Junior-Subordinated Capital Securities Markets

July 2021 Updates

Credit prices were mixed as US Treasury prices rose in July in a continuing theme of the Fed ongoing bond buying with no hint of taper timing. The treasury market improved across the curve as the Fed committee continues to suggest that the path of the economy will depend on the course of the virus (and its variants). Chairman Powell says the Fed is *"some ways away from its employment goals"* and does not offer an indication of when the Fed will taper – though the committee is indeed talking about tapering. So, the Fed ended the month by emphasizing that lift-off on the federal funds rate *"is not on the radar screen."* Real rates on the front end of the curve (e.g., UST 5yr TIPS) ended the month 34bps lower at -1.98%; the 5yr implied breakeven inflation rate (i.e., the difference in yields between the 5yr UST and the 5yr Treasury Inflation Protected Security) rose 12bps to close at 2.62% (its highest level in over 10yrs); and gold prices rose 2.49% after falling 7.17% in June. On the back end of the curve, the 30yr US Treasury bond closed yielding 1.89% (20bps lower) and the US Treasury 10yr note closed yielding 1.22% (25bps lower). The yield differential between these two longer US treasuries steepened 5bps to +67bps, well off the wide for the year of +85bps. The S&P500 rose again to new highs during the month and closed July 2.28% higher. The VIX (i.e., Chicago Board Options Exchange Volatility Index) rose 15.22% off its lowest level of the year (15.83), but the move up was almost unrecognizable because the pullback in the S&P 500 was brief and shallow as equities continued their linear ascent under immaculate financial conditions thanks to the Fed's ongoing bond buying boosters and negative real rates.

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 0.36% to close yielding 3.92% (6bps higher).
- Global bank credit (measured by ICE BofA ***e0ba*** index) rose 0.71% to close yielding 1.48% (10bps lower).
- The BBB rated 5-10yr corporate sector (measured by ICE BofA ***c6a4*** index) rose 1.19% to close yielding 2.07% (16bps 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 $354 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 $148 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 $502 billion universe of fixed-rate junior-subordinated USD capital securities with preferred securities (measured by ***iocs***) being a 71% subset and contingent capital securities (measured by ***cdlr)*** being a 29% 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*) @ 43% *of i0cs***
    - Comprised of IG $25par and IG $1,000par (incl. US AT1)
        - The *p0p1* rose 0.23% this month to close yielding 1.87% (+3bps)
        - Headcount was unchanged, but face value rose by $2.9 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 0.71% this month to close yielding 2.85% (-8bps)
        - 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 0.89% this month to close yielding 3.28% (-13bps)
        - Headcount was unchanged; face value was unchanged
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 0.38% this month to close yielding 2.97% (+9bps)
        - Headcount rose by 4; face value rose by $1.4billion

Overall, the ICE BofA All US Capital Securities Index (***i0cs***) rose 0.43% in July to close yielding 2.51%, which was 1bp higher than last month's closing yield and a spread of +180bps over comparable US Treasury securities (14bps 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 the entity's 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 primarily held in our portfolios. The ICE BofA USD Contingent Capital Index (***cdlr***) rose 0.31% this month to close yielding 3.42%, which was 1bp lower than last month and a spread of +280bps over comparable US Treasury securities (12bps wider).

SPECTRUM
Asset Management

Snapshot of Junior Subordinated Spread Sector Moves:

Capital Securities Spread Value Matrix	p0p4	p0p4-e0ba	stb8	stb8-e0ba	cdlr	cdlr-e0ba
	(a)	(b)	(a)	(b)	(a)	(b)
	Retail	Retail	NoCo	NoCo	CoCo	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	34	-75	246	137	332	224
Stdev	123	105	48	29	62	35
Monthend	**52**	**-25**	**218**	**141**	**264**	**187**
Sector Spread Score¹	**0.31**		**-0.22**		**-1.08**	
Last Month's Score¹	**0.47**		**0.05**		**-0.79**	

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**	0.15		-0.58		-1.10	
****Relative**		0.48		0.14		-1.06

** 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.)

Spread/mdurMat	**-2.12**	**-0.40**	**-0.71**
Probability Estimate to Spread Benefit	**1.70%**	**34.44%**	**23.87%**
		Memo: e0ba	**0.04%**

Source: Bloomberg, ICE Bond Indices

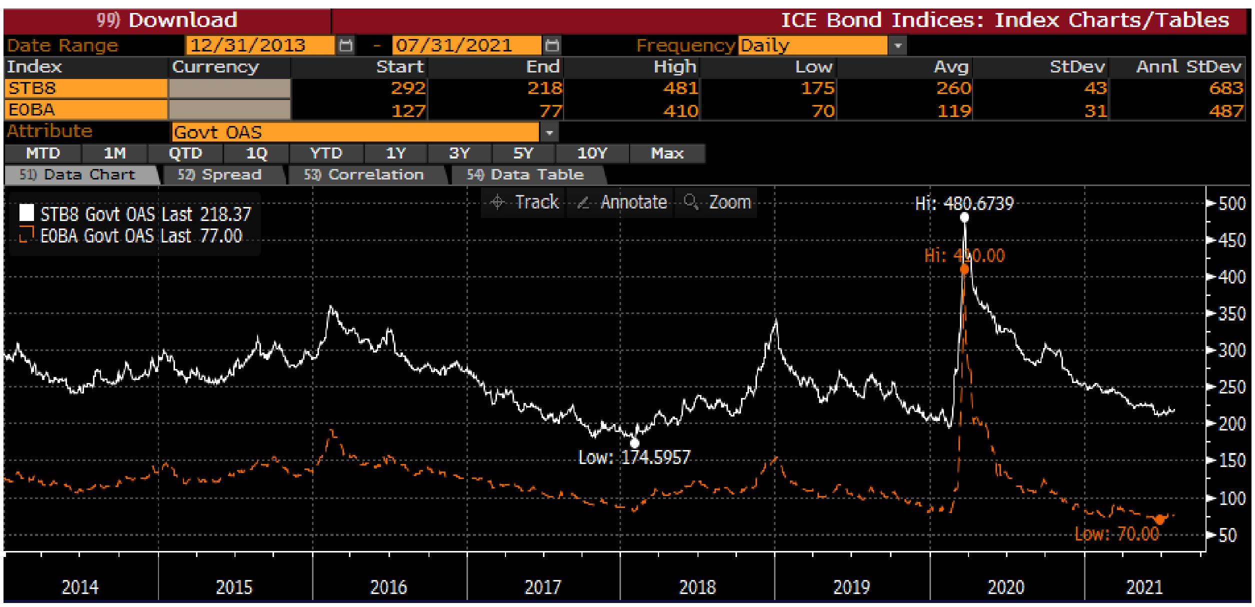
Implications of Market Activity:

$25par Retail Preferred Securities Sector

The retail preferred securities sector declined $0.27 in July to $107.83 just off its all-time high of $108.10 set last month. The softer price lifted the sector's benchmark (*p0p4*) yield by 18bps to 1.64% -- for a spread of 124bps to comparable US Treasuries (28bps wider; aided by the UST rally). Redemption pressures eased this month (after the biggest net redemption wave in 3yrs last month) as the face value of the $25par market was unchanged for July – this is impressive because there was a surge of over $5.6 billion in new issuance this month so redemptions equaled inclusions to the benchmark. Generally, we can call the retail market a "four-twenty" because 4 of the 8 deals (or 52% of face value) that came were priced at 4.20%; the range for the issuance was 4% - 4.5%. The lowest dividend of 4.00% was a $750mm fixed-forever First Republic Bank (BBB-) preferred stock; the highest dividend of 4.50% was a $300mm fixed-forever Stifel Financial Corp (BB-) preferred stock; and the median dividend was also the biggest deal (and a big deal overall for the retail market) – a $2billion 4.20% JP Morgan (Baa2/BBB-) fixed-forever preferred stock. Other notable preferred stock issuances this month were $1.25 billion of Wells Fargo 4.25% fixed-forever preferreds and $500mm 4.20% Renaissance Re Holdings (BBB) fixed-forever preferreds. We have noticed that the insurance company sector has become a particularly big buyer of retail $25par preferred securities recently – primarily because the yield premiums in IG 10-15yr corporates are at 10yr lows and the differential between IG preferreds and IG 10-15yr corporates is still generally well above its lows. For example, the IG preferreds-to-IG corporate spread is still 80bps higher than the low spreads set in 2018; and if an IG 4.20 can be bought, then the relative income premium earned could still be just slightly less than the average spread over the last 10 years. In an era of yield repression and inflation (where the real return on the UST 10yr note is -1.10% and the 10yr breakeven inflation rate is 2.20%) a real income potential on IG preferreds of 2.00% (or +310 to the 10yr TIPS) appears attractive and worth the buy and hold – especially when the average 10yr historical annual default rate on the preferred and capital securities market (i.e., including below investment grade) is just 11bps.

<u>$1,000par Institutional Preferred Securities Sector</u>

The $1,000 par institutional sector of the preferred securities market rose $0.36 in July. 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

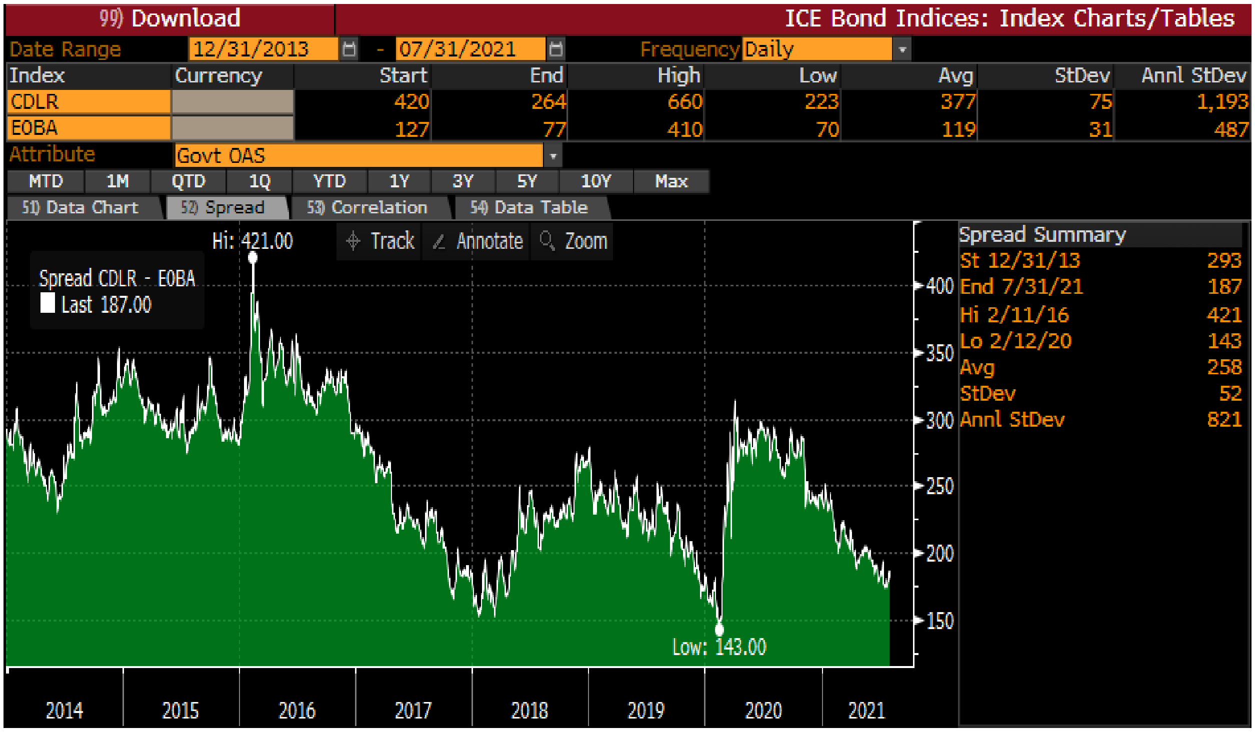
We look back to 2013 to include three intra-cycle sparks or shocks: 1) the aftermath of the bottom of the Taper Tantrum (2014), 2) the commodity implosion and high yield (oil) market bust (2016) and 3) the market's revolt to the Fed's overshoot on rates (2018) – and now, the ongoing recovery from the COVID-19 pandemic. NoCo spreads to comparable treasuries closed 14bps tighter (+212). Relative to more senior financials, NoCos moved 1bp tighter and have room to further tighten because at +141bps to senior financials, spreads in NoCos are 0.14 standard deviations better than average. As yields compress to treasuries, the potential capital benefit to further spread tightening should statistically diminish – all else being equal. This month, treasury prices moved up more than NoCo prices, so spreads widened by 6bps relative to treasuries – as a result, the estimated probability of spread duration benefiting NoCo capital rose modestly from 26.43% to 34.44% this month.

New issuance is NoCos this month wasn't nearly as active as in the retail sector. Goldman Sachs (ba1/BB) issued a $1000par AT1 for the second time this year – this time, a 3.65% 5yr fixed-to-refixed perpetual preferred stock at +292bps to the US Treasury 5yr note. The deal did well and closed the month up ½ point.

Contingent Capital Securities Sector

The CoCo sector declined $0.20 this month as the European bank equities sector declined 8.4% by mid-month and then staged a comeback to close just 0.84% lower. The European bank sector is up over 25% 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 European Banking Authority published the results of regular stress tests – and they were good. The banks began the tests with an average 15% common equity tier1 ratio (the primary capital measure to absorb losses and the highest level since the inception of stress tests) and completed the adverse scenario test above 10% -- a solid outcome and adequately supportive. The European Central Bank must have had a strong inclination on what these results would be because earlier in July, it stated that it would lift restrictions on common equity buybacks and dividend payments. This was all good news because it suggests confidence from the regulator that the Eurozone is emerging from the economic malaise caused by the coronavirus. 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

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. The relative OAS differential between CoCos and more senior financials widened by 6bps this month with a difference of 187bps 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 still compressed in other sectors. Despite CoCos’ overall sector spread score of -1.08 being the lowest of the three junior subordinated sectors, CoCos still provide 46bps of additional spread to NoCos and 212bps of additional spread to retail preferred securities; and CoCos offer the highest absolute yields in additional tier-1 capital securities and the lowest durations. Importantly, the incremental yield available in the sector reflects the second-best probability estimate of spread benefit at 23.87%, which is multiple times higher than what is scored for more senior financials (*e0ba*). There were no CoCos issued this month given the anticipation of the stress test results.

Outlook:

The Fed has convincingly reiterated that its policies will be **outcome-based** – that is, until more recently. That notwithstanding, the Fed has two desired outcomes: 1) a significantly improved labor market, and 2) inflation maintaining a track above 2%. But there were mixed messages over inflation views coming from the Fed last month that certainly played through this month helping to support a significant long bond rally since May -- a 5 standard deviation term streak. It is now uncertain whether the Fed will follow a patient and fearless path of flexible average inflation targeting ("FAIT") based on outcomes or switch back to fearful expectations leading to arbitrary rate increases that can be poorly timed – the latter is hardly delaying lift-off by "*waiting for the outcomes*" as the June dot changes suggested. Aside from lift-off views, the Fed does appear to be setting the balance sheet table for tapering its bond purchases because of the way it worded its July statement: *"the economy has made progress toward its goals and the Committee will continue to assess progress in the coming months*". No doubt, labor market improvements into the 3rd quarter will be key indicators for the market's determination of just how "*some way away from its employment goals"* the economy really is according to the Fed – we believe there is a 40% chance of taper in November, a 70% chance of a taper in December and virtually a 100% chance of a taper by January. The market is thinking January so repricing expectations before January would likely lead to a meaningful rise in real yields (again).

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") and positive equity performance in the financial sectors from higher rates. We believe that the Fed will achieve its goals and that a long-term trend reversal is begrudgingly underway for rising US Treasury bond rates. Importantly, the relative performance path for hybrids compared to corporates would be supported by enhanced yields (and lower durations in the institutional sector) than for investment grade corporate bonds; and enhanced credit (and lower default risks) compared to junk bonds. Retail $25par preferreds measure up as fully priced, so to prepare for the long haul, diversifying retail portfolios into some $1,000par NoCos and CoCos could help to mitigate higher capital risks in the retail sector and potentially soften the landing of the taper impact impelling sustained higher real yields that's likely going to get underway later this year.

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