SPECTRUM
Asset Management

Junior-Subordinated Capital Securities Markets

October 2020 Updates

Credit prices improved modestly this month as the US economy continued to rebound but weigh on US Treasury prices. Yields in junior subordination edged lower and spreads tightened against higher Treasury yields. The Fed didn't meet during October but wasn't shy about voicing its desire for fiscal spending to supplement its new policy of "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; @ -1.22%) went sideways even though nominal rates went up by 10bps (implying a rising inflation expectation) and gold prices slipped (inconsistent with a rising inflation expectation) to stay stuck in a 3-month long correction of 9%. The 30yr US Treasury bond closed the month yielding 1.64% (19bps higher). The US Treasury 10yr note closed the month yielding 0.86% (18bps higher). The yield differential between these two longer US Treasury terms closed at 78bps (1bp higher than last month; 30bps steeper on the year). The S&P500 declined 2.78% this month after falling 3.92% last month and the VIX (i.e., Chicago Board Options Exchange Volatility Index) vaulted up by 44% to close at 38.02 – the highest level since June, which was the last time US Treasury yields were this high. Equity appears to be showing increasing concern that the election outcomes this week will be unclear (i.e., contested) and that more COVID based lockdowns could be coming to the US. Indeed, risk of election outcomes being uncertain for days, weeks or even months after Election Day because of mass mail-in balloting and inconsistent state rules to count them is just one day away from showtime.

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 0.47% to close yielding 5.76% (1bp lower).
- Global bank credit (measured by ICE BofA ***e0ba*** index) rose 0.21% to close yielding 1.57% (3bps lower).
- The BBB rated 5-10yr corporate sector (measured by ICE BofA ***c6a4*** index) rose 0.06% to close yielding 2.26% (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 $325 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 $143 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 $466 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***
    - <u>Comprised of IG $25par and IG $1,000par US AT1</u>
        - The *p0p1* rose 0.44% this month to close yielding 2.33% (-21bps)
        - Headcount was +2, face value increased by $3.9 billion
2. **ICE BofA US Capital Securities Index (*c0cs*) @ 25% of *i0cs***
    - <u>Comprised of dated IG $1,000par hybrids (no US AT1)</u>
        - The *c0cs* rose 0.34% this month to close yielding 3.30% (-1bp)
        - Headcount was -1; face value declined by $1.0 billion
3. **ICE BofA High-Yield Capital Securities Index (*h0c*s) @ 5% of *i0cs***
    - <u>Comprised of BIG $1,000par legacy Tier1 and BIG $1,000par hybrids</u>
        - The *h0cs* rose 0.59% this month to close yielding 4.16% (unchanged)
        - Headcount was -1; face value declined by $0.8 billion
4. **ICE BofA High Yield Fixed Rate Preferred Index (*p0hy*) @ 26% of *i0cs***
    - <u>Comprised of BIG $1,000par US AT1 and BIG $25par</u>
        - The *p0hy* rose 1.29% this month to close yielding 4.69% (unchanged)
        - Headcount was -5; face value declined by $3.7 billion

Overall, the BofA All US Capital Securities Index (***i0cs***) rose 0.63% in October to close yielding 3.27%, which was 9bps lower than last month's closing yield and a spread of +274bps over comparable US Treasury securities (2bps wider).

<u>Contingent Capital Securities</u>

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 0.71% this month to close yielding 4.54%, which was 4bps lower than last month and a spread of +363bps over comparable US Treasury securities (9bps tighter).

Snapshot of Junior Subordinated Sector OAS Spread 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	92	-32	264	141	386	263
Stdev	122	104	44	24	73	52
Monthend	165	58	300	193	392	285
Sector Spread Score[1]	0.73		1.49		0.25	
Last Month's Score[1]	0.84		1.27		0.30	

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	0.60		0.82		0.08	
**Relative		0.87		2.17		0.42

** Absolute = Option Adjusted US Government Spread*

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

Source: Bloomberg, ICE Bond Indices

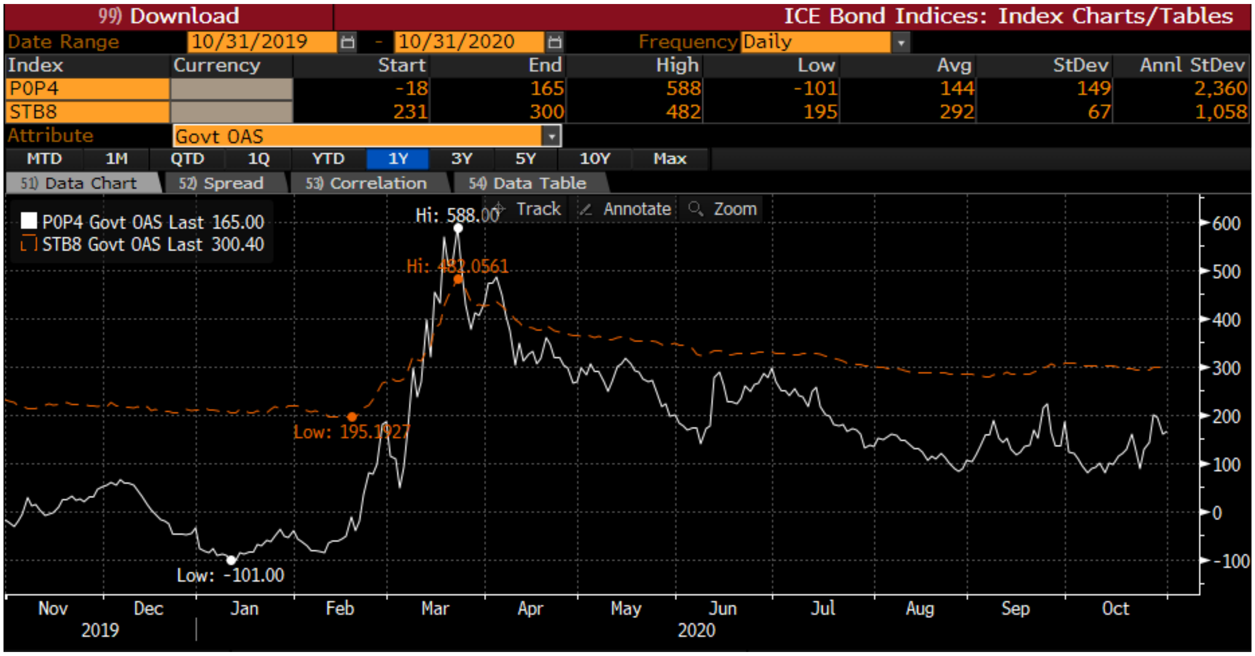
Implications of Market Activity:

$25par Retail Preferred Securities Sector

The retail preferred securities sector edged up $0.16 this month as spreads tightened but more from the sliding US Treasury market than form a rallying retail market. The beacon for the retail market this month was US Bancorp's $500 million issuance of 3.75% fixed-for-life perpetual preferred stock – this dividend rate beat the 3.875% record set by Public

Storage last month. In fact, US Bancorp has had a good record of issuing at the tops of short-term issuance cycles (i.e., either at the tights of spreads or the lows in yields) over the past 15years. We suspect that they've done it again in front of the elections and in front of what will ultimately be more and more fiscal spending next year. The issue never made it above par and closed the month down $1.85 (-7.40%) over its first eight days of trading. We warned last month that the implication of a continuing refunding trend with ever low coupons is that the duration risk of the retail sector is increasing the lower yields go (even though the measured duration is declining as yields go lower because of the sector's negative convexity) and that low absolute rates are likely to run into a wall of growing fiscal excess (a topic to discuss in our upcoming 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) – beware of this US Bancorp issue being a favored source of retail tax-loss harvesting in December if it continues to trade at a discount especially given the strength of equity so far this year.

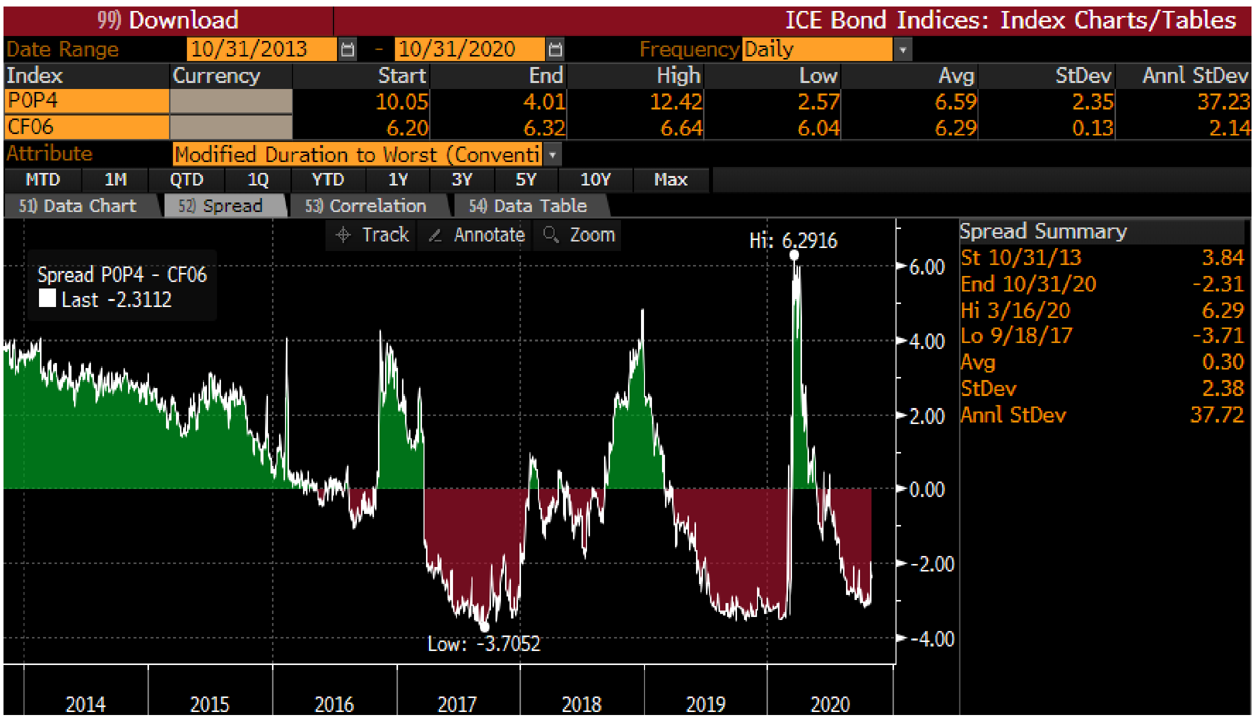
The graph below shows the spread in the $25par market (i.e., p0p4) over the past year compared to the spread in the $1,000 par institutional preferred securities market (stb8), which we call "NoCos" to distinguish $1,000 preferred securities from $1,000par contingent capital securities (CoCo) risks:



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 that tried to recover this month, but got exhausted by bond market weakness. As a result, the $25par market widened by 87bps from its tights (78bps) on October 13th to close the month tighter still, but by just 20bps due mostly to higher US Treasury yields. Over a longer perspective (i.e., the last 7yrs), the $25par market closed October spread 0.60 standard deviations wide of its average option adjusted UST spread of 92bps and 0.87 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:

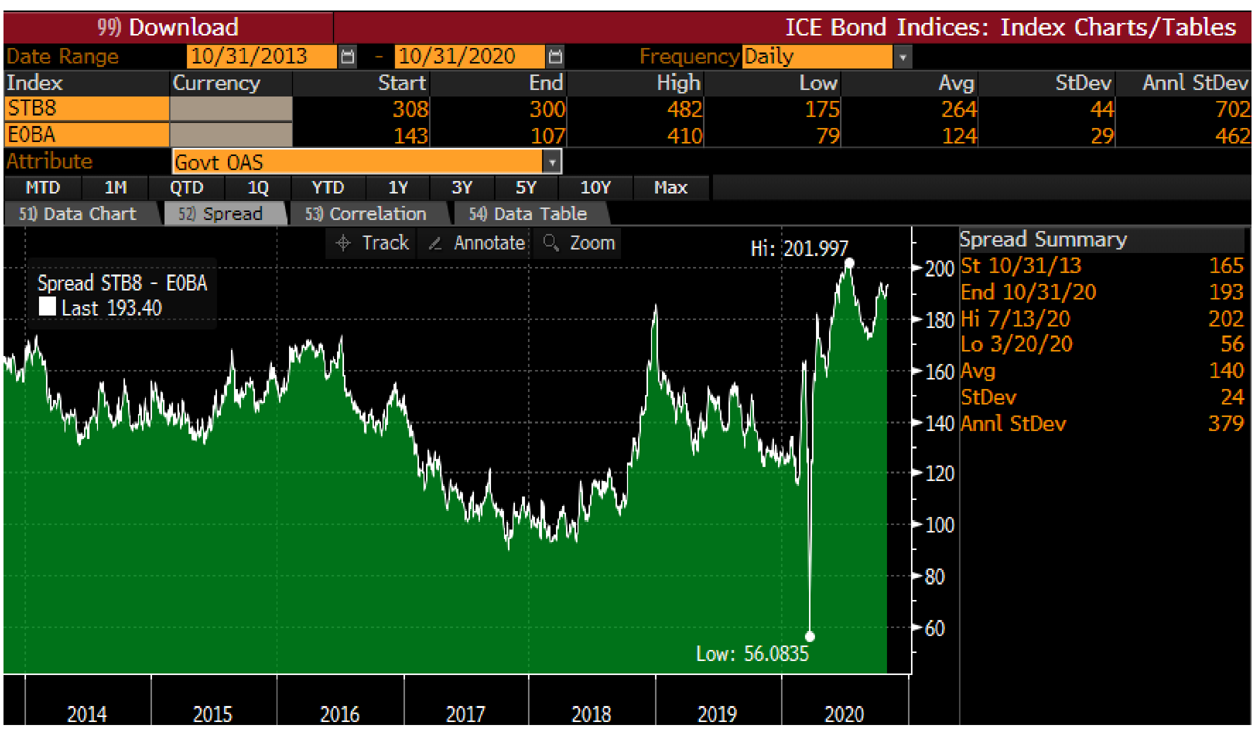


Source: Bloomberg

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 4.27 to 3.12 range and closed marginally higher by 0.35yrs, which is still 2.31yrs *lower* than the 5-10yr US financial sector (measured by *cf06).* The retail sector still has a better than average value according to our sector spread score (0.73) and some room to run lower on duration (or higher in premium), but we think better buying opportunities (i.e., at higher durations) will be available in the coming months as the election brings change.

$1,000par Institutional Preferred Securities Sector

The $1,000 par institutional sector of the preferred securities market rose $0.20 in October. 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:



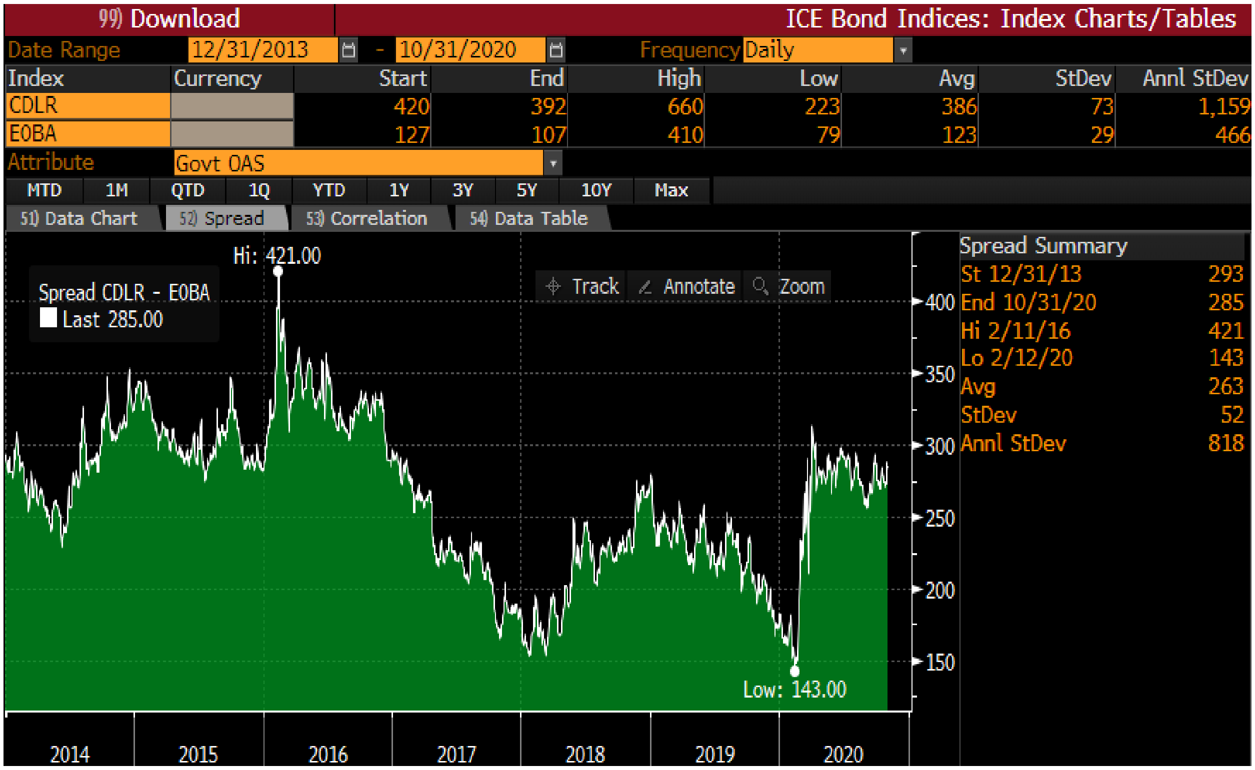
Source: Bloomberg

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 seems to be looking beyond to recovery thanks to the Fed, primarily. At the end of the month, NoCo spreads to comparable treasuries closed 9bps tighter (+300) on the month. This move was 5bps less than the move tighter in more senior financials this month – NoCos have room to further tighten because at +193 to senior financials, spreads in NoCos have a relative spread score of 2.17 standard deviations better than average; and 0.82 standard deviations better than average to comparable treasury OAS.

Low yields encouraged Bank of New York to refund its $25par issue (5.20%) with a 3.70% $1,000par preferred stock issue this month. Overall, new issuance in NoCos is running at about 3.2x the pace of last year. 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). Overall, NoCos are scoring as the best value in junior subordination with a sector spread score of 1.49, which is 17% higher than last month.

Contingent Capital Securities Sector

The CoCo sector closed $0.19 higher this month as European bank equity channeled their lows for the summer and bunds rallied into fears over resumed lockdowns. 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 3bps to close the month with an OAS of +285bps. The relative value opportunity in CoCos compared to more senior financials stands at 0.42 standard deviations better than average. Despite the sector's overall sector spread score of 0.25 being the lowest of the three junior subordinated sectors, CoCos still provide 92bps of additional spread to NoCos and 227bps of additional spread to retail preferred securities. There were 2 new CoCo issues this month (Svenska Handelsbanken and Julius Baer Group) – both investment grade with sub-5% coupons.

Outlook:

Talks of additional fiscal stimulus dominated bond market headlines this month, but the wrangling turned out to merely be a game of political cat and mouse between US Treasury Secretary Mnuchin and House Speaker Pelosi (I will leave it to you to decide who played the cat and who played the mouse). The primary disagreements were on non-COVID related wants in the House bill and a total package that would have been far beyond anything the republican controlled US Senate was willing to approve. We expect more stimulus after the elections and a big number regardless of who wins the White House. To repeat what we said last month – though this is 2020 and nothing is in clear sight. President Trump has gained in the battleground states since then, so the presidential race is within the margin of error in key battlegrounds but well behind Joe Biden in the national polls. National polls are more of a forecast for who will win the popular vote and can misguide expectations on electoral college outcomes, which is all that matters for a presidential election in the United States. There are many different scenarios that could play through and regardless of how probable or improbable things look now, they can quickly change -- and then change again. Mass mail-in balloting greatly complicates this election as the rules between states vary vastly and have already been challenged at the Supreme Court. For example, some states require signatures to be verified, while others leave it to election officials; and some states will not accept votes after Election Day while others will allow votes to count well after Election Day (e.g. up to nine days later in North Carolina). So far, over 93 million votes have been cast before Election Day which is about 70% of the total votes cast in 2016 though this election is expected to have a far higher (record) turnout before its complete.

We expect already elevated market volatility to last well beyond the November 3rd US Election Day and it could extend into 2021 if the courts come into play. It is impossible to tell which way this election will go; and the process will be far from unremarkable. Metropolitan area business owners in Los Angeles and New Your City are using plywood as window barricades to protect their merchandise and major boulevards will be closed to protect against riots by emboldened anarchists. Big Tech is under congressional investigation for censorship and election interference. It is impossible to get a clear view of the horizon except to know that there is a landing somewhere. We will wait until the smoke clears to suggest to you how the landscape looks before forming our 2021 outlook later this month.

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November 2, 2020