Stonebridge Preferred Securities
Market Report
First Quarter, 2021

Highlights

- **Flows into actively-managed preferred and hybrid funds outpaced passive funds during the first quarter of 2021,** as investors sought institutional exposure and active duration management, helping to support secondary prices.
- **We expect most new issuance in 2021 should come in the form of refinancing,** which may provide a positive technical backdrop to the preferred and hybrid securities market.
- **Credit fundamentals across the preferred and hybrid issuer base remain strong,** cushioning the coupon-paying capacity of issuers.
- **The preferred and hybrid securities market offers one of the highest yields across the fixed-income universe** along with potential tax advantages and a low to moderate duration profile.
- **We believe active management will be criticial in 2021** given the potential for increased inflation expectations and continued rate volatility as economies continue to reopen as the vaccine rollout progresses.

MARKET RECAP

The performance of the preferred and hybrid securities market was mixed during the first quarter of 2021 as rising interest rates weighed on longer-duration institutional securities and the $25 par retail market. The move higher in interest rates was driven by increased inflation expectations from the vaccine rollout, further fiscal stimulus measures and the reopening economy. While the Federal Reserve (the Fed) continued to remain dovish in its messaging, it did increase its growth expectations for the economy and reduced its unemployment forecast for 2021. Also during the March Fed meeting, four members of the Federal Open Market Committee were looking for a rate hike as early as 2022, compared to just one member at the December meeting. As the rate curve steepened in 1Q2021, returns were cushioned by the high income offered in the preferred and hybrid securities market as well as from yield-spread tightening. Variable rate and floating-rate securities outperformed during the period, while lower coupon $25 par securities underperformed. Non-investment grade (non-IG) $1000 par securities and contingent convertible capital securities (CoCos) from non-U.S. banks outperformed during the period, mainly due to their defensive rate structures and wider valuations entering the period. Conversely, $25 par securities, which are dominated by longer-duration fixed-for-life coupon structures and IG $1000 par institutional securities underperformed.

Entering the year, it appeared that a split Congress was likely, dampening expectations for further stimulus measures and limiting meaningful changes to tax and regulatory policy. However, with the Democratic sweep of the Georgia elections in early January, Joe Biden and the Democrat-led Congress were able to pass a $1.9 trillion stimulus package in early March. This bill included more direct stimulus payments to qualified individuals, as well as expanded unemployment benefits. The passage of this bill also paved the way for a potential infrastructure spending bill and some offsetting increases in taxation. These enormous and unprecedented spending programs increased inflation expectations among market participants, compounded by the expanded vaccine rollout and approval of the Johnson & Johnson vaccine. Meanwhile, the European Central Bank (ECB) pledged its commitment to accommodative policy and announced that it will increase its bond purchases in the coming months to combat rising yields. Despite the move higher in yields, policy remains supportive and optimism remains high with the reopening economy, which should continue to drive risk appetite for investors and further beta compression, in our opinion.

Fund flows into the preferred and hybrid securities market were negative during the first quarter of 2021, although investors clearly differentiated between active and passive management. Actively managed exchange-traded funds (ETFs) saw inflows of over $430MM during the period, while passively managed funds, which are mostly concentrated in longer-duration $25 par retail securities, suffered outflows of about $540MM. Market technicals improved during the latter part of the period, as opportunistic investors stepped into the market to take advantage of the improved valuations from the rate driven sell-off. Compared to other fixed-income asset classes, preferreds continue to offer relatively high yields, potential tax advantages due to QDI eligibility for qualified securities and strong credit fundamentals across the issuer base. Although spreads tightened during the period, they remain at historically wide levels, and the variable rate coupon structures in the market may provide rate protection for investors wary of rising Treasury yields.

Issuance

- **The retail market shrunk by $1.5bn.** During the first quarter of 2021, issuers redeemed nearly double the number of retail securities that were issued in the market, resulting in a $1.5bn net reduction to the market size. Some of this was driven by redemptions being pre-financed in prior quarters or being re-financed through institutional securities, as well as some straight redemptions with no issuance.
- **Preferreds remain a consistent source of attractive income.** The average coupon on new issuance in the preferred securities market was 5.02% during 1Q21, up slightly from the 4.99% in 4Q20. New issues in the retail market experienced an average coupon of 5.43%, while issuance in the institutional market averaged 4.40%.

- **Despite the uptick in redemptions, the preferred securities market ended the quarter with net positive issuance.** Net 1Q21 issuance finished at +$4.9bn, which is broken up between +$6.4bn from the institutional market and -$1.5bn within the retail market.
- **We expect issuers will continue to take advantage of low rates through refinancing.** Refinancing has been the major theme in the preferred market recently, particularly within the retail market. With rates remaining relatively low, this is a trend we'd expect to continue for the foreseeable future. Moreover, approximately $5bn in upcoming redemptions have already been announced and there remains a significant number of potential call candidates later this year. As a result, we expect net supply to be relatively flat for the remainder of 2021.
- **Treasury-based reset spreads continue to replace LIBOR[1] as market standard.** During the period, 100% of the variable rate securities issued in the preferred securities market used the Treasury-based reset index structure.

Investment Outlook

Macroeconomic & Geopolitical Trends:

- **Vaccine rollout drives U.S. rebound, with slower progress in Europe.** The U.S. has made major progress in its vaccine rollout, ending the quarter with almost 40% of the population receiving at least one dose. This has spurred a rebound in economic activity, particularly within some of the hardest hit industries such as entertainment, restaurants and hospitality. European economies have started to rebound as well, but progress lags the U.S. so far. We expect the positive sentiment on both the U.S. and European economies to continue as more people get vaccinated and restrictions get lifted.
- **Political headlines shifted from elections to policy.** With the Presidential electoral college voting and inauguration concluded in January, the focus in Washington has shifted toward policy. During the first quarter, Congress passed a $1.9trn stimulus bill, and the Biden administration is currently pursuing an infrastructure bill and tax policy changes at both the corporate and personal level. Negotiations remain fluid, and the final form may take shape in the second quarter. Potential tax policy implications on the preferred market, if any, remain uncertain. All else equal, higher tax rates increase the QDI benefit offered by many preferred securities.
- **OPEC+ re-starting production, but market still expecting supply deficits as demand comes back.** As the vaccine rollout continues, refined product demand is coming back strong. Gasoline, diesel and jet fuel demand are now only -3%, -5%, and -29% below 2019 same-week levels, respectively. As demand recovers, OPEC+ production is going to start coming back online at a faster pace. But the market took this news as a positive and is still pricing in demand outpacing supply, causing inventories to continue to draw. Goldman is forecasting 2M b/d of additional production that OPEC+ needs to bring online by October to keep up with their expected demand return.

Interest Rates & Monetary Policies:

- **Treasury yields grabbed the spotlight in the first quarter.** After reaching a record low last year, the 10-year Treasury rate moved dramatically in the first quarter, almost doubling from 0.91% to a high of 1.75%. The 10-year rate closed the quarter at 1.74% after averaging 1.32%. Meanwhile, front-end rates fell in the first quarter. 3-month T-bills dropped ~7 bps to 0.02%, 3-month LIBOR fell 5 bps to 0.19% and LIBOR's expected replacement, SOFR[2], fell 6 basis points (bps) to 0.01%. We expect investors to focus on inflation prints in the second quarter to gauge if the 10-year can reach 2% or consolidate near current levels.
- **Central banks push back on concerns of rising inflation.** Central banks, most notably the Fed, firmly held the line on loose monetary policy amid concerns of rising interest rates and inflation expectations. As noted above, inflation prints in the coming months may present a challenge to the Fed's messaging, although officials continue to view rising inflation expectations as transitory. This leads us to expect little change in central bank policy during the second quarter, with a small possibility of changes in messaging for the second half of the year.

Credit:

- **Capital restrictions lifted for most U.S. banks, pending 2Q21 stress test results.** U.S. banks continued their strong rebound during 4Q20 earnings season with over 95% beating consensus earnings estimates. After an initial drop during 1Q20, capital ratios climbed higher over the final 3 quarters with the average ratio now almost 1% higher. The economic rebound, combined with a significant build up in loan loss protection through both reserves and excess capital, allowed the Fed to announce removal of capital restrictions after 2Q21.
- **Most European banks reinstated common dividends post year-end results.** In Europe, almost 80% of banks beat consensus estimates when reporting 4Q20 results during the first quarter, following a similarly solid 3Q20 earnings season. Average loan loss provisioning fell toward pre-pandemic levels during the third and fourth quarters, and capital ratios jumped by 10% on average during 2020. Following the ECB's decision to lift restrictions on common dividends in 2021, most banks reinstated their common dividend policies, which we view as a positive reflection of their strong credit profiles.

[1] The London Interbank Offered Rate (LIBOR) is a benchmark interest rate that banks charge each other for short-term loans.
[2] The Secured Overnight Financing Rate (SOFR) is a measure of the cost of borrowing cash on an overnight basis in the U.S. Treasury repo markets.

- **Recovering energy demand and leverage-reducing actions are credit positive in 2021.** Despite the negative sentiment toward the energy sector throughout 2020, midstream credits within Stonebridge managed portfolios actually reported a marginal EBITDA increase year-over-year on average, while a number also announced dividend cuts to further support the positive credit momentum. Within Stonebridge's midstream energy exposure, only one credit has experienced a downgrade from rating agencies since year end 2019. Looking forward, there is a credit supportive backdrop for the sector with high commodity prices, positive FCF positions, and management teams focused on de-levering. Stonebridge continues to see pockets of opportunity within the Midstream preferred market, supported by a positive sector environments.

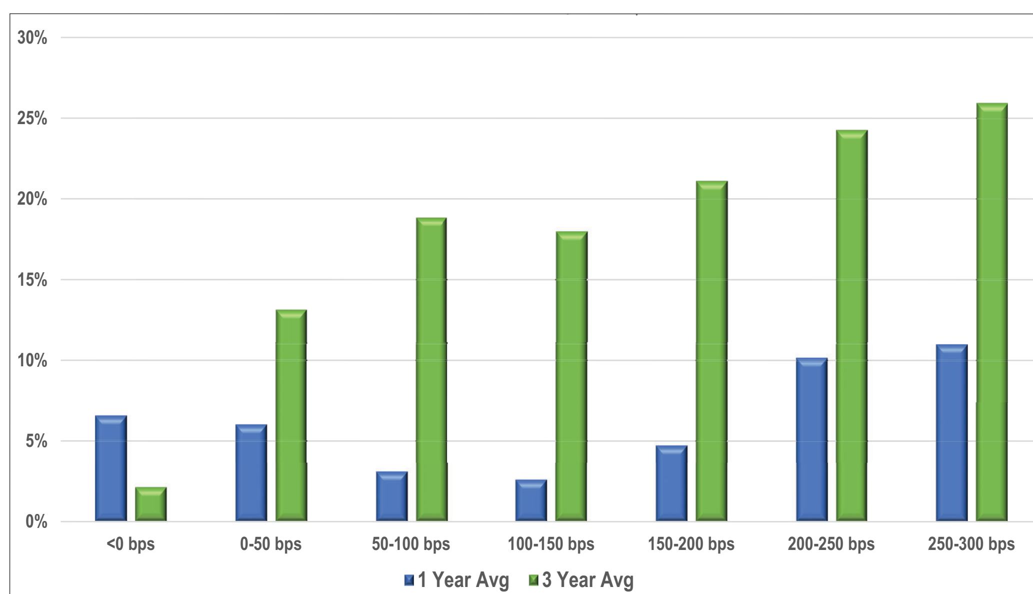
Market Structure:

- **Major steps taken on LIBOR transition.** During the Q1 2021, New York state officially passed legislation that allows for the use of a replacement rate to LIBOR on securities governed under New York law. This bill marks a critical step in addressing legacy contracts that mature after mid-2023 and do not have appropriate fallback language to replace LIBOR. Although this bill only applies to securities written under New York law, it should provide the framework for other states to pass similar legislation. There are also efforts at the federal level to pass a similar bill which we view as the cleanest solution.

Valuation and Portfolio Positioning:

- **Yield spreads of preferreds remain at historic wides.** As of 3/31/21, the current yield spread over 10-year Treasuries (GA 10) for the preferred securities market, as represented by the custom blend index*, was 427 bps. Going back to 1996, any time the market achieved a spread wider than 400 basis points, the cumulative return over the next 3-year period on average was over 20%.
- **Preferreds have historically performed well in rising-rate environments.** Although we may continue to experience some near-term volatility in preferreds as a result of the steepening of the U.S. Treasury curve, historically, preferreds have demonstrated positive forward returns when the 2s/10s curve differential steepened. The spread differential between the 2-year and 10-year treasuries widened by 79 bps during the quarter to approximately 158 bps. The historical average 3-year forward return for preferreds was over 21% when the 2s/10s curve was between 150-200 bps (Figure 1). In fact, the worst historical 3-year forward returns were achieved when the curve was inverted and the best returns were when the curve was steepest.

Figure 1. Historical Forward Returns of Preferreds based on 2 yr / 10 yr Treasury Curve Steepness



Source: Stonebridge Advisors LLC, ICE Data Services, Bloomberg L.P. data from 12/31/1996 - 3/31/2021.

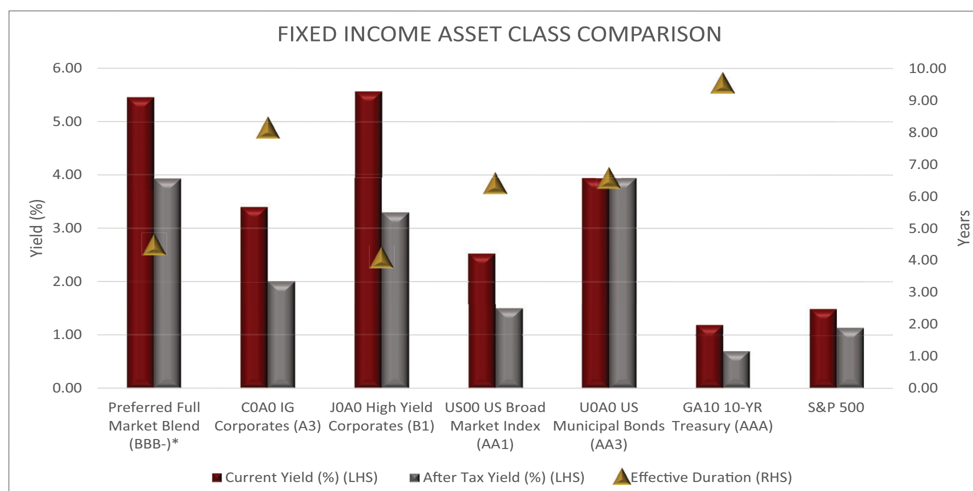
From 12/31/1996 thru 12/31/2013 Preferred Securities are represented by the ICE BofA Fixed-Rate Preferred Securities Index (P0P1) and from 12/31/2013 to present Preferred Securities are represented by a custom blend of ICE indices (30% P0P4 / 30% CIPS / 30% CDLR / 10% HIPS). See Index Definitions on last page

The curve steepness is calculated by the 10-year Treasury yield less the 2-year Treasury yield. Returns are calculated using the 1-year and 3-year forward looking total return from each month-end period. **Past performance is not indicative of future results and there can be no guarantee historical trends will continue into the future.**

- **Preferreds offer incremental yield over other asset classes.** We believe preferreds offer better relative value than most other credit risk asset classes in the current rate environment due to the high yields combined with the high quality of the issuers and intermediate to low duration profile. As shown in Figure 2 on the next page, the absolute yield pick up in preferreds over other investment-grade rated asset classes ranges from 1.5% to over 2%. Issuers of preferred securities have a similar credit risk profile as issuers of investment-grade corporate bonds. Average rating differentials at the security level are due to subordination of preferreds. For taxable investors, the tax-advantaged income offered in many preferred securities increases the value of the after-tax yield of preferred securities.

*Custom blend index: A blend of the following ICE indices: 30% P0P4-ICE BofA Core Plus Fixed Rate Preferred Securities Index / 30% CIPS-ICE BofA US Investment Grade Institutional Capital Securities Index / 30% CDLR-ICE USD Contingent Capital Index / 10% HIPS-ICE BofA US High Yield Institutional Capital Securities Index.

Figure 2. Yield Comparison of Preferreds vs Other Asset Classes



Source: Stonebridge Advisors LLC, ICE Data Services, Bloomberg L.P. as of 3/31/2021.

*Market Weighted Index Comprised of 30% P0P4 | 30% CIPS | 30% CDLR | 10% HIPS

Assumes 40.8% Federal Tax Rate, no state tax. QDI eligible securities are determined by Bloomberg and Stonebridge.

- **Portfolio positioning and where we see value currently.** In the face of rising rates and volatile market conditions, we believe active management has been beneficial to investors in the first quarter of 2021 and will continue to have an important role in portfolio positioning and performance for the remainder of the year. Increased fiscal and monetary support, both in the U.S. and globally, may speed up the economic recovery, which will be a positive for credit and should continue to support beta compression in the market. It may also lead to inflationary pressure and a further rise in rates which could increase the potential for further near-term market volatility. As a result, we believe that actively managing portfolios, including positioning in a higher percentage of variable-rate securities than passive funds, will be advantageous. We favor securities on the 2-5 year part of the curve and have increased weightings in high reset variable-rate securities, while avoiding weaker reset structures on the front-end of the curve and low coupon fixed-rate securities. We continue to believe the secondary market will likely find technical support from investor inflows and limited net new supply as refinancing continues. Attractive valuations, combined with high yields and strong issuer credit fundamentals, will likely drive outperformance of preferreds compared to other fixed-income asset classes in the coming months.

Index Definitions:

P0P1 – ICE BofA Fixed Rate Preferred Securities Index – tracks the performance of fixed-rate U.S. dollar denominated preferred securities issued in the U.S. domestic market. All holdings are investment-grade rated.

P0P4 – ICE BofA Core Plus Fixed Rate Preferred Securities Index – tracks the performance of fixed-rate U.S. dollar denominated preferred securities issued in the U.S. domestic market. This index is comprised of 100% retail securities and does not require securities to be investment-grade rated.

CIPS – ICE BofA US Investment Grade Institutional Capital Securities Index – tracks the performance of U.S. dollar denominated investment grade hybrid capital corporate and preferred securities publicly issued in the U.S. domestic market.

CDLR – ICE USD Contingent Capital Index – subset of the ICE BofA Contingent Capital Index including all securities denominated in U.S. dollars.

C0A0 – ICE BofA US Corporate Index – tracks the performance of U.S. dollar denominated investment grade corporate debt publicly issued in the U.S. domestic market.

J0A0 – ICE BofA US Cash Pay High Yield Index – tracks the performance of U.S. dollar denominated below investment grade corporate debt, currently in a coupon paying period, that is publicly traded in the U.S. domestic market.

GA10 – ICE BofA Current 10-Year US Treasury Index – is a one-security index comprised of the most recently issued 10-year U.S. Treasury note.

HIPS – ICE BofA US High Yield Institutional Capital Securities Index – tracks the performance of U.S. dollar denominated sub-investment grade hybrid capital corporate and preferred securities publicly issued in the U.S. domestic market.

US00 – ICE BofA US Broad Market Index – tracks the performance of US dollar denominated investment grade debt publicly issued in the US domestic market, including US Treasury, quasi-government, corporate, securitized and collateralized securities.

U0A0 – ICE BofA US Municipal Securities Index – tracks the performance of U.S. dollar denominated investment grade tax-exempt debt publicly issued by U.S. states and territories, and their political subdivisions, in the U.S. domestic market.

S&P 500 Index – is an unmanaged index of 500 stocks used to measure large-cap U.S. stock market performance.

Indexes are unmanaged and an investor cannot invest directly in an index.

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The first quarter performance for the Taxable Preferred Composite and the Tax-Advantaged QDI Preferred Composite are available upon request by contacting Stonebridge Advisors LLC at 203-762-0004.