Junior-Subordinated Capital Securities Markets

June 2021 Updates

Credit and US Treasury prices went up in June as the Fed indicated more fear of inflation than it had led on in its repeated dismissive pronouncements since March. The move up in longer dated treasuries was abrupt following the FOMC's shift to a plausible lift-off to the federal funds rate in 2022 rather than 2023. But Chairman Powell downplayed the FOMC dot plot as "not a great forecaster" of policy moves. The Fed's mixed messaging that reassociated growth with inflation rather than assuring a flexible average inflation target (i.e., letting the economy fearlessly run hot to garner its sustained inflation goal) squeezed the 5yr-30yr steepening trades to cover-short after a stellar and profitable run into June. So, the Fed closed another quarter throwing their rhetorical book at bonds again by squeezing the steepening trade (that had indicated higher inflation expectations) out of the market akin to its squeeze on the 1st quarter's close when it dismissed inflation as (merely) "transitory" which flipped the momentum from selling to buying in US Treasury bond market. Real rates on the front end of the curve (e.g., UST 5yr TIPS; @ -1.64%) ended the month 12bps higher -- the 5yr implied breakeven inflation rate (i.e., the difference in yields between the 5yr UST and the 5yr Treasury Inflation Protected Security) declined 10bps to close at 2.50% (still its highest level in over 10yrs); and gold prices retraced 7.17% after rising 7.80% in May. The 30yr US Treasury bond closed the month yielding 2.09% (20bps lower) and the US Treasury 10yr note closed yielding 1.47% (17bps lower). The yield differential between these two longer US Treasury terms flattened 3bps to +62bps, well off the wide for the year of +85bps. The S&P500 dipped after the Fed meeting, but then zoomed to close 2.22% higher for the month. The VIX (i.e., Chicago Board Options Exchange Volatility Index) declined 5.55% to its lowest level of the year (15.83),

but it is still higher than the 200-day moving average for the VIX (15.15) the week before the pandemic hit markets last year.

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 1.37% to close yielding 3.77% (38bps lower).
- Global bank credit (measured by ICE BofA ***e0ba*** index) rose 0.74% to close yielding 1.58% (2bps lower).
- The BBB rated 5-10yr corporate sector (measured by ICE BofA ***c6a4*** index) rose 1.13% to close yielding 2.20% (14bps 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 <u>two core characteristics</u>:

1. any non-payment of distributions would <u>not</u> 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 $349 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 $151 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 $500 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***
    - Comprised of IG $25par and IG $1,000par (incl. US AT1)
        - The *p0p1* rose 1.35% this month to close yielding 1.74% (-58bps)
        - Headcount declined by 10, face value declined by $5.1 billion
2. **ICE BofA US Capital Securities Index (*c0cs*) @ 25% of *i0cs***
    - Comprised of dated IG $1,000par hybrids (excl. US AT1)
        - The *c0cs* rose 1.04% this month to close yielding 2.91% (-13bps)
        - Headcount was unchanged; face value was unchanged
3. **ICE BofA High-Yield Capital Securities Index (*h0cs*) @ 5% of *i0cs***
    - Comprised of BIG $1,000par legacy Tier1 and BIG $1,000par hybrids
        - The *h0cs* rose 1.42% this month to close yielding 3.32% (-21bps)
        - Headcount rose 3; face value rose by $2.5billion
4. **ICE BofA High Yield Fixed Rate Preferred Index (*p0hy*) @ 27% of *i0cs***
    - Comprised of BIG $1,000par US AT1 and BIG $25par
        - The *p0hy* rose 1.57% this month to close yielding 2.79% (-61bps)
        - Headcount declined by 3; face value declined by $1.85billion

Overall, the ICE BofA All US Capital Securities Index (***i0cs***) rose 1.34% in June to close yielding 2.41%, which was 46bps lower than last month's closing yield and a spread of +161bps over comparable US Treasury securities (36bps 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 comprised of US dollar denominated constituents (exclusively), which represent 59% 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 0.92% this month to close yielding 3.38%, which was 16bps lower than last month and a spread of +266bps over comparable US Treasury securities (18bps 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	313
Low	-178	-267	175	55	223	143
Range	766	518	306	146	437	170
Average	33	-76	246	137	334	224
Stdev	125	106	48	29	62	35
Monthend	**24**	**-46**	**212**	**142**	**251**	**181**
Sector Spread Score[1]	**0.11**		**-0.27**		**-1.28**	
Last Month's Score[1]	**0.47**		**0.06**		**-0.80**	

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 (a)	p0p4-e0ba (b)	stb8 (a)	stb8-e0ba (b)	cdlr (a)	cdlr-e0ba (b)
***Absolute**	-0.07		-0.71		-1.34	
****Relative**		0.28		0.17		-1.23

** 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.)

	Retail	NoCo	CoCo
Spread/mdurMat	**-2.42**	**-0.63**	**-0.66**
Probability Estimate to Spread Benefit	**0.77%**	**26.43%**	**25.36%**
		Memo: e0ba	**0.03%**

Source: Bloomberg, ICE Bond Indices

Implications of Market Activity:

$25par Retail Preferred Securities Sector

The retail preferred securities sector rose $1.91 in June to an all-time high of $108.10. This cut the sector's benchmark (*p0p4*) yield down by 95bps to 1.40% -- a spread compression of 86bps for an option adjusted spread of 93bps to comparable US Treasuries. The trend of declining coupon continued as overall headcount reductions called away more securities than the market could replace. Ultimately, the sector's modified duration dropped by 1.44yrs to 2.82yrs, which is in line with its negative convexity characteristic. Last month we emphasized that that the sector's very active call-and-replace cycle is adding structural extension risk and that security selection is very important when allocating risk in the $25par sector.

June was certainly a stellar performance month for the retail sector and was largely aided by the S&P 500's relentless linear move higher which fostered ongoing declines in equity volatility and tightening of spreads. The significantly tighter spread move was impressive given the backdrop of a strong US Treasury bond market. Indeed, the strength and length of the US Treasury bond rally has surprised many (us included at this point) – more on this later. Financial market conditions are immaculate, and issuers are taking advantage of cheap funding rates. Two new issues of note in the retail sector this month are: 1) Globe Life 4.25% $25par 50yr subordinated notes and 2) Bank of Hawaii 4.375% fixed rate perpetual preferred stock – both issues have an average BBB rating. Both have similar current returns, but as prices rise the duration skews are very different – remembering that duration skew is a measure of relative risk for negative convexity. So, if yields ever do rise again, say by 100bps, the Global Life paper should decline 3.35% less than Bank of Hawaii (all else being equal of course) because its modified duration skew below par is 3.35yrs lower. It's impossible to see this incremental risk on the surface, but the subtle difference of a 50yr hard maturity (for Global Life) compared to no maturity (for Bank of Hawaii) makes an increasing difference the lower

yields go. In fact, if these securities were both priced 100bps cheaper, the downside duration differential between the two would be cut in half – active management is important.

$1,000par Institutional Preferred Securities Sector

The $1,000 par institutional sector of the preferred securities market rose $0.65 in June. Relative values to more senior financials are just above average now as spreads on product up the capital structure have rallied to new lows this month. The chart below shows the option adjusted 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 of 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 pandemic. NoCo spreads to comparable treasuries closed 14bps tighter (+212). Relative to more senior financials, NoCos moved 10bps tighter and have room to further tighten because at +142bps to senior financials, spreads in NoCos have a relative spread score of 0.17 standard deviations better than average. As yields compress to treasuries, the potential capital benefit to further spread tightening should diminish – all else being equal. But market current moves are rarely equal to prior moves. This month the yield curve flattened which made the rolling spread to 30yr treasuries more attractive if NoCos payments increase over time as the forward yield curve implies – as a result, the estimated probability of spread duration benefiting NoCo capital rose modestly from 16.53% to 26.43% this month.

There were more than a few new deals this month in the NoCo sector. Three highlights were: 1) $1 billion (Baa3/BB) Capital One 3.95% fixed-to-refixed non-cumulative perpetual preferred stock @+316bps vs. the 5yr US Treasury note, 2) $1bil. Ally Financial (nr/BB-) 4.70% fixed-to-refixed non-cumulative perpetual preferred stock @+348bps vs. the 7yr US Treasury note and 3) a 3 part $2.45 bil. (Ba1/BB+) Vodafone 60yr junior subordinated debt deal priced along the 5yr, 10yr and 30yr spots on the curve – the 5yr fixed to refixed structures did better than the longer dated structures because of the general view is that the yield curve will bear flatten as it shifts up over the longer run giving the 5yr re-fixings more income than the 10yr bonds have today and a bit more capital protection as yields rise – well, if the Fed will ever allow it.

Contingent Capital Securities Sector

The CoCo sector closed $0.47 higher this month even as the European bank equities sector declined 4.4% after making new highs for the year earlier in the month. The European bank sector is up over 26% this year (off long-term lows) helping to tighten CoCo spreads as loan quality has stayed resilient to chronically lackluster growth which is beginning to improve. 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 20bps this month with a difference of 181bps 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 are compressed in other sectors. Despite CoCos' overall sector spread score of -1.23 being the lowest of the three junior subordinated sectors, CoCos still provide 39bps of additional spread to NoCos and 227bps of additional spread to retail preferred securities; and CoCos offer the highest absolute yields in additional tier-1 capital securities and the lowest durations. Since the 2015-2016 high spread zones, we believe that supportive

regulation, improved capital, and sustained loan quality skews the data sample to over-test downside risk which has since been materially mitigated by these core improvements – in effect, there is an improved new normal for CoCo credits, so the poor CoCo sector spread scores include legacy risks that are not as "bad" now as the back test scores them, nonetheless, the data is the data. Importantly, the incremental yield available in the sector reflects the second-best probability estimate of spread benefit at 25.36%, which is multiple times higher than what is scored for more senior financials (*e0ba*). The CoCo sector also has the lowest modified duration (3.34yrs) of the three junior subordinated sectors (and like NoCos, no duration skew risk). There were two CoCos issued this month: $750mm (nr/BB) UBS 3.875% contingent capital securities priced +310bps to the UST5yr and $750mm (Ba2/B+) Natwest Group 4.60% contingent capital securities priced +320bps to the UST10yr – both closed the month above par.

Outlook:

The Fed has convincingly reiterated that its policies will be **outcome-based** – that is, until its June FOMC meeting. That notwithstanding, the Fed has two desired outcomes: 1) a significantly improved labor market, and 2) inflation maintaining a track above 2%. 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*." But there were mixed messages coming from the Fed meeting this month and it sparked a significant long bond rally and bull flattener in US Treasuries. Up until the meeting, the Fed had an outcome-based mindset to policymaking and that was the primary difference between current policy and past policy (i.e., the policy that led to the taper tantrum (2013) was expectations-based). So, now despite inflation being touted as merely transitory and jobs still 9mm short of pre-pandemic levels, the Fed has grown concerned that inflation impulses are stronger than expected. Consequently, the dots report showed that 7 members (up from 4) now anticipate a target funds lift-off in 2022 with 2 rate hikes forecasted for 2023. That was a hawkish surprise, and

the Treasury bond market has zoomed higher since then and successfully squeezed the remaining inflation-steepeners out of their shorts. Chairman Powell nonetheless repeated his transitory narrative for inflation but said there are some risks that inflation may be more than just transitory. The confusion is whether the Fed will follow a patient and fearless path of flexible average inflation targeting ("FAIT") based on outcomes like it has said or switch back to improved growth leading to higher inflation expectations leading to arbitrary rate increases – the latter is hardly waiting for the outcomes. Basically, the US Treasury market's rally is telling the Fed that it believes the Fed has cut the "neutral target funds rate" from 2.5% (basically believing the Fed) to something less. But who can tell where the neutral rate is if you pull back the accommodation before inflation has maintained any non-transitory track above 2%? The Fed either has a patience disorder or it made another communication mis-step akin to 2018 when Chairman Powell said, "we are a long way from neutral" after its September meeting. Remember then the Fed bumped the target funds band up to 2%-2.25% (about equal to inflation), communicated there was a lot more to go and sparked a long bond rally that zoomed prices higher on fears that the Fed was going to over-shoot and cause a recession. The Fed ultimately got just one more hike in before it had to capitulate by cutting rates to 1.5%-1.75% and start buying T-bills the following year. So, where is the neutral federal funds rate that brings harmony to growth, labor markets and inflation? The market clearly had overpriced it as 2.0%-2.5% (or ranging around zero on a real basis if the Fed is to sustain inflation higher than 2%) even though the logic of the dots still implies that range – the reason is that the Fed has balked on inflation well in advance of it being "sustained" above 2% – after all, transitory does not mean sustained. So, bonds have rallied to tell the Fed it needs to keep rates low for longer to get the sustained outcomes it hopes for -- especially in advance of a growth drag potential from the Biden administration's desired tax hikes.

The $6 trillion Biden budget proposal will run a $1.8 trillion deficit in 2022. It proposes to raise the top individual tax rate back to 39.6% (from 37%). The administration also seeks to increase

the long-term capital gains tax rate and qualified dividend income tax rate to 39.6% for incomes over $1million. It also proposes to raise the corporate income tax rate from 21% to 28%, which is a 33% tax hike on corporations and a drag on forward P/E multiples. Overall, the budget (which includes a $3 trillion tax hike) will elevate government debt to the highest levels as percent of GDP since World War II and run annual deficits of at least $1.3 trillion for the next 10 years – this could be a 5% annual growth rate pushed into the US government securities markets and a strong technical force to lift negative real yields on long bonds. Despite the conflicted narrative that inflation is transitory, a repricing of the neutral federal funds rate to 1.5% would mean the Fed should indeed run the economy hot with an entrenched negative real funds rate of about 1% -- this should bring the steepener trades back into play when the taper happens. Frankly, we do not believe that the Fed can taper this time at the same pace that it tapered in 2014 when the time comes (December or sooner) – it can probably taper only ½ as fast given the tax hike plans (and Cororna virus variants) which would mean a lift-off delayed into 2024 (or late 2023 at the earliest). Indeed, if the of the long-term dots were notched down at some point (perhaps to buoy credit at some point) that would imply a Fed determined to sustain inflation. This coupled with the ongoing massive budget deficits that effectively accelerate the taper from growing supply could re-normalize real interest rates on long bonds to sustain a level above 1% which would offer a premium for the uncertainties of the Fed managing its flexible average inflation target.

The macro backdrop for now is still positively anchored by the Fed bond bully as real rates have plummeted back to February's deeply negative levels. 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 (this being our "bond bully index"), though the ride has been like a roller coaster. We believe that the Fed will achieve its goals and that a long-term trend reversal is underway for rising US Treasury bond rates. Importantly, the relative performance path for hybrids would be supported by enhanced yields

(and lower durations) compared to investment grade corporate bonds; and enhanced credit (and lower default risks) compared to junk bonds. Retail $25par preferreds measure up to be even more fully priced than last month, so to prepare for the long haul, we recommend diversifying retail portfolios into $1,000par NoCos and CoCos when possible, to mitigate higher capital risks in the retail sector and potentially soften the landing of the taper that's coming.

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