Junior-Subordinated Capital Securities Markets

August 2021 Updates

Credit performance was mixed in August as US Treasury prices slipped as the ongoing theme of the Fed's bond buying began to shift toward increasing taper odds. The treasury market retested its low yield of last month (the rally has lasted since March) and then drifted higher as Fed members increasingly talked of not only tapering but tapering sooner. The Kansas City Fed's annual August Jackson Hole symposium is often a venue for meaningful policy news from the Federal Reserve Bank. This year, Chairman Powell found it necessary to make it clear that the Fed will separate tapering from rate hikes (because of the Fed's hawkish mistake in June that rallied bonds and flattened the curve) by opening his speech with, *"the timing and pace of the coming reduction in asset purchases will not be intended to carry a direct signal regarding the timing of interest rate lift-off."* So, the Fed ended the month asking the market for a dovish divorce – or at least a separation by emphasizing that lift-off could be years away from a certain settlement on the taper. Real rates on the front end of the curve (e.g., UST 5yr TIPS) ended the month 20bps higher at -1.78%; the 5yr implied breakeven inflation rate (i.e., the difference in yields between the 5yr UST and the 5yr Treasury Inflation Protected Security) fell 11bps to close at 2.51% (still essentially bound in a 10bps channel since February); and gold prices finished unchanged but still 19.3% higher on the year. On the back end of the treasury curve, the 30yr bond closed yielding 1.93% (4bps higher) and the 10yr note closed yielding 1.31% (9bps higher) -- the yield differential between the two longer US treasuries flattened 5bps to +62bps, well under the wide for the year of +85bps. The S&P500 rose again to new highs during the month closing 2.90% higher. The VIX (i.e., Chicago Board Options Exchange Volatility Index) declined 9.65% just off its lowest level of the year (15.83) as share markets continued their linear ascent under immaculate financial conditions thanks to the Fed's ongoing bond buying boosters and relentless (yet unsustainable) longer term 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 0.54% to close yielding 3.84% (18bps lower).
- Global bank credit (measured by ICE BofA ***e0ba*** index) fell 0.02% to close yielding 1.52% (2bps higher).
- The BBB rated 5-10yr corporate sector (measured by ICE BofA ***c6a4*** index) fell 0.20% to close yielding 2.14% (5bps higher).

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 $355 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 $150 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 $505 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*) @ 42% *of i0cs***
    - Comprised of IG $25par and IG $1,000par (incl. US AT1)
        - The *p0p1* rose 0.05% this month to close yielding 2.28% (+32bps)
        - Headcount was down 1, but face value rose by $875 million
2. **ICE BofA US Capital Securities Index (*c0cs*) @ 24% of *i0cs***
    - Comprised of dated IG $1,000par hybrids (excl. US AT1)
        - The *c0cs* rose 0.36% this month to close yielding 2.83% (-3bps)
        - Headcount was down 1; face value declined $700mm
3. **ICE BofA High-Yield Capital Securities Index (*h0cs*) @ 6% of *i0cs***
    - Comprised of BIG $1,000par legacy Tier1 and BIG $1,000par hybrids
        - The *h0cs* rose 0.70% this month to close yielding 3.26% (-4bps)
        - Headcount was down 1; face value decreased by $729mm
4. **ICE BofA High Yield Fixed Rate Preferred Index (*p0hy*) @ 29% of *i0cs***
    - Comprised of BIG $1,000par US AT1 and BIG $25par
        - The *p0hy* rose 0.15% this month to close yielding 3.03% (+3bps)
        - Headcount rose by 4; face value rose by $1.9 billion

Overall, the ICE BofA All US Capital Securities Index (***i0cs***) rose 0.19% in August (but the price fell 0.26%) to close yielding 2.69%, which was 13bps higher than last month's closing yield and a spread of +193bps over comparable US Treasury securities (11bps 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 0.39% (but the underlying price slipped 0.10%) this month to close yielding 3.28%, which was unchanged from last month and a spread of +275bps over comparable US Treasury securities (1bp tighter).

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	-74	245	137	331	223
Stdev	122	104	48	29	63	35
Monthend	71	-4	212	137	259	184
Sector Spread Score[1]	0.49		-0.34		-1.13	
Last Month's Score[1]	0.31		-0.22		-1.08	

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	0.30		-0.69		-1.14	
**Relative		0.67		0.00		-1.11

** 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	-2.09	-0.36	-1.03
Probability Estimate to Spread Benefit	1.82%	35.96%	15.11%
		Memo: e0ba	0.04%

Source: Bloomberg, ICE Bond Indices

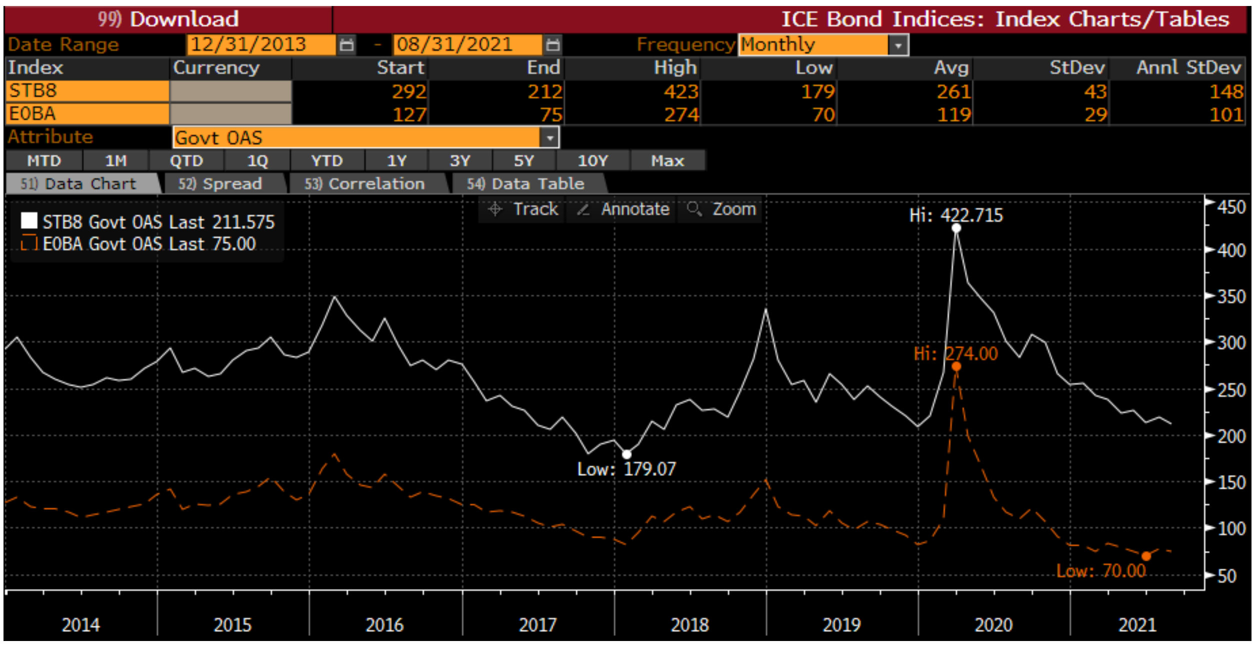
Implications of Market Activity:

$25par Retail Preferred Securities Sector

The retail preferred securities sector declined $0.75 in August to $106.98 which is two months off its all-time high of $108.10 set in June. The softer price lifted the sector's benchmark (*p0p4*) yield by 44bps to 2.15% -- for a spread of 167bps to comparable US Treasuries (39bps wider). Refunding pressures continued this month with over $1.3 billion of redemptions which helped keep 2021 in a moderate net redemption phase as real interest rates remain deeply negative from the Fed's bond buying enabling redemption economics to be attractive. Since 2013 (i.e., the time of the Fed's last taper), the annualized income component of the $25par market has declined from 6.91% to 5.12% which represents an annualized decline of 3.4% per year – roughly twice as much as the average rate of inflation during the period. This income burn rate has been partially offset by approximately 2.9% of average annual capital gains as the sector's yield-to-maturity hit a record low of 4.45% just last month – down from a high of 6.88% in 2013. So, it's clear that if longer term interest rates rise even modestly from here (and we think they will because the Fed has clearly said that the taper in coming) that "a nickel ain't worth a dime anymore." – Yogi Berra. The reason is that the $25par market's modified duration to maturity is 15.55yrs compared to 11.64yrs in 2013 which implies more capital risk with less income support for the fixed-for-life-or-perpetuity retail sector. Fortunately, we can mitigate some of this risk over the longer term through security selection (e.g., with some adjustable-rate structures) and by diversifying some portfolios in $1,000 par preferred securities that are predominantly adjustable-rate income securities.

$1,000par Institutional Preferred Securities Sector

The $1,000 par institutional sector of the preferred securities market rose $0.02 in August. 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

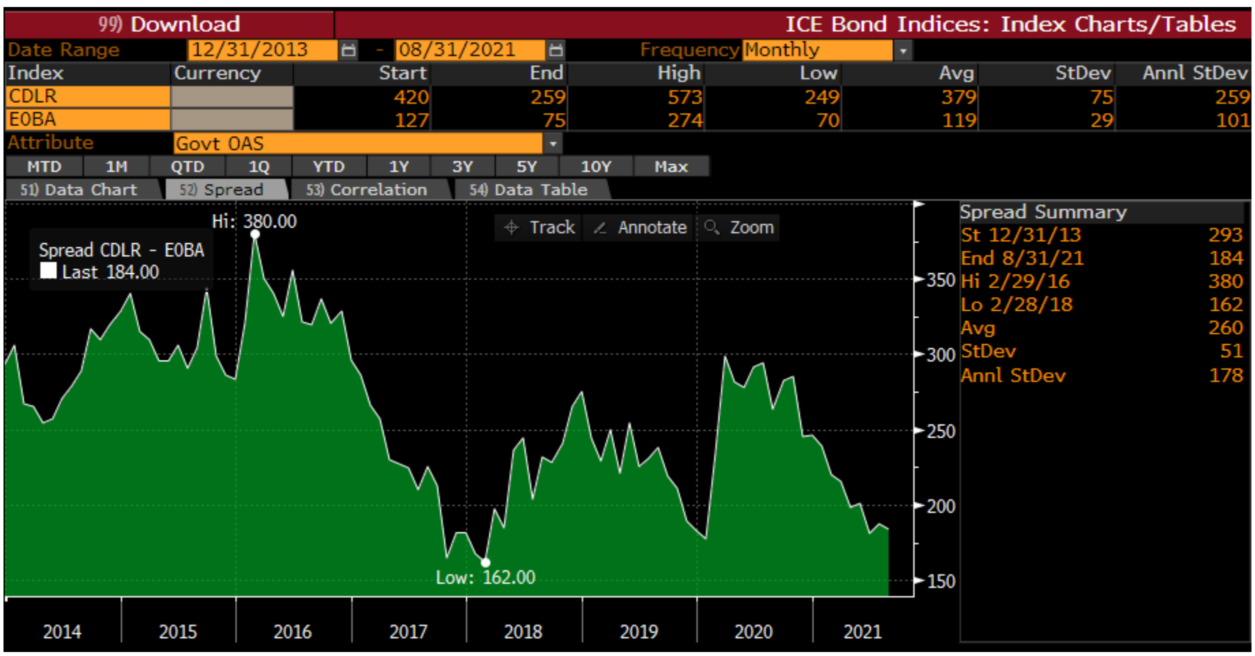
We look back to 2013 to include three intra-cycle sparks or shocks within the broader economic cycle from 2013's QE-III to 2020's QE-IV: 1) the aftermath of the bottom of QE-III's Taper Tantrum (2014), 2) the commodity implosion and high yield (oil) market bust (2016) and 3) the market's revolt to the Fed's overshoot on rates (2018) – and now, the ongoing fear of and recovery from the COVID-19 pandemic (2020+). NoCo spreads to comparable treasuries closed 6bps tighter (+212). Relative to more senior financials, NoCos moved 4bps tighter and have room to further tighten because at +137bps to senior financials, spreads for NoCos are -0.21 standard deviations less than average or 2.09 standard deviations off the tightest spread set in late 2017. We expect the yield compression on junior subordination to more senior credit to continue grinding tighter though there is likely to be some correction along the way from the excesses created by the Fed's massive balance sheet expansion that should be fully tapered through next year. From an historical relative spread perspective, the position of the junior subordinated spread differential looks like where it was in late 2016 as credit climbed out of the commodities crisis – though absolute spreads today are lower as the Fed engineered a market immunity to the coronavirus. As we do not expect the Fed to raise the funds rate for some time, the likelihood of junior subordinated spreads making a move tighter yet is plausible – the estimated probability of spread duration benefiting NoCo capital rose modestly from 34.44% to 35.96% this month though as rates rise this benefit would be more defensive (i.e., mitigating capital erosion) than offensive (i.e., increasing capital gains) – importantly, compounding premium income should be base story line.

Relevant new issuance is NoCos this month was more active than in the retail sector. There were three highlights: 1) $1.6 billion of (baa2/BB+) American Express 3.55% 5yr fixed-to-refixed preferred stock, 2) $500mm of (Baa2/BBB-) M&T Bank 3.50% 5yr fixed-to-refixed preferred stock, and 3) $500 million of Liberty Mutual 4.125% 5yr fixed-to-refixed junior subordinated debt. The deals did well and closed the month up over 1point.

Contingent Capital Securities Sector

The CoCo sector declined $0.10 this month as the European bank CoCos digested all the good news that flowed from last month. The European bank equities sector rallied 4.2% to finish the month up near the highs for the year and is almost breaking out from their attempt to rally through its triple test of all-time lows set in 2012/ 2018/ 2019 – with an anchor weight subsequently chained to the sector from the pandemic. Basically, all this year's rally in European banks has done is to have risen the sector back up (i.e., 77% from last year's pandemic low) to where its low was during the European sovereign debt crisis in 2012 – indeed it's been a lost decade for European bank equity investors. But it's been a bonanza for contingent capital securities investors – especially since 2016 which was the fundamental test for CoCos and one the regulators chose not to fail by improving the Pillar-2 capital standards supporting CoCos. Since then, CoCos have accumulated returns of 53.5% in euros while equity has accumulated just 17.10% -- though at least the European bank sector's annual equivalent return of 2.9% has beaten Eurozone average inflation of rate of 1.0% over the period.

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 reflected higher pre-Pillar-2 risks, we believe that the supportive regulation from Pillar-2, improved core capital earned & issued, and sustained loan quality skews the data sample to over-test prospective downside risks which have since been materially mitigated by these core improvements. In effect, there is an improved "normal" for CoCo credits in the capital stack that not even the pandemic could break – the proof is in the green (above) as the subordination in excess of more senior financials which peaked in 2020 & 2018 are both still much lower than the peak differentials in 2016 before Pillar-2 was fixed. This month, the relative OAS differential between CoCos and more senior financials widened by 3bps with a difference of 184bps 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 credit spreads are compressed in other sectors. Despite the CoCo sector's spread score of -1.13 being the lowest of the three junior subordinated sectors, CoCos still provide 47bps of additional spread to NoCos and 188bps 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 15.11%, which is still multiple times higher than what we estimate is available for more senior financials (*e0ba*) – the implication here is that the defensive down in capital structure play in CoCos can still defend the goal.

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 have been mixed messages over inflation views coming from the Fed since June (i.e., that it would move rates up too soon) that Chairman Powell made certain to rectify in his speech at Jackson Hole – well, at virtual Jackson Hole thanks to the delta variant. There is no question that ongoing mutations of COVID-19 are causing broad social and economic disruptions, but we do not believe they'll slow the Fed's determination to taper its bond purchases this year while utopian financial conditions persist. The trick for Powell's messaging (if he is to keep his job) will be to signal its policy shifts as enabling a soft landing. The speech certainly exuded confidence in the Fed's transitory inflation narrative and dovish comments dispelled concerns of an early lift-off. For example, "Indeed, responding may do more harm than good, particularly in an era where policy rates are much closer to the effective lower bound even in good times." So, low for longer on the target funds is the message and we think that "longer" will last for quite a while (e.g., perhaps into 2024) – our clues to a lift-off getting nearer will be first for the 10yr TIPS rate to hold a positive yield and then for the 2yr treasury note yield to breakout of the federal funds rate upper bound (and stay out) to trend up enough to give the Fed the lift-off room it will need. If this can happen, then the Fed would be able to claim having made its exit Goldilocks – but landing it won't be easy. The Three Bears are ongoing coronavirus fears, resurging global conflicts and social change. Each will likely challenge the Fed to engineer a landing a bit shy of perfect, though indeed any landing is a good landing.

The Fed is the master pilot which should achieve its goals. Importantly for our clients and other readers, hybrids are an aircraft that can glide on the supplemental lift of added income compared to investment grade bonds and with less default turbulence compared to junk bonds. Hybrids have also been re-engineered with modified landing gear that allows for income to rise over time (if treasury bond rates rise) helping to make for a softer expected landing. The quality financial passengers and modified landing gear makes hybrids not only a relatively "cheap ticket", but also a cheap inflation hedge – and one that can book a positive real rate of return rather than the negative real rates guaranteed by the entire TIPS curve and some corporates.

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