SPECTRUM
Asset Management

# Junior-Subordinated Capital Securities Markets

## April 2022 Updates

The fixed income markets came under renewed and significant pressure in April, after getting somewhat of a relief last month (though still negative) only because the decline was tempered by tighter spreads – particularly in hybrids. April reversed the spread gains in hybrids (corporates too) and pushed them back to revisiting their wides for the year set in early March. The combination of wider spreads and higher UST rates this month now has hybrid yields approaching (and in some cases passing) their highs of 2013, 2016 and 2018. April was record-setting, though not in ways most would consider a fond memory as it was the worst month in 25yrs for retail hybrids if we exclude the 2008-2009 Great Financial Crisis. Ironically, the Fed's consistent reuse of its balance sheet since the financial crisis is recognized by the Fed as being part of the inflation problem, which is why the Fed's next steps are to reduce its System Open Market Account.

The 30yr bond closed April yielding 2.95% (50bps higher). The 10yr note closed yielding 2.88% (55bps higher) -- the yield differential between the two longer US treasuries flattened 5bps to +7bps. Real rates on the front end of the curve (e.g., UST 5yr TIPS) ended the month 52bps higher at -0.40%; the 5yr implied breakeven inflation rate (i.e., the difference in yields between the 5yr UST and the 5yr Treasury Inflation Protected Security) declined 8bps higher to close at 3.35%. The VIX (i.e., Chicago Board Options Exchange Volatility Index) zoomed up 62% to 33.40 as the S&P 500 finished the month down 8.80% at 4132, which is a new low for the 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) fell 3.64% to close yielding 6.95% (92bps higher).
- Global bank credit (measured by ICE BofA ***e0ba*** index) fell 3.50% to close yielding 4.66% (76bps higher).
- The BBB rated 5-10yr corporate sector (measured by ICE BofA ***c6a4*** index) fell 4.47% to close yielding 3.73% (59bps 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 (37%) and the institutional $1,000par market (63%). The USD Contingent Capital Index of US dollar denominated junior-subordinated capital securities ***(cdlr)*** represents $149 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 $504 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. ***1.*** **ICE BofA Fixed Rate Preferred Index (*p0p1*) @ 43% *of i0cs***
    - Comprised of IG $25par and IG $1,000par (incl. US AT1)
        - The *p0p1* fell 5.47% this month to close yielding 5.44% (+91bps)
        - Headcount was up 1; face value up $2.575billion
2. **ICE BofA US Capital Securities Index (*c0cs*) @ 23% of *i0cs***
    - Comprised of dated IG $1,000par dated hybrids (excl. US AT1)
        - The *c0cs* fell 2.53% this month to close yielding 4.95% (+52bps)
        - Headcount was down 1; face value down $1billion
3. **ICE BofA High-Yield Capital Securities Index (*h0c*s) @ 5% of *i0cs***
    - Comprised of BIG $1,000par legacy Tier1 and BIG $1,000par hybrids
        - The *h0cs* fell 2.44% this month to close yielding 5.88% (+38bps)
        - Headcount unchanged; face value unchanged
4. **ICE BofA High Yield Fixed Rate Preferred Index (*p0hy*) @ 29% of *i0cs***
    - Comprised of BIG $25par and BIG 1,000par (incl. US AT1)
        - The *p0hy* fell 4.36% this month to close yielding 6.01% (+59bps)
        - Headcount was down 2; face value down $675million

Overall, the ICE BofA All US Capital Securities Index (***i0cs***) fell 4.28% in April to close yielding 5.50%, which was 69bps higher than last month's closing yield and a spread of +237bps over comparable US Treasury securities (12bps 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 the entity's 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 primarily held in our portfolios. The ICE BofA USD Contingent Capital Index (***cdlr***) fell 2.66% this month to close yielding 6.31%, which was 80bps higher from last month and a spread of +359bps over comparable US Treasury securities (37bps wider).

**Discussion of Retail and Institutional Sectors:**

We report on the retail and institutional sectors using statistical tables in a *Spread Value Matrix* to provide readers with data on absolute and relative spread positionings. The data samples are sourced from ICE BofA benchmarks starting in March 2017, which is when retail benchmark calculations on yield-to-worst for currently callable $25par preferred securities were improved to reflect actual yields even if negative. We'll provide measures of inflation coverage in a *Purchasing Power Matrix*; and a table for yield-to-worst, net of inflation and historical default in a *Real Yield Matrix* that compares hybrids, investment grade corporates and high yield bonds. Finally for each sector, we'll show data on prior credit cycles to give you a *Comprehensive Risk Estimate* to the average bottom of the last 3 credit cycles (2013, 2016 and 2018) -- the rationale here is to illustrate risk measures, but not an outlook to that end. By following these tables monthly (and sometimes as "pop-outs" in flash reports), investors should gain consistent insights to assist in making more informed and supportive asset allocation decisions using junior subordinated capital securities.

**Snapshot of Junior Subordinated Spread Sector Moves vs, Global Financials:**

| | p0p4 | p0p4-e0ba | stb8 | stb8-e0ba | cdlr | cdlr-e0ba |
|---|---|---|---|---|---|---|
| Capital Securities Spread Value Matrix | (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 | 479 | 200 | 660 | 313 |
| Low | -178 | -267 | 174 | 53 | 223 | 143 |
| Range | 766 | 518 | 305 | 147 | 437 | 170 |
| Average | 47 | -60 | 241 | 135 | 325 | 219 |
| Stdev | 119 | 105 | 45 | 27 | 62 | 35 |
| Monthend | 196 | 67 | 257 | 127 | 327 | 198 |
| Spread Scores: | | | | | | |
| (monthend-ave)/stdev | 1.25 | 1.21 | 0.36 | -0.30 | 0.03 | -0.60 |
| Δ from Last Month | 0.53 | 0.40 | 0.56 | 0.10 | 0.63 | 0.51 |

*Source: Bloomberg; ICE BofA Bond Indices*

* Absolute = Option Adjusted US Government Spread; (current-ave)/stdev

** Relative = spread to global financials measured by e0ba ICE Bond Index; (current-ave)/stdev

Spreads got more positive in April with CoCos widening the most, but NoCos and retail following closely behind. Most notable this month, are the spreads relative to average spreads, all of which are greater than average but all within 1stdev wide of absolute and relative historical comparisons. No doubt, hybrids are a better value now than they were in March as we'll discuss more below.

**Implications of Market Activity**:

## $25par Retail Preferred Securities Sector

The retail preferred securities sector measured by *p0p4* fell $6.85 in March to $88.97, continuing the sector's discount dive which started in February after trading at a premium since December 2018 (i.e., excluding the COVID Crisis). The total return of the investment grade benchmark of the retail market (i.e., *p0p2; which we need to use to look back 12yrs or more*) has been down each of the 4 months this year -15.44% -- this is a new record by a wide margin (excluding the financial crisis period of 2008-2009) for either before or after the financial crisis dating back to 1997. The prior record was in the 9.34% decline at the start of the COVID Crisis in Feb-Mar2020. In fact, the longest string of negative months was in 2013 with 6 straight declines totaling -8.18%. April's decline in the *p0p2* total monthly return was a -4.26 standard deviation move which left the sector 65% cheaper in just 4 months than all the annual periods over the past 25yrs, except 2008. Here's a look at the retail sector's 3 prior credit cycles compared to end of month valuations:

| Retail Pfds. | Valuation Implosions | | | Average | | Diff. to | |
|---|---|---|---|---|---|---|---|
| Credit Cycle Bottoms > | 2013 | 2016 | 2018 | Prior Bottoms | Current | Average | |
| GA10 | 2.98% | 1.64% | 2.74% | **2.45%** | 2.88% | 0.43% | |
| PCE DEFY | 1.48% | 0.59% | 1.86% | **1.31%** | 6.40% | 5.09% | how to get 640 |
| Real UST10yr | 1.50% | 1.05% | 0.88% | **1.14%** | -3.52% | -4.66% | |
| $25Coupon | 6.64% | 6.46% | 6.05% | **6.38%** | 5.45% | -0.93% | |
| $25Price | $94.06 | $98.66 | $93.09 | **$95.27** | $88.92 | -$6.35 | |
| $25Current Yield | 7.06% | 6.55% | 6.50% | **6.70%** | 6.13% | -0.57% | |
| Mdur Worst | 9.52 | 10.44 | 10.95 | **10.30** | 11.31 | 1.01 | |
| CY Spread vs. T10yr | 4.08% | 4.91% | 3.76% | **4.25%** | 3.25% | -1.00% | |
| *Source: Bloomberg; ICE BofA Bond Indices* | | | | | | -5.90% | Est. Price Risk to AveCY |
| | | | | **Comprehensive Risk Est.** | | 0.23% | **Est. Price Risk + CY** |
| | | | | Recapture Rate (yrs.) | | 0.96 | Est. Price Risk / CY |
| | | | | | *Memo:* | -14.39% | Total Return YTD |

The current yield of the retail sector closed April at 6.13%, which was 43bps higher than last month yet still 57bps lower than the average current yield at the bottom of the last three credit cycles. The current yield spread to the 10yr is 100bps less than the average of the last three credit cycle bottoms. The implication of a 0.57% yield increase to 6.70% (the average current yield of the prior bottoms) is an estimated 5.90% price decline using the average modified duration of 10.30; then adding back a current book yield (assuming a 12month path) of 6.13% makes the Comprehensive Risk Estimate for the retail sector positive at 0.23% compared to -4.60% last month. It would take 0.96yrs to recapture this capital loss with book income. There is no question that the retail sector is a better relative value now than it was at premium prices (or compared to last month). Now that the comprehensive risk estimate indicates a positive return the retail sector looks like a fair value; and cheap enough in the absolute to meaningfully mitigate the measured capital risk with high income in less than 1yr.

## $1,000par Institutional Preferred Securities Sector

The $1,000 par institutional sector of the preferred securities market fell $3.24 in April. Yields rose by 57bps in NoCos this month compared to a 77bps rise in yield for more senior US financials. Here's a look at the institutional preferred securities sector's 3 prior credit cycles compared to end of month valuations:

| Institutional Pfds. | Valuation Implosions | | | Average | | Diff. to | |
|---|---|---|---|---|---|---|---|
| Credit Cycle Bottoms > | 2013 | 2016 | 2018 | Prior Bottoms | Current | Average | |
| GA10 | 2.94% | 1.75% | 2.74% | **2.48%** | 2.88% | 0.40% | |
| PCE DEFY | 1.17% | 0.59% | 1.86% | **1.21%** | 6.40% | 5.19% | |
| Real UST10yr | 1.77% | 1.16% | 0.88% | **1.27%** | -3.52% | -4.79% | |
| Coupon | 6.77% | 6.43% | 5.88% | **6.36%** | 5.19% | -1.17% | |
| Price | $103.96 | $99.62 | $97.23 | **$100.27** | $97.37 | -$2.90 | |
| Current Yield | 6.51% | 6.45% | 6.05% | **6.34%** | 5.33% | -1.01% | |
| Mdur Worst | 5.90 | 5.23 | 4.64 | **5.26** | 4.09 | -1.17 | |
| CY Spread vs. T10yr | 3.57% | 4.70% | 3.31% | **3.86%** | 2.45% | -1.41% | |
| *Source: Bloomberg; ICE BofA Bond Indices* | | | | | | -4.12% | Est. Price Risk to AveCY |
| | | | | **Comprehensive Risk Est.** | | 1.21% | **Est. Price Risk + CY** |
| | | | | Recapture Rate (yrs.) | | 0.77 | Est. Price Risk / CY |
| | | | | | *Memo:* | -7.90% | Total Return YTD |

The current yield of the institutional preferred sector closed April at 5.33%, which was 20bps higher than last month, but still 101bps lower than the average current yield at the bottom of the last three credit cycles. The current yield spread is 141bps lower than the average of the last three credit cycle bottoms. The implication of a 1.01% yield increase to 6.34% (the average current yield of the prior bottoms) is an estimated 4.12% price decline using the modified duration of 4.09; then adding back a current book yield (assuming a 12month path) of 5.33% makes the Comprehensive Risk Estimate for the NoCo sector equal to 1.21%. It would take 0.77yrs to recapture this capital loss estimate with book income. The 5yr US treasury note yield has risen by 166bps this year, which has cut NoCo prices by 9.48% so far this year. The combination of higher rates and some spread widening has moved the NoCo sector into a more cushioned valuation this month (evidenced by the recapture rate of less than 1.00) and a more positive Comprehensive Risk Estimate.

There were two notable NoCo issues placed this month:

1. Bank of America 6.125% 5yr fixed-to-refixed perpetual preferred stock (Baa3/BBB-) resettable at +323bps off the 5yr constant maturing US treasury yield.
2. PNC 6.00% 5yr fixed-to-refixed perpetual preferred stock (Baa2/BBB-) resettable at +300bps off the 5yr constant maturing US treasury yield.

The last time a US bank came with an institutional perpetual preferred stock at or above 6% was in March 2015. Both deals traded up, but closed the month wrapped around par.

## **Contingent Capital Securities Sector**

The CoCo sector declined $3.19 as European bank stocks fell 4.98% as the Ukraine war is the region's back yard worsened and economic moods dimmed. The news last month that the European Central Bank is suggesting that the capital rules for CoCos be "enhanced" to provide for more going-concern loss absorption is basically acquiescing that CoCos are not as good as they thought they were in blowing up investors in a "going concern" test. Ironically, European bank going concerns have gotten better since CoCos were created and so have Pillar-2 capital rules, all of which further de-risked CoCos from their original design. Were it not for the failure and absorption of BPOP, there would not be a primary example of a CoCo being zeroed-out, but then BPOP was also falsely propped up by the regulators in the stress tests for years as appearing to be a "going concern" -- until suddenly it was suddenly all gone. Recent calls by supervisors for a capital stack redesign that may eliminate CoCos in favor of more simple common equity tier1 because CoCos paid during the COVID crisis are arbitrary and counterproductive. The fact is that CoCos paid because regulators let them pay – and regulators let them pay because the ECB was propping up the economy while banks were still profitable; and banks were being forced to boost loan loss reserves which made them the primary instruments of systemic support. Ultimately, it would be counterproductive for European regulators to say "no" to CoCo AT1, when the US banking system has a vibrant AT1 market of its own. Indeed, there would be complaints of a competitive global advantages for shareholders of US banks over European banks – remember those same outcries in the late 1990s that lead to European step-ups when US banks were rapidly issuing TrupS? These complaints of no loss absorption because COVID didn't force them are sour grapes for some reason and odd punishment for good deeds by European banks to support the financial system. The bottom line is that CoCo's need a genuine (deep) recession test that challenges loan quality and we have not had one yet – the question is will the ECB allow a deep recession to happen without printing money again? Could it be that the European supervisors know that the ECB cannot print money to infinity and beyond because inflation would become unhinged, so they are seeking to prepare the banking system for the inevitable capital jolt? But as equity markets would decline in this scenario, the AT1 CoCo resource would become more useful and the fixed income investor would be needed. Diversity is not just a social term – it has use in the capital stack too if the concern really is to be ongoing.

Here's a look at the contingent capital securities sector's 3 prior credit cycles compared to April's closing valuations:

| CoCo Securities | Valuation Implosions | | | Average | | Diff. to | |
|---|---|---|---|---|---|---|---|
| Credit Cycle Bottoms > | 2013 | 2016 | 2018 | Prior Bottoms | Current | Average | |
| GA10 | 3.01% | 1.75% | 2.88% | **2.55%** | 2.88% | 0.33% | |
| PCE DEFY | 1.48% | 0.59% | 1.86% | **1.31%** | 6.40% | 5.09% | |
| Real UST10yr | 1.53% | 1.16% | 1.02% | **1.24%** | -3.52% | -4.76% | |
| Coupon | 7.63% | 6.40% | 6.78% | **6.94%** | 6.16% | -0.78% | |
| Price | $105.04 | $89.12 | $96.21 | **$96.79** | $96.08 | -$0.71 | |
| Current Yield | 7.26% | 7.18% | 7.05% | **7.16%** | 6.41% | -0.75% | |
| Mdur Worst | 4.76 | 5.30 | 3.95 | **4.67** | 3.10 | -1.57 | |
| CY Spread vs. T10yr | 4.25% | 5.43% | 4.17% | **4.62%** | 3.53% | -1.09% | |
| *Source: Bloomberg; ICE BofA Bond Indices* | | | | | | -2.33% | Est. Price Risk to AveCY |
| | | | | **Comprehensive Risk Est.** | | 4.08% | **Est. Price Risk + CY** |
| | | | | Recapture Rate (yrs.) | | 0.36 | Est. Price Risk / CY |
| | | | | | *Memo:* | -9.17% | Total Return YTD |

The current yield of the institutional preferred sector closed April at 6.41%, which was 21bps higher than March and 75bps lower than the average current yield at the bottom of the last three credit cycles. The current yield spread is 109bps lower than the average of the last three credit cycle bottoms. The implication of a 0.75% yield increase to 7.16% (the average current yield of the prior bottoms) is an estimated 2.33% price decline using the modified duration of 3.10; then adding back the current book yield (assuming a 12month path) of 6.41% makes the Comprehensive Risk Estimate for the NoCo sector 4.08%. It would take 0.36yrs to recapture this capital loss with book income. CoCo prices are 1.48% lower than NoCo prices so far this year as CoCo spreads have been separately impacted by the risks to Europe's economy resulting from Russia's attack on Ukraine. The combination of higher rates and CoCo yields rising 53bps more than NoCos this year has moved the CoCo sector into the best cushioned valuation between the two institutional sectors. The sector also has a positive Comprehensive Risk Estimate that is higher than the 5yr breakeven inflation rate in US treasuries.

## Outlook:

The Fed meeting was on the minds of investors all month. As the meeting was last week, it really is a topic for May so, all we'll say here is some of what we heard from Chairman Powell in the press conference. He characterized the US economy as "*very strong*" and labor markets as "*extremely tight*". As a result, the Fed believes that the economy is well prepared for hikes of 50bps at the "next couple of meetings", which means June & July. This would inflate the federal funds rate to 2% by the summer and put it spot on the 2022 median with three more meetings to go. If the Fed went another 25bps at each of the last 3 meetings after that it would have a federal funds rate of 2.75% which would be an early arrival of the DOTS report median for 2023 and 2024.

The most significant move in US treasury yields was in the spread between the 2yr note and the 10yr note, which widened from -8bps to 45bps mid-month and then tightened a bit to close 30bps wider at 22bps. The significance here is that the 2yr note always leads the Fed actions on the federal funds rate. So, if the spread between 2s & 10s inverts, the bond market would be signaling to the Fed that it needs to stop raising rates and perhaps even start cutting rates soon or risk a recession. There is no doubt that the Fed has emphasized the strength in the economy and labor markets just as about as hard as it emphasized that inflation was transitory for much of last year. Real rates are rising (at least the real rates measured in US treasury breakevens) and the widening spread in 2s to 10s indicates that the market will let the Fed hike all the way up to 2.75% because 10yr yields rose beyond that to close at 2.94% in April. Basically, the higher the UST 10yr yield goes, the more room the bond market is giving the Fed to adjust up its concept of a neutral federal funds which sits at 2.75% for now. In other words, the bond market is buying the exceptionally strong labor market narrative (i.e., truth) and repricing interest rates based on the Fed's need to act fast and furious on maintaining control over inflation.

The following *Purchasing Power Matrix* helps us keep track of how attractive hybrids are relative to more senior financials in covering 5yr inflation breakevens with investment yields:

| | A | B | C | D=B/C | E=D/A |
|---|---|---|---|---|---|
| Purchasing Power Matrix: Financials | Mdur | YTW% | 5yrBE Inflation% | Inflation Coverage | Inflation Coverage/ Mdur |
| Retail $25par (p0p4) | 11.31 | 5.76 | 3.35 | 1.72 | 0.15 |
| NoCos (stb8) | 4.09 | 5.37 | 3.35 | 1.60 | 0.39 |
| CoCos (cdlr) | 3.10 | 6.36 | 3.35 | 1.90 | 0.61 |
| More Sr. Fins (e0ba) | 5.08 | 4.04 | 3.35 | 1.21 | 0.24 |

*Source: Bloomberg; ICE BofA Bond Indices*

The contingent convertible sector (CoCos) is the winner on Inflation Coverage and risk adjusted coverage when factoring duration. The retail sector is now outpacing the NoCo sector for Inflation Coverage, but investors would have to take additional duration risk to receive the benefit. More senior financials can cover inflation too, but not by as much and institutional hybrids; CoCos & NoCos have better duration risk coverages, as well.

Defense continues to be our primary investment objective this year and positive real yields help us make that play. Real yields are becoming increasingly attractive in hybrids and even more so when we adjust historical default risks from real yields. Below we assess a more comprehensive view of real yields net of inflation and net of default in a *Real Yield Matrix* to double risk adjusted yield comparisons in hybrids and corporates:

| Real Yield Matrix | Hybrids | | Corporates | |
|---|---|---|---|---|
| | Preferreds | CoCos | IG Corps | BIG Corps |
| Bloomberg Index | *cips+hips* | *cdlr* | *c6c0* | *h0a0* |
| Mod.Duration | 4.09 | 3.1 | 6.36 | 4.59 |
| Yield-to-Worst | 5.37 | 6.36 | 4.48 | 7.05 |
| Inflation[1] Adjustment | 3.35 | 3.35 | 3.35 | 3.35 |
| Real Yields | 2.02 | 3.01 | 1.13 | 3.70 |
| Default[2] Adjustment | -0.11 | -0.11 | -0.04 | -2.57 |
| **YTW, net, net adj.** | **1.91** | **2.90** | **1.09** | **1.13** |
| *Composite Rating* | *BBB2* | *BB1* | *BBB1* | *B1* |
| **Last Month End:** | **Hybrids** | | **Corporates** | |
| | Preferreds | CoCos | IG Corps | BIG Corps |
| YTW, net, net adj. | 1.26 | 1.98 | 0.24 | 0.03 |
| Change from Last | 0.65 | 0.92 | 0.85 | 1.10 |

*Source: Bloomberg; ICE BofA Bond Indices*

[1] *Inflation assuption based on the UST5yr breakeven inflation rate*
[2] *Sprectrum's 10yr annual default study through 2020*

Hybrids offer the most positive double-net real yield opportunity in credit. The changes from March are noteworthy with junk bonds yields moving up the most, followed by CoCos, investment grade corporates and NoCos. The positive real yield opportunities that made hybrids worthy inflation combatants last month have gained in stature this month – the climb is likely to be ongoing as the Fed begins reducing its balance sheet next month. The steepening yield curve is the second order effect on the UST curve for now as the first order effect was the fast and furious rise of the 2yr note. The steeper 2s to 10s go, the more room the bond market is giving the Fed to manage a soft landing. We do not believe that landing can happen without the equity market legitimately testing the risk of a recession looming over the horizon – this would mean a test of 3800 on the S&P. The Fed draining $47.5 billion per month from June-August and then doubling down afterwards puts it on a pace to pul in $523billion of market liquidity by the end of the year – this is the primary reason why real yields are rising, the stock market is falling; and spreads are widening. The surprise decline in 1q22 US GDP, the war in Eastern Europe and the ongoing lock-downs in China make for a very difficult job for central banks whose policy functions can only influence the demand side of the price equation. No doubt, too much money chasing too few goods is an even more complex problem when supply paradigms take time and investment to change. It will take some time for central banks to realize that inflation has permanently elevated for years. The biggest risk is that the Fed (and other central banks) will keep pushing interest rates higher to break demand into the void of what is already a broken (and changing) global supply system in effect, making recession the goal -- just as inflation used to be the goal, but now is the enemy. Inflation expectations becoming unanchored would be the central bank's worst nightmare and they will see to it that it does not happen -- the implication of this goal is for hybrids to become increasingly attractive. We will keep following the Comprehensive Risk Estimates, Recapture Rates and double-net YTW for hybrids and update you on the changes as we move along this precarious global macro-economic path. Despite an overall stagflationary outlook that could still weigh some on fixed income prices, the hybrid sectors can, nonetheless, offer solid relative yield plays to mitigate risks and improve cashflows when compared to other fixed income sectors – and the playbook improved in April. Though the plays are likely to get even better, there appears to be less risk in hybrids, and potentially more risk in equity, with recaptures for our measured risks now less than 1yr across all hybrid sectors.

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May 9, 2022

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