Stonebridge Preferred Securities
Market Report
Third Quarter, 2020

MARKET RECAP

The preferred and hybrid securities market continued to perform across all market segments during the third quarter of 2020 as the global economy showed signs of improvement versus the prior quarter. The aggressive fiscal and monetary support provided in the U.S. and globally helped to prevent worst-case economic scenarios, although unemployment still remains significantly higher than pre-COVID levels while inflation has been muted. As yields remained very low globally, fund flows increased significantly into the preferred and hybrid securities market, improving market technicals and supporting new issuance. After lagging during the second quarter of 2020, the $25 par retail market was the big outperformer during the period, as investors flocked to passive exchange-traded funds (ETFs) in the space, seeking yield and long duration, fixed-for-life coupon structures. Non-investment-grade (Non-IG) institutional $1000 par securities modestly outperformed $1000 par IG institutional securities during the period, while European bank additional Tier 1 (AT1) securities underperformed. This underperformance largely occurred during the second half of September, as BREXIT fears resurfaced along with an uptick of virus cases in Europe. However, the European Central Bank (ECB) remains very accommodative and European bank AT1s still managed to return over 3% during the period.

The stimulus package passed by Congress during the second quarter of 2020 helped to reduce unemployment and buoy consumer spending in the United States, but Congress remains at an impasse regarding additional stimulus measures. Without further stimulus and the potential for an uptick in COVID-19 cases as the weather gets cooler, there are risks to the economic recovery. However, both political parties have signaled a willingness to compromise in order to pass additional stimulus measures. For its part, the Federal Reserve (the Fed) reassured markets through its commitment to keep short-term interest rates at historically low levels until average inflation hits its 2% target, thereby keeping rates pegged at 0-0.25% for several years and allowing for an inflation overshoot. Furthermore, the Fed remained committed to using whatever tools were necessary to support normal market functioning, liquidity and support to the economic recovery. In Europe, the ECB is expected to remain accommodative and potentially expand its bond-purchasing program. Thus far, the economic contraction in Europe has not been as deep as initially feared, but the ECB remains committed to act as forcefully as needed to support the recovery.

Fund flows into the preferred and hybrid securities market increased significantly during the third quarter as rates remained historically low. Also, net new supply of only $2BN in the retail market helped to support a largely positive market technical. As the 2020 presidential election approaches, there is potential for elevated volatility across financial markets. The polls have remained relatively stable between Donald Trump and Joe Biden, with Joe Biden maintaining a lead of about 6-8 points average nationally. With a large number of votes expected to occur via mail due to the COVID-19 pandemic, results of the election are likely to be announced later than usual and the odds of a contested election are higher than normal. Although this may create pockets of volatility, we generally believe that various policy measures should remain accommodative and support the preferred and hybrid securities market.

Highlights:

- Preferred and hybrid securities ETFs experienced over $1.75 billion (USD) of inflows during 3Q 2020.
- The broad preferred and hybrid securities market (P0P1) closed the quarter trading at 104.56% of par, up over 3.5 points during the period.
- The $25 par retail market (P0P4) was the best-performing part of the preferred and hybrid market in 3Q, returning 5.89% during the period, driven by strong fund flows into passive, retail-only ETFs and limited net supply of only $2BN.
- The Non-IG institutional market (HIPS) returned 4.74% during the period, outperforming IG institutional securities (CIPS) by nearly 40 bps.
- All segments of the preferred and hybrid market have rebounded from their March lows, but still remain lower YTD by about 1-8 points from a price perspective.
- The issuance market was very strong in 3Q, with $29BN in new issuance and net supply totaling $18BN.
- The Treasury yield curve modestly steepened during the period, as the 2-year/10-year spread widened to 55 basis points (bps), with short-term rates remaining extremely low.
- 3-Month LIBOR hit all-time low levels during the quarter, ending the period at 23 bps.
- Current yield spreads of preferred and hybrid securities (P0P1) versus 10-year Treasuries (GA10) decreased by 23 bps during the period to end at 461 bps, which remains at an historically wide level.

Issuance:

- **YTD gross issuance is up 26% compared to last year.** At this time last year, gross preferred & hybrid issuance was at $68.5bn while this year we have already reached $85.8bn. This is nearly equal to the entire gross issuance from all of 2019. The boost in this year's issuance mainly comes from institutional preferreds, which are up 44% compared to last year at this time. The retail market continues to see positive net issuance as well, but thus far its gross issuance is down 9% compared this time last year.

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- **The third quarter was marked by a sharp increase in refinancing & opportunistic issuance.** This was plainly noticeable in the retail market where nearly every issuer announced a redemption shortly after coming to the market with a new deal. The third quarter also witnessed a diverse array of issuers and multiple new deals from the same issuer in some cases. This allowed issuers to further take advantage of lower financing costs.
- **New issue coupons continue to gradually trend lower.** As expected in current market conditions, new deals continue to price tighter. The tightening, however, has been progressing at a relatively steady pace. Although four new deals came to the market priced with high 3% coupons in 3Q, the average coupon of new deals in the preferred & hybrid space is still well above 5%. In 2019, the average coupon of new deals was at 6%, therefore showing that coupon spreads on new deals versus Treasuries have actually increased this year despite the tightening.
- **Current issuance trend should continue over the next few months.** The robust trend in gross supply should remain consistent as issuers continue to refinance and take advantage of low rates. With $6.4bn already set to be redeemed over the next few weeks and a large number of deals with high coupons becoming callable by year-end combined with a low-rate environment, we expect net issuance to remain relatively flat.

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, we have seen economic activity rebounding off the lows suffered in late March/April. Economic data continues to show positive trends in jobless claims and consumption, but both still remain well off pre-COVID-19 levels. Governments are refraining from implementing stricter lockdowns in spite of rising COVID-19 case numbers with select states lifting all restrictions, but fatality rates continue to fall. In our opinion, if the trend of lower fatality rates continues into the fourth quarter, we would expect politicians to resist reinstituting economic lockdowns. However, uncertainty still remains in the U.S. regarding both the impact on COVID-19 cases from states loosening restrictions and additional government stimulus.
- **U.S. elections and BREXIT negotiations remain key market risks.** The U.S. elections should dominate the geopolitical landscape throughout most of the remainder of the year, particularly if the results are contested. Ballot counting alone could leave the winner unknown for a number of weeks, and a contesting of results could extend well beyond that timeframe. In our view, a concession from either candidate could be enough for risk assets to rally for the remainder of the year. In Europe, there are signs of progress on the EU-UK trade agreement with less than 3 months left until the end of the transition period, but uncertainty remains high. A no deal BREXIT combined with COVID-19 could cause a volatile situation for both the UK and the EU, so we continue to expect some form of an agreement as the base case.
- **In spite of lagging demand, OPEC+ messages continued market support.** With lagging gasoline, diesel, and jet fuel demand, oil prices have retreated from their post-COVID-19 highs in late-August. And while there are recent signs of some OPEC+ production cheating among a few countries, Saudi's oil minister issued a warning to bearish oil speculators, saying 'We will never leave this market unattended' and that they would be 'proactive and preemptive' in response to lower prices. This makes clear the hint that OPEC+ could extend production cuts that would be supportive of the oil market supply/demand balance.

Interest Rates & Monetary Policies:

- **Treasury yields both rallied and tried to break out in the third quarter.** U.S. Treasury yields were little changed in the third quarter. However, while the 10-year Treasury rate started at 0.66% and averaged 0.64% during the quarter, the range was wide at 0.50% to 0.79%. Treasuries rallied into early August, but then sold off for a few weeks. Just when speculation rose that yields could break out higher, volatility dropped, and the 10-year rate ended the quarter only 2 bps higher at 0.68%. The front-end of the rates market settled down in the third quarter after quite a bit of movement in the prior quarter. 3-month T-bills dropped 6 bps to 0.09%, 3-month LIBOR[1] dropped 7 bps to 0.23% and LIBOR's expected replacement, SOFR[2] (Secured Overnight Financing Rate), was flat at 0.08%.
- **Central banks stayed the course during the third quarter.** Central banks continued the extraordinary accommodation announced earlier in the year. The one major policy change was the Fed's decision to allow inflation to overshoot the 2% target by shifting to a 2% average over time instead of a specific 2% target. The ECB kept policy unchanged in the September meeting, but expectations are rising for an increase in asset purchases by the December meeting. The Fed's shift in inflation policy has placed pressure on the ECB to follow a similar objective.

Credit:

- **U.S. banks' credit continues to hold up well.** U.S. banks have held up well despite taking record reserves against potential future loan losses during the first half. U.S. banks were able to build significant loan loss reserves and maintain solid capital ratios, while over 75% of U.S. banks still beat consensus earnings estimates. Due to the unprecedented times, the Fed is running a second stress test on the U.S. banking sector in Q4 using updated economic inputs since the test in June. We do not anticipate significantly different results compared to the June release. The Fed also decided to extend the capital

[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 US Treasury repo markets.

action limitations on the banking sector, which includes restricting share buybacks during Q4 and capping common dividend payouts. At the same time, they specifically authorized the payments of preferred dividends without restrictions. These actions should be supportive of the preferred market as they will ensure meaningful capital retention with very little risk towards the preferred dividends, in our opinion.

- **European banks had a solid 2Q earnings season with positive signals for 3Q.** Overall, we continue to see strong AT1 coupon-paying capacity and intentions across major European banks. Second quarter earnings season was better than expected, with ~70% of banks beating consensus earnings estimates. Loan losses and capital ratios were better than expected as well. More recently, numerous European banks have communicated consistent-to-improved loan loss guidance in the third quarter. Recall that the ECB communicated during the second quarter the importance of differentiating between AT1 coupons and common dividends, with ECB officials commenting on numerous occasions that there were no plans to place any constraints on AT1 coupon payments. This position did not change during the third quarter, and restrictions could actually ease by year-end. According to Bloomberg, "Several members of the ECB's supervisory board, who supported initial requests that banks forgo dividends, see further extensions of the ban doing more harm than good."
- **Strong 2Q Midstream results highlight cash flow resiliency and attractive relative value.** Stonebridge continues to take a very selective approach to investing within the energy industry, focusing our holdings in the largest, most diverse and least commodity-priced exposed Midstream Energy credits. Only one of our Midstream Energy credits has experienced any credit ratings downgrades YTD. Several credit supportive actions were taken by our Midstream credits in 2Q, including dividend, CapEx, and OpEx cuts. In an historically difficult quarter during 2Q, our Midstream credits beat EBITDA consensus expectations by 5%+ on average, demonstrating the resiliency of their cash flows and lack of any material exposures to distressed E&Ps. Given the underlying fundamental stability shown in 2Q, we see attractive value in our Midstream securities trading at 80.8% of par on average.

Market Structure:

- **Continued progress on LIBOR transition, but major decisions still loom.** The Alternative Reference Rate Committee (ARRC) has continued to solicit investor feedback as it tries to ensure the transition goes as smoothly as possible. We have seen a number of proposals submitted by the ARRC on how to handle various issues with legacy LIBOR products, and we would expect to see some developments related to these proposals in the fourth quarter. Additionally, the derivatives market will officially make the shift to using SOFR as the floating-rate benchmark for all cleared swaps on October 16th.
- **New issuance continues shift towards new standard for security structures.** During the third quarter, we continued to see new issuance using the 5-year Treasury rate for the back-end coupon calculation on variable rate preferreds. There have been a number of unique structures issued over the past year as the market searched for the replacement to a LIBOR-based back-end, but the 5-year Treasury reset seems to have taken hold as the standard market conventional structure. Stonebridge views this as a positive development in the preferred market as this was the most attractive structure for investors.

Valuation and Portfolio Positioning:

- **Yield spreads of preferreds remain at historic wides.** As of 9/30/20, the current yield spread over 10-year Treasuries for the IC BofA Fixed Rate Preferred Securities Index was at 461 bps. Going back to 1996, any time the market achieved a spread wider than 450 bps, the cumulative return over the next 3-year period on average was over 20%. In this extraordinarily low interest rate environment, coupled with strong issuer credit fundamentals, we believe there is room for spread tightening in preferreds relative to where spreads have trended historically.
- **Preferreds offer incremental yield over other asset classes.** On an absolute and taxable equivalent basis, we believe preferreds offer better relative value than most other credit risk asset classes. As shown in figure 1, the absolute yield pick up in preferreds over other investment-grade rated asset classes ranges from 1.25% 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 incremental yield of preferred securities.

Figure 1. Yield Comparison of Preferreds vs Other Asset Classes – Q3 2020

Index	Ticker	Average Rating	Effective Duration[1] 3Q2020	Spread (over 10-Year Treasuries) 3Q20	Current Yield 3Q2020	Taxable Equivalent* 3Q2020	Total Return 3Q2020	Total Return YTD
ICE BofA Fixed Rate Preferred Securities	**P0P1**	**BBB2**	**3.95**	**4.61%**	**5.24%**	**6.34%**	**4.90%**	**2.30%**
ICE BofA Core Plus Fixed Rate Preferred Securities	**P0P4**	**BBB3**	**4.58**	**5.02%**	**5.65%**	**6.58%**	**5.89%**	**2.30%**
ICE BofA US IG Institutional Capital Securities	**CIPS**	**BBB2**	**4.28**	**4.44%**	**5.07%**	**5.76%**	**4.38%**	**3.56%**
ICE BofA USD Contingent Capital	**CDLR**	**BB1**	**3.03**	**5.75%**	**6.37%**	**7.16%**	**3.90%**	**2.08%**
ICE BofA US Corporate	C0A0	A3	8.33	2.77%	3.39%	3.39%	1.69%	6.62%
ICE BofA US Cash Pay High Yield	J0A0	B1	3.95	5.36%	5.98%	5.98%	4.72%	-0.23%
ICE BofA US Current 10-Yr Treasury	GA10	AAA	9.64	NA	0.63%	0.63%	0.04%	12.73%
ICE BofA US Mortgage Backed Securities	M0A0	AAA	2.34	2.46%	3.09%	3.09%	0.11%	3.74%
ICE BofA US Municipal Securities	U0A0	AA3	6.78	3.36%	3.99%	6.74%	1.19%	3.18%
S&P 500	SPX	NA	NA	NA	1.76%**	NA	8.93%	5.57%

Source: Stonebridge Advisors LLC, ICE Data Services as of 9/30/2020 *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.

- **Risk adjusted returns for preferred securities are better than investment-grade and high-yield bonds.** On an absolute and risk-adjusted basis, preferreds have been the top-performing credit based asset class, topping both investment-grade and high-yield corporate bonds over the past 10-years (figure 2). Preferreds have accomplished this with a lower correlation to equities than high yield. We believe the similarly high credit quality and incremental yield of preferreds versus other investment-grade corporates contributes to the higher rate of return over time.

Figure 2. Risk Adjusted Returns of Preferred Securities vs Other Credit Based Asset Classes

Benchmark	Total Return (as of 09/30/2020)				Standard Deviation				Sharpe Ratio
	1YR	3YR	5YR	10YR	1YR	3YR	5YR	10YR	10YRS
Preferreds (P0P1)	4.34%	4.97%	6.16%	6.29%	11.50%	7.76%	6.56%	5.70%	1.11
IG Corporates (C0A0)	7.84%	6.38%	5.96%	5.14%	10.68%	6.89%	5.80%	4.98%	1.00
High Yield (J0A0)	2.35%	3.84%	6.61%	6.26%	14.92%	9.23%	8.03%	7.04%	0.89

Source: Bloomberg and Stonebridge Advisors LLC as of 9/30/2020

Past performance is no guarantee of future results.

- **Active management is critically important in the current environment.** With the uncertainty due to macro conditions highlighted above, Stonebridge is committed to protecting investor portfolios against near-term risks, while also positioning for future outperformance. Our focus is on improving the quality of investor portfolios, including strengthening the holdings in terms of credit and security structure, while also positioning for the possibility of interest-rate volatility post the U.S. elections. We are finding value across the entire universe of preferreds, including both the $25 par exchange-traded and $1000 par over-the-counter markets and strive to make portfolio adjustments as opportunities are presented. We believe the secondary market will likely find technical support from investor inflows and limited new issue supply over the next 3 months. Attractive valuations, combined with high-yields and strong issuer credit fundamentals will likely drive outperformance of preferreds compared to other asset classes, in our opinion.

Source: ICE Data Services and Bloomberg using monthly data from 12/31/1996-9/30/2020.

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 below. 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.***

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.

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The third 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.