Stonebridge Preferred Securities
Market Report
Second Quarter, 2020

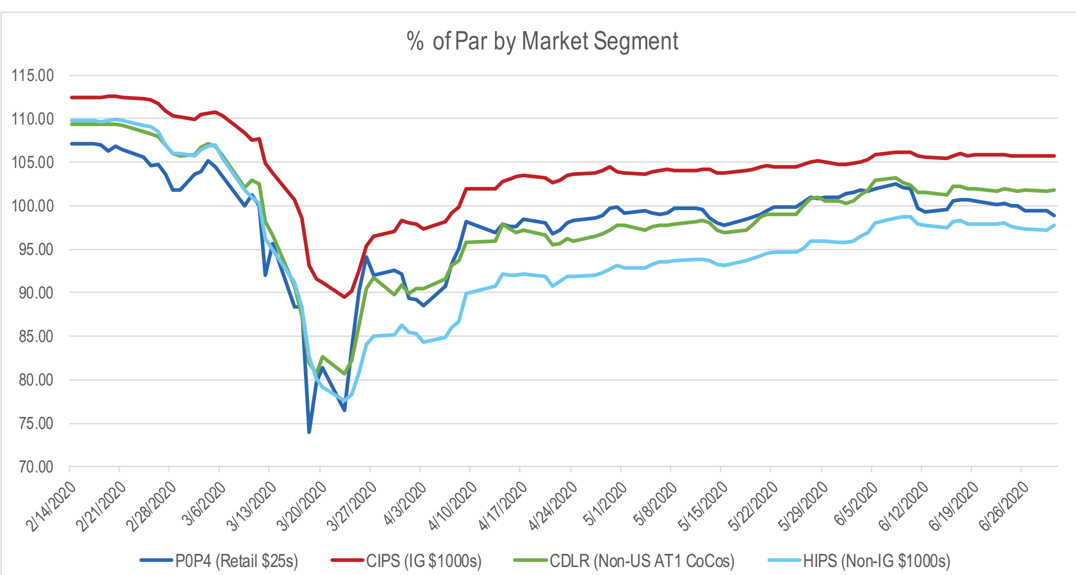
MARKET RECAP

The preferred and hybrid securities market rebounded across all market segments during the second quarter of 2020 after experiencing a sharp sell-off during the latter half of the prior quarter. While pockets of volatility persisted during the second quarter due to economic, political, social and COVID-19 related headlines, trading in the preferred and hybrid securities market was orderly during the period in contrast to the sharp liquidity-driven sell-off in March. Also driving the improvement in the markets was the combination of monetary and fiscal stimulus in the United States, Europe and around the globe, along with recovering economic data that appears to show markets bottomed out in April. After lagging during the first quarter of 2020, non-investment-grade (Non-IG) institutional $1000 par securities significantly outperformed $1000 par IG institutional securities during the period, reflecting improved investor confidence. European bank additional Tier 1 (AT1) securities also performed strongly during the period after lagging U.S. banks during the first quarter of 2020. This was aided by the European Central Bank (ECB), which expanded its stimulus and easing measures, including corporate bond buying, and fiscal policy across all major governments, as negotations for a large Eurozone-wide stimulus package were discussed. The worst-performing segment of the market was the $25 par retail market, which suffered from a large uptick in supply and tepid demand during the latter part of the quarter. However, this part of the market still managed to return nearly 9% during the period.

The Federal Reserve (Fed) and Congress approved additional easing and stimulus measures, respectively, during the period in order to continue to support the economic recovery. The Fed, in particular, helped to improve market functioning and investor confidence by directly purchasing corporate bond ETFs as well as a broad portfolio of corporate bonds. This helped to tighten corporate spreads both directly and indirectly. The Fed also established the Main Street Lending Program to provide additional support to small- and medium-sized businesses that have been affected by the COVID-19 pandemic. Meanwhile, Congress approved additional stimulus to continue to support businesses and workers affected by the pandemic. It is unclear if there will be another round of stimulus going forward from Congress, although Jerome Powell, the chairman of the Fed, encouraged continued fiscal stimulus to support the recovery as needed.

Fund flows into the preferred and hybrid securities market improved during the second quarter of 2020, although a massive increase in new supply—with limited redemptions—largely offset the positive technical impact. Generally speaking, the market technical was weak by the end of the period, as a large influx of USD supply, particularly in regional U.S. banks, weighed on the markets. Additionally, the Fed released its annual bank stress tests near the end of the period, which highlighted the strength of the banking system due to its high capital levels and ability to withstand a sustained economic slowdown. Although share buybacks were suspended and equity dividends were subject to limitations, the impact at the preferred level was positive, in our opinion, due to increased capital retention at the banks. Finally, the odds for the 2020 election swung during the period as Joe Biden amassed a large lead in the polls over the incumbent, Donald Trump. Although markets have not yet reacted strongly to this change, Joe Biden has signaled a willingness to increase corporate taxes as well as capital gains rates. As the election heats up in the third quarter of 2020, there could potentially be pockets of volatility as the market adjusts to the policies of each candidate.

Figure 1. Comparison of Preferred Market Segments after Market Peak on 2/14/2020 thru 6/30/2020



Source: ICE Data Services and Stonebridge.

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Highlights:

- Preferred and hybrid securities ETFs experienced ~$490 million of inflows during Q2 2020.
- The broad preferred and hybrid securities market (P0P1) closed the quarter trading at 100.88% of par, up about 5 points during the period.
- The Non-IG institutional market (HIPS) was the top-performing segment of the preferred and hybrid securities market in Q2 2020, returning 14.49%, followed by non-U.S. bank AT1s CoCos (CDLR), which returned 13.29%.
- All segments of the preferred and hybrid securities market have rebounded from their March lows, but remain 6-12 points below their peak in mid-February (Figure 1).
- The issuance market was very strong in Q2, with nearly $26BN in new issuance and net supply totaling about $16.5BN.
- The Treasury yield curve steepened during the period, as the 2-year/10-year spread widened to 51 basis points (bps) as short-term rates fell.
- 3-Month LIBOR[2] plummeted during the quarter from 1.45% to 0.30%.
- Current yield spreads of preferred and hybrid securities (P0P1) versus 10-year Treasuries (GA10) increased by nearly 40 bps during the period to end at 484 bps, which is the widest monthly data reading in the past 7 years.

Figure 2. Comparison of Fixed Income Asset Classes – Q2 2020

Index	Ticker	Average Rating	Effective Duration[1] 2Q2020	Spread (over 10-Year Treasuries) 2Q20	Current Yield 2Q2020	Taxable Equivalent* 2Q2020	Total Return 2Q2020	Total Return YTD
ICE BofA Fixed Rate Preferred Securities	**P0P1**	**BBB2**	**4.50**	**4.84%**	**5.47%**	**6.68%**	**6.95%**	**-2.49%**
ICE BofA Core Plus Fixed Rate Preferred Securities	**P0P4**	**BBB3**	**5.69**	**5.27%**	**5.90%**	**6.93%**	**8.80%**	**-3.39%**
ICE BofA US IG Institutional Capital Securities	**CIPS**	**BBB2**	**4.01**	**4.70%**	**5.33%**	**6.05%**	**9.72%**	**-0.78%**
ICE USD Contingent Capital	**CDLR**	**BB1**	**2.84**	**5.95%**	**6.58%**	**7.18%**	**13.29%**	**-1.75%**
ICE BofA US Corporate	C0A0	A3	8.22	2.85%	3.48%	3.48%	9.27%	4.84%
ICE BofA US Cash Pay High Yield	J0A0	B1	4.20	5.68%	6.31%	6.31%	9.58%	-4.73%
ICE BofA US Current 10-Yr Treasury	GA10	AAA	9.63	NA	0.63%	0.63%	0.67%	12.69%
ICE BofA US Mortgage Backed Securities	M0A0	AAA	2.20	2.58%	3.21%	3.21%	0.81%	3.62%
ICE BofA US Municipal Securities	U0A0	AA3	6.82	3.41%	4.04%	6.82%	2.66%	1.97%
S&P 500	SPX	NA	NA	NA	1.94%**	NA	20.54%	-3.08%

Source: Stonebridge Advisors LLC, ICE Data Services
*Assumes 40.8% Federal Tax Rate, no state tax;
** Dividend yield.
Past performance is no guarantee of future results.
[1] Effective duration – A measure of a fixed-income security's sensitivity to changes in interest rates reflecting the expected change in price given a 100 basis point rise in rates, including the impacts of embedded options.

Issuance:

- **The retail market continues to maintain positive net issuance.** The retail market began the quarter with very little issuance. In fact, there was zero issuance in the month of April. Issuance began to pick up in May with a new deal being announced nearly every other day. The quarter ended with net issuance of $2.2BN and gross issuance of $5BN. There had been concerns about the retail market shrinking not long ago. However, issuance picked up in the first quarter of 2019, and has consistently maintained net positive issuance levels in the following quarters.
- **The institutional market saw its strongest quarter in terms of net issuance since 1Q18.** Similar to the retail market, the institutional market barely saw any issuance at the beginning of the quarter. However, the institutional market saw a new issue announced nearly every day for the last two months of the quarter, bringing it to a net issuance of $14.2BN for 2Q20. The majority of issuance in Q2 came with a USD Treasury reset index as opposed to LIBOR or SOFR[3] (Secured Overnight Financing Rate).
- **The second quarter of 2020 was marked with record low redemptions.** There were only 15 redemptions in both the institutional and retail market combined. The retail market saw $2.9BN in redemptions, while the institutional market saw $6.7BN, and most of these redemptions took place earlier in the quarter. June was the driest with only 4 redemptions in both markets combined.
- **Net new issuance theme expected to continue in second half of year.** We expect banks to continue building up capital ratios in the second half of 2020 through preferred stock issuance. Current market conditions incentivize regional and mid-cap banks to utilize preferred stock to meet regulatory capital requirements, reflected by the significant number of issuers that tapped the markets in Q2. Additionally, we expect to see a number of large deals refinanced, supporting gross issuance totals in the second half.

Investment Outlook

Macroeconomic & Geopolitical Trends:

- **Easing of lockdowns brought a rebound in economic activity.** As governments in the U.S. and Europe lifted economic restrictions, economic activity rebounded off the lows suffered in late March/April. The first major sign of a U.S. rebound came from a surprise employment number for May, when nonfarm payrolls jumped 2.5 million, beating economic consensus forecasts by 10 million. While coronavirus cases have risen in recent weeks, governments are refraining from a return to full lockdowns, erring for selective restrictions. Fatality rates continue to fall despite higher new cases. In our opinion, if the trend of lower fatality rates continues into the second half of the year, we would expect the economic rebound to persist.
- **U.S. elections and BREXIT negotiations garnered more headlines.** The President's handling of the pandemic, the economic slowdown and national protests over racial inequalities continue to dominate headlines, making it harder for the President's campaign to break through. Joe Biden has signaled

[2]The London Interbank Offered Rate (LIBOR) is a benchmark interest rate that banks charge each other for short-term loans.

[3]The Secured Overnight Financing Rate (SOFR) is a measure of the cost of borrowing cash on an overnight basis in the US Treasury repo markets.

his intention to increase corporate taxes and possibly capital gains rates, which could create market volatility heading into the election. On the other side of the pond, there has not been much progress on the EU-UK trade agreement with only 6 months left until the end of the transition period. A no deal BREXIT, combined with COVID-19, could cause a volatile situation for the UK. As a result, we expect some action to be taken.

- **Big OPEC+ supply cuts act as bridge to a more balanced oil market.** Cooler heads prevailed back in April as Russia, Saudi Arabia, and the rest of OPEC+ agreed to a 9.7 million barrel per day production cut through June, which was then extended through July. While COVID-driven demand destruction continues to weigh on markets, the gradual recovery in refined product demand, coupled with the extension of the OPEC+ cuts, have supported a rebound.

Interest Rates & Monetary Policies:

- **Treasury yields were less volatile in the second quarter.** U.S. Treasury yields were little changed in the second quarter. The 10-year Treasury rate, which started the quarter at 0.67%, rose to almost 90 bps in the beginning of June before returning back down to 0.66%. We saw quite a bit of divergence on the front-end of the rates market. While 3-month T-bills stayed just under 0.15% during the second quarter, 3-month LIBOR dropped from 1.45% to 0.30%. Meanwhile, LIBOR's expected replacement, SOFR, started the second quarter at only 0.01% and rebounded to a mere 0.08% at the end of the second quarter.
- **Central banks remain committed to easing.** The extraordinary accommodation provided by central banks around the world has been broad-based, spanning across interest rate cuts to asset purchases and liquidity facilities to support financial market functioning and real economy lending. As we discussed in our last newsletter, we believe that major central banks would not hesitate to employ even more innovative ways to support financial conditions and market liquidity, and that occurred during the second quarter, as the Fed expanded lending to businesses and included various corporate bonds and ETFs in asset purchase programs.

Credit:

- **U.S. banks' credit remains strong during severe economic shock.** The Fed released the results of its annual stress test on the U.S. banking sector in June, which measures each bank's ability to remain well-capitalized during a severe economic downturn. In our opinion, both the results of the stress test and the actions taken by the Fed in response were positive for preferred securities. The limitations placed on the banks include restricting share buybacks during Q3 and capping common dividend payouts, which we believe should ensure meaningful capital retention over the second half of the year. At the same time, the Fed specifically authorized the payments of preferred dividends without restrictions. The Fed also communicated its view that banks are in a strong position to continue paying common dividends, demonstrating how preferred dividends are not even close to being called into question, in our opinion.
- **The ECB continues to support AT1 coupon payments.** Overall, we continue to see strong AT1 coupon-paying capacity and intentions across major European banks. First quarter earnings season and company guidance on loan losses were better than expected, and point to manageable loan losses in the coming quarters, in our view. Our internal stress test on the European banks revealed substantial resources to handle the anticipated increase in loan losses. Following significant regulatory easing measures taken over the past few months, along with restrictions placed on paying common dividends, the ECB communicated the importance of differentiating between AT1 coupons and common dividends. ECB officials commented on numerous occasions that there were no plans to place any constraints on AT1 coupon payments.
- **Energy has recovered, but still has room to run.** Stonebridge continues to take a very selective approach to investing within the energy industry. While our holdings are focused in the largest and best-positioned midstream credits with low direct commodity price exposure, higher oil prices paint an improved volumetric outlook for these companies. Several credit supportive actions were taken by our midstream credits in Q2, including dividend, CapEx, and OpEx cuts. Finally, it is worth noting that we only had one ratings downgrade among our midstream credits during Q2.

Market Structure:

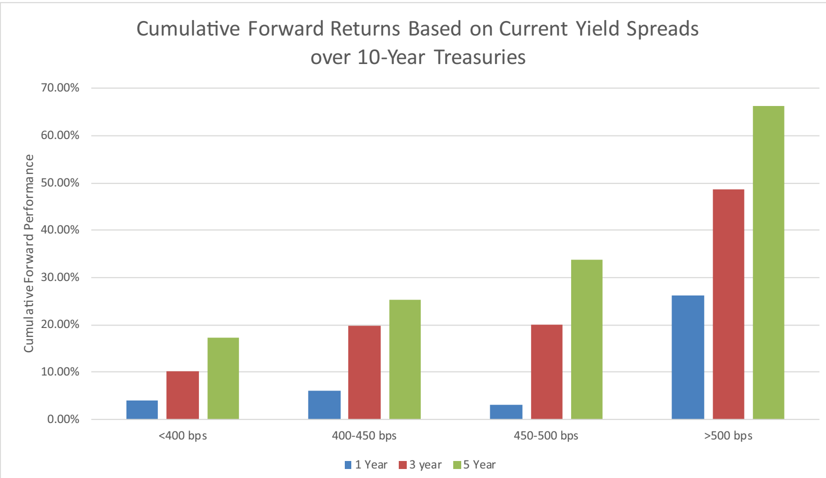
- **Proposal submitted to address legacy U.S. Dollar LIBOR contracts.** The Alternative Reference Rate Committee (ARRC) submitted a proposal to set a spread adjustment to reflect the difference between LIBOR and the new market standard when changing the benchmark index rate. ARRC recommended using the 5-year median spread difference between the two rates, which matches the methodology recommended by participants in the derivatives market.
- **New Issuance represents a shift toward new standard for security structures.** During the second quarter, we witnessed a new market convention for the back-end coupon calculation in variable-rate preferreds that seemed to take hold. Prior to this quarter, there have been a number of unique structures issued as the market searched for the replacement to a LIBOR-based back-end. In the wave of new issuance during Q2, the common theme was a back-end reset rate using the 5-year Treasury yield. Stonebridge views this as a positive development in the preferred market as this was the most attractive structure for investors.

Valuation and Portfolio Positioning:

- **Preferred yield spreads are at historically attractive levels.** As of 6/30/20, the current yield spread over 10-year Treasuries for the ICE BofA Fixed Rate Preferred Securities Index is 484 basis points. Going back to 1996, any time the market achieved a spread wider than 450 basis points, the cumulative return over the next 3-year period—on average—was over 20%. In this extraordinarily low interest-rate environment (that is likely to remain low for an extended period of time), we do believe there is room for spread tightening in our asset class relative to where spreads have trended historically and with the strength of the underlying credit fundamentals (Figure 3).
- **Preferreds offer value over other asset classes.** From a valuation perspective, we believe preferreds offer better relative value in terms of yield and credit quality than most other credit risk asset classes. As shown in Figure 2, the current yield differential between preferreds and investment-grade corporates ranges from 1.85% to over 3%, depending on the market segment of preferreds. Credit ratings for preferred and hybrid securities are lower due

to subordination risk; however, the issuers themselves exhibit similar credit risk as IG corporate issuers. Compared to high-yield securities, the difference in yield ranges from -0.98% for the CIPS index to a gain of +0.27% for the CDLR index, makes us believe investors will take on significantly less issuer credit risk in the preferred and hybrid market than high-yield securities.

Figure 3. Historical Forward Returns Based on Preferred Current Yield Spreads versus 10-year Treasuries



Source: ICE BofA and Bloomberg using monthly data from 12/31/1996-6/30/2020.
Past performance is not indicative of future results.
Preferred Securities are represented by the ICE BofA Fixed-Rate Preferred Securities Index (P0P1) while 10-year Treasuries are represented by GA10. See Index Definitions at the end of this newsletter. Current yield spreads are calculated by comparing the current yield of P0P1 and GA10. Past performance is not indicative of future results and there can be no guarantee historical trends will continue into the future.

- **Active management is critically important in the current environment.** The heightened volatility across financial markets is constantly creating new risks as well as opportunities. We are committed to continually improving the quality of investor portfolios, including strengthening a portfolio in terms of credit quality and security structure, extending duration into securities with longer call protection and sourcing relative value opportunities in both the secondary and primary market. Given the unprecedented nature of the COVID-19 virus outbreak, along with the upcoming presidential elections, we believe it may take 6 months or longer to see normalization in the global financial markets. In the meantime, given the strong credit quality and attractive valuations in the preferred and hybrid securities market, we believe that investors can earn a high current income along with the potential for further appreciation as we wait for an economic recovery.

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.

M0A0 – ICE BofA US Mortgage Backed Securities Index – tracks the performance of U.S. dollar denominated fixed rate and hybrid residential mortgage pass-through securities publicly issued by U.S. agencies in the U.S. domestic market.

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.

SPX - 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.

The second 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.