Stonebridge Preferred Securities
Market Report

First Quarter, 2022

Highlights

- **Flows into preferred and hybrid exchange-traded funds (ETFs) were negative during the first quarter of 2022, ending the year with over $1.8 billion of outflows,** contributing to the market selloff.
- **The preferred and hybrid securities market ended the period trading below par,** providing improved opportunities for investment within primary and secondary markets.
- **Credit fundamentals across the preferred and hybrid issuer base are well positioned to deal with monetary policy and geopolitical risks,** buffering the coupon paying capacity of issuers.
- **The preferred and hybrid securities market offers one of the highest yields across the fixed-income universe** along with potential tax advantages and a low to moderate duration profile.
- **Active management will be criticial throughout 2022** given the potential for increased rate volatility.

MARKET RECAP

The preferred and hybrid securities market earned negative returns across all market segments in the first quarter of 2022 as interest rates moved sharply higher across the Treasury curve. The Federal Reserve (Fed) became increasingly hawkish and increased the Federal Funds Target Rate for the first time since 2018 in order to combat the highest inflation readings in decades. In response to the Fed's pivot, 2-year Treasury yields moved higher by over 150 basis points (bps), reflecting the market's increased expectations for front-end rate hikes. Meanwhile, the Treasury yield curve flattened significantly as 10-year Treasury yields moved higher by only about 83 bps during the period, resulting in a flat 2s/10s curve. Investment grade (IG) $1000 par securities were the best performing market segment during the quarter, returning -5.15%, while non-IG $1000 par securities returned -5.55%. The longer duration $25 par exchange-traded retail market was the most volatile segment during the first quarter and underperformed significantly, returning -8.16%. Finally, contingent convertible capital securities (CoCos) from non-US banks returned -6.68% for the first quarter. Despite CoCos having the shortest effective duration profile among all preferred market segments, they suffered during the second half of the quarter after the Russian invasion of Ukraine.

ETF fund flows into the preferred and hybrid securities market weighed on the $25 par retail market during the first quarter of 2022. Passively managed funds, which are mostly concentrated in longer duration $25 par retail securities, had nearly $1.9 billion of outflows during the period. Actively managed ETFs, which tend to provide exposure to the $1000 par institutional market, had nearly $60 million of inflows. With the selloff during the period, the preferred and hybrid securities market is now trading below par across both the $25 par retail and $1000 par institutional market, providing select opportunities for variable rate securities to pull to par in our opinion. Compared to other fixed-income asset classes, preferreds continue to offer relatively high yields, potential tax advantages due to qualified dividends income (QDI) eligibility for qualified securities and strong credit fundamentals across the issuer base. We believe that this backdrop provides a compelling investment rationale for the preferred and hybrid securities market in 2022.

Investment Outlook

Issuance and Supply Expectations:

- **The preferred market witnessed a meaningful drop in gross and net issuance, but new issuance opportunities should be significantly more attractive.** Gross issuance in the preferred market dropped by nearly 60% during the period, compared to the prior year. Based on our redemption and refinancing forecasts, we expect this trend to continue in the upcoming months. However, with the repricing we have witnessed in the market, we are bullish on the pricing of new issuance in the near future. For instance, average new issuance coupons in 1Q22 increased by nearly 40 bps in the $1000 par institutional market vs the prior quarter, despite limited issuance while rates spiked during the latter half of the period.

Macroeconomic & Geopolitical Trends:

- **The geopolitical world suffered a seismic shift.** The geopolitical world was turned on its head during the first quarter once Russia invaded Ukraine. Sanctions imposed by the U.S. and EU against Russia have caused significant geopolitical and macroeconomic disruptions. The knock-on effects have exacerbated existing problems such as supply chain issues and rising inflation. Inflation has jumped into the 6-8% range in both the U.S. and Europe and well into the double digit range across various emerging markets. Current forecasts point to inflation cooling in the second half of the year, but risks remain to the upside in these forecasts. We expect the market to remain focused on the international stage during the second quarter before shifting focus to the U.S. midterm elections later in the year.

- **Oil prices likely to remain elevated, driven by Russian supply risk and OPEC capacity restraints.** Russia's invasion of Ukraine has caused a lot of countries and international oil buyers to shun their oil. Furthermore, pressure continues to build on the EU to institute a full import ban on Russian oil, which could take 3M+ barrels per day off the market. OPEC+ countries outside of Saudi and the UAE are not physically able to produce more oil at the moment. Finally, labor shortages and investor pressure is stopping U.S. producers from growing production materially. Prices have temporarily dropped below $100 as the U.S. and other IEA countries tap into their Strategic Petroleum Reserves (SPR), however this is only a temporary solution to supply shortages.

Interest Rates & Monetary Policies:

- **Treasury yields rose sharply during the first quarter, but the curve flattened.** A confluence of macro factors drove significant rate volatility during the first quarter, including rate hikes/forecasts, Fed tapering expectations, continued high inflation prints and the Russia/Ukraine war. The 10-year Treasury yield ranged from 1.51% at the end of 4Q21 to as high as 2.47% during the first quarter, before closing at 2.34%. Despite the 83 bps increase in the 10-year yield, the Treasury curve still experienced significant flattening during the period with 2-year and 5-year Treasury yields up 160 bps and 120 bps, respectively. As a result, the spread between the 2-year and 10-year Treasury yields briefly inverted before ending the quarter flat. The inversion of the 2s/10s Treasury curve is a commonly referenced recession indicator, although alternative spreads are not flashing the same warning signs. The 3-month vs. 10-year spread closed the quarter at 184 bps, while the Fed near term forward spread, which Powell specifically referenced as the Fed's preferred recession risk indicator, closed at 253 bps. We expect rate volatility to continue throughout the second quarter, as all the same macro drivers still remain.
- **Higher inflation accelerates central bank policy tightening.** Recent geopolitical events worsened an already difficult inflation picture, thus forcing a more hawkish shift by central banks in the U.S. and Europe. The Fed has been more clear in its hawkish shift, and we see significantly increased chances of multiple 50 bps rate hikes in upcoming meetings. We also now anticipate the Fed to start balance sheet reduction as early as May with monthly caps accelerating sooner than expected. Meanwhile, the European Central Bank (ECB) has been slower to react to inflation trends. We expect a more hawkish tilt from the ECB during the second quarter, but also expect the ECB to lag the Fed in rate hikes and balance sheet reduction.

Credit:

- **Exposure to Russia/Ukraine is minimal.** Stonebridge has no direct investments in Russian or Ukranian securities. Most issuers owned in portfolios have little to no exposure to Russia, and Stonebridge does not foresee ratings or coupon payment risk for the few issuers with direct exposure to Russia.
- **U.S. Banks outlook continues to strengthen.** The median equity analyst EPS forecast has still increased YTD for both FY22 and FY23, despite all the macro headwinds. This reflects the U.S. Banks being well positioned to manage higher inflation/rates, as their interest income benefits from the higher yields, while increasing real asset collateral values reduce loan loss risks. Additionally, we don't expect any credit impact related to Russia for any U.S. bank, as exposure is very limited across the sector.
- **European banks face new challenges on solid footing.** In Europe, banks entered 2022 in their best shape in years, having come out of the pandemic battle-tested and with much higher capital ratios than before the pandemic began. Looking forward, European banks should benefit from interest rates rising into positive territory during the first quarter. While inflation presents challenges to the broad economy, the effect on rising interest rates presents a tailwind to bank earnings. Additionally, Russian exposure is immaterial across most European banks, while the handful of banks with direct exposure there have less than 3% of their balance sheet at risk. Even in the most extreme scenario, we see no ratings impact with the likely outcome being a delay in share buyback programs.
- **Strong credit profile outlooks remain for Midstream and Utilities, in spite of inflation outlook.** While the vast majority of Stonebridge's Midstream exposure is not directly exposed to commodity price moves, they can still benefit from increased transport volumes during a higher oil/gas price environment. Midstream companies continue to use a majority of their free cashflow for de-leveraging and we should continue to see positive ratings momentum in the sector. We don't foresee a materially negative impact from inflation on Utilities either, as all of our regulated utilities have commodity price and other cost pass-through regulatory mechanisms.

Market Structure:

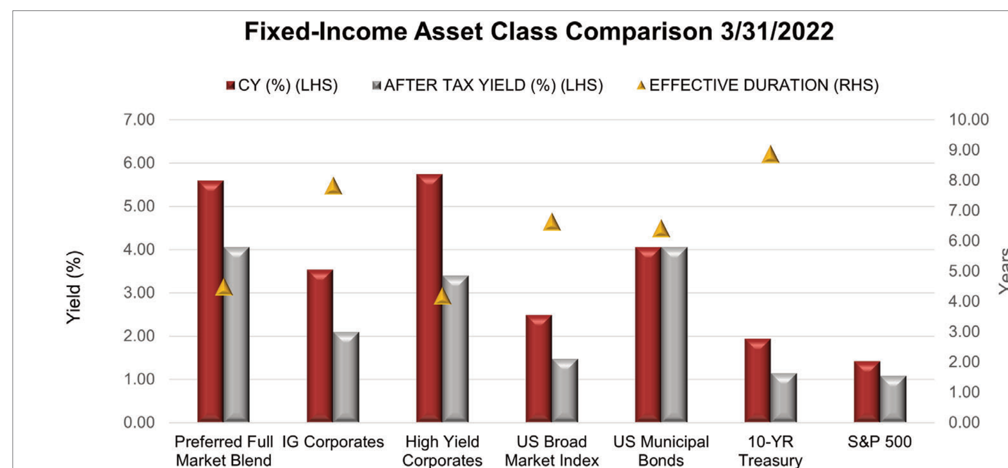
- **LIBOR[1] transition bill officially signed into law.** During the first quarter, President Biden officially signed the bill that allows for the use of a replacement rate to LIBOR on all U.S. securities. This will ensure a smooth transition to an alternative floating-rate index for all legacy securities that reference LIBOR. We believe the uniqueness of this situation furthers the importance for active management as the complexity of the transition could provide some significant market dislocations.
- **Stonebridge remains highly focused on LIBOR-based exposure.** Stonebridge has gone through and identified the potential outcomes of each security if LIBOR is no longer available. This analysis has been utilized in all portfolio decisions, particularly towards eliminating exposure to those with potential adverse outcomes. Stonebridge has reduced LIBOR-based exposure as a whole, shifting into securities with Swaps and Treasury based back-ends.

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

Valuation and Portfolio Positioning:

- **Preferreds offer incremental yield and spread over other asset classes.** Preferred securities offer some of the highest yields on both a current yield and after tax basis relative to other fixed-income asset classes. As shown in Figure 1, the absolute yield pick-up in preferreds over other investment grade rated asset classes ranges from 1.5% to over 3.5%. For taxable investors, the tax-advantaged QDI offered by many preferred securities increases the value of the after-tax yield of preferred securities. Additionally, the current yield spread of preferreds versus investment grade corporate bonds is over 200 bps, which is over 25 bps wide of the historical average going back 25 years. We believe that the additional pick up in yield spread versus investment grade corporate bonds coupled with lower average effective durations will provide support to current valuations on a relative basis. Issuers of preferred securities have a similar credit risk profile as issuers of investment grade corporate bonds, while the average rating differentials at the security level are due to the subordination of preferreds.

Figure 1. Yield Comparison of Preferreds vs Other Fixed-Income Asset Classes



Ticker	BLEND*	C0A0	J0A0	US00	U0A0	GA10	SPX
Rating	BB3	A3	B1	AA1	AA3	AAA	N/A
Total Return 1Q2022	-6.55%	-7.74%	-4.53%	-6.05%	-6.18%	-6.75%	-4.60%
Total Return FY21	3.59%	-0.95%	5.29%	-1.58%	1.83%	-3.68%	28.71%

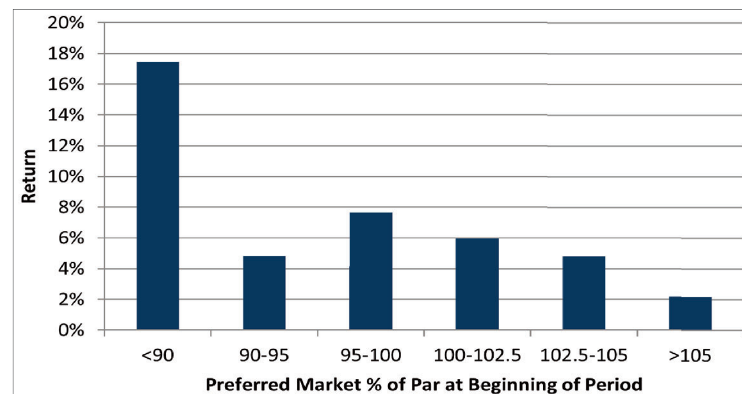
Source: Stonebridge Advisors LLC, ICE Data Services, Bloomberg L.P. as of 3/31/2022.

*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.

Assumes 40.8% Federal Tax Rate, no state tax. QDI eligible securities are determined by Bloomberg and Stonebridge.

- **Current valuations based on percent of par are at their most attractive levels in nearly 2 years.** The full preferred and hybrid securities market based on a blended index of $1000 par and $25 par securities is trading at 98.64% of par. The $25 par segment of the preferred and hybrid securities market is trading at 95.82%, while the $1000 par segment is trading at 99.87% of par. The $1000 par segment has outperformed $25 pars primarily due to it's concentration in variable rate securities, which have outperformed fixed-rate securities year-to-date given the generally lower sensitivity to interest rate volatility. (Conversly, the $25 par segment is concentrated in fixed-rate securities.) We believe the overall preferred market has priced in the potential for further volatility and, historically, preferreds have performed very well on a 1-year forward return basis when the market was trading below par. The average 1-year forward return of the preferred market with a percent of par in the 95-100% range was 7.65% since 1992. (Figure 2).

Figure 2. Historical Performance of Preferreds based on percent of par (12/31/1992 – 3/31/2022)



Source: ICE Data Services and Stonebridge LLC

Preferred Securities are represented by a blend of ICE indices (30% P0P4 / 30% CIPS / 30% CDLR / 10% HIPS). Prior to 12/31/2013, preferred securities are represented by the ICE BofA Fixed Rate Preferred Securities Index (P0P1). Please see Index Definitions in the back of the presentation. Calculation based on monthly data points.

Past performance is not indicative of future results and there can be no guarantee historical attractive returns will continue into the future.

- **Performance outlook and portfolio positioning.** The preferred market is positioned to perform well in the current environment where risks from inflationary pressures, rising rates and geopolitical conflicts have increased. Preferreds have historically performed well during periods of rising short and long-term interest rates, and wider current yield spreads offer a potential cushion against rising rates. From a credit standpoint, preferred securities are concentrated in high quality issuers, which could help to insulate the asset class in a recessionary environment and against current geopolitical risks. U.S. and European banks are well capitalized to withstand current geopolitical risks and other major sectors including insurance, utilities and REITs are relatively defensive in nature. After the recent underperformance, the preferred market has room for potential appreciation due to higher current yields and higher average yield-to-calls, as well as prices now being below par. We believe valuation metrics for preferreds are at the most attractive levels since the onset of the pandemic, providing an improved risk reward balance relative to the beginning of the year.

  Market volatility has led to even more discernibility across preferred market segments and security structures when it comes to portfolio positioning for clients. We continue to seek out value in preferreds across the entire interest rate curve, but have maintained a bias towards high quality credits on the shorter end of the curve along with securities that contain a component of rate protection, such as variable rate securities. A dearth of new supply has limited our investment in new issuance, although the repricing in the market should provide significantly better opportunities in '22 compared to '21. Targeting relative value swaps in favor of improving valuation and security structure, as well as taking advantage of dislocations in the $25 par segment are specific areas where we continue to reposition to generate higher returns for clients going forward.

Index Definitions:

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 U.S. dollar denominated investment grade debt publicly issued in the U.S. 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.

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.

Investment risks specific to Taxable Preferred Composite and the Tax-Advantaged QDI Preferred Strategies include counterparty payment risk, liquidity risk, operational risks such as documentation, settlement, systems failures and human errors, reconciliation differences, and other risks, all of which are fully described in Item 8 of Stonebridge's ADV-2A Brochure, which is available at all times at www.adviserinfo.sec.gov/firm/summary/134017

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