SPECTRUM
Asset Management

Junior-Subordinated Capital Securities Markets

April 2021 Updates

Most credit prices went up in April and spreads moderately tightened as US Treasury prices rose after a record blow-off last quarter. The move up in longer dated treasuries was encouraged by the Fed, which voiced repeatedly that *"substantial further progress"* would be required before any talk of tapering bond purchases would happen. Real rates on the front end of the curve (e.g., UST 5yr TIPS; @ -1.75%) ended the month virtually unchanged -- the 5yr implied breakeven inflation rate (i.e., the difference in yields between the 5yr UST and the 5yr Treasury Inflation Protected Security) slipped 1bp to close at 2.59% (just off the highest level in over 12yrs); and gold prices rose 3.60% after dropping 1.52% in March. The 30yr US Treasury bond closed the month yielding 2.30% (11bps lower) and the US Treasury 10yr note closed yielding 1.63% (11bps lower). The yield differential between these two longer US Treasury terms closed unchanged at +67bps. The S&P500 zoomed 5.24% to new highs to close at 4181. The VIX (i.e., Chicago Board Options Exchange Volatility Index) declined 4.07% as the share markets gained momentum and new highs. The transitioning of markets from a COVID impacted phase of central bank support to a post-COVID phase of self-sustainability is an inconsistent process as more countries are extending lockdowns as others are trying to further unlock. After the Fed meeting at the end of the month, Chairman Powell signaled that the central bank would continue purchasing bonds without any thoughts of or even a hint of tapering. The Fed views higher long-term nominal rates (and a steeper curve) as proof of policy success as its statement on the meeting removed the word "considerable" in modifying "downside risks" that are ongoing for the economy.

Before we talk hybrids, 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 1.10% to close yielding 4.02% (26bp lower).
- Global bank credit (measured by ICE BofA ***e0ba*** index) rose 0.78% to close yielding 1.65% (12bps lower).
- The BBB rated 5-10yr corporate sector (measured by ICE BofA ***c6a4*** index) rose 1.09% to close yielding 2.39% (15bp lower).

Review of Market Structure:

The market for hybrids or **global junior-subordinated capital securities** (*i.e.,* "**Jsubs**") as we call them is comprised of two core sectors:

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 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 $345 billion (face amount) of investment grade and below investment grade instruments in both the retail $25par market (36%) and the institutional $1,000par market (64%). The USD Contingent Capital Index of US dollar denominated junior-subordinated capital securities ***(cdlr)*** represents $146 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 $487 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.

<u>Preferred Securities</u>

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 "<u>gone-concern</u>" 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*) @ 43% *of i0cs***

- <u>Comprised of IG $25par and IG $1,000par (incl. US AT1)</u>
  - ❖ The *p0p1* rose 1.32% this month to close yielding 1.91% (-42bps)
  - ❖ Headcount declined by 2, face value declined by $1.3billion

2. ICE BofA US Capital Securities Index (*c0cs*) @ 25% of *i0cs*

- <u>Comprised of dated IG $1,000par hybrids (excl. US AT1)</u>
  - ❖ The *c0cs* rose 1.10% this month to close yielding 3.05% (-14bps)
  - ❖ Headcount rose by 1; face value declined by $0.9billion

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 1.91% this month to close yielding 3.34% (-21bps)
  - ❖ Headcount rose by 2; face value declined by 1.75billion

4. ICE BofA High Yield Fixed Rate Preferred Index (*p0hy*) @ 27% of *i0cs*

- <u>Comprised of BIG $1,000par US AT1 and BIG $25par</u>
  - ❖ The *p0hy* rose 1.30% this month to close yielding 3.51% (-11bps)
  - ❖ Headcount rose by 2, face value rose by $2.0billion

Overall, the BofA All US Capital Securities Index (***i0cs***) rose 1.29% in April to close yielding 2.69%, which was 26bps lower than last month's closing yield and a spread of +181bps over comparable US Treasury securities (9bps 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 comprised of US dollar denominated constituents (exclusively), which represent 58% 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 1.26% this month to close yielding 3.55%, which was 31bps lower than last month and a spread of +278bps over comparable US Treasury securities (21bps tighter).

Snapshot of Junior Subordinated Spread Sector Moves:

Capital Securities Spread Value Matrix	p0p4 (a) Retail	p0p4-e0ba (b) Retail	stb8 (a) NoCo	stb8-e0ba (b) NoCo	cdlr (a) CoCo	cdlr-e0ba (b) CoCo
Sample Periods	03/31/2017 to Date		03/31/2017 to Date		03/31/2017 to Date	
Jr-Subs	*Absolute	**Relative	*Absolute	**Relative	*Absolute	**Relative
High	588	251	481	201	660	421
Low	-178	-267	175	55	223	143
Range	766	518	306	146	437	278
Average	79	-41	261	140	380	260
Stdev	114	97	44	24	75	52
Monthend	56	-23	223	144	277	198
Sector Spread Score¹	-0.01		-0.35		-1.28	
Last Month's Score¹	0.46		0.21		-0.48	

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

	p0p4	p0p4-e0ba	stb8	stb8-e0ba	cdlr	cdlr-e0ba
*Absolute	-0.20		-0.86		-1.37	
**Relative		0.19		0.17		-1.19

** Absolute = Option Adjusted US Government Spread*

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

Monthend estimate of spread duration benefit (units of stdev.)

	p0p4	stb8	cdlr
Spread/mdurMat	-2.00	-1.02	-0.91
Probability Estimate to Spread Benefit	2.28%	15.39%	18.14%
		Memo: e0ba	6.43%

Source: Bloomberg, ICE Bond Indices

Implications of Market Activity:

$25par Retail Preferred Securities Sector

The retail preferred securities sector rose $0.58 in April, which cut the sector's benchmark yield by 27bps from last month to 2.00% -- overall, spreads tightened by 20bps to close at +152bps. The negative convexity caused by aging 5yr call options and premiums prices that predominate $25par paper makes the sector's duration decline when its yield declines. This month, the decline in yield cut the retail sector's modified duration by 0.31yrs to 3.58yrs. Suffice it to say that when modified duration-to-worst declines in the sector, price risk is rising more than is implied by duration. To uncomplicate this concept of negative convexity, let's view the retail sector as if the calls won't happen – in other words, consider the yield-to-maturity as option-free; and consider the commensurate yield spread and modified duration to maturity as option free too. This month, the sector closed with a YTM of 4.84%, which was a spread of +254 and a modified duration of 15.39yrs. When looking a spread per unit of modified duration-to-maturity, we find that this value (16.50) is now posting an all-time low -- in the chart above, we estimated this as -2.00 standard deviations below the mean (i.e., 22.21). We consider this measure to be an approximate z-score on spread benefit left in a sector – in other words, in terms of confidence intervals, the retail sector shows (only) a 2.28% confidence interval to spread duration being a potential benefit to investors (i.e., the "probability estimate to spread benefit") if rates rise because there is not much spread left from the sample period to tighten. Indeed, as spreads tighten and price premiums grow, we're particularly cautious of the lower retail coupons as they would be the likely first sale candidates in any stock market correction – if the Fed would allow such a thing. Retail sector issuance picked up at the end of the month, with non-cumulative preferred stock deals for (Ba2/BB) First Horizon Corp (4.70%) , (Ba1/BB+) Regions Financial Corp (4.45%) and (Baa3/BB) Capital One Financial (4.375%) – all three were trading below par after syndicate.

$1,000par Institutional Preferred Securities Sector

The $1,000 par institutional sector of the preferred securities market rose $1.20 in April. Relative values to more senior financials are still above average as yields on product up the capital structure have rallied to new lows with the yield compression. The chart below shows the yield-to-worst spread of NoCos (i.e., *stb8*: a custom weighted combination of ICE BofA's *cips* and *hips*) vs. Eurodollar Banking Index spread (i.e., *e0ba*) since 2013:

Source: Bloomberg

We look back to 2013 to include three intra-cycle sparks or shocks: 1) the aftermath off the bottom of the Taper Tantrum (2014), 2) the commodity implosion and high yield (oil) market bust (2016) and 3) the market's revolt to the Fed's overshoot on rates (2018) – and now, the ongoing recovery from the COVID-19 recession. NoCo spreads to comparable treasuries closed 15bps tighter (+223). Relative to more senior financials, NoCos moved 11bps tighter yet still have room to further tighten because at +144bps to senior financials, spreads in NoCos have a relative spread score of 0.17 standard deviations better than average. But, as yields compress to treasuries, the potential capital benefit to further spread tightening is diminishing – for NoCos, the estimated probability of spread duration benefiting capital is 15.39% based on our sample.

There were three notable new deals this month in the NoCo sector: 1) $920mil. Sumitomo Life Insurance (A3/A-) 3.375% jr. subordinated bonds @+175 vs. the 10yr US treasury, 2) $1.35bil. Ally Financial (nr/BB-) 4.70% 5yr fixed-to-refixed non-cumulative perpetual preferred stock @+387, and 3) $675mm Goldman Sachs Group (Ba1/BB) 3.80% 5yr fixed-to refixed non-cumulative perpetual preferred stock @+297 – all three traded up after syndicate.

Contingent Capital Securities Sector

The CoCo sector closed $0.82 higher this month as European bank equities sector rallied to highs for the year. The rising equity values in the sector (off chronic long-term lows) are helping to tighten CoCo spreads as loan quality has stayed resilient to chronically lackluster growth. 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:

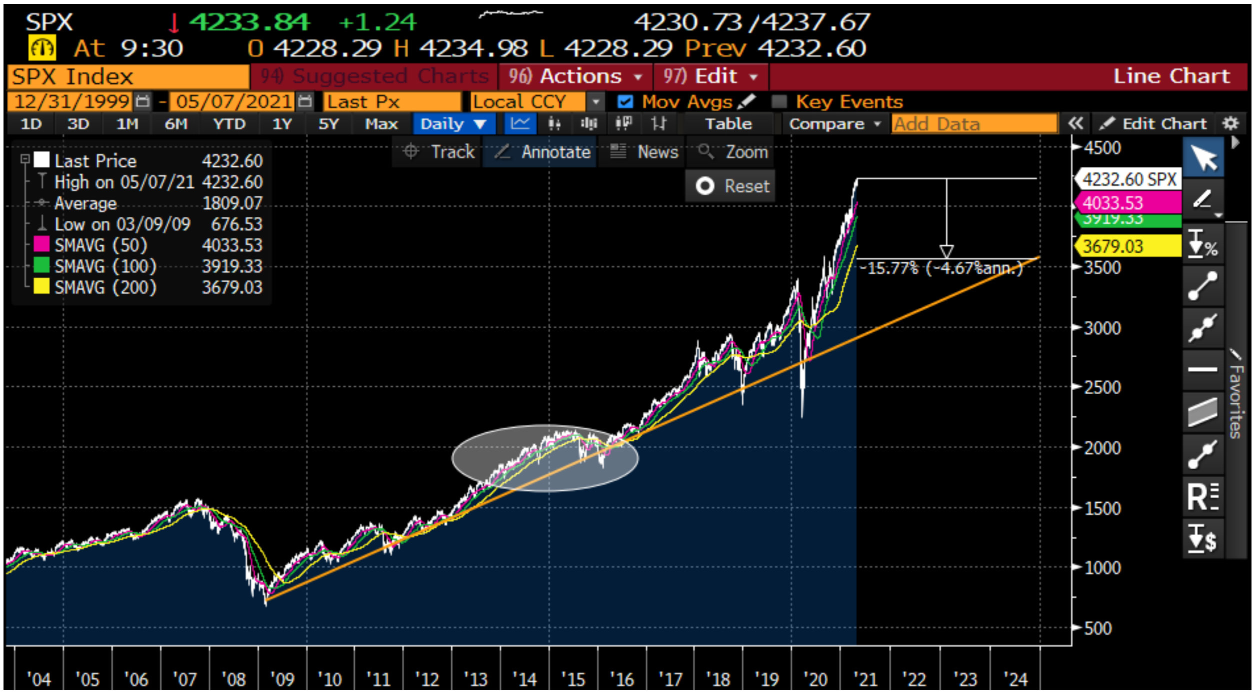
Source: Bloomberg

The relative OAS differential between CoCos and more senior financials tightened by 17bps to close the month with a difference 198bps in favor of CoCos. The relative value opportunity in CoCos compared to more senior financials is below average, but still appears reasonable given how much market spreads have compressed in other sectors. Despite CoCo's overall sector spread score of -1.28 being the lowest of the three junior subordinated sectors, CoCos still provide 54bps of additional spread to NoCos and 221bps of additional spread to retail preferred securities; and offer the highest absolute yields in additional tier-1 capital securities. The incremental yield available in the sector reflects to best relative confidence interval available for some spread benefit 18.14%, which is 2.8x the estimate for more senior financials (e0ba). There was no new issuance in CoCos this month. The HSBC (Baa3/nr/BBB) 4.70% contingent capital securities issued last month closed 2 points higher in April.

Outlook:

The Fed convincingly reiterated last month that its policies will be **outcome-based**. It has two desired outcomes: 1) a significantly improved labor market, and 2) inflation maintaining a track above 2% once it gets there. According to Chairman Powell, "*Substantial further progress toward its goals is needed*" and the Fed "*will signal well in advance that it believes its outcomes have been met*." For the near term, the Fed will be very accommodative as *"the ongoing health crisis continues to weigh on the economy, and risks to the economic outlook remain"*. Any convincing data viewed through the Fed's rearview mirror. When asked about tapering bond purchases, Chairman Powell said that, "*progress would require more than one good jobs report*". Indeed, the very strong March payroll report (+916k) in early April set a tone for very strong expectations again for the April payrolls (+1mm) -- and the whisper number kept creeping up only to significantly disappoint at just +266k jobs in the report last Friday. Despite the disappointment, the long bond could not hold a bid and closed lower on the day after an impressive 2 ¾ point range day. This certainly takes any expectation of a June taper off the table and only allows 3 more reports before the annual Jackson Hole event when many folks believe the Fed will at least start talking about hinting about tapering its bond purchases. We still think The Fed will hint on expectations for taper timing at Jackson Hole because the health crisis thar drags the outlook should be significantly resolved by then. The muted response to a big labor market disappointment on Friday suggests that COVID relief will soon wind down.

Chairman Powell has conceded to "*some things*" in the markets looking a little "*frothy*". This reminds me of former Fed Chairman Alan Greenspan's famous "irrational exuberance" comment back in the mid-90s. There is no question that financial conditions in markets are immaculate. In fact, we have never (yes, never ever) witnessed a melt-up in equity to the <u>degree</u> we are witnessing currently – for proof, look at the 200-day moving average on the S&P 500 in a daily series from Y2K (you will see an 80^{o} ray trending up & to the right) which has moved far in excess of any arbitrary trendline to underscore the series:



No doubt, there is more fear of missing out than there is of getting out of equity markets. So, we agree with Chairman Powell that some things appear a little frothy. Nonetheless, the central bank support that has fueled financial conditions will still be in full operation for some time and rising yields in US treasuries are taking a pause as any taper talks are still over the nearer term horizon. Though, it also appears that the bull tightener in credit is beginning to meet some resistance more recently.

The Biden Administration's tax increase proposed for later this year could make growth grind a gear when shifting from recovery into expansion next year. But the Fed will all but assure expansion with a double clutch of patience for the outcomes. Fiscal spending will be the primary growth fuel once the vaccine boosters are broadly distributed, and a Fed taper is eventually underway. Ultimately, the pace of equity market exuberance cannot be sustained on an 80^{0} ray, so we do expect friction from not only the Biden tax plan, but also from less monetary policy grease running into the mid-term elections next year. Both are likely to slow down the pace of rising long term interest rates from what we experienced last quarter and apply the brakes to the supercharged stock market. Indeed, the US mid-term elections this cycle will be a battle of significantly opposing ideologies which makes an equity correction (typical of election cycles) on the heels of a fed taper that much more likely. Comparatively, the amount of equity progress made from a successful bond taper in 2013 (shown above in the shaded oval) has already been achieved with the current purchases from the Fed. This could compel the Fed to ultimately taper at a slower pace than last time because "*a little frothy*" can still get further frothy. As we have stated before, economies can keep on growing but stocks can get overpriced – that appears to be the case now.

The macro backdrop notwithstanding, hybrid financials should continue to be among the expansion's top credit beneficiaries, and we expect hybrid spreads to tighten somewhat further along an ultimate path of rising 10yr TIPS rates. We believe that the Fed will achieve its goals and that a long-term trend reversal is underway for rising US Treasury bond rates, a steeper yield curve and sustained desired inflation above 2%. If the shift to progressive policies in America takes hold over the next three years, then an implication should be for sustained higher rates and lower spreads as inflation flows through to higher equity prices and both are leant support from Modern Monetary Theory and cheaper US dollars. Importantly, the relative performance path for hybrids would be supported by enhanced yield (and lower duration) compared to investment grade corporate bonds; and enhanced credit (and lower default risk) compared to junk bonds.

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