Junior-Subordinated Capital Securities Markets

February 2023 Updates

The bond markets declined in February, which ushered in a modest correction of what was an extraordinarily powerful bond market last month. The Fed continued to emphasize that interest rates would be higher for longer as there was no mention of "disinflation" in the recent FOMC minutes and concerns that the labor markets continue to be tight. The 30yr bond closed the month yielding 3.92% (29bps higher) and the 10yr note closed yielding 3.92% (43bps higher). Real rates on the front end of the treasury curve (e.g., UST 5yr TIPS) rose by 34bps (to 1.66%); the 5yr implied breakeven inflation rate (i.e., the difference in yields between the 5yr UST and the 5yr Treasury Inflation Protected Security) increased by 26bps to close at 2.59%. Clearly, the bond market is also very confident in the Fed's inflation fighting resolve as the core inflation measures continue to wane. The VIX (i.e., Chicago Board Options Exchange Volatility Index) rose 6.7% to 20.70 as the S&P 500 declined to 3970, down 107 points, which was still above the 20% decline mark (3835) which would suggest that a recession is imminent.

Before we talk hybrids, the performance for comparative references on returns and yield changes in some of the other corporate credit sectors is shown below:

- The junk market (measured by the ICE BofA High Yield ***h0a0*** index) fell 1.29% to close yielding 8.59% (41bps higher).
- Global bank credit (measured by ICE BofA ***e0ba*** index) fell 2.09% to close yielding 5.61% (55bps higher).
- The BBB rated 5-10yr corporate sector (measured by ICE BofA ***c6a4*** index) fell 2.89% to close yielding 5.82% (54bps 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 $334 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 $484 billion universe of fixed-rate junior-subordinated USD capital securities with preferred securities (measured by ***iocs***) being a 68% subset and contingent capital securities (measured by ***cdlr)*** being a 32% 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*) @ 45% *of i0cs***
    - Comprised of IG $25par and IG $1,000par (incl. US AT1)
        - ❖ The *p0p1* fell 2.16% this month to close yielding 6.33% (+48bps)
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 1.18% this month to close yielding 6.64% (+39bps)

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* fell 3.27% this month to close yielding 7.95% (+62bps)
4) **ICE BofA High Yield Fixed Rate Preferred Index (*p0hy*) @ 27% of *i0cs***
    - Comprised of BIG $25par and BIG 1,000par (incl. US AT1)
        - The *p0hy* fell 1.92% this month to close yielding 7.62% (+41bps)

Overall, the ICE BofA All US Capital Securities Index (***i0cs***) fell 1.92% in February to close yielding 6.83%, which was 45bps higher than last month's closing yield and a spread of +269bps over comparable US Treasury securities (9bps 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 60% 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 4.87% this month to close yielding 7.55%, which was 80bps lower than last month and a spread of +370bps over comparable US Treasury securities (61bps tighter).

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 provide measures of inflation coverage in a ***Purchasing Power Matrix***; and a table for yield-to-worst, net of inflation and of historical default in a ***Real Yield Matrix*** that compares hybrids, investment grade corporates and high yield bonds. Finally, we show data on prior credit cycles for each sector 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 relative to prior down credit cycles, but not necessarily an outlook to that direction. 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. Each signal is intended to be independently supplementary to foster a more balanced value assessment for each sector.

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	486	205	660	313
Low	-178	-267	176	60	223	143
Range	766	518	310	145	437	170
Average	65	-45	251	140	331	221
Stdev	121	104	47	27	61	34
Monthend	117	-2	247	128	337	218
Spread Scores:						
(monthend-ave)/stdev	0.43	0.41	-0.09	-0.44	0.10	-0.09
Δ from Last Month	0.08	0.06	-0.09	-0.26	0.20	0.24

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

Here, we look at option adjusted spread (OAS) to haircut spread to comparable US Treasuries for interest rate volatility and time to expiry. The way we interpret the above option adjusted spread table is by the statistical positioning of the *Spread Scores* where, **zero** = "*fair value*", **+/- 1stdev.** = "*undervalued*"/ "*overvalued*", respectively and **+/- 2stdevs** = "*very undervalued*"/ "*very overvalued*", respectively.

Spread performance for hybrids this month was stellar aided in large part by long bonds and stocks. The Absolute Spread Score on retail paper widened by 0.08 standard deviations; and at 0.43 represents an above average *fair value*. The Absolute Spread Score for the institutional $1,000par preferred securities sector ("NoCos") tightened by 0.09 standard deviations; and

represents a somewhat below average *fair value*. The Absolute Spread Score for the CoCo sector tightened by widened by 0.10 standard deviations; and represents a somewhat above average *fair value*. Note that these are statistical positionings and the absolute differentials and price risks between sectors are further considered through the Comprehensive Risk Estimates below.

Implications of Market Activity:

$25par Retail Preferred Securities Sector

The retail preferred securities sector measured by *p0p4* fell $3.00 to $86.40, after the single biggest monthly move up last month since May 2009. At the end of last year, our Comprehensive Risk Estimate (CRE) for the $25par market was deeply positive (i.e., 8.90%), which meant that over the next 12mos., the return potential was 8.90% even if the sector's current yield retraced to 6.70% or the average of the last three credit cycle bottoms. After the strong rally in January, the CRE of return dropped to -0.33% -- the 9.23% return differential in just one month reflected to magnitude of January's more. This month's score computed from the three prior credit cycles is positive again at 1.87%:

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%	3.90%	1.45%	
PCE DEFY	1.48%	0.59%	1.86%	1.31%	5.40%	4.09%	
Real UST10yr	1.50%	1.05%	0.88%	1.14%	-1.50%	-2.64%	
$25Coupon	6.64%	6.46%	6.05%	6.38%	5.43%	-0.95%	
$25Price	$94.06	$98.66	$93.09	$95.27	$86.59	-$8.68	
$25Current Yield	7.06%	6.55%	6.50%	6.70%	6.27%	-0.43%	
Mdur Worst	9.52	10.44	10.95	10.30	12.34	2.04	
CY Spread vs. T10yr	4.08%	4.91%	3.76%	4.25%	2.37%	-1.88%	
Source: Bloomberg; ICE BofA Bond Indices						-4.40%	Est. Price Risk to AveCY
				Comprehensive Risk Est.		1.87%	Est. Price Risk + CY
				Recapture Rate (yrs.)		0.70	Est. Price Risk / CY
					Memo:	10.59%	Total Return YTD

The current yield of the retail sector closed February at 6.27%, which was 20bps higher than last month and 43bps lower than the average current yield at the bottom of the last three credit cycles. The current yield spread to the 10yr US Treasury note is 237bps which is 188bps less than the average spread of the last three credit cycle bottoms as retail preferred yields are still high, but spread is being squeezed by UST yields being high, as well -- a gauge to yields being high is the discount price to the sector. The dollar price of the retail sector is $8.68 lower than the average of the prior bottoms, which means that there is more convexity to the retail market during this cycle than there was during the prior cycles even though yields were higher. The implication of a 0.43% current yield decline to 6.70% (the average current yield of the prior bottoms) is an estimated 4.40% price decrease using the current modified duration of 12.34; then adding back a current book yield (assuming a 12month path) of 6.27% makes the *Comprehensive Risk Estimate* for returns in the retail sector positive again at 1.87%. The income recapture rate of the illustrated price loss is 0.70yrs because the market yield is higher than the illustrated price risk indicating the retail sector has more opportunity than risk.

We note 2 new issues in the retail sector:

1. $325mm (Baa3/BB+) Huntington Bancshares 6.875% 5yr fixed-to-refixed (+270) perpetual preferred stock
2. $300mm (Baa1/BBB) Associated Bancorp 6.625% 5yr fixed-to-refixed (+281) subordinated debt due in 2033

$1,000par Institutional Preferred Securities Sector

The $1,000 par institutional sector of the preferred securities market fell $1.69 as yields rose 46bps to 7.16% this month. The following table illustrates the institutional preferred securities sector's three prior credit cycles compared to closing valuations this month:

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%**	3.90%	1.42%	
PCE DEFY	1.17%	0.59%	1.86%	**1.21%**	5.40%	4.19%	
Real UST10yr	1.77%	1.16%	0.88%	**1.27%**	-1.50%	-2.77%	
Coupon	6.77%	6.43%	5.88%	**6.36%**	5.17%	-1.19%	
Price	$103.96	$99.62	$97.23	**$100.27**	$93.22	-$7.05	
Current Yield	6.51%	6.45%	6.05%	**6.34%**	5.55%	-0.79%	
Mdur Worst	5.90	5.23	4.64	**5.26**	3.73	-1.53	
CY Spread vs. T10yr	3.57%	4.70%	3.31%	**3.86%**	1.65%	-2.22%	
Source: Bloomberg; ICE BofA Bond Indices						-2.95%	Est. Price Risk to AveCY
				Comprehensive Risk Est.		2.59%	**Est. Price Risk + CY**
				Recapture Rate (yrs.)		0.53	Est. Price Risk / CY
					Memo:	4.39%	Total Return YTD

The current yield of the institutional preferred sector closed the month at 5.55%, which was 9bps higher than last month. This brings the current yield of the sector to 79bps less than the average current yield at the bottom of the last three credit cycles. The implication of a 0.79% current yield increase to 6.34% (the average current yield of the prior bottoms) is an estimated 2.95% price decline using the modified duration of 3.73; then adding back a current book yield (assuming a 12month path) of 5.55% makes the *Comprehensive Risk Estimate* for the NoCo sector equal to a 2.59% horizon return to accept the risk, which is 39bps better than last month. It would take 0.53yrs to recapture this capital loss estimate with book income. The NoCo sector continues to be in a cushioned valuation position.

There were 2 IPOS of note this month in NoCos:

1. $1.5bil (Baa2/BBB-) PNC 6.25% 5yr fixed-to-refixed (+280) perpetual preferred stock
2. $500mm (Baa1/BBB+) Prudential 6.75% 10yr fixed-to-refixed jr. sub debt due in 2053

Contingent Capital Securities Sector

The CoCo sector fell $2.18 as this month to $91.32. The 6.5% rise in the European bank sector helped the CoCo sector spread, but bonds declining more than offset the spread duration benefits for the sector. At 5.56% net of historical default and current inflation expectations, the CoCo sector has a 207bp advantage over high yield (i.e., junk) bonds.

The following table illustrates the contingent capital securities sector's three prior credit cycles compared to closing valuations this month:

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%**	3.90%	1.35%	
PCE DEFY	1.48%	0.59%	1.86%	**1.31%**	5.40%	4.09%	
Real UST10yr	1.53%	1.16%	1.02%	**1.24%**	-1.50%	-2.74%	
Coupon	7.63%	6.40%	6.78%	**6.94%**	6.28%	-0.66%	
Price	$105.04	$89.12	$96.21	**$96.79**	$91.37	-$5.42	
Current Yield	7.26%	7.18%	7.05%	**7.16%**	6.87%	-0.29%	
Mdur Worst	4.76	5.30	3.95	**4.67**	2.74	-1.93	
CY Spread vs. T10yr	4.25%	5.43%	4.17%	**4.62%**	2.97%	-1.64%	
Source: Bloomberg; ICE BofA Bond Indices						-0.80%	Est. Price Risk to AveCY
				Comprehensive Risk Est.		6.08%	**Est. Price Risk + CY**
				Recapture Rate (yrs.)		0.12	Est. Price Risk / CY
					Memo:	3.04%	Total Return YTD

The current yield of the CoCo sector closed February at 6.67%, which was 20bps higher than last month and 29bps less than the average current yield at the bottom of the last three credit cycles (i.e., 7.16%). The current yield spread to treasury 10yr notes is 164bps lower than the average of the last three credit cycle bottoms because 10yr treasury yields are higher than in prior cycles. The CoCo price average of $91.37 is lower than 2 of the last 3 three cycles, which (like the other hybrid sectors) highlights that the term structure of interest rates (i.e., high real US Treasury yields) being the primary reason for discounted prices. The implication of a 0.29% current yield increase to 7.16% (the average current yield of the prior bottoms) is an estimated 0.80% price decline using the modified duration of 2.74; then adding back the current book

yield (assuming a 12month path) of 6.87% makes the *Comprehensive Risk Estimate* for return in the CoCo sector 6.08%. The recapture rate of the estimated capital risk is just one month for CoCos.

There were 2 IPOS of note this month in CoCos:

3. $1.0bil (Ba1/NA) Intned 7.50% 5yr fixed-to-refixed (+350) AT1
4. $500mm (Ba1/BBB-) Sweda 7.625% 5yr fixed-to-refixed (+329) AT1

Outlook:

This month, the market corrected modestly from the massive rally to start the year. Investors are generally anticipating one of the most widely expected decelerations in policy tightening in decades (i.e., from +50bps down to +25bps). At the end of the month, the target federal funds bound was raise by another 25bps to 4.50% - 4.75%. We continue to believe that the risk to the terminal rate is over 5% given the strength in labor and resilience in the financial system and that risk will prevail before the Fed is done.

- Three key questions remain for Fed policy on federal funds:
  1. How high?
     - ✓ Answer: 4.75% - 5.00%
       - ❖ **Risk: 5.25% - 5.50%**
  2. How fast?
     - ✓ Answer: by March 2023
       - ❖ **Risk: by June 2023**
  3. How long?
     - ✓ Answer: hold for 1yr = March 2024
       - ❖ **Risk: hold for 6 months = December 2023**

The Federal Reserve Bank's preferred measure of inflation is the PCE Deflator – Chairman Powell wants to sustain a positive real federal funds rate. We know that The Fed always gets what the Fed wants, and the Fed wants a PCE Deflator-to-federal funds rate gap to show a

positive real rate. Though the gap has narrowed, we do not expect the Fed to stop raising rates until the PCE deflator crosses into the federal funds bound – then, there should be one more 25bps hike to complete the cycle and anchor its desired disinflation goal – a positive real federal funds rate is the evidence to that goal being achieved. The yield curve is making another strong move to invert with Treasury 2yr notes rising more than 10yr notes and the 2s-10s curve now being inverted by 108bps, which is the most since the early 1980s – this is 227bps less than the average of the trailing 200 months.

Main takeaways:

- **Rate hikes are nearing the end**—inflation is waning but slowly, and the federal funds rate should rise steadily to a terminal rate – likely 5.50%.
- **The Fed will invert the gap** – this should create a positive real rate between federal funds and the PCE Deflator as rates are held high for some time to further slow inflation.

Why they matter:

- **The rate hikes and curve inversion make lower duration sectors more attractive than higher duration sectors** – the CoCo sector has the best Comprehensive Risk Estimate, followed by NoCos and retail $25par paper.

The high absolute level of rates and the yield curve inversion is creating an anomaly where investors are getting paid more for less duration. Here's a look at the multiples of 5yr average implied inflation that are available in hybrids compared to more senior financials:

	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)	12.34	6.30	2.59	2.43	0.20
NoCos (stb8)	3.73	7.20	2.59	2.78	0.75
CoCos (cdlr)	2.74	8.26	2.59	3.19	1.16
More Sr. Fins (e0ba)	4.80	5.62	2.59	2.17	0.45

Source: Bloomberg; ICE BofA Bond Indices

The inflation coverages are still quite robust at 2.43x to 3.19x for junior subordination. The contingent convertible sector (CoCos) is still the winner on *Inflation Coverage* and risk adjusted coverage when factoring in duration. The Noco sector wins the silver medal again on both scores. The retail sector measures up too, but one must accept 3.3x the duration risk of NoCos to get the coverage.

High rates and the deeply inverted curve make CoCos and NoCos uniquely attractive for current income when factoring in qualified dividend inclusions ("QDI") – this value is not only absolute, but also relative compared to more senior financials:

	A	B	C	D=C-B	E=D/A
Purchasing Power Matrix: Financials	OAS 5yr Stdev. (%)	YTW%	QDI Adjusted% (1.23x factor)	QDI Yld Difference	QDI Diff./OAS Stdev.
Retail $25par (p0p4)	1.08	6.30	7.75	1.45	1.34
NoCos (stb8)	0.46	7.20	8.86	1.66	3.60
CoCos (cdlr)	0.63	8.26	10.16	1.90	3.02
More Sr. Fins (e0ba)	0.36	5.62	5.62	0.00	0.00

Source: Bloomberg; ICE BofA Bond Indices

Bottomline:

- When considering spread risks (measured by units of standard deviation) on hybrids that have QDI available as an income subsidy, the NoCo sector offers an additional 3.60 standard deviations of spread; and the CoCo sector offers an additional 3.02 standard deviations of spread. Clearly, high absolute shorter-term rates are augmenting the fully taxable yield equivalents on institutional paper relative to retail paper.

Maintaining a core portfolio defense in structure and liquidity are our primary investment objectives this year. Real yields are quite 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, investment grade corporates and below investment grade corporates (i.e., junk bonds):

Real Yield Matrix	Hybrids		Corporates	
	Preferreds	CoCos	IG Corps	BIG Corps
Bloomberg Index	cips+hips	cdlr	c6c0	h0a0
Mod.Duration	3.73	2.74	6.17	4.14
Yield-to-Worst	7.20	8.26	5.61	8.65
Inflation[1] Adjustment	2.59	2.59	2.59	2.59
Real Yields	4.61	5.67	3.02	6.06
Default[2] Adjustment	-0.11	-0.11	-0.04	-2.57
YTW, net, net adj.	4.50	5.56	2.98	3.49
Composite Rating	BBB3	BB1	BBB1	B1
Last Month End:	Hybrids		Corporates	
	Preferreds	CoCos	IG Corps	BIG Corps
YTW, net, net adj.	4.26	5.15	2.68	3.27
Change from Last	0.24	0.41	0.30	0.22

Source: Bloomberg; ICE BofA Bond Indices

[1] Inflation assuption based on the UST5yr breakeven inflation rate
[2] Sprectrum's 10yr annual default study through 2021

Hybrids offer the most positive double-net real yield opportunity in credit. As the Fed focuses more on labor (i.e., one of its policy objectives which is still robust) and wage cost increases than it will on recession, it should keep its more restrictive policy in place until its job is comfortably done on inflation – Hybrid yields rates are likely to stay elevated for some time, which should keep the window of opportunities in Hybrids (and QDI) open for longer too despite the rally year-to-date. In a year when we don't expect duration to be a major contributor to institutional performance, the income accretion component of Hybrids (especially those with QDI) looks compelling to core corporates and to high yield, net of default.

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