Junior-Subordinated Capital Securities Markets

December 2020 Updates

Credit prices continued to improve In December closing out a concerning year for public health yet a remarkable year for financial markets. Yields in junior subordination declined as new issuance was well received and helped to tighten spreads with higher US Treasury yields. Uncertainty over a contested US presidential election continued to dominate the news with high emotions. The Fed met for its last meeting of the year and did not waiver from its commitment to buy bonds at the current pace. Real rates on the front end of the curve (e.g., UST 5yr TIPS; @ -1.64%) went down even though 5yr nominal rates (0.48%) were unchanged again; and gold prices rose 6.83% after falling 6.25% in November. The 30yr US Treasury bond closed the month yielding 1.64% (7bps higher) and the US Treasury 10yr note closed yielding 0.91% (7bps higher). The yield differential between these two longer US Treasury terms was unchanged at +73bps on the month -- 26bps steeper on the year. The S&P500 rose steadily through December to close 3.71% higher despite the VIX (i.e., Chicago Board Options Exchange Volatility Index) creeping up 11% to close at 22.76 – basically, channeling the lows set for the VIX since February before the pandemic hit markets. The 2020 general election treated Republicans well in the House of Representatives with unexpected pickups, but control of the House is still thinly held by the Democrat Party.

Before we summarize the outlook below, let’s look at performance in some of the more senior corporate credit sectors for comparative references on returns and yield changes:

- The junk market (measured by the ICE BofA High Yield ***h0a0*** index) rose 1.91 % to close yielding 4.21% (51bp lower).

- Global bank credit (measured by ICE BofA ***e0ba*** index) rose 0.40% to close yielding 1.29% (8bps lower).
- The BBB rated 5-10yr corporate sector (measured by ICE BofA ***c6a4*** index) rose 0.91% to close yielding 1.82% (-13bp 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 $336 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

$144 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 $480 billion universe of fixed-rate junior-subordinated USD capital securities with preferred securities (measured by ***iocs***) being a 70% subset and contingent capital securities (measured by ***cdlr)*** being a 30% 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 0.44% this month to close yielding 1.25% (-67bps)
        - Headcount declined by 2, face value declined by $1.8 billion
2. **ICE BofA US Capital Securities Index (*c0cs*) @ 25% of *i0cs***
    - Comprised of dated IG $1,000par hybrids (no US AT1)

        - ❖ The *c0cs* rose 0.34% this month to close yielding 2.88% (-14bps)
        - ❖ Headcount rose by 5; face value rose by $4.8 billion

3. **ICE BofA High-Yield Capital Securities Index (*h0cs*) @ 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 3.36% (-17bps)
        - ❖ Headcount and face value both were unchanged

4. **ICE BofA High Yield Fixed Rate Preferred Index (*p0hy*) @ 25% of *i0cs***
    - <u>Comprised of BIG $1,000par US AT1 and BIG $25par</u>
        - ❖ The *p0hy* rose 1.79% this month to close yielding 3.63% (-0.18bps)
        - ❖ Headcount rose by 1; face value rose by $1.3 billion

Overall, the BofA All US Capital Securities Index (***i0cs***) rose 1.56% in December to close yielding 2.35%, which was 39bps lower than last month's closing yield and a spread of +210bps over comparable US Treasury securities (26bps tighter).

<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 "<u>going-concern</u>" 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 57% of the mature master multi-currency benchmark (*coco*). We will utilize the USD benchmark (*cdlr*) as it more meaningfully reflects the contingent capital

currency types held in our portfolios. The ICE BofA USD Contingent Capital Index (***cdlr***) rose 1.03% this month to close yielding 3.76%, which was 14bps lower than last month and a spread of +320bps over comparable US Treasury securities (12bps tighter).

Snapshot of Junior Subordinated Spread Sector Moves:

	p0p4	p0p4-e0ba	stb8	stb8-e0ba	cdlr	cdlr-e0ba
	(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	479	200	660	421
Low	-178	-267	174	53	223	143
Range	766	518	305	147	437	278
Average	85	-37	262	139	385	263
Stdev	118	100	44	24	73	51
Monthend OAS	43	-38	253	172	327	246
Sector Spread Score¹	-0.18		0.59		-0.56	
Last Month's Score¹	0.25		0.78		-0.53	

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**	-0.36		-0.20		-0.79	
****Relative**		-0.01		1.38		-0.33

** 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 zoomed up another $1.64 this month which cut the sectors benchmark yield to just 1.29% as spreads tightened from the combination of the strong price rise and a modest rise in US Treasury yields. The beacon for the $25par market this month was a first-time deal to the retail market for Signature Bank of New York (Ba1/nr/BB) – the bank priced a $730mm 5% fixed-for-life perpetual preferred stock that traded a little heavy over the first few days with more issuance added to the final book than was initially launched. But once the paper had enough time to be distributed, the issued traded up by 2.5% by yearend. For comparison, US Bancorp's $500 million issuance of 3.75% fixed-for-life perpetual preferred stock that came in October traded up by 1.6% in December after breaking to a 7.4% discount before the election – by the end of the year, even the retail market's lowest dividend payer (i.e., the USB 3.75%) was trading at a premium. We continue to be concerned that the implication of a continuing $25par market refunding trend with ever low coupons is that the current yield cushions are getting compressed while premiums are getting inflated -- even though the measured duration (falsely) indicates capital risk is declining. The sector's negative convexity could hit a wall of growing fiscal excess (a topic to discussed 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) – we are cautious of the lowest coupons or more recent issues as these would be the likely first sale candidates in any market correction, which we think is coming for a number of reasons: 1) accelerated massive fiscal spending by the Biden Administration, 2) rising bond yields anticipating fiscal excess, and 3) a stock market correction (allowing more runway to further advance from fiscal jubilee before a tax increase).

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:

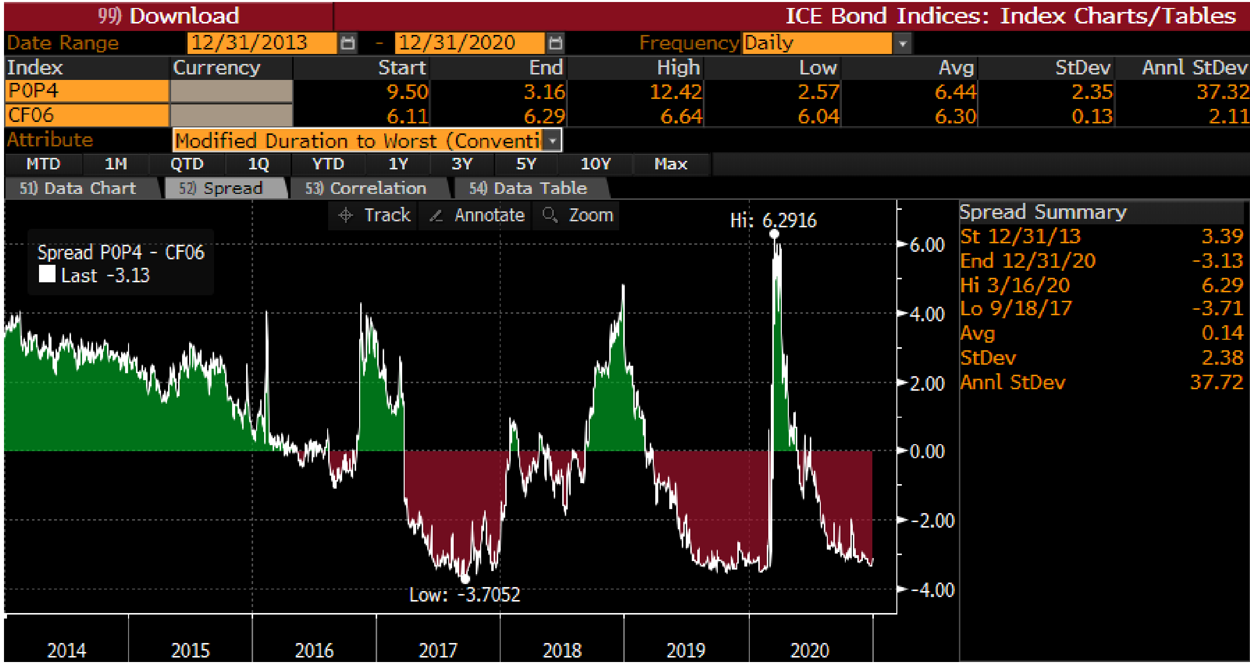
Index	Currency	Start	End	High	Low	Avg	StDev	Annl StDev
P0P4		-36	43	588	-101	155	141	2,233
STB8		210	254	482	195	300	60	949

Source: Bloomberg

This month, the sector spread closed at new lows since the COVID collapse in March (shown by the 698bp vertical climb). The low spread marked in January came when UST rates were much higher (i.e., the UST 5yr was 1.60% one year ago vs. 0.47% currently) and preferred yields were as low then as they are now. So, it seems that retail investors care more about absolute yield than about relative spread – this makes sense as yield is so scarce and not expected to get much lift from the Fed.

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 3.34 to 2.90 range and closed at 3.16 – this is still 3.13yrs *lower* than the 5-10yr US financial sector (measured by *cf06).* The retail sector appears poised for a correction. We're being very selective in the $25par sector and anticipate better buying opportunities (i.e., at higher durations; higher yields) will be available through the course of the first quarter of the new administration.

$1,000par Institutional Preferred Securities Sector

The $1,000 par institutional sector of the preferred securities market rose $0.84 in December. The NoCo sector has recovered all its yield break this year marking a new record 7yr low in early December. But relative values still statistically compelling because more senior financials have rallied even lower yields and tighter spreads. 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 by now have looked far beyond. By the end of the month, NoCo spreads to comparable treasuries closed 12bps tighter (+254). This move was 3bps more than the move tighter in more senior financials – NoCos have room to further tighten because at +173 to senior financials, spreads in NoCos have a relative spread

score of 1.33 standard deviations better than average but just 2 bps below the average OAS (+256) to US treasuries.

There were two new deals to note this month in NoCos: 1) $1.5b Citigroup 4.00% fixed-to-refixed preferred stock @+360 vs. the 5yr constant maturity US treasury, and 2) $2.5b Charles Schwab 4.00% fixed to re-fixed preferred stock @ +308 vs the 10yr constant maturity US treasury. Overall, NoCos are scoring as the best value in junior subordination with a sector spread score of 0.59 to close the month.

Contingent Capital Securities Sector

The CoCo sector closed $0.57 higher this month despite European bank equity drifting lower this month after a strong move up last month -- resumed lockdowns are weighing on the recovery. The graph below shows the spreads in CoCos (i.e., *cdlr*) relative to more senior spreads measured in Eurodollar bank credit (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 1bp to close the month with an OAS of +246bps. The relative value opportunity in CoCos compared to more senior financials stands at -0.33 standard deviations below average. Despite the sector's overall sector spread score of 0.25 being the lowest of the three junior subordinated sectors, CoCos still provide 60bps of additional spread to NoCos and 249bps of additional spread to retail preferred securities. There were 2 new CoCo issues this month (Credit Suisse 4.50% and HSBC 4.60%) – both issues traded up, but HSBC outpaced Credit Suisse by over 1pt given the better coupon and investment grade ratings.

Outlook:

Core fiscal stimulus beyond the 2nd COVID stimulus (and perhaps a 3rd) is very likely in 2021. The incoming Biden Administration will impose significant policy challenges and according to the new Senate Majority Leader Chuck Schumer, we should all "Buckle up." We expect a President Biden to moderate policy change, but there will probably be pressure to advance the Democrat Party's more extreme social policies quickly. We will save opinions on the broader implications of their unity agreement on the economy until we get more details following the inauguration. Due to the Republican's loss of both senate seats (and the Senate majority), our outlook summary has been modified to a quicker path to higher US treasury yields. We outline the key topics below:

1. US Interest Rates – modestly higher (i.e., the UST10yr above 1.50%); steeper on the front end; eventually flatter on the backend with the Fed extending the duration of its balance sheet to govern the ascent of long-term yields
2. European Interest Rates – well anchored to stay negative across the curve
3. Global capital securities – constructive against backdrop of a relentless Fed to absorb spending
    a. $25par preferred securities – fully valued, but should outperform senior financials primarily from income accruals

b. $1,000 par preferred securities – best relative value to seniors

c. Contingent capital securities – fair absolute value to seniors

4. Outlook Summary – We expect Democrat control of the federal government to forge ahead on their more socialist desires described as “a contract that invests in people and promotes shared prosperity”. Continued bond buying, yield curve control and Fed balance sheet duration extensions are highly probable to mitigate the relentless US treasury supply pressures from the expanding government – this high supply should elevate treasury yields next at a faster pace, while being “controlled” by the Fed governing down the classic “crowding out” effect of accelerated supply.

The stated Biden campaign agreement with Bernie Sander’s strengthening socialist wing states “forging a new social and economic contract with the American people” which should mean more government controls conjoined with more government spending (debt) and tax increases (burdens). There is no divided government to potentially slow the pace of change. We expect this “contract” to be executed with astounding boldness – we’ll assess as we go. But for now, we anticipate this change as being a significant shift that will increase the power and controls of the federal government in historic fashions. The immediate objective will be more COVID relief (i.e., vaccines and direct payments to Americans) and for the Fed to effectively monetize the debt supply, which equity loves -- though love can still have relationship problems (i.e., corrections) along the way.

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January 8, 2021

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