Stonebridge Preferred Securities
Market Report
First Quarter, 2020

MARKET RECAP

After a strong start to the first quarter of 2020, the preferred and hybrid securities market experienced a sharp sell-off during the latter half of the quarter as the COVID-19 economic disruption rippled across financial markets. The breakdown of OPEC+ negotiations between Russia and Saudi Arabia added to the already volatile market, causing oil prices to plummet further. All segments of the preferred and hybrid securities market sold off during the quarter, although they bounced significantly higher from their lows in mid-March. Investment-grade (IG) institutional $1000 par securities outperformed the $25 par retail market during the first quarter, while non-IG institutional securities significantly underperformed all other parts of the preferred and hybrid securities market. Outsized redemptions among open-end funds and exchange-traded funds (ETFs), combined with de-leveraging of closed-end funds, further contributed to the market sell-off in March.

In response to the United States economy largely grinding to a halt and expectations of a spike in unemployment, the Federal Reserve (Fed) and Congress approved massive easing and stimulus measures, respectively, designed to support financial markets, workers and businesses across the country. The details of these programs and how they relate to the preferred and hybrid securities market can be found in the investment outlook section of this newsletter. At the same time, we witnessed large and unprecedented monetary and fiscal policy measures taken by countries across the world to help prevent a deep and protracted global recession. These actions, along with the drastic economic slowdown due to the COVID-19 virus, have materially changed the landscape of the preferred and hybrid securities market from where things stood in mid-February.

Figure 1 below details the changes in the markets and the risks within the preferred and hybrid securities market from the beginning of the period, the high water mark on Februrary 14th and at the end of the quarter. Figure 2 shows the pricing dislocations experienced throughout the second half of Q1 2020 across the $25 par retail market (P0P4), investment-grade institutional securities (CIPS), non-IG institutional securities (HIPS) and non-US AT1 contingent convertible capital securities (CDLR), or CoCos.

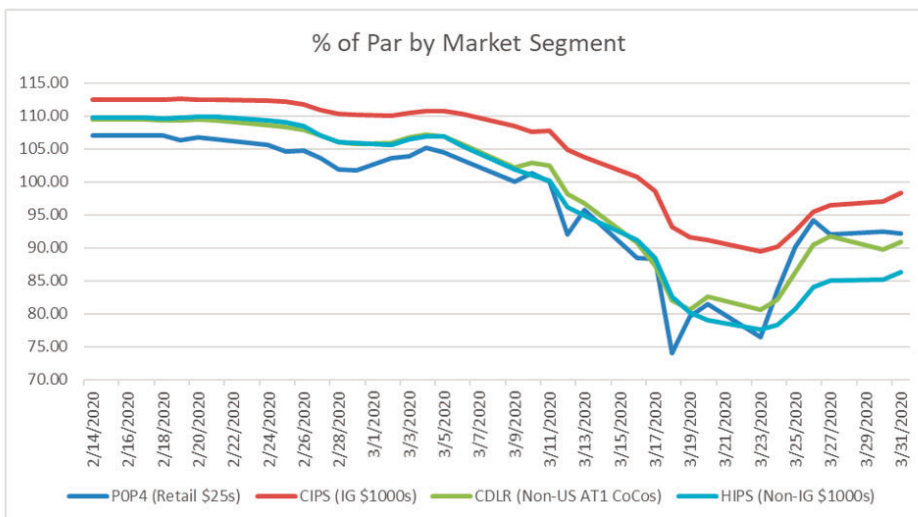
Figure 1. Comparison of Market Metrics and Relative Risks throughout Q1 2020

Market Metrics	12/31/2019	2/14/2020	3/31/2020
% of Par	106.17	107.74	95.51
Current Yield (CY) (%)	5.30	5.20	5.86
CY Spread over 10-Year Treasuries (bps)	353	348	447
Net QTD ETF Fund Flows (MMs)	N/A	$1,816.24	$ 168.72
3-Month LIBOR (%)	1.91	1.69	1.45
10-Year Yield (%)	1.92	1.58	0.67

Risks	12/31/2019	2/14/2020	3/31/2020
Valuation Risk	Med	Med/High	Low
Credit Risk	Low	Low	Med/High
Extension Risk	Low	Very Low	High
Reinvestment Risk	High	Very High	Low
Regulatory Risk	Med/High	Med/High	Med/Low

Source: ICE Data Services, Bloomberg, and Stonebridge. P0P1 is utilized as the preferred market proxy in all risk metrics. GA10 utilized as 10-Year Treasury proxy. All opinions mentioned in the risk table are from Stonebridge as of 4/1/2020 and subject to change at any time without notice.

Figure 2. Comparison of Preferred Market Segments after Market Peak on 2/14/2020



Source: ICE Data Services and Stonebridge.

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Highlights:

- Preferred and hybrid ETFs experienced $1.82 billion of inflows through 2/14/2020, followed by almost $1.65 billion of outflows in the second half of the quarter.
- The preferred and hybrid securities market experienced big dislocations between the performance of each market segment on a day-to-day basis throughout the second half of Q1 2020 (shown in Figure 2).
- The IG institutional market (CIPS) was the top-performing segment of the preferred and hybrid securities market in Q1 2020, returning -9.57%.
- The $25 par retail market (P0P4) was the most volatile market segment during the quarter, but was the second best-performing segment, earning -11.2%. Meanwhile, the non-IG institutional market (HIPS) was by far the worst performer, returning -18.13%, while the CoCo market (CDLR) lost 13.28%.
- Rates across the yield curve plummeted during the period, touching all-time lows in some cases, as global central banks eased monetary policy in response to the COVID-19 outbreak.
- Current yield spreads of preferred and hybrid securities (P0P1) versus 10-year Treasuries (GA10) spiked nearly 100 basis points (bps) during the period to end at 447 bps, which is the widest monthly data reading since the Taper Tantrum of 2013.

Figure 3. Comparison of Fixed Income Asset Classes – Q1 2020

Index	Ticker	Average Rating	Effective Duration[1] 1Q2020	Current Yield 1Q2020	Taxable Equivalent* 1Q2020	Total Return 1Q2020	Total Return FY2019
ICE BofA Fixed Rate Preferred Securities	**P0P1**	**BBB2**	**6.00**	**5.86%**	**7.11%**	**-8.83%**	**17.71%**
ICE BofA Core Plus Fixed Rate Preferred Securities	**P0P4**	**BBB3**	**7.47**	**6.34%**	**7.45%**	**-11.20%**	**17.42%**
ICE BofA US IG Institutional Capital Securities	**CIPS**	**BBB2**	**3.59**	**5.85%**	**6.52%**	**-9.57%**	**18.57%**
ICE BofA USD Contingent Capital Index	**CDLR**	**BB1**	**1.68**	**7.37%**	**8.07%**	**-13.28%**	**18.10%**
ICE BofA US Corporate	C0A0	A3	7.51	3.89%	3.89%	-4.05%	14.23%
ICE BofA US Cash Pay High Yield	J0A0	B1	4.28	7.12%	7.12%	-13.06%	14.40%
ICE BofA US Current 10-Yr Treasury	GA10	AAA	9.26	1.39%	1.39%	11.93%	8.91%
ICE BofA US Mortgage Backed Securities	M0A0	AAA	2.25	3.31%	3.31%	2.79%	6.51%
ICE BofA US Municipal Securities	U0A0	AA3	6.66	4.13%	6.96%	-0.68%	7.74%
S&P 500	SPX	NA	NA	2.42%**	NA	-19.60%	31.49%

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.

Investment Outlook

Macroeconomic & Geopolitical Trends:

- **Economic restrictions from the coronavirus outbreak extend through April.** Escalation in the coronavirus outbreak overshadowed all previous trends during the first quarter. U.S. federal government restrictions on economic/social activity were extended through April. We expect the anticipated bending of the curve in new virus cases to drive economic and market trends during the second quarter. The depth and duration of the economic slowdown remains highly uncertain, but if the outbreak can be brought under control during the second quarter, we would expect a meaningful economic rebound to follow.
- **Governments take fiscal actions to combat the economic slowdown.** The U.S. federal government passed three coronavirus stimulus packages totaling an estimated $2trn in size, and there is the potential for a fourth package depending on how the virus outbreak trends in the coming weeks. Numerous governments across Europe and the rest of the world have simultaneously pursued fiscal stimulus measures. We anticipate additional measures across the major global economies to combat the sudden drop in business activity, consumer spending and employment.
- **Saudi-Russia oil price war weighs on energy markets. The Saudi-Russia oil price war weighs on energy markets.** Russia walked away from the Vienna OPEC+ meeting, resulting in Saudi ramping up production to try and force Russia back to the negotiating table. Combined with the COVID-driven oil demand destruction, this supply shock has resulted in materially lower oil prices, causing stress across the broader energy markets. We expect Russia/Saudi to eventually come to a supply cut agreement, but COVID-driven demand will continue to pressure prices in the near-term.

Interest Rates, Monetary Policies & Bank Regulation:

- **Treasuries yields drop below 1%.** U.S. Treasury yields gradually moved lower in the first half of the quarter before experiencing a sharp decline during late February into early March. The 10-year Treasury rate, which started the quarter at 1.91%, touched an all-time intraday low of 0.31% on March 9th and then retraced some of the drop going into quarter-end. The biggest drop in yields came in the front-end of the curve with 3-month T-bills ending the quarter 145bps lower compared to the 125bps drop in the 10-year and 106bps for the 30-year.
- **Central banks ramp up liquidity measures.** The extraordinary accommondation 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. While extensive, we believe that major central banks would not hesitate to employ even more innovate ways to support financial conditions and market liquidity.

- **Bank regulators take action to ease lending capacity.** While central banks have directed most actions to smooth the functioning of financial markets, they have taken additional measures at the bank regulatory level to ensure solid bank system financial strength and availability of lending to the real economy. Both the U.S. and EU have eased capital buffers and provided guidance to banks to allow more flexibility in working with borrowers for loan modifications and payment delinquencies. These actions provide relief from potentially rigid and pro-cyclical loan loss reserving requirements.

Credit:

- **Banks are well positioned for extreme economic stress.** Overall, we continue to see strong preferred dividend/coupon paying capacity across both U.S. and European banks, which comprise the majority of the preferred & hybrid securities market. In addition to the favorable regulatory actions mentioned above, banks entered the current downturn from a position of strength. U.S. and European banks enjoy capital levels that are double the levels seen prior to the global financial crisis. The major U.S. and European banks in the preferred & hybrid securities market generate ~$400bn in annual pre-provision earnings. Announcements to suspend share buybacks and common dividends save ~$170bn in equity for a total buffer against loan losses of $570bn prior to potential tax benefits. To put this figure into context, the banks in this group recorded loan loss provisions of ~$55bn last year and ~$305bn in the worst year of the global financial crisis (2009).
- **Insurance.** According to S&P 500 Index, the insurance industry exhibits the lowest historical default rate across the major sectors as followed by the top rating agency. In addition to being highly regulated, we also attribute this relatively low default rate to lower liquidity needs relative to banks and other industries. We expect property & casualty insurers to be more defensive relative to life insurers.
- **Utilities.** Utilities should remain defensive plays as exposure to demand weakness caused by COVID-19 is limited for gas/electric utilities. The majority of our gas and electric utilities have mostly (if not fully) regulated business models and have regulatory mechanisms that protect cash flows from demand volatility.
- **Real Estate Investment Trusts (REITs).** REITs also exhibit relatively low historical default rates, and we see manageable exposures across the majority of REIT issuers. Stonebridge focuses on the larger, more diversified REITs with low exposure to higher-risk markets such as retail/malls. As REITs are required by law to distribute at least 90% of taxable income in order to maintain REIT status, we see relatively low preferred dividend deferral risk.
- **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, as income is generally fee-based with no direct ties to oil price moves. Stonebridge's exposure is concentrated within diversified investment-grade issuers whose revenue isn't directly tied to oil prices.

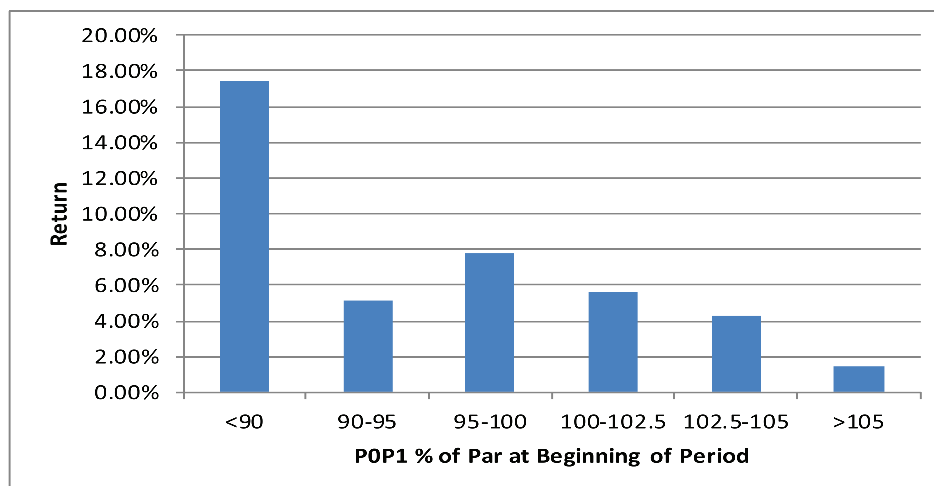
Market Structure:

- **Proposal submitted to address legacy U.S. Dollar LIBOR[2] contracts.** The Alternative Reference Rate Committee (ARRC) submitted a proposal to resolve uncertainty for securities without fallback language that replaces LIBOR with a new market standard. This would be achieved through legislation that overrides existing terms for calculating the floating-rate benchmark with the new recommended benchmark replacement language. Stonebridge views this as the cleanest way to address the issue while minimizing legal uncertainty and adverse economic impact.

Valuation and Portfolio Positioning:

- **Preferred and hybrid securities market trading at at a discount to par.** At the end of the quarter, the broad preferred and hybrid securities market based on P0P1 was trading at 95.51% of par. Historical analysis shows that, since 1992, when preferreds are trading at 95-100% of par, the average 1-year forward total return is 7.57% (Figure 4). Additionally, the only period where the 1-year forward return was not positive with prices starting below par was during the credit crisis of 2007-2008.

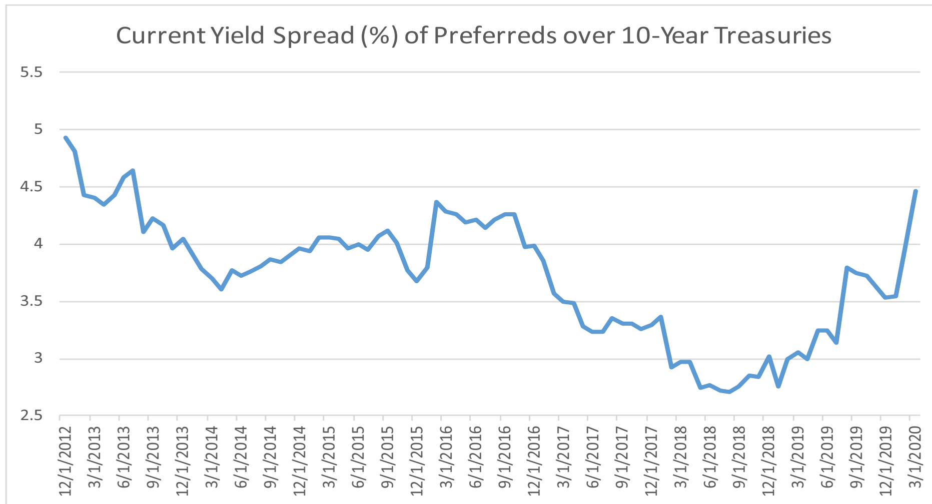
Figure 4. Historical 1-Year Forward Returns Based on Percentage of Par Values



Source: Stonebridge, ICE-BAML. Preferred Securities are represented by the ICE BofA Fixed-Rate Preferred Securities Index (P0P1). The % of par is determined by using month-end prices for the index. Returns are calculated using the 1-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.**

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

Yields and spreads are at widest levels since 2013. With interest rates at historic lows, absolute yields and yield spreads of preferreds and hybrids relative to U.S. Treasuries and other credit-spread products widened in 1Q20. The broad preferred market is trading at a current yield spread of 447 bps. This is the widest current yield spread over the 10-year treasuries since the Taper Tantrum in 2013. This presents an opportunity for investors to earn an attractive yield while they wait for an economic recovery, especially in light of the relative strength of the underlying credit fundamentals.



Source: Stonebridge, ICE BAML. **Past performance is not indicative of future results.**

Market is now priced to perpetuity (or maturity). The preferred and hybrid securities market began the year with most market participants valuing securities on a yield-to-call basis; however, with below par values, heightened perceived credit risk, wide spreads relative to Treasuries and the LIBOR forward curve moving sharply lower, it requires a reassessment of valuation on a yield-to-perpetuity or maturity basis. As a result, fixed-rate security structures, along with high reset variable-rate security structures, should be more defensive in this environment.

Active management matters. During this period of disruption, Stonebridge is actively managing its strategies to improve portfolio composition and position to perform well in a market recovery. Actions we are taking include strengthening the portfolio in terms of credit quality and security structure, extending duration into securities with longer call protection and improving liquidity. Given the unprecedented nature of the Covid-19 virus outbreak, we believe it may take 6 months or longer to see normalization in the global financial markets. As a result, we are also modestly increasing cash balances to protect against further volatility and take advantage of market dislocations to position into opportunistically undervalued securities.

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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.