Stonebridge Preferred Securities
Market Report
Fourth Quarter, 2019

MARKET RECAP

The preferred and hybrid securities market continued to perform in the fourth quarter of 2019, finishing the year with returns close to 18% for the broad market. Institutional $1000 par securities outperformed the $25 par retail market in the fourth quarter, partially due to a large uptick in new supply in the $25 par market compared to negative net supply for the institutional market. The European contingent convertible market (CoCos) outperformed all other parts of the preferred and hybrid securities market in the fourth quarter. This was driven by an extension of the BREXIT deadline into early 2020 and the U.K. conservative party, led by Boris Johnson, consolidating power in the December 2019 elections, which paved the way for an agreed BREXIT date of January 31, 2020.

Global central banks remained accommodative during the fourth quarter of 2019, as the Federal Reserve (the Fed) continued to pump liquidity into overnight repo markets and kept short-term rates at historically low levels during its December meeting. Meanwhile, the European Central Bank (ECB) held its deposit rate at negative levels and helped support credit markets with its corporate bond-buying program. Despite these actions, 10-year Treasury yields rose about 25 basis points (bps), ending the period at 1.91%, and the interest rate curve steepened. In the absence of meaningful increases in inflation or economic growth, monetary policy is likely to remain loose globally for the foreseeable future.

Fund flows during the fourth quarter of 2019 remained strong as investors continued to hunt for yield in the low-rate environment. This helped support the preferred and hybrid securities market as investors largely shrugged off headlines and geopolitical developments. Positive fund flows, net negative supply and relatively attractive valuations drove outperformance in the institutional $1000 par market versus the $25 par retail market during the period. In particular, European AT1 securities outperformed all parts of the market during the period, led by Italian, U.K. and peripheral banks. Looking ahead, the new President of the ECB, Christine Lagarde, has signaled intentions to encourage policymakers to utilize fiscal policy in order to stimulate economic growth and inflation within the Eurozone, passing the torch from monetary policy. On the trade front, tensions between the U.S. and China eased during the period with the announcement of an upcoming phase 1 trade deal, although this is not expected to be substantive. Finally, President Donald Trump was formally impeached by the U.S. House of Representatives, with a Senate trial likely in early 2020. Markets largely ignored this outcome as the Senate is not expected to vote to remove the president.

Figure 1. Comparison of Fixed Income Asset Classes – Q4 2019

Index	Ticker	Average Rating	Effective Duration[1] 4Q2019	Current Yield 4Q2019	Taxable Equivalent* 4Q2019	Total Return 4Q2019	Total Return FY2019
ICE BofA Fixed Rate Preferred Securities	**P0P1**	**BBB2**	**4.00**	**5.30%**	**6.45%**	**2.00%**	**17.71%**
ICE BofA Core Plus Fixed Rate Preferred Securities[2]	**P0P4**	**BBB3**	**4.26**	**5.59%**	**6.58%**	**1.40%**	**17.42%**
ICE BofA US IG Institutional Capital Securities[2]	**CIPS**	**BBB2**	**4.74**	**5.23%**	**5.88%**	**2.79%**	**18.57%**
ICE BofA USD Contingent Capital Index[2]	**CDLR**	**BB1**	**3.25**	**6.24%**	**6.87%**	**3.97%**	**18.10%**
ICE BofA US Corporate	C0A0	A3	7.65	3.71%	3.71%	1.15%	14.23%
ICE BofA US Cash Pay High Yield	J0A0	B1	3.31	6.16%	6.16%	2.59%	14.40%
ICE BofA US Current 10-Yr Treasury	GA10	AAA	9.05	1.77%	1.77%	-1.77%	8.91%
ICE BofA US Mortgage Backed Securities	M0A0	AAA	3.54	3.42%	3.42%	0.66%	6.51%
ICE BofA US Municipal Securities	U0A0	AA3	6.84	4.08%	6.89%	0.63%	7.74%
S&P 500	SPX	NA	NA	1.97%**	NA	9.07%	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.

[2] Please note that effective January 1, 2017, we are using the ICE BofAML Core Plus Fixed Rate Preferred Securities Index (P0P4), to represent the $25 par retail preferred securities market. We believe that this index is a more accurate representation of the retail preferred securities market than the ICE BofAML Fixed Rate Preferred Securities Index (P0P1) that we previously used given that P0P1 now has material exposure to the $1000 par institutional preferred securities market. We also now use the ICE BofAML U.S. IG Institutional Capital Securities Index (CIPS) to represent the $1000 par institutional preferred securities market. For Q1 2020, we changed the Contingent Convertible Index from ICE BofAML USD Investment Grade Contingent Capital Index (COCU) to the ICE BofAML USD Contingent Capital Index (CDLR). This index is 100% USD CoCo securities, including both investment grade and non-investment grade securities.

IN THIS ISSUE:

- Market Recap
- Issuance
- Investment Outlook

Highlights:

- Passive preferred and hybrid exchange-traded funds (ETFs) experienced close to one billion dollars of inflows during the quarter, while active preferred and hybrid ETFs added over $600 million.
- The $25 par retail market (P0P4) earned 1.40% during the fourth quarter of 2019, underperforming the institutional non-CoCo market (CIPS) by almost 140 bps and the CoCo market (CDLR) by almost 250 bps.
- Boris Johnson's conservative party won a significant victory in the December election, compiling 365 total seats and a majority of 80 seats in the House of Commons.
- The interest rate curve steepened during the quarter as the 2-year and 10-year Treasury yield spread widened by ~30 bps during the quarter, while the 3-month and 10-year part of the curve widened by about 50 bps.
- Current yield spreads of preferred and hybrid securities (P0P1) versus 10-year Treasuries (GA10) tightened to 353 bps during the period.
- Solid credit fundamentals in the Financial sector, especially among banks, and strong investment-grade corporate earnings (average senior rating of "A" across preferred and hybrid issuers) should continue to support the preferred and hybrid securities market compared to other asset classes, in our opinion.

Issuance

- **2019 was the biggest year for retail issuance in recent memory.** The retail market had been shrinking over the past few years and had not experienced net positive supply over the past 5 years. However, in 2019 there was a surge of new retail deals, ending the year with $13.2 billion in net supply. The last time the retail market saw positive net supply was in 2014 when it ended the year with $2.7 billion. By contrast, net retail issuance in 2018 stood at -$9.0 billion.
- **Net institutional issuance remained flat.** When comparing 2019 data to 2018, the institutional market had about the same number of new issuance and redemptions in both years. Net issuance in 2018 and 2019 stood at $15.6 billion and $15.8 billion, respectively. What sets the two years apart is that 2019 had less U.S. issuers but more CoCo issuance.
- **2019 saw a significant drop in coupon level.** Although this may not come as a huge surprise as interest rates and yields have been moving lower over the past year, the preferred and hybrid securities market did experience a large drop in coupon rates over the past year. In the first quarter of 2019, coupon pricing of new issuance averaged 7.2% for institutional securities and 6.4% for new retail issuance. By the fourth quarter, the average coupon had dropped to 5.4% for new institutional deals and 5.6% for retail. Most new issuance priced in the low 5% to high 4% range for investment-grade issuers by the end of the year.
- **Issuance in 2020 expected to be similar to last year.** We expect gross issuance to increase slightly compared to last year as companies look to take advantage of low funding costs in the current environment. The majority of new issuance will come from companies refinancing existing higher-cost securities, so net issuance is expected to be slightly lower than 2019. One theme we may see in 2020 is the continuation of new entrants issuing into the preferred and hybrid securities market. These companies may view preferred/hybrid securities as attractive long-term financing with the benefit of partial equity treatment in their leverage ratios.

Investment Outlook

Interest Rates & Central Bank Policies:

- **Treasuries consolidated while drifting lower during the fourth quarter.** While the 10-year Treasury rate ended the fourth quarter 25 bps wider, Treasuries mostly consolidated throughout the last quarter of the year within a range of 1.70-1.95% for the 10-year and 2.15-2.45% for the 30-year. Consolidation in the Treasury market ran counter to the reflation in risk assets. After finishing the year at 1.92%, the 10-year rallied back into the middle of the range to start off 2020.
- **Central banks continued easing measures during the fourth quarter.** The Fed announced the last rate cut in October, and guided expectations for a hold on rates for the foreseeable future. More importantly, the Fed expanded its balance sheet by ~$400 billion, or over 10%, from September to December in order to provide liquidity to the repo market. There is a common view in the market that this flood of liquidity has been a major contributor to the recent reflation in risk assets.
- **Fed balance sheet growth could persist throughout the first quarter of 2020.** Fed officials have signaled intentions to continue adding liquidity to the repo market well into February of 2020, if not into March and April. This implies that Fed balance sheet expansion could continue through the first quarter of 2020, and possibly into the second quarter.

- **Treasury curves steepened in the fourth quarter.** The 3M/10Y and 2Y/10Y parts of the Treasury curve steepened during the fourth quarter by ~50 bps and ~30 bps, respectively. The 3M/10Y curve ended the year without inversion, while the 2Y/10Y curve only temporarily inverted during the third quarter.

Macroeconomic & Geopolitical Trends:

- **Concerns wane of a near-term recession and global growth slowdown.** Concerns of slowing global growth and recession risk that escalated during 2019 have eased on improving manufacturing/trade data, fading trade tensions and support from monetary easing. Looking forward, we expect the market to focus on continued improvement in economic data. The U.S. and China signed a phase I trade deal, which still left some tariffs in place, but no further skirmishes are expected as trade talks are set to resume after the U.S. presidential elections. The market continues to shrug off protests in Hong Kong and strikes in France, as well as increased tensions in the Middle East following aggressive actions between the U.S. and Iran.
- **A beginning to a BREXIT conclusion.** After suffering multiple defeats, Boris Johnson called for a snap election in which his party won an overwhelming number of seats, giving him a clear majority that opened the door for an agreement on a BREXIT deal. An orderly BREXIT is now scheduled for January 31, 2020. We expect the market to focus on December 31, 2020, which is the deadline for the UK and EU to reach a new trade agreement. Otherwise, trade will revert to World Trade Organization rules.
- **U.S. politics expected to garner more media attention.** The pool of Democrats running for president has been cut in half but there has yet to be a clear frontrunner. The House of Representative has sent two articles of impeachment to the Senate and a trial is set to take place over the next few weeks. On a more bipartisan note, the United States-Mexico-Canada Agreement has passed through Congress and is on its way to becoming law.

Credit:

- **Fundamentals remain strong.** Strong investment-grade corporate earnings (average senior rating of "A" across preferred and hybrid issuers) should continue to support the preferred and hybrid securities market compared to other asset classes. We expect positive credit fundamental trends across major segments of the preferred securities market, namely in banks, insurance and utilities, to persist in 2020.
- **Banks screen positively from a credit perspective.** Banks (comprising over 70% of the preferred securities market) are well capitalized across the U.S. and Europe, and improving capital ratios in recent years stand in contrast to the trend of increasing leverage across non-financial issuers within the corporate bond market. Asset quality is stable across U.S. banks despite an uptick in one-off issues and some signs of tightening underwriting standards. Asset quality continues to improve across European banks, most notably Italian banks.

Market Structure:

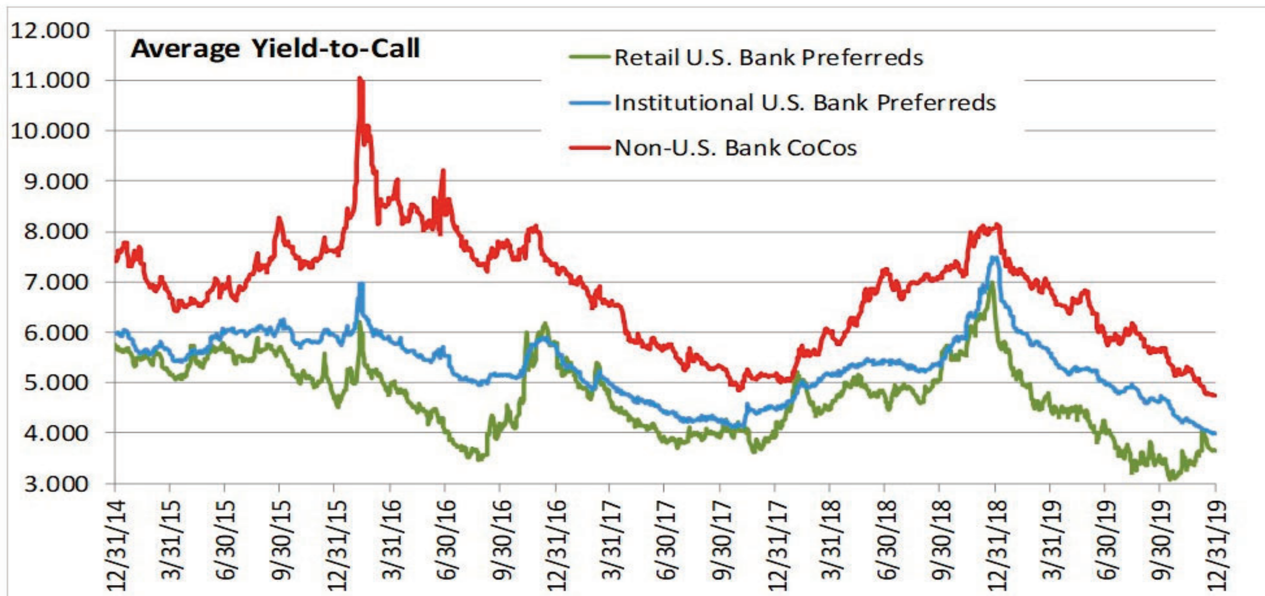
- **Expect major developments on London Inter-bank Offered Rate (LIBOR)[3] transition during 2020.** The proposed end-date of LIBOR is less than 2 years away and a number of key issues still need to be resolved. During 2019, the focus from central banks and regulators was to gather feedback from market participants on several factors involved in the transition, while pressuring issuers to use Secured Overnight Financing Rate (SOFR) instead of LIBOR as the floating-rate benchmark on new securities. These were important steps in developing the market for SOFR-based securities and ensuring they have the framework in place for a smooth transition, but significant work still needs to be done. With only 2 years remaining, regulators have started to amplify warnings about the need for institutions to focus on having everything in place for the shift away from LIBOR, so we expect a much stricter and hands-on approach from regulators this year.
- **Active management critically important as market transitions from LIBOR to new coupon reset structures.** Following the initial LIBOR phase-out announcement in July 2017, the credit research team at Stonebridge read through the prospectuses of every security we own with LIBOR as the floating benchmark and identified a minority of securities that contained potentially unfavorable LIBOR language. We have held discussions with all of the issuers of these securities in order to better understand their intentions. We have factored the LIBOR language into all of our investment decisions since then, and have been closely monitoring new developments from regulators and issuers. Additionally, we've seen a number of unique security structures as the market searches for a new standard convention for the back-end coupon calculation. This has added significant complexity to appropriately valuing securities, further increasing the importance of active management from a dedicated manager.

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

Preferred and Hybrid Valuation:

- **Preferred & hybrid securities continue to screen well relative to other asset classes in the current low-rate environment.** In particular, relative valuations in the preferred and hybrid securities market should be supported going forward, in our opinion, by the high-quality underlying issuer credit fundamentals, the attractive duration profile and high current yields compared to other asset classes (see Figure 1 for comparison). Preferreds may also offer tax-advantaged income to certain investors that is not available in other fixed-income asset classes.
- **Stonebridge sees better relative valuation in the $1000 par institutional market than $25 par retail securities.** As shown in Figure 2, the yield-to-call is better in the $1000 par market, particularly European AT1 securities, versus $25 par securities. As coupons tighten across the market, we generally see more opportunities in institutional $1000 par securities than the retail $25 par exchange-traded securities due to better yield profiles, as well as more favorable security structures and characteristics. That being said, we continue to see individual opportunities in $25 par exchange-traded securities, but believe there is generally more upside potential in the institutional $1000 par market.
- **After experiencing double-digit returns in 2019, the preferred and hybrid securities market is not likely to repeat this kind of performance in 2020.** However, accommodative central bank policy, strong issuer credit fundamentals and relatively attractive yields compared to other fixed-income classes should continue to support the market. Looking forward, we expect the majority of 2020 returns to be in the form of income, with potential for some modest capital appreciation if spreads or interest rates tighten further, or modest depreciation if rates rise materially.

Figure 2. Average Yield to Call by Market Segment



Data Source: Bloomberg and Stonebridge as of 12/31/2019.
Past performance is not indicative of future results.

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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.