SPECTRUM
Asset Management

Junior-Subordinated Capital Securities Markets

April 2024 Updates

The US Treasury bond slid in April amid hotter than expected consumer inflation data which caused policymakers to doubt their confidence in the disinflationary trend especially given the ongoing strength in financial conditions. This caused many Wall Street rates strategists to revise up their aggressive rate calls for this year. Senior credit markets turned down for the year, but capital securities are still up this year despite a negative month in April. The UST 10yr note yield trended up for most of the month and closed 48bps higher at 4.68% as traders further tempered their bullish views. The spread between UST2yr notes and UST10yr notes dis-inverted by more 6bps from -42bps to -36bps (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 4.78% (44bps higher). Real rates on the front end of the treasury curve (i.e., UST 5yr TIPS) zoomed up by 48bps (to 2.29%); the 5yr implied breakeven inflation rate (i.e., the difference in yields between the 5yr UST and the 5yr Treasury Inflation Protected Security) actually slipped 1bp to 2.43% - this implied average inflation rate for the next 5yrs is now as high as it was prior to the massive bond rally last October. As the primary basis for the US government bond market blow-off this month was doubt over disinflation narrative and the Fed's more hawkish pivot on rate cuts this year, the bond market has cut its rate cut probability to just 2 cuts this year. Indeed, the Fed and markets must deal with a very challenging pricing conflict created by ongoing excess fiscal spending (i.e., ongoing UST debt issuance) not being aligned with the Fed's desire to gain confidence in its disinflationary goal. The effect of massive fiscal excess, zooming treasury debt costs and quantitative tightening (though soon to taper) still risks a "fiscal fit" (i.e., some clear concern expressed by lower UST bond market prices challenging Congress to gain control over spending

in the face of persistently high interest costs). This technical pressure on real rates would keep US Treasury yields and the term premium higher for longer -- the second order effect would be tighter credit spreads for longer too because the fiscal excess is fundamentally stimulative unless, resultant real rates were to zoom too high and derail the stock market rally. For now, expectations are for spreads to grind even tighter. We are not concerned that tighter than average spreads will reverse back to (or through) the mean any time soon because fiscal excess is ongoing, and the Fed will be forced to cut rates some by the weight of debt expense. The S&P 500 slipped 4.2% from its high while the VIX (i.e., Chicago Board Options Exchange Volatility Index) rose 20.3% to 15.65 – nonetheless, financial conditions are still about as good as it gets.

Before we talk preferreds and capital securities, the performance of the other corporate credit sectors are shown below for comparative references on returns and yield changes:

- The junk market (measured by the ICE BofA High Yield ***h0a0*** index) fell 1.00% to close yielding 8.08% (33bps higher).
- Global bank credit (measured by ICE BofA ***e0ba*** index) fell 1.44% to close yielding 5.75% (38bps higher).
- The BBB rated 5-10yr corporate sector (measured by ICE BofA ***c6a4*** index) fell 2.14% to close yielding 5.92% (42bp 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 comprise 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 preferreds and capital securities satisfy 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 $316 billion (face amount) of investment grade and below investment grade instruments in both the retail $25par market and the institutional $1,000par market – this benchmark can essentially be divided by looking at the *ICE BofA Core Plus Fixed Rate Preferred Securities* Index (***p0p4*** = 35.3% of i0cs) and the *ICE US Institutional Capital Securities Index* (***iips*** = 64.3% of i0cs). *The USD Contingent Capital Index* of US dollar denominated hybrids ***(cdlr)*** sums to $137 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 $456 billion universe of fixed-rate junior subordinated USD capital securities with preferred securities (measured by ***iocs***) being a 69% subset and contingent capital securities (measured by ***cdlr)*** being a 31% subset of the total global USD junior subordinated group.

Preferred Securities

In the preferred securities sleeve, there are four true 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***
   - Comprised of IG $25par and IG $1,000par (incl. US AT1)
     - ✞ The ***p0p1*** fell 2.63% this month to close yielding 6.46% (+49bps)
2) ***ICE BofA US Capital Securities Index* (*c0cs*) @ 25% of *i0cs***
   - Comprised of dated IG $1,000par dated hybrids (excl. US AT1)
     - ✞ The ***c0cs*** fell 1.36% this month to close yielding 6.77% (+42bps)
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*** fell 0.90% this month to close yielding 7.59% (+25bps)
4) ***ICE BofA High Yield Fixed Rate Pfd Index* (*p0hy*) @ 25% of i*0cs***
   - Comprised of BIG $25par and BIG 1,000par (incl. US AT1)
     - ✞ The ***p0hy*** fell 2.11% this month to close yielding 8.05% (+47bps)

The *ICE BofA All US Capital Securities Index* (*i0cs*) fell 2.06% this month to close yielding 6.98%, which was 45bps higher than last month's closing yield and a spread of +219bps over comparable US Treasury securities (6bps 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 procedure (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 made up of US dollar denominated constituents (exclusively), which represent 58% of the mature master multi-currency benchmark (*coco*). We will use 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 0.74% this month to close yielding 7.87%, which was 32bps higher than last month and a spread of +2.96bps over comparable US Treasury securities (8bps 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 among the three USD junior subordinated sectors.

Snapshot of Junior Subordinated Spread Sector Moves vs. Global Financials:

	p0p4	p0p4-e0ba	iips	iips-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	477	199	660	472
Low	-178	-267	179	51	223	143
Range	766	518	298	148	437	329
Average	76	-36	255	142	336	223
Stdev	116	98	46	25	63	37
Monthend	85	-4	207	118	283	194
Spread Scores:						
(monthend-ave)/stdev	0.08	0.33	-1.04	-0.96	-0.84	-0.78
Δ from Last Month	0.22	0.28	0.02	-0.40	0.14	0.35

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, values of **0 to +/- 1stdev.** = "*fair value*", outside of **+/- 1stdev.** = "*undervalued*"/ "*overvalued*", and scores outside of **+/- 2stdevs** = "*very undervalued*"/ "*very overvalued*".

Spread performance (i.e., change in spread from last month) for junior subordinated capital securities was better in the institutional sector than in the retail sector this month. The Absolute Spread Score on retail paper widened by 0.22 standard deviations; **the $25par sector is a *fair value* with a Spread Score of 0.08 standard deviations from average**. The Absolute Spread Score for the institutional $1,000par preferred securities sector ("NoCos") widened by 0.02 standard deviations; **NoCos are *overvalued* with a Spread Score of -1.04 standard deviations from average**. The Absolute Spread Score for the CoCo sector widened 0.14 standard deviations; **CoCos are a *negative fair value* with a Spread Score of -0.84 standard deviations from average**. This now continues a string of four consecutive months that the absolute spread scores have been less than average for institutional product -- we believe this is the early stage of a trend in completing this credit cycle with lower-than-average spreads being sustained as real UST yields rise from record fiscal spending and resultant funding supply need in US governments. Note that these statistical positionings provide an absolute and relative view on some historical spreads, which can be further complimented with some cycle perspectives from the *Comprehensive Risk Estimates* below that give some perspectives on absolute yields.

Implications of Market Activity:

$25par Retail Preferred Securities Sector

The retail preferred securities sector measured by *p0p4* declined $3.56 to $83.95 and the yield-to-worst popped up 53bps to 6.60% this month as the UST bonds fell, and the equity market traded off from its highs. There was no retail sector issuance this month. The two largest $25par passive ETFs (iShares Preferred and Income ETF, PFF; and Invesco Preferred ETF, PGX), had about $188million of combined net money outlow this month.

This month's *Estimated Price Risk to Average Current Yield* got much better as the price of the retail sector declined. The current yield is now just 19bps less 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 2.3% price loss. There is always a Fed cycle associated with the credit cycle, but no cycle is exactly like prior cycles because economic factors that cause credit spread differences change. Given that spreads in retail preferreds are wider than average this month at 0.08 standard deviations more than average, it appears that most of the higher yields in the retail market are explained by spread sensitivities and less risk tolerance for duration as US treasury yields have moved up against the consensus narrative that began the year.

Retail Pfds. (pop4)	Valuation Implosions			Average		Diff. to	
Credit Cycle Bottoms >	2013	2016	2018	Prior Bottoms	Current	Average	
GA10	2.98%	1.64%	2.74%	**2.45%**	4.68%	2.23%	
PCE DEFY	1.48%	0.59%	1.86%	**1.31%**	2.70%	1.39%	
Real UST10yr	1.50%	1.05%	0.88%	**1.14%**	1.98%	0.84%	
$25Coupon	6.64%	6.46%	6.05%	**6.38%**	5.47%	-0.91%	
$25Price	$94.06	$98.66	$93.09	**$95.27**	$83.97	-$11.30	
$25Current Yield	7.06%	6.55%	6.50%	**6.70%**	6.51%	-0.19%	
Mdur Worst	9.52	10.44	10.95	**10.30**	12.71	2.41	
CY Spread vs. T10yr	4.08%	4.91%	3.76%	**4.25%**	1.83%	-2.41%	
Source: Bloomberg; ICE BofA Bond Indices						-2.30%	Est. Price Risk to AveCY
				Comprehensive Risk Est.		4.21%	Est. Price Risk + CY
				Recapture Rate (yrs.)		0.35	Est. Price Risk / CY
					Memo:	1.10%	Total Return YTD

The current yield of the retail sector closed the month at 6.51%, which was approximately 19bps 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 183bps which is 241bps less than the average spread of the last three credit cycle bottoms as retail preferred yields are high but spread is being “squeezed” by UST yields being high as well -- a gauge to yields being high is the discounted price of the sector. The rebalanced dollar price of the retail sector is $83.97 this month and $11.30 lower than the average price of the prior bottoms, which means that there is significantly more convexity to the retail market during this cycle than there was during the prior cycles even though yields were mostly higher. The implication of a 0.19% current yield increase to 6.70% (the average current yield of the prior bottoms) is an estimated 2.30% price decline using the current modified duration of 12.71; then adding back a current book yield (assuming a 12month path) of 6.51% makes the *Comprehensive Risk Estimate* for returns in the retail sector positive at 4.21% (465bps better than last month). It would take 0.35yrs to recapture this capital loss estimate with book income. Overall, yields in the retail sector

improved to become a *fair value* in the absolute and more cushioned compared to the institutional sector if spreads were to widen.

- Below investment grade (BIG) $25pars outperformed investment grade (IG) retail paper by 0.07% this month; and has outperformed by 2.06% for the year.

$1,000par Institutional Preferred Securities Sector

The $1,000 par institutional sector of the preferred securities market declined $1.43; and yields-to-worst rose by 40bps to 7.10% this month. The following table illustrates the institutional preferred securities sector's three prior credit cycles compared to closing valuations this month:

Institutional Pfds.(iips)	Valuation Implosions			Average		Diff. to	
Credit Cycle Bottoms >	2013	2016	2018	Prior Bottoms	Current	Average	
GA10	2.94%	1.75%	2.74%	**2.48%**	4.68%	2.20%	
PCE DEFY	1.17%	0.59%	1.86%	**1.21%**	2.70%	1.49%	
Real UST10yr	1.77%	1.16%	0.88%	**1.27%**	1.98%	0.71%	
Coupon	6.77%	6.43%	5.88%	**6.36%**	5.55%	-0.81%	
Price	$103.96	$99.62	$97.23	**$100.27**	$95.25	-$5.02	
Current Yield	6.51%	6.45%	6.05%	**6.34%**	5.83%	-0.51%	
Mdur Worst	5.90	5.23	4.64	**5.26**	3.98	-1.28	
CY Spread vs. T10yr	3.57%	4.70%	3.31%	**3.86%**	1.15%	-2.71%	
Source: Bloomberg; ICE BofA Bond Indices						-2.03%	Est. Price Risk to AveCY
				Comprehensive Risk Est.		3.79%	Est. Price Risk + CY
				Recapture Rate (yrs.)		0.35	Est. Price Risk / CY
					Memo:	3.09%	Total Return YTD

The current yield of the institutional preferred sector closed the month at 5.83%, which was 24bp higher than last month. The $95.24 price of the NoCo sector is $5.02 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 51bps less than the

6.34% average current yield at the bottom of the last three credit cycles. The implication of a 0.51% current yield increase to 6.34% (the average current yield of the prior bottoms) is an estimated 2.03% price decline using the modified duration of 3.98; then adding back a current book yield (assuming a 12month path) of 5.83% makes the *Comprehensive Risk Estimate* for the NoCo sector equal to a 3.79% horizon return to accept the risk, which is 117bps more than last month. It would take 0.53yrs to recapture this capital loss estimate with book income. We consider the NoCo sector to be *fair value* in the absolute but *overvalued* on spread.

- Below investment grade (BIG) $1000pars outperformed investment grade (IG) institutional paper by 0.52% this month; and by 2.14% this year.

The new issuance market was active again this month. Some examples are:

- (Ba1/BB+) Goldman Sachs 7.50% 5yr fixed-to-refixed perpetual AT1 +281
- (Baa2/BBB) Royal Bank of Canada 5yr fixed-to-refixed AT1 +289
- (A3/A-) Nippon Life 5.95% 10yr fixed-to-refixed junior subordinated debt +185

Contingent Capital Securities Sector

The CoCo sector fell $1.24 to $95.23 as yields-to-worst rose 32bps to 7.87% this month. The following table illustrates the contingent capital securities sector's three prior credit cycles compared to closing valuations this month:

CoCo Securities (cdlr)	Valuation Implosions			Average		Diff. to	
Credit Cycle Bottoms >	2013	2016	2018	Prior Bottoms	Current	Average	
GA10	3.01%	1.75%	2.88%	**2.55%**	4.68%	2.13%	
PCE DEFY	1.48%	0.59%	1.86%	**1.31%**	2.70%	1.39%	
Real UST10yr	1.53%	1.16%	1.02%	**1.24%**	1.98%	0.74%	
Coupon	7.63%	6.40%	6.78%	**6.94%**	6.52%	-0.42%	
Price	$105.04	$89.12	$96.21	**$96.79**	$95.10	-$1.69	
Current Yield	7.26%	7.18%	7.05%	**7.16%**	6.86%	-0.31%	
Mdur Worst	4.76	5.30	3.95	**4.67**	2.90	-1.77	
CY Spread vs. T10yr	4.25%	5.43%	4.17%	**4.62%**	2.18%	-2.44%	
Source: Bloomberg; ICE BofA Bond Indices						-0.89%	Est. Price Risk to AveCY
				Comprehensive Risk Est.		5.96%	**Est. Price Risk + CY**
				Recapture Rate (yrs.)		0.13	Est. Price Risk / CY
					Memo:	2.36%	Total Return YTD

The current yield of the CoCo sector closed the month at 6.86%, which was 17bps higher than last month and is 31bps less than the average current yield at the bottom of the last three credit cycles (i.e., 7.16%). The average rebalanced CoCo price of $95.10 is lower than 2 of the last 3 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 0.31% current yield increase to 7.16% (the average current yield of the prior bottoms) is an estimated 0.89% price decline using the modified duration of 2.90; then adding back the current book yield (assuming a 12month path) of 6.86% makes the *Comprehensive Risk Estimate* for return in the CoCo sector 5.96% (69bps better than last month). It would take 0. 13yrs to recapture this capital loss estimate with book income. We consider the CoCo sector to be *fair value* in the absolute but marginally *overvalued* on spread.

There was no CoCo new issuance this month.

Outlook:

A Fed conundrum: We still believe that if the Fed cuts rates too soon it could impair its credibility as an inflation fighter especially as the recent data shows strength not weakness and labor markets are still doing well. The Fed is faced with a continuing conundrum that needs to break one way or the other this year – on the one hand, if the Fed cuts rates too soon, then financial conditions will improve even more and long-term inflation expectations could become unanchored; but on the other hand, if the Fed leaves rates too high for too long it could prompt a fiscal fit in the US Treasury markets caused by the rising costs of the massively uncontrollable US debt load (the Congressional Budget Office warns of a fiscal crunch). Either way, it appears inflation will stay elevated (i.e., stubbornly above the Fed's 2% goal), while the Fed subtly edges up its long-term neutral rate. The bond market has retreated to just 2 rate cuts priced into this year (down from 6 cuts to start the year) as the inflationary results of the dovish pivot last year are coming to light.

The equity market is essentially dismissing the need for the Fed to keep interest rates high for longer because fiscal growth pressures (something the Fed cannot directly opine on) are trading against "restrictive" rates pressure causing financial conditions to remain stellar – indeed, hardly an outcome to create worry about growth and unemployment. The yield curve is still inverted so, if the Fed gets its soft landing, then there will be no recession and certainly no need for an inverted yield curve to be ongoing and predicting what won't be coming (i.e., a recession) – especially now that the Fed is tapering down its balance sheet run-off starting in June, which means that the Fed will be mopping up more of what the Treasury is selling. We expect the 2s10s yield curve to normalize by the end of next year to a moderately positive slope – the question is: Which way will the curve twist to normalize? Our view is that 2yr note yields will rally more than 10yr note yields in a moderate bull twist because of political persuasion (though

no doubt will be denied) under the weight of budget pressures – the implication here is longer-term inflation expectations rising, which is perhaps why the US Treasury intends to sell Bills (to the Fed as fills the taper gaps with reinvestment purchases) and buy bonds from the secondary market akin to Japan's famous era of "yield curve control". This is seem to be an oddly "coordinated" scheme of Treasury saying to the Fed, "help me help you help me" use your balance sheet to manipulate bond rates lower (though false demand) so we can increase the auction sizes in 10s & 30s without a sudden shock against demand but rather a slow burn.

Implications for Junior Subordinated Capital Securities:

There should be ongoing ample opportunities to buy attractive hybrid yields this year because the UST market remains in a confirmation mode (or hope mode) and cannot run more than what the Fed ultimately does which, the more the year progresses, appears will be less than the bond market had originally discounted – so, a longer term UST rally (i.e., the UST10yr) for this year has largely already been played out by last year's move, hence the further backup this month. We expect capital returns this year to be largely related to tightening spreads. Dec-24 SOFR futures should trade back up toward federal funds parity as the year progresses to the election -- we expect that level to finish 2024 in a 4.50%-4.75% range, which means the US Treasury 10yr note yield doesn't have much room to decline unless the Fed capitulates to inflation; yet if it capitulates to inflation, then a bear steepener could impel the 10yr note to another test of 5% to discount not only endless supply, but also a higher inflation premium as noted. It seems the best thing the Fed can do is to stay the course, watch the data patiently and stay high for longer given the fiscal excess and an economy that, at least to now, continues to be supported.

Our credit team views hybrid credit fundamentals are generally sound and the purchasing power matrix scores of hybrids are even better now than they were this time last year – this, despite the laudable credit performance this year.

	A	B	C	D=B/C	E=D/A
Purchasing Power Matrix: Financials	Mdur	YTW%	YoY Inflation%	Inflation Coverage	Inflation Coverage/ Mdur
Retail $25par (p0p4)	12.71	6.61	3.50	1.89	0.15
NoCos (IIPS)	3.98	7.12	3.50	2.03	0.51
CoCos (cdlr)	2.90	7.95	3.50	2.27	0.78
More Sr. Fins (e0ba)	4.74	5.78	3.50	1.65	0.35

Source: Bloomberg; ICE BofA Bond Indices

- Hybrid yields are mostly lower, breakeven inflation is unchanged and inflation coverage is down this month but still generous.
- Hybrid yield CPI inflation coverages are 1.89x to 2.27x for junior subordination – shown above. Contingent convertibles (CoCos) are the winners on *Inflation Coverage* and risk adjusted coverage when factoring in duration. The NoCo sector wins the silver medal 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.

In relation to positioning:

- 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* ***Please note that on the table below we have corrected previously provided data on Global High Yield Corporate Defaults to reflect only volume weighted default data for High Yield Corporate Bonds.***

Real Yield Matrix	Hybrids		Corporates	
	Preferreds	CoCos	IG Corps	BIG Corps
Bloomberg Index	*iips*	*cocu*	*c6c0*	*h0a0*
Mod.Duration	3.98	2.94	6.09	3.61
Yield-to-Worst	7.12	7.72	5.79	8.20
Inflation[1] Adjustment	3.50	3.50	3.50	3.50
Real Yields	3.62	4.22	2.29	4.70
Default[2] Adjustment	-0.55	-0.55	-0.04	-2.53
YTW, net, net adj.	**3.07**	**3.67**	**2.25**	**2.17**
Composite Rating	*BBB3*	*BBB3*	*BBB1*	*B1*
Last Month End:	**Hybrids**		**Corporates**	
	Preferreds	**CoCos**	**IG Corps**	**BIG Corps**
YTW, net, net adj.	2.95	3.45	2.10	2.02
Change from Last	☆ 0.12	☆ 0.22	☆ 0.15	☆ 0.15

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*

- Hybrids still offer the most positive double-net real yield opportunity in corporate credit.
- The Fed should cut rates by 50bps later this year, though elevated real yields in US treasuries will likely persist because of a higher terminal rate (i.e., “r-star”) being necessary in the new paradigms de-globalization, de-carbonization, and fiscal excess (all inflationary).
- The structural “pull toward par” discounts should reward hybrid investors who take advantage of today’s lower prices and higher yields. The predominant “fixed-to-refixed income” means if rates do stay higher than they have in the past coming out of this rates cycle, income in hybrid portfolios can rise even if spreads tighten more.

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CIO, Spectrum Asset Management
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