STONEBRIDGE
Advisors LLC

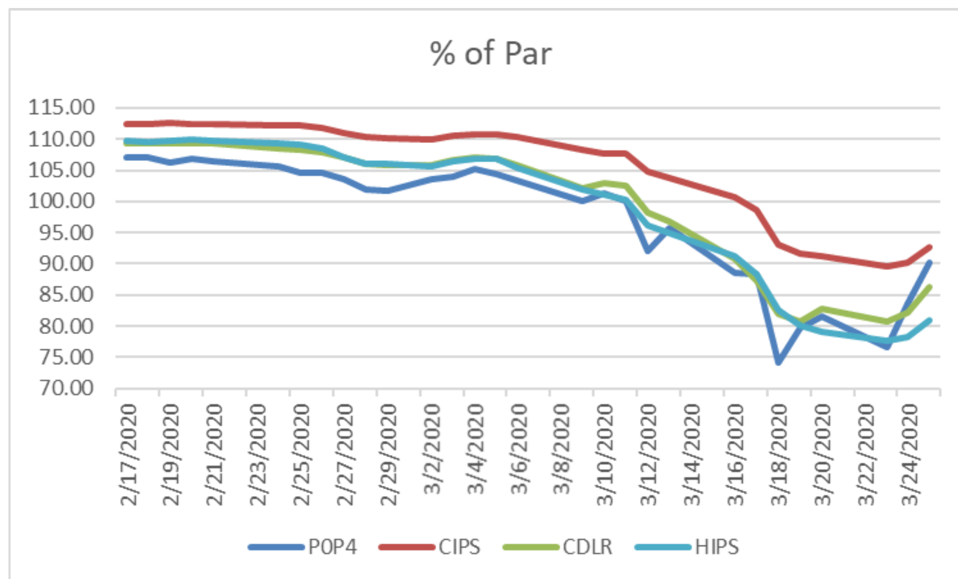
Stonebridge F.A.Q. on the Preferred & Hybrid Securities Market, March 27, 2020

Summary

- **The increase in market volatility has created opportunities across each segment of the preferred and hybrid securities market.**
- **Stonebridge is actively re-positioning to improve overall quality and modestly increasing duration of portfolios.**
- **Stonebridge believes that the banking industry entered this downturn in a position of strength and faces little risk of preferred securities dividend deferrals.**
- **Higher risk sectors remain a very small component of the overall preferred and hybrid securities market.**

How has each segment of the preferred and hybrid securities market performed since the COVID-19 outbreak?

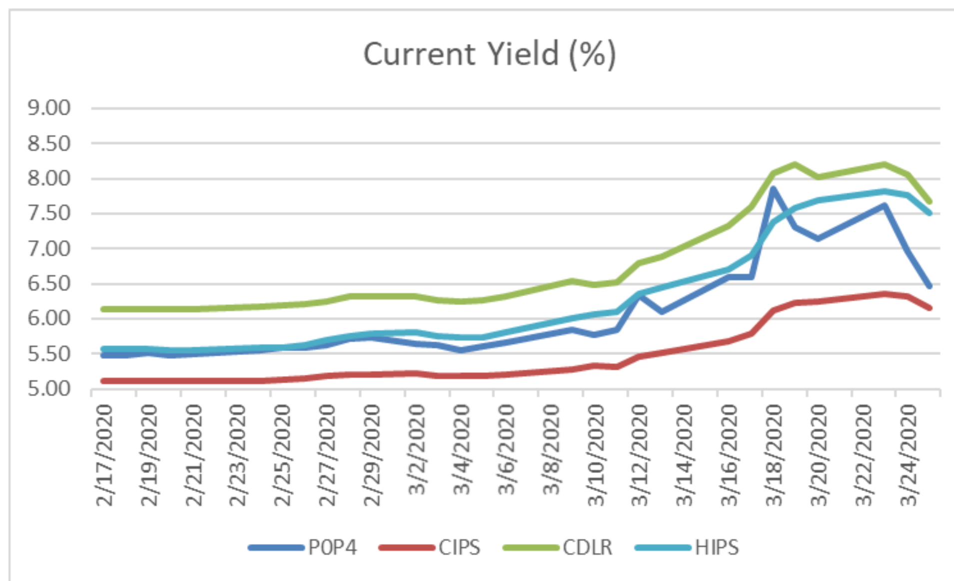
We have seen large dislocations between the $25 par retail market (P0P4), the IG institutional market (CIPS), the non-IG institutional market (HIPS), and the non-US AT1 contingent convertible capital market (CDLR), or CoCos, since the market highs in mid-February. As shown in the graph below, the IG institutional market has outperformed the other market segments significantly. The $25 par retail market has been the most volatile market segment, suffering the steepest losses and recovering sharply. Meanwhile, Cocos and non-IG institutional securities have lagged the recovery from the lows after selling off significantly in mid-March. These valuation dislocations are likely to continue as buying and selling has largely been one-directional on any given day over the past few weeks.



Source: ICE BofA and Stonebridge Advisors, LLC

Where are yields trading in each market segment of the preferred and hybrid securities market?

Yields have widened significantly across the entire preferred and hybrid securities market, ranging between 80 basis points (bps) to 155 bps of widening by market segment from 2/17 (market highs) through 3/25. The CoCo market has experienced the greatest widening and now offers yields north of 7.5% as of 3/25 close. Also, prior to the sell-off, the current yield spread of IG vs non-IG institutional securities was only 10 bps. This has ballooned to over 100 bps as of 3/25.



Source: ICE BofA and Stonebridge Advisors, LLC

Is Stonebridge re-positioning its portfolios in light of the COVID-19 economic disruption?

Much has changed over the past 6 weeks and Stonebridge is actively managing its portfolios accordingly. We have been taking the following actions and will look to continue to do so going forward:

- Improving the credit quality of the portfolios and focusing on the sectors and issuers that we believe should be most resilient during this recessionary period. We continue to favor larger, higher-quality banks, property & casualty and diversified life insurers and high-quality utilities.
- Reducing exposure to industries that we believe will be most impacted from the COVID-19 outbreak and identifying idiosyncratic risks in the portfolios. This includes mortgage real estate investment trusts (REITs), master limited partnerships (MLPs) and retail property-exposed REITs.
- Focusing on what we believe are the best structures within the preferred and hybrid securities market. The vast majority of the market was trading at a premium prior to the crisis, with most securities pricing to their first call dates. Nearly all securities are now trading at a discount, which requires evaluating securities to perpetuity. Moreover, the LIBOR* forward curve has moved sharply lower. Fixed-for-life structures along with high reset fixed-to-float securities should be more defensive in this environment, in our view.
- Extending duration and favoring securities with longer call protection as interest rates are likely to be lower for longer in light of the massive central bank intervention globally.
- Opportunistically taking advantage of market dislocations as higher than average volatility in the market has created pricing discrepancies between industries as well as market segments, including the retail, US institutional, and non-US institutional markets.
- Increase cash balances modestly in order to help protect against potential outflows or take advantage of opportunities that may present themselves. We want to avoid being a forced seller in this market as much as possible.

- Improving liquidity in the portfolios by focusing on adding larger, well-followed issuers that have a large, diverse buyer base. Liquidity has been challenged at times during the COVID-19 sell-off and we would like to remain as nimble as possible.

What is the latest news in the banking industry?

Overall, we continue to see strong preferred dividend/coupon paying capacity across both U.S. and European banks. Banks are the largest industry within the Preferred & Hybrid Securities market. There are a few observations we highlight in the banking industry over the past week:

- **Regulatory actions continue to be helpful to banks and countercyclical:** The most recent regulatory action was within the CARE Act bill, which allows U.S. banks to suspend requirements under GAAP for loan modifications, as well as temporarily delay the new loan loss reserving methodology that is in the midst of being implemented this year. The European Central Bank (ECB) is taking similar actions on the new reserving methodology for European banks. These actions provide relief from potentially rigid and pro-cyclical loan loss reserving requirements.
- **Expect a more moderate pace of loan loss reserve increases:** It is important to understand the process that banks follow for loan loss reserving. Individual loans go through a progression from delinquency, perhaps modification, to potentially an actual default. There are different reserving requirements for these various categories. We do not foresee the abrupt halt in economic activity leading to a broad swath of abrupt defaults. This, along with regulatory relief actions, leads us to anticipate a more moderate increase in loan loss provisions over the first and second quarters, and the risk of materially higher provisions might not occur until later in the year. In the meantime, should the coronavirus outbreak ease and economic activity improves, regulatory relief actions will have smoothed the process of reserving to mitigate major earnings hits.
- **Banks are conserving capital in the meantime:** While the outcome noted above is certainly manageable, the risk of a more prolonged downturn exists. We note a trend this week of more bank and regulatory announcements towards retaining capital through halting stock buyback programs and reviewing common dividend plans. As we discussed in our other market updates, banks are in a solid position heading into this economic downturn, with record capital levels and strong earnings. We view the halting of stock buybacks and potential common dividend reductions as prudent and positive for bank credit profiles and preferred securities. We expect any dividend changes to be specific to common dividends, not preferred dividends. We note that no banks that we follow have even hinted to altering preferred dividend payments.
- **There are some positives in the news for banks:** We also note that not all trends are negative. For example, Bloomberg reported that JPMorgan's equity derivatives desk has achieved $1.5bn of revenue so far this year. We expect a mixed bag in trading revenues looking forward with pockets of increased activity and revenue.
- **The debt markets are open and credit spreads are tightening:** The primary debt issuance market has opened, and banks are issuing. We view this development positively, along with a tightening in bank credit spreads this week. We observe average bank credit spread tightening of 60-70 bps across 10-year senior and subordinated debt.

What is the latest news in the insurance industry?

Insurance is the next largest industry segment in the Preferred & Hybrid Securities market.

- **Exposures are manageable:** News flow has been relatively light. Most comments from companies have focused on exposures within investment portfolios in light of market volatility. We view exposures as manageable for the large majority of the issuers we follow.
- **Insurers face fewer capital management pressures:** Insurance companies face less pressure or need to address stock buyback programs or common dividend plans.
- **The primary debt issuance market has opened, and insurers are issuing.** We observe average insurance credit spread tightening of 30-40 bps across 5-30-year senior debt.

What is the latest news in the utilities industry?

Utilities comprise the third largest industry segment in the Preferred & Hybrid Securities market.

- **Relative exposure remains limited:** News flow remains quite light. In our view, utility exposure to demand weakness caused by COVID-19 is limited. The majority of utilities that we follow have mostly, if not fully, regulated business models with regulatory mechanisms that protect cash flows from demand volatility.

What has Stonebridge observed in higher risk sectors?

- *Energy:* Stonebridge continues to take a very selective approach to investing within the energy industry. While midstream energy preferred security prices have been correlated with oil, direct commodity exposure at the underlying midstream companies remains limited. The bigger concern for the midstream companies that we follow is volumetric exposure to overall U.S. crude production, for which we do not anticipate the risk of a material decline until later in 2020 or 2021.
- *Mortgage REITs:* There was a sharp sell-off in mortgage REITs after a wave of negative headlines about unmet margin calls and dividend suspensions across a number of companies. Mortgage REITs faced a very difficult operating environment recently, triggered by tighter financing across the short-term repo markets. Mortgage-backed security (MBS) market conditions led to a spike in collateral requirements at the same time as market liquidity dried up, leaving certain mortgage REITs unable to fund margin calls. This led to a small number of announced dividend suspensions. In response to mortgage market conditions, the Federal Reserve expanded their purchasing of Agency MBS, which has brought signs of stability to the MBS market.

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Please note: All opinions expressed constitute judgements as of the date of release and are subject to change without notice. There can be no assurance any forecasts will be achieved.

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

Index Definitions:

P0P4 - ICE BofA Core Plus Fixed Rate Preferred Securities Index – tracks the performance of fixed-rate US dollar denominated preferred securities issued in the US domestic market. This index is comprised of 100% retail securities and does not require securities to be investment-grade rated.
CIPS – ICE BofA US IG Institutional Capital Securities Index – tracks the performance of US dollar denominated investment grade hybrid capital corporate and preferred securities publicly issued in the US domestic market.
GA10 – ICE BofA Current 10-Year US Treasury Index – is a one-security index comprised of the most recently issued 10-year US Treasury note.
CDLR – ICE BofA USD Contingent Capital Index – Subset of the ICE BofA Contingent Capital Index including all securities denominated in US dollars.
CIPS – ICE BofA US High Yield Institutional Capital Securities Index – tracks the performance of US dollar denominated sub-investment grade hybrid capital corporate and preferred securities publicly issued in the US domestic market.