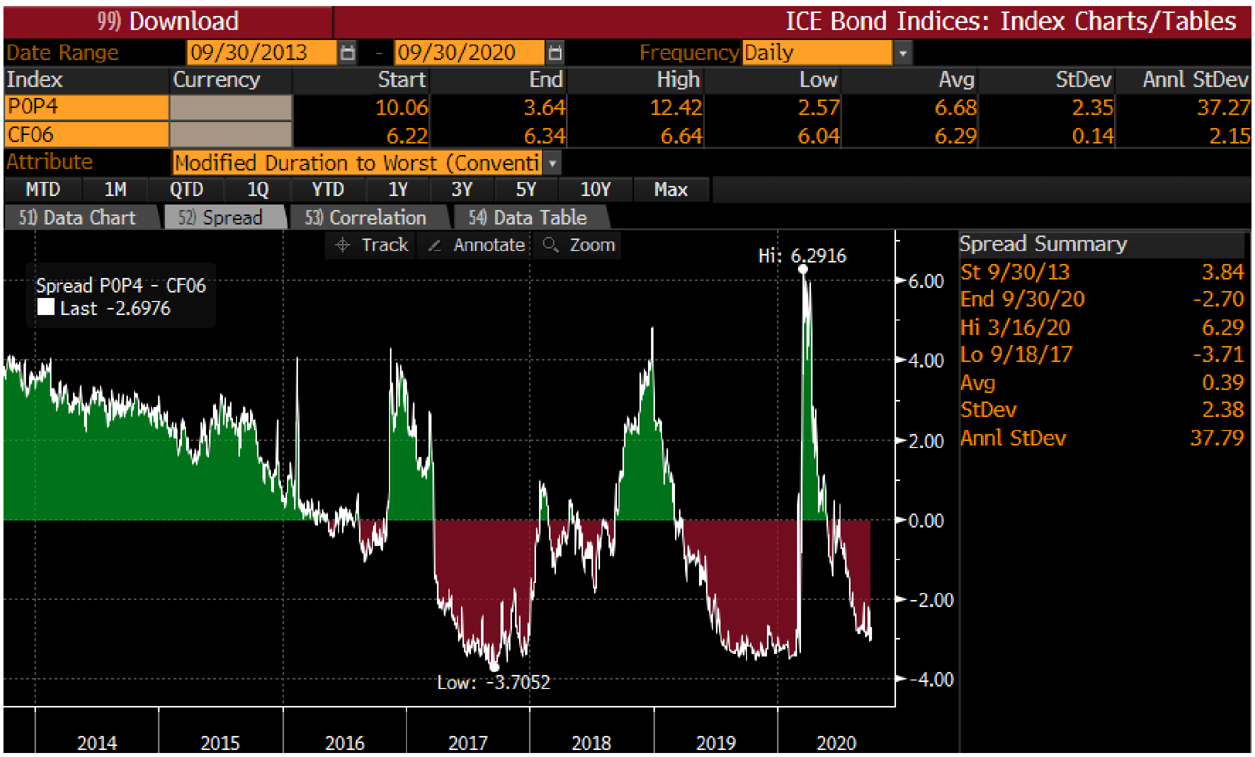
The graph below shows the spread in the $25par market (i.e., p0p4) over the past year compared to the spread in the $1,000 par institutional preferred securities market (stb8), which we call "NoCos" to distinguish $1,000 preferred securities from $1,000par contingent capital securities (CoCo) risks:



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. The correction that followed (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, but the rally paused in September with a noticeable correction. As a result, the $25par market widened by 80bps to an OAS of 185 by month's end, which improved its sector spread score considerably. Over a longer perspective (i.e., the last 7yrs), the $25par market closed September spread 0.76 standard deviations wide of its average option adjusted UST spread of 92bps and 0.91 standard deviations in excess of its 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:

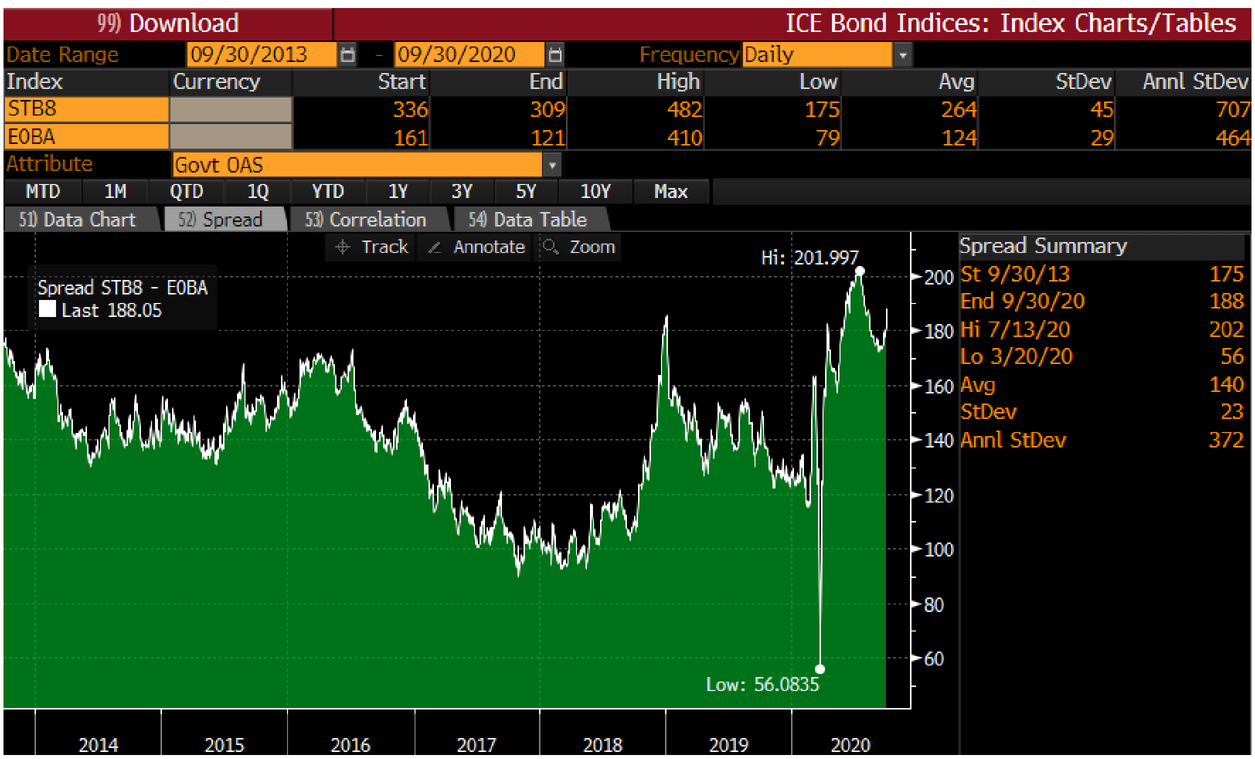


Source: Bloomberg

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 traded in a 4.21 to 3.16 range and closed marginally lower by 0.02yrs, which closed the measure at 2.70yrs less than the 5-10yr US financial sector (measured by *cf06).* The combination of another -1.00yr left to hit the low (-3.70) and the better than average value according to our sector spread score (0.84) leads us to conclude that the retail sector still has some potential upside and tightening available before appearing statistically overbought.

$1,000par Institutional Preferred Securities Sector

The $1,000 par institutional sector of the preferred securities market declined $1.41 in September. The NoCo sector has recovered all its yield break this year marking a new (record) 7yr low in early September (i.e., lower than the prior record set in February before the coronavirus hit). But relative values still look attractive because more senior financials have rallied even lower and tighter. The chart below shows the yield-to-worst 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 25bps wider (+309), which was 0.56 standard deviations wider on the month. This move was 13bps more than the move wider in more senior financials this month – NoCos have room to further tighten because at +188 to senior financials, spreads in NoCos have a relative spread score of 2.08 standard deviations better than average; and 0.44 standard deviations better than average to comparable treasury OAS.

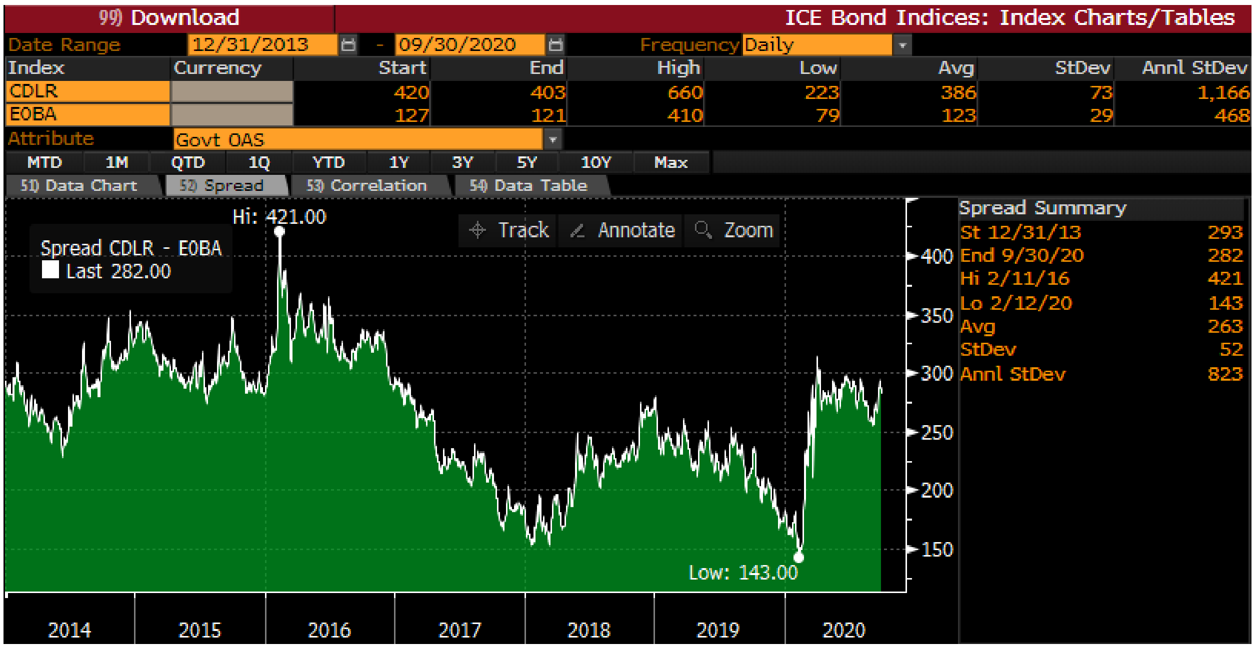
Low yields encouraged more issuance this month, which sums to over 3x the pace of last year by the end of September. Notables are:

1. MetLife 3.85% perpetual preferred stock (Baa2/BBB) +358
2. GM 5.70% perpetual preferred stock (Ba2/BB+) +500
3. Southern Company 4.00% jr. sub debt due 2051 (Baa3/BBB) +373

Issuance in the NoCo sector was all well received and pulled an issue of its own (MetLife) through the 4% level like in the retail sector. Toward the end of the month, prices slipped below par only to recover by month end – clearly the "go-go" IPOs did better than the overall sector. 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. Overall, NoCos are scoring as the best value in junior subordination with a sector spread score of 1.27, which is 26% higher than last month.

Contingent Capital Securities Sector

The CoCo sector closed $1.30 lower this month as European bank equity made lows for the summer and the bund curve bull flattened. 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 widened by 19bps this month to bring the sector advantage back up above average by 0.37 standard deviations at +282bps. The relative value opportunity in CoCos improved with the price correction this month. Its sector spread score (i.e., the average statistical location to the mean) increased to 0.30. The absolute yield advantage of CoCos compared to NoCos closed September at 94bps and indicated the additional spread available for the structural differences between the two (described above). The regulatory MDA buffers (i.e., equity cushions available before an AT1 coupon would be reduced) have grown substantially over the past two quarters since yearend because of common dividend savings – for example, among the EURO STOXX Banks Index (sx7e) members, the MDA has grown by $42billion: Commerzbank +64%, UniCredit +63%, and ING +62% are among the highest and BBVA +6%, Credit Agricole +18% and Caixabank + 14%

among the lowest. We expect the European banks to continue growing common equity tier1 while the common dividend omissions continue through the rest of this COVID-19 year.

Outlook:

According to the Fed, "additional fiscal support will likely be needed" to help the economy recover from COVID-19. This view helped to motivate further negotiations between the Trump administration and House democrats, which last month had a $2 trillion bid-offer spread on the bill. Negotiations effectively reopened when the House proposed (and then passed) their $2.2 trillion stimulus bill despite knowing it wouldn't be signed by the president. Talks of additional stimulus (other than targeted stimulus) are currently shelved with a $1.6 trillion bid from US Treasury Secretary Mnuchin and a $2.2 trillion offer from House Speaker Pelosi, so the bid-ask has tightened to $600 billion but both sides still agree to disagree. We have no doubt that (no matter who wins the White House) additional stimulus will be coming and the Fed will likely make a point out of reemphasizing their expectation for more stimulus again during its next meeting immediately after the election. Despite the impasse and US treasuries going sideways for most of the September, US Treasury bond yields have risen considerably to start October in anticipation of more spending among other things (i.e., big lead in the presidential race by Joe Biden).

By this time next month, the elections will be behind us but uncertainty over clearly identifying who has won will likely be ongoing because the political vitriol in America is deep – so deep, that the courts will likely be involved among many state races and the US Supreme court may become the final gavel to help affirm outcomes. This year being 2020 is ironic because it has been a year of anything but a "2020" vision for America's; and in some cases (e.g., the death of Justice Ginsburg & President Trump's illness) we have been caught almost blind. Rather than discussing outlook scenarios based on what could happen from the election, we will wait until after the election for a somewhat less foggy view and will discuss politics and policy as it relates to our macro view then. In the meantime, an unmelodious process to determine the election winners is likely, but we do expect a "smooth" transitions once it is all figured out.   Currently, the polls show that a transition is likely in the White House – but remember, this is 2020 and nothing is clear. President Trump could stage a dramatic comeback (?) or at least it could appear that way on election night – then the mail in counts keep come in (weeks later in some cases) and things could change. Of course, the exact opposite could happen too with a Biden "win", but then mail-in vote counts in critical states flip the states. Or there could be an electoral tie forcing the states to decide in state House procedures to vote electors -- and if we don't know by inauguration day, Speaker Pelosi could be the "acting president" until we do know. So many different scenarios could play through and regardless of how probable or improbable things look now they can change quickly – after all, this is 2020. 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's continued buying of $80 billion per month Treasury securities (plus $40 billion per month in mortgages) is welcomed constant liquidity, but if the 2000 election is any lesson, the path forward for tighter credit spreads is likely to be interrupted by an election correction and gain(loss) related selling (especially with a Biden win) despite the Fed's best efforts.

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