Stonebridge Preferred Securities
Market Report
Fourth Quarter, 2020

Highlights

- All segments of the preferred and hybrid securities market were positive during 4Q2020, led by outperformance in Non-IG securities as spreads between IG and Non-IG securities compressed significantly.
- The $25 par retail market continued to be supported by strong inflows into passive, retail-only exchange-traded funds (ETFs) and limited net supply.
- The average new issuance coupon in 2020 was 5.40%, with a median of 5.25% and a record breaking $60.60bn in net issuance. Issuers took advantage of lower rates through refinancing, which is a theme we expect to continue over the next few months.
- In spite of some recent tightening of lockdowns in the U.S. and UK, positive economic catalysts loom for 2021. We have lowered our forward assessment of geopolitical risk with the U.S. elections and BREXIT falling back into the rearview mirror. OPEC+ continues to be very supportive of oil prices.
- We remain constructive on our credit outlooks across the major sectors/issuers in the preferred market.
- There were positive developments on LIBOR[1], as regulators extended the discontinuation deadline from year-end 2021 to June 2023.
- Current yield spreads of preferred and hybrid securities versus 10-year Treasuries (GA10) decreased by 50 basis points (bps) during the period to end at 458 bps, which remains at a historically wide level.
- The Treasury yield curve continued to steepen during the period, as the 2-year/10-year spread widened to 79 bps, with short-term rates remaining extremely low. Treasury Curve steepening has historically resulted in higher cumulative returns for preferreds.
- Preferreds continue to offer incremental yield pickup of at least 1.5% over other investment-grade asset classes.

MARKET RECAP

The preferred and hybrid securities market tightened significantly across all market segments during the fourth quarter of 2020 as several vaccine candidates showed significant efficacy in preventing the COVID-19 virus. This breakthrough generated optimism for an economic recovery in the second half of 2021 and served as a catalyst for beta compression within the preferred and hybrid securities market, as industries most affected by the pandemic outperformed. Central banks around the globe continued with their pledge for accommodative policy, with the European Central Bank (ECB) pumping an additional $600bn into its asset purchasing program and the Federal Reserve (the Fed) maintaining its willingness to overshoot on inflation to reach a long-term average level of 2%. Although employment and economic data seemed to level off in the fourth quarter compared to a strong rebound in 3Q2020, low yields and tighter spreads drove fund flows into the preferred and hybrid securities market, improving market technicals and supporting new issuance. Non-investment-grade (Non-IG) institutional $1000 par securities outperformed $1000 par investment-grade (IG) institutional securities during the period, as spreads between IG and non-IG securities compressed significantly. The $25 par retail market returned nearly 5% during the fourth quarter as strong fund flows pushed prices higher. Meanwhile, European bank additional Tier 1 (AT1) securities were the second best-performing market segment due to a combination of their relatively high yields, supportive monetary policy and a BREXIT deal between the United Kingdom (UK) and the European Union (EU) in late December.

After months of negotiations and political posturing, Congress passed a $900bn stimulus package in December, which included a $600 direct payment to qualified individuals. This was largely expected by markets and helped support investor sentiment as the stimulus was viewed as a bridge to the vaccine. Moreover, the November elections in the U.S. were received positively by markets, as Joe Biden defeated Donald Trump and avoided a close, contested election, and the slim Democratic majority in congress should reduce the likelihood for significant changes to tax policy and regulations. Furthermore, the Fed remained committed to sustained dovish policies, pledging to keep short-term interest rates near 0% for several years while continuing its bond buying program. We believe the global backdrop of low yields and stimulative fiscal policies, along with the vaccine rollout, should help drive continued risk appetite for investors and further beta compression.

Fund flows into the preferred and hybrid securities market continued to be strong during the fourth quarter of 2020 as investors flocked to higher yielding asset classes. As spreads compressed during the period, interest in preferred securities increased due to their relatively high yields, potential tax advantages due to QDI eligibility for qualified securities and strong credit fundamentals across the issuer base. Although interest rates crossed the 1% threshold for the first time in months after the conclusion of the Georgia Senate races, spreads remain at historically wide levels and could serve as a cushion against volatility unless rates move materially higher.

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

Issuance

- **The average new issuance coupon in 2020 was 5.40%, with a median of 5.25%.** When compared to 2019, which had an average new issuance coupon of 6.09%, the preferred securities market only saw a decrease of 69 bps. Meanwhile, the 10-Yr USD Treasury yield saw a 100 bps decrease in 2020. Although there were some deals that priced at record lows, the majority of new issuance in both the retail and institutional markets were priced at attractive levels, showing that the preferred securities market retains its ability to invest at attractive yields.
- **The retail market saw another year of growth, while the institutional market saw record high issuance.** Although the retail market ended the fourth quarter with net issuance of -$462k, it still managed to end the year with $6.14bn in positive net issuance. This is a significant decrease from the previous year, but it marks the second consecutive year of positive net issuance. The institutional market, on the other hand, saw net issuance of $14.27bn for the fourth quarter and $54.46bn for the year, which is a 343% increase from 2019.
- **Issuers took advantage of lower rates through refinancing, which is a theme we expect to continue over the next few months.** One of the major themes seen in 2020 was refinancing, especially in the retail market. The refinancing theme took off further in the second half of the year where nearly every new issuance, especially from frequent issuers, was for refinancing purposes. We also noticed new issuers coming into the preferred space, especially on the retail side, which helped retail maintain a positive net issuance for the year. Additionally, we continued to see issuers moving away from LIBOR and SOFR[2] based back-end reset indexes and moving towards Treasury-based resets. With rates remaining low, 2021 may be like 2020 where issuers will continue to take advantage of lower rates by refinancing higher coupon issues. Net supply may stay relatively flat over the next few months as a result.

Investment Outlook

Macroeconomic & Geopolitical Trends:

- **Positive economic catalysts loom.** In spite of some recent tightening of lockdowns in the U.S. and UK, positive economic catalysts loom for 2021. As companies ramp up their vaccine production, we expect lockdowns to ease and economic data to return to more normalized levels. This sentiment is reflected by the rising U.S. Manufacturing PMI data, which reached the highest level since September 2014 in the final December report. Additionally, the Democrats' Senate victories in Georgia provide optimism for further stimulus and infrastructure spending in the U.S., creating a strong environment for the Financials, Energy, REIT and Utilities sectors. Uncertainty still remains with some short-term headwinds, but in Stonebridge's opinion, the 2021 outlook is positive for the economy and in particular, the main preferred issuer sectors.
- **U.S. elections and BREXIT fall back into the rearview mirror.** The uncertainty of the U.S. elections lifted over the course of the fourth quarter, but not until the Georgia Senate runoff and Presidential Electoral College voting were concluded in the first week of 2021. Over in Europe, the 4½ year BREXIT drama finally drew to a close, with the EU and UK finally agreeing on a trade agreement on December 31st. With these two political overhangs subsiding, we lower our forward assessment of geopolitical risk.
- **OPEC+ continues to be very supportive, pushing oil prices up to a 10-month high.** As we wait for the vaccine roll out to boost gasoline, diesel, and jet fuel demand, it is crucial to the global oil supply/demand market balance that OPEC+ stays vigilant in their supply cuts. Last week's OPEC+ meeting to decide on February production output plans confirmed this stance. In an unexpected move, Saudi Arabia actually took a voluntary cut of an additional 1 million barrels/day in February and March, while allowing Russian production to go up 65k barrels/day. This was a completely unexpected and a positive development that pushed WTI prices up above $52, a 10-month high.

Interest Rates & Monetary Policies:

- **Treasury yields rose modestly in the fourth quarter.** The 10-year Treasury rate started at 0.68%, ended at 0.91% and averaged 0.85% during the fourth quarter. There were moments when the 10-year tried to break north of 1.00%, but the highest it reached during the quarter was 0.975%. It was not until 2021 began that the 10-year yield was able to breach 1.00%. Meanwhile, the front-end of the rates market remained anchored in the fourth quarter. 3-month T-bills dropped ~3 bps to 0.07%, 3-month LIBOR rose less than 1 bp to 0.24% and LIBOR's expected replacement, SOFR, fell 1 bp to 0.07%. We see justification for the consensus view of a modest rise in interest rates.
- **Central banks took additional actions during the fourth quarter.** The ECB grabbed the central bank spotlight during the fourth quarter by adding €500bn to its asset purchase program and extending the timeframe by nine months until at least March 2022. The ECB also enhanced a number of other pandemic-related measures and lending facilities. In the U.S., the Fed held its currently accommodative course. We do not expect meaningful changes or announcements from the Fed or ECB during the first quarter of 2021.

Credit:

- **U.S. bank credit continues to hold up well.** The majority of U.S. banks remained profitable despite taking record reserves against potential future loan losses during the first half. The strong performance continued through 3Q earnings, with over 90% of banks beating consensus EPS while median capital ratios increased from year-end. Due to the unprecedented times, the Fed ran a 2nd stress test on the U.S. banking sector in 4Q using updated economic inputs from the June test. The results were a positive surprise, as the Fed determined that the banks are in a strong enough position to restart share

[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.

buybacks in 1Q21. There is still a significant amount of uncertainty related to the economy but the stress test demonstrates the banks are well capitalized with solid reserves, putting them in a good position to weather future loan losses, in our opinion.

- **European banks reported two consecutive solid earnings quarters, and can reinstate common dividends.** In Europe, over 80% of European banks beat consensus estimates when reporting 3Q20 results during the fourth quarter, following a similarly solid 2Q20 earnings season. Loan loss provisions fell by ~60% from 2Q20 and core equity tier 1 ratios jumped by almost 50 bps to 15.2% on average. The performance was inline with what we suspected would happen over the course of the year. As expected, the ECB allowed European banks to reinstate common dividends in '21 with some limitations. In our view, dividend reinstatements with limitations is the best case outcome for the credit profiles of European banks.
- **Strong 3Q 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 in 2020. Several credit-supportive actions taken by our Midstream credits in 2020 included dividend, CapEx, and OpEx cuts. On average, our Midstream Energy credits' 3Q20 EBITDA was up 2.5% Y-O-Y, beating expectations by ~6%, with all companies reaffirming/increasing FY20 guidance. We continue to see pockets of opportunity in the preferred securities market amid underlying fundamental stability and positive trends in the energy markets.

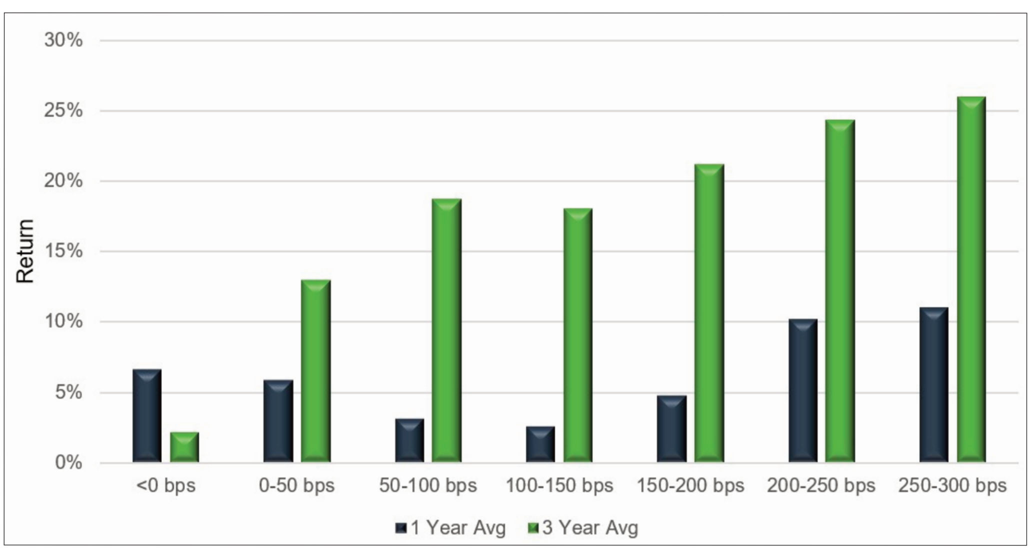
Market Structure:

- **Positive developments on LIBOR transition.** During the fourth quarter, regulators announced USD LIBOR rates will continue being published through June 30, 2023, an extension from the original end date of December 31, 2021. Market participants will still have to stop writing new LIBOR-based contracts by the end of 2021, but the rate will continue to be published for existing securities. In our opinion, this development is highly constructive for the preferred securities market, as it gives more time to address shortcomings in the fallback language of LIBOR-based deals. Additionally, there is a proposed bill in the state of New York that would allow for use of a replacement rate as the commercially substantial equivalent to LIBOR. This would allow for a seamless transition on securities written under New York law that don't have replacement language. We see the potential for the bill to be expanded to the federal level to address all securities.

Valuation and Portfolio Positioning:

- **Yield spreads of preferreds remain at historic wides.** As of 12/31/20, the current yield spread over 10-year Treasuries for the preferred securities market, as represented by the custom blend index*, over 10-year Treasuries (GA10) was 458 bps. 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%.
- **Preferreds have historically performed well in rising rate environments.** Our outlook for interest rates is for gradual steepening of the U.S. Treasury yield curve as the COVID-19 vaccine is rolled out globally and economic activity likely picks up. Although we may experience some initial weakness in preferreds as a result of moving higher on the long end of the Treasury curve, historically preferreds have demonstrated positive forward returns when the 2s/10s curve differential steepened. The current 2s/10s curve differential is 79 bps, which historically has indicated positive forward returns for the next 3 years. The average 3-year forward return for preferreds was 18.70% when the 2s/10s curve was 50-100bps (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 - 12/31/2020.

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).

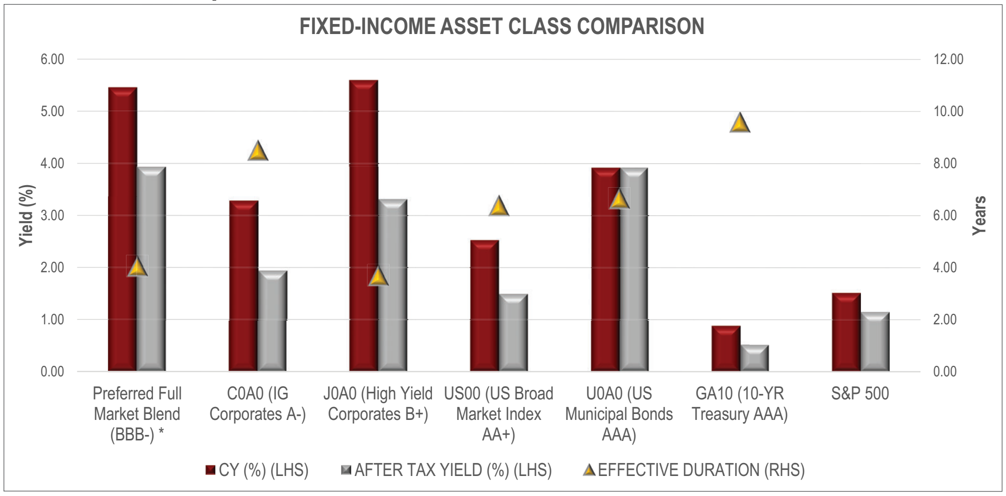
See Index Definitions on last page

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.**

*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.

- **Preferreds offer incremental yield over other asset classes.** We believe preferred securities offer better relative value than most other credit risk asset classes. As shown in figure 2, the absolute yield pick up in preferreds over other investment-grade rated asset classes ranged 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.

Figure 2. Yield Comparison of Preferreds vs Other Asset Classes



Source: Stonebridge Advisors LLC, ICE Data Services, Bloomberg L.P. as of 12/31/2020.

*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.** We firmly believe that active management will have an important role in portfolio positioning and performance in 2021 as we face inflationary pressures and the potential for an economic recovery that could lead to higher interest rates. An economic recovery will be positive for credit and continue to support beta compression in the market, but higher rates could result in initial near-term 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 3-7 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 also modestly increased our cash weighting across strategies coming into year-end in anticipation of potential volatility and to take advantage of opportunities as they arise in both the primary and secondary market. We continue to believe the secondary market will likely find technical support from investor inflows and limited net new supply as refinancing continues. In our opinion, attractive valuations combined with high yields and strong issuer credit fundamentals will likely drive outperformance of preferreds compared to other asset classes.

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 fourth 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.