Junior-Subordinated Capital Securities Markets

September 2023 Updates

The US Treasury bond market experienced it weakest month of the year scoring its 5th straight monthly decline which sent yields up to their highest levels since before the Great Financial Crisis. The Fed's rate decision toward the end of the month left the federal funds rate unchanged at 5.25% (lower bound), but the primary messaging was delivered through the "dots" (i.e., each voting member's view on where the policy rate should be over the near term). The message was clear: the policy rate will likely settle in around the current level and stay above 5% for next year too. The rate cut bond bulls capitulated sending treasury yields zooming higher which elevated credit yields as well. The spread between UST2yr notes and UST10yr notes further de-inverted this month (after closing the 2nd quarter at its lows of -107) by another 28bps to -48bps – note that the average slope of the US Treasury 2s-10s yield curve has been 113bps since Dec-1999 with a high of +281bps (and a low of -107). The 30yr bond closed the month yielding 4.70% (49bps higher) and the 10yr note closed yielding 4.57% (46bps higher). Real rates on the front end of the treasury curve (e.g., UST 5yr TIPS) rose by 26bps (to 2.39%); the 5yr implied breakeven inflation rate (i.e., the difference in yields between the 5yr UST and the 5yr Treasury Inflation Protected Security) rose by 8bps to close at 2.25%. Last month we emphasized that the bond market was anticipating the Fed keeping rates elevated for longer (which was subsequently affirmed at the Fed meeting) as the back end of the curve cheapened to push up on real rates; and that the Fed would not tolerate an inflation target higher than 2% -- the implication would be more economic friction helping to slow spending and labor growth; and that would likely weigh on near-term equity prices causing credit spreads to widen. The Fed must deal with a very challenging conflict between ongoing excess fiscal spending not being aligned with the Fed's urgent disinflationary goal. The effect of massive fiscal excess, zooming treasury debt costs and quantitative tightening may indeed lead to a "fiscal fit" causing even higher real rates on the treasury term structure if labor markets and oil prices don't cool down. The VIX (i.e., Chicago Board Options Exchange Volatility Index) seems to be starting to realize the risks to fiscal and monetary inflexibilities as it rose 29% off its lows by month end to close at 17.52 as the S&P 500 slipped 220pts to 4288, which is 10.27% off its record high (i.e., a "re-correction" after breaking a rising trend that started a year ago).

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 1.16% to close yielding 8.94% (56bps higher).
- Global bank credit (measured by ICE BofA ***e0ba*** index) fell 1.69% to close yielding 6.21% (43bps higher).
- The BBB rated 5-10yr corporate sector (measured by ICE BofA ***c6a4*** index) fell 2.31% to close yielding 6.34% (50bps higher).

Review of Market Structure:

The market for **hybrids** or **global junior-subordinated capital securities** (*i.e.,* "**Jsubs**") 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 Jsubs are comprised of two sub-sets that represent a broad group of hybrids, 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 $322 billion (face amount) of investment grade and below investment grade instruments in both the retail $25par market (35%) and the institutional $1,000par market (65%). The USD Contingent Capital Index of US dollar denominated hybrids ***(cdlr)*** represents $131 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 $453 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*) @ 44% *of i0cs***

o Comprised of IG $25par and IG $1,000par (incl. US AT1)

- The *p0p1* fell 1.35% this month to close yielding 7.07% (+19bps)

2) **ICE BofA US Capital Securities Index (*c0cs*) @ 25% of *i0cs***

o Comprised of dated IG $1,000par dated hybrids (excl. US AT1)

- The *c0cs* fell 0.84% this month to close yielding 7.43% (+32bps)

3) **ICE BofA High-Yield Capital Securities Index (*h0cs*) @ 6% of *i0cs***

o Comprised of BIG $1,000par legacy Tier1 and BIG $1,000par hybrids

- The *h0cs* rose 0.14% this month to close yielding 8.44% (+14bps)

4) **ICE BofA High Yield Fixed Rate Pfd Index (*p0hy*) @ 25% of i*0cs***

o Comprised of BIG $25par and BIG 1,000par (incl. US AT1)

- The *p0hy* fell 1.35% this month to close yielding 9.01% (+31bps)

Overall, the ICE BofA All US Capital Securities Index (***i0cs***) fell 1.13% this month to close yielding 7.70%, which was 26bps higher than last month's closing yield and a spread of +296bps over comparable US Treasury securities (20bps 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 57% 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 0.42% this month to close yielding an 8.86%, which was 41bps higher than last month and a spread of +405bps over comparable US Treasury securities (15bps 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) Retail	(b) Retail	(a) NoCo	(b) NoCo	(a) CoCo	(b) CoCo
Sample Periods	03/31/2017 to Date		03/31/2017 to Date		03/31/2017 to Date	
Jr-Subs	*Absolute	**Relative	*Absolute	**Relative	*Absolute	**Relative
High	588	251	486	205	660	472
Low	-178	-267	176	60	223	143
Range	766	518	310	145	437	329
Average	75	-38	256	143	338	225
Stdev	120	102	48	27	64	37
Monthend	131	-2	297	164	367	234
Spread Scores:						
(monthend-ave)/stdev	0.47	0.35	0.85	0.78	0.45	0.24
Δ from Last Month	-0.17	-0.28	0.18	-0.04	0.18	0.06

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 negative for all three sectors with NoCo spread performance widening the most. The Absolute Spread Score on retail paper tightened by 0.17 standard deviations; **the $25par sector is somewhat *undervalued* with a Spread Score of 0.47 standard deviations from average**. The Absolute Spread Score for the institutional $1,000par preferred securities sector ("NoCos") widened by 0.18 standard deviations; **NoCos are the most *undervalued* with a Spread Score of 0.85 standard deviations from average**. The Absolute Spread Score for the CoCo sector widened 0.18 standard deviations; **CoCos are somewhat *undervalued* with a Spread Score of 0.45 standard deviations from average**. Note that these statistical positionings provide an absolute and relative view on some historical spread, which can be further complimented with some cycle perspectives from the Comprehensive Risk Estimates below.

<u>Implications of Market Activity</u>:

<u>$25par Retail Preferred Securities Sector</u>

The retail preferred securities sector measured by *p0p4* fell $2.20 to $80.61 but the yield-to-worst declined by 6bps to 6.80% this month because of some calls and rebalancing. There was no relevant issuance in the retail sector during September. The two largest $25par passive ETFs (iShares Preferred and Income ETF, PFF; and Invesco Preferred ETF, PGX), had about $120million of combined net money outflow this month. The overall retail $25par sector closed the month up 3.01% on a year-to-date basis. This month's Comprehensive Risk Estimate from the three prior credit cycles is more than the sector's current yield for the first time since we have been following the measure. This is because the current yield is now greater than the average current yield for the past 3 credit cycles, so if we experience a regression to the mean current yield over the next 12 months it would imply a price gain. Indeed, there is always a Fed cycle associated with the credit cycle, but no cycle is exactly like prior cycles. Given that spreads in retail preferreds are 0.47 standard deviations wide of average, it appears that most of the higher yields in the retail market are explained by elevated US treasury yields.

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%**	4.58%	2.13%	
PCE DEFY	1.48%	0.59%	1.86%	**1.31%**	3.50%	2.19%	
Real UST10yr	1.50%	1.05%	0.88%	**1.14%**	1.08%	-0.06%	
$25Coupon	6.64%	6.46%	6.05%	**6.38%**	5.45%	-0.93%	
$25Price	$94.06	$98.66	$93.09	**$95.27**	$80.56	-$14.71	
$25Current Yield	7.06%	6.55%	6.50%	**6.70%**	6.77%	0.06%	
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%**	2.19%	-2.06%	
Source: Bloomberg; ICE BofA Bond Indices						0.70%	Est. Price Risk to AveCY
				Comprehensive Risk Est.		7.47%	**Est. Price Risk + CY**
				Recapture Rate (yrs.)		-0.10	Est. Price Risk / CY
					Memo:	3.01%	Total Return YTD

The current yield of the retail sector closed the month at 6.77%, which was approximately 6bps higher 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 219bps which is 206bps 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 rebalanced dollar price of the retail sector is $80.56 this month and $14.71 lower than the average price 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 0.06% current yield <u>decrease</u> to 6.70% (the average current yield of the prior bottoms) is an estimated 0.70% price <u>increase</u> using the current modified duration of 12.34; then adding back a current book yield (assuming a 12month path) of 6.77% makes the *Comprehensive Risk Estimate* for returns in the retail sector positive at 7.47%. The assumed loss recapture rate with income has flipped to be negative which means that there is no loss needing to be assumed because the market yield is higher than the average highest yields of the prior credit cycles. Overall, yields in the retail sector appear to be undervalued but spreads are only somewhat undervalued.

Performance Memo: Total Return ~ p0p4 -1.61%:

The primary performing sectors (using GICS Sub-industries) of p0p4 this month were Alternative Carriers (+8.07%), Mult-Line Insurance (+1.29%), and Leisure Products (+0.70%).

The primary underperforming sectors of p0p4 this month were Diversified REITS (-11.41%), Real Estate Operating Companies (-9.30%), and Renewable Electricity (-6.52%).

Year-to-date, below investment grade (BIG) $25pars have underperformed investment grade (IG) retail paper by 2.14%, which is 15bps better than last month.

$1,000par Institutional Preferred Securities Sector

The $1,000 par institutional sector of the preferred securities market fell $1.22, and yields-to-worst rose 24bps to 8.02% 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%**	4.58%	2.10%	
PCE DEFY	1.17%	0.59%	1.86%	**1.21%**	3.50%	2.29%	
Real UST10yr	1.77%	1.16%	0.88%	**1.27%**	1.08%	-0.19%	
Coupon	6.77%	6.43%	5.88%	**6.36%**	5.31%	-1.05%	
Price	$103.96	$99.62	$97.23	**$100.27**	$90.32	-$9.95	
Current Yield	6.51%	6.45%	6.05%	**6.34%**	5.88%	-0.46%	
Mdur Worst	5.90	5.23	4.64	**5.26**	3.95	-1.31	
CY Spread vs. T10yr	3.57%	4.70%	3.31%	**3.86%**	1.30%	-2.56%	
Source: Bloomberg; ICE BofA Bond Indices						-1.81%	Est. Price Risk to AveCY
				Comprehensive Risk Est.		4.07%	**Est. Price Risk + CY**
				Recapture Rate (yrs.)		0.31	Est. Price Risk / CY
					Memo:	2.75%	Total Return YTD

The current yield of the institutional preferred sector closed the month at 5.88%, which was 13bps higher than last month. The $90.32 price of the NoCo sector is $9.95 less than the average price over the last three credit cycles – the implication of the discount is an embedded **"pull toward par"** as time ages and the prospect of higher coupon resets approach becoming available in less than 4yrs on average. The current yield of the sector is 46bps less than the 6.34% average current yield at the bottom of the last three credit cycles. The implication of a 0.46% current yield increase to 6.34% (the average current yield of the prior bottoms) is an estimated 1.81% price decline using the modified duration of 3.95; then adding back a current book yield (assuming a 12month path) of 5.88% makes the *Comprehensive Risk Estimate* for the NoCo sector equal to a 4.07% horizon return to accept the risk, which is 58bps more than last month. It would take 0.39yrs to recapture this capital loss estimate with book income. The NoCo sector continues to be in a cushioned valuation position.

CitiGroup (Ba1/BB+) issued $1.5 billion of perpetual fixed-to-refixed preferred AT1 at 7.625% stock this month – it essentially prefunded other AT1 securities that are floating with higher absolute yields.

Performance Memos: Total Return ~ cips -0.92%; hips -0.54%:

The primary performing sectors (using GICS Sub-industries) of investment grade NoCos (cips) this month were Industrial Machinery (+7.08%), Mult-line Utilities (+0.77%) and Specialized Finance (0.67%).

The primary underperforming sectors of investment grade NoCos were Consumer Finance (-4.23%), Oil & Gas (-3.21%), and Investment Banking and Brokerage (-2.75%).

The primary performing sectors (using GICS Sub-industries) of below investment grade NoCos (hips) this month were Broadline Retail (+11.63%), Distribution Companies (1.77%), and Multi-Line Utilities (+0.59%).

The primary underperforming sectors of below investment grade NoCos were Broadcasting (-3.68%), Regional Banks (-1.98%) and Consumer Finance (-1.49%).

Year-to-date, below investment grade (BIG) $1000pars underperformed investment grade (IG) institutional paper by 2.79%, which was 42bps better than last month.

Contingent Capital Securities Sector

The CoCo sector fell $0.89 to $89.31 as yields-to-worst rose 22bps to 8.75% this month. 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%**	4.58%	2.03%	
PCE DEFY	1.48%	0.59%	1.86%	**1.31%**	3.50%	2.19%	
Real UST10yr	1.53%	1.16%	1.02%	**1.24%**	1.08%	-0.16%	
Coupon	7.63%	6.40%	6.78%	**6.94%**	6.25%	-0.69%	
Price	$105.04	$89.12	$96.21	**$96.79**	$89.20	-$7.59	
Current Yield	7.26%	7.18%	7.05%	**7.16%**	7.01%	-0.16%	
Mdur Worst	4.76	5.30	3.95	**4.67**	2.58	-2.09	
CY Spread vs. T10yr	4.25%	5.43%	4.17%	**4.62%**	2.43%	-2.19%	
						-0.41%	Est. Price Risk to AveCY
				Comprehensive Risk Est.		6.60%	**Est. Price Risk + CY**
				Recapture Rate (yrs.)		0.06	Est. Price Risk / CY
					Memo:	-5.86%	Total Return YTD

Source: Bloomberg; ICE BofA Bond Indices

The current yield of the CoCo sector closed the month at 7.01%, which was 11bps higher than last month and 16bps less than the average current yield at the bottom of the last three credit cycles (i.e., 7.16%). The average CoCo price of $89.20 is still 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 the discount is an embedded **"pull toward par"** and time ages and the prospect of higher coupon resets approach becoming available in less than 3yrs on average. The implication of a 0.16% current yield increase to 7.16% (the average current yield of the prior bottoms) is an estimated 0.41% price decline using the modified duration of 2.59; then adding back the current book yield (assuming a 12month path) of 7.01% makes the *Comprehensive Risk Estimate* for return in the CoCo sector 6.60%. The recapture rate of the estimated capital risk is less than one month for CoCos.

Banco Bilbao (Ba2/nr) issued a $1.0billion 8.50% AT1 fixed-to-refixed CoCo security this month – the deal was well received but the sector edged lower after the issuance due to macro concerns.

Performance Memos: Total Return ~ cdlr -0.44%:

The primary performing sectors of the CoCo benchmark (cdlr) by country (as CoCos are primarily diversified banks) were Denmark (0.54%), Norway (0.49%) and Italy (0.35%).

The primary underperforming country sectors of the CoCo benchmark (cdlr) were Columbia (-4.42%), Germany (-1.95%) and Switzerland (-0.06%).

Outlook:

The September Fed meeting and the press conference that followed convinced the bond market the Fed will indeed keep rates high for an extended period – it conveyed this by leaving one more hike on the table this year and elevating the median policy rate for 2024 from 4.625% to 5.125%. The dots for 2025 are so dispersed (i.e., 2.625% - 5.525%) that they offer little if any information except that someday, the policy rate may slip back down toward the Fed's 2% inflation goal. When that goal will be achieved is uncertain and in Chairman Powell's words, "*there's a long way to go*" because housing has "*picked up somewhat*" and consumer spending is "*particularly robust*".

- The hawkish intent of elevating the dots in 2024 was to persuade markets that the Fed is serious about keeping rates elevated for an extended period so lag effects from market adjustments can do the inflation fighting in advance of a Fed action; and as markets fight in real time, the **messaged rate hike action may ultimately be unnecessary**.
- Importantly, **for the market adjustments to work, the adjustments need to be large enough to make a difference**. The move in treasury yields this month was what the Fed was aiming to achieve – fiscal pressures that spend money conflict with quantitative

tightening pressures that withdraw money so **technical supply pressure on real rates is likely to continue** especially if activity remains "robust".

- The Fed's ongoing balance sheet reductions are the <u>backstories</u> which we expect will create accumulating friction to aggregate demand and burgeoning US government debt financing should become problematic to fiscal flexibilities (<u>and get more headlines</u>).

- Keep this Chairman Powell quote in mind: ***"It will be appropriate to cut rates at such time as inflation is coming down really significantly and we're talking about a couple of years out".*** The implication here is that <u>bond markets (i.e., hybrids) should rally in advance of that cut</u> which means they should be in a rally trend during the extended period when the Fed has "stopped".

- The problem this month was that the bond market was too convinced that multiple cuts would happen next year, and the Fed had to spoil that notion by messaging through the dots. Now, the bond market is not only fearful that the Fed hasn't stopped, but also fearful that it will have to wait a long time before cuts will happen.

- **Burgeoning rates are putting fiscal policy into a pickle** because **fiscal policy cannot cut taxes as <u>deficits are too high,</u> and it cannot spend more because <u>inflation is too high.</u>**
    - The next fiscal policy move will be spending cuts but that won't be until 2025 at the earliest so there is an entrenched and painful **"crowding out" process underway to rein in government spending (eventually) that has no prospect of reversing.** We've referred to this process as potentially leading to a **"fiscal fit"** in the treasury market where a bear steepener happens first (to cause the recession that chokes inflation) followed by the bull steepener (to create the recovery through rate cuts).

- **Equity investors have become accustomed to the Fed printing money** to foster growth and fuel valuations higher, but <u>inflation is too high</u>. Consequently, **monetary policy or currency creation is in a pickle too!**
    - **<u>Timing</u> is everything** – with the Fed running off its balance, the UST market is getting a chance to price in real fundamental term structure risks while the Fed pulls more and more currency out of circulation which increasingly draws down

and reprices liquidity. The primary proof of waning liquidity is higher real rates on treasury inflation protected securities (TIPS), which are holding well over 2% on 5yr TIPS for the first time since 2006 – a 5% yield on the 5yr UST note is likely.

Bottomline to outlook:

- As spreads were mixed and yields move higher, there remained little fear of missing out on attractive hybrid yields as the underpinning of US treasury rates should stay elevated as the US Treasury market is feeling the weight of inflation and the relentless supply tsunami caused by endless $1trillion deficits.
- **We continue to be cautious on fixed-for-life hybrids** (predominantly concentrated in the $25par sector) because a 1999 type tax-loss selling scenario is percolating with unrealized equity gains potentially looking for a loss pair from NYSE listed preferred securities closer to year end – time will tell.
- **Ongoing equity complacency has abated somewhat but may still elevate more** as real rates and zooming US government borrowing costs gain more headlines and impel fiscal limitations.
- **There is good value in the junior subordinated fixed-to-refixed sectors based on discounted prices** and elevating forecast coupons with unique total return prospects can **"pull price toward par"** over the intermediate term in variable rate sectors (discussed earlier), even if real rates were to go higher over the next few years, which would only mean more income from higher reset coupons.
- Today's high hybrid yields are attractive based on our Comprehensive Risk profiles which compels us to be **bullish on buying junior subordination in quality financials** despite money market yields being high too. By the time short rates do finally come down, prices on term spread product should have already made a good move higher in anticipation of that move**.**
- There are attractive yields available in hybrid preferred securities which offer significant yield advantages to corporate bonds, shown here:

Purchasing Power Matrix: Financials	A Mdur	B YTW%	C 5yrBE Inflation%	D=B/C Inflation Coverage	E=D/A Inflation Coverage/ Mdur
Retail $25par (p0p4)	12.34	6.94	2.25	3.08	0.25
NoCos (stb8)	3.95	8.07	2.25	3.59	0.91
CoCos (cdlr)	2.58	8.86	2.25	3.94	1.53
More Sr. Fins (e0ba)	4.60	6.21	2.25	2.76	0.60

Source: Bloomberg; ICE BofA Bond Indices

- Hybrid yield inflation coverages are generous at 3.08x to 3.94x for junior subordination – shown above. The contingent convertible sector (CoCos) is 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 more duration risk in a mostly "fixed-forever" sector structure to get the coverage.

<u>In relation to positioning:</u>

- Maintain a defensive orientation by positioning fixed-to-refixed structures and barbelling these discounts with current coupon new issuance which embeds a "pull toward par" backstory to preserve capital and offer the potential for income growth.
- Real hybrid yields are compelling and even more so when we consider subtracting estimated historical credit default risks from real yields – shown here in a *Real Yield Matrix*

Real Yield Matrix	Hybrids		Corporates	
	Preferreds	CoCos	IG Corps	BIG Corps
Bloomberg Index	*cips+hips*	*cdlr*	*c6c0*	*h0a0*
Mod.Duration	3.95	2.58	6.11	3.83
Yield-to-Worst	8.07	8.86	6.14	8.94
Inflation[1] Adjustment	2.25	2.25	2.25	2.25
Real Yields	5.82	6.61	3.89	6.69
Default[2] Adjustment	-0.49	-0.49	-0.05	-2.72
YTW, net, net adj.	**5.33**	**6.12**	**3.84**	**3.97**
Composite Rating	*BBB2*	*BB1*	*BBB1*	*B1*
Last Month End:	Hybrids		Corporates	
	Preferreds	CoCos	IG Corps	BIG Corps
YTW, net, net adj.	5.13	5.87	3.43	3.58
Change from Last	☆ 0.20	☆ 0.25	☆ 0.41	☆ 0.39

Source: Bloomberg; ICE BofA Bond Indices

[1] *Inflation assuption based on the UST5yr breakeven inflation rate*
[2] *Sprectrum's 10yr annual default study through 2023 to date*

- The recent lift in yields further supports Hybrids as offering the most positive double-net real yield opportunity in credit.
- As the Fed is very likely to be no more than 1 step away from a full stop on rate hikes, the elevated real yields in US treasuries will likely persist well into 2024.
- Hybrid yields will probably stay elevated for some time too, especially given the high likelihood of recession next year from the deeply inverted yield curve (now un-inverting but still negative) and net deposit outflows from the banking system that are the normal result of ongoing QT.
    - **The window of opportunities in Hybrids should be available for some time as short-term volatility periods are likely to elevate somewhat from still reasonably complacent levels in equity.**

- Over the longer term, eventual rate cuts to offer some insurance against an extended recession next year would be politically pleasing especially if burgeoning US debt expenses populate the headlines.
- The structural "pull toward par" discounts should reward hybrid investors who take advantage of today's lower prices and wider than average spreads. Indeed, large sectors of the hybrid markets are not "fixed income", but rather "fixed-to-refixed income".

Phil Jacoby
CIO, Spectrum Asset Management
October 9, 2023

Spectrum Asset Management, Inc. is a leading manager of institutional and retail preferred securities portfolios. A member of the Principal Financial Group® since 2001, Spectrum manages institutional portfolios for an international universe of corporate, insurance and endowment clients, mutual funds distributed by Principal Funds Distributor, Inc., and preferred securities separately managed account solutions distributed by Principal Global Investors, Inc.