# Stonebridge Preferred Securities | Market Report

First Quarter, 2023

## HIGHLIGHTS

- **The preferred and hybrid market continues to trade at historically wide valuations,** with very attractive yield to worst (YTW) valuations and spreads and an average discount to par around ~88%.
- **The preferred and hybrid market offers one of the highest yields across the fixed income universe.**
- **Credit fundamentals across the preferred and hybrid issuer base withstood idiosyncratic risks faced by a number of banks.** Stonebridge continues to adjust exposures for rising recession risks.
- **Flows into preferred and hybrid ETFs stabilized following the Credit Suisse takeover and were net positive during the last two weeks of the quarter,** ending the period with -$140MM in net outflows. Actively managed ETFs saw $160MM of net inflows during the period.
- **Active management is more critical than ever** given the potential for continued rate volatility and rising recession risks.

## MARKET RECAP

The preferred and hybrid securities market remained volatile during the first quarter of 2023, with mixed performance across market segments. After rallying throughout the month of January, all market segments experienced modest losses in February as rates across the Treasury curve moved sharply higher, driven by hotter than expected economic and inflation data. The preferred and hybrid market entered the month of March with some of the best year-to-date returns across all fixed income asset classes. This all changed rapidly as Silicon Valley Bank announced on March 8th that they were looking to raise capital in order to offset realized losses on their securities portfolio. The capital raise failed, and a cascading effect of deposit withdrawals and diminished bank confidence ensued, which led to the rapid failure of Silicon Valley Bank on March 10th. Days later, New York regulators announced the failure of Signature Bank. The Fed and Treasury acted quickly to provide liquidity to the system, and liquidity needs slowed as quarter-end approached.

With confidence in the financial system shaken, Credit Suisse (CS), the only European Global systematically important bank (GSIB) that was in a state of restructuring, suffered its own crisis of confidence and wealth management outflows leading to a government orchestrated takeover by UBS. As part of this takeover, the regulator announced the full write-down of CS additional tier 1 (AT1) securities while equity holders received compensation. This controversial decision precipitated a sharp sell-off across the entire European AT1 market, which was tempered by reassuring comments from other central banks, predominately the European Central Bank (ECB) and Bank of England (BOE). Despite a period of significant rate and market volatility, by month-end, market technicals became more balanced and buyers stepped back into the market as financial contagion fears receded. Performance was very mixed across market segments as a result of the volatility. The longer duration $25 par exchange-traded retail market was the best performing market segment, returning 4.42%. Investment grade (IG) $1000 par securities returned 1.10% while non-investment grade (non-IG) $1000 par securities returned -3.46%. Contingent convertible capital securities (CoCos) were the worst performing market segment, returning -11.05%.

ETF fund flows into the preferred and hybrid market were negative in the quarter, totaling approximately -$140MM. However, the outflows occurred mostly on the passive side of the market, while actively managed ETFs, which tend to provide exposure to the $1000 par institutional market, had almost $160MM of net inflows. After the sharp sell-off in March, the preferred market ended the period trading with some of the most attractive valuations since the global financial crisis on a YTW and percent of par basis. As we potentially enter an economic slowdown in '23, preferred market YTW spreads versus other fixed income asset classes, including BB HY and IG corporates, are trading significantly wider than their long-term averages. Although volatility is likely to remain elevated as the Fed continues its hawkish monetary policy stance, we think that the preferred and hybrid market is set up longer term for outperformance given its improved valuations and underlying credit fundamentals.

## INVESTMENT OUTLOOK

***Issuance and Supply Expectations:***

**The preferred market witnessed an increase in both gross and net issuance in 1Q23, but primary markets came to a halt after the increase in market volatility.** 1Q23 saw $11.94bn in gross issuance vs $5.75bn in 4Q22, and -$769mm in net issuance vs -$9.25bn in 4Q22. The increase in net issuance was mostly influenced by the retail market, which witnessed $849mm in net issuance; the institutional market witnessed -$1.62bn, which is a significant improvement compared to -$9.2bn in 4Q22. The average new issuance coupon settled at just about 8%, which is a decrease of ~80 basis points (bps) compared to the previous quarter. However, secondary pricing widened significantly near the end of the period. Looking forward, absent continued market volatility, we expect a modest increase in supply above fairly muted levels last year in the coming months.

***Macroeconomic & Geopolitical Trends:***

**Unforced errors in the banking industry raise recession fears as inflation remains elevated.** The first quarter started with macroeconomic concerns easing a bit. Risk assets caught a bid, which faded once January ended. Inflation prints in the U.S. and Europe disappointed, lifting expectations for additional rate hikes. Rate hike expectations peaked in early/mid-March, and then Silicon Valley Bank (SVB) pursued an ill-advised plan to crystalize security losses and then raise equity. When this plan failed, a bank run occurred at speed never before seen driven by social media posts coupled with the modern ease of electronic fund transfers. The Fed and Treasury acted quickly to provide liquidity to the system, and liquidity needs slowed as quarter-end approached. Meanwhile, Credit Suisse was unable to withstand the liquidity shock, and was forced into an acquisition by UBS, but not before the Swiss government wrote down the bank's AT1 securities (more on this below). Despite the liquidity shock subsiding, banks now face increased funding costs which tends to tighten lending standards increasing recession odds. Last quarter, we viewed the ability of central banks to orchestrate soft landings in their economies as the main risk factor in 2023. Soft landing odds are not yet zero, but are being challenged. In our view, inflation prints in the coming months remain the most important datapoints to guide central banks. Even if rate hikes end soon and inflation drops, economies could suffer recessions if central banks balk at rate cuts.


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# Preferred Securities

**Geopolitical tension still persistently relevant; OPEC+ continues to show their support for oil prices.** While we believe global geopolitical tail risk has eased in the near-term, sustained acrimony over Russia's invasion of Ukraine, China's implicit support of Russia, and Taiwan's precarious position continues to divide the rest of the world. Agitators like Iran and North Korea have ramped up their saber-rattling. Honduras switching allegiances from Taiwan to Beijing and U.S. setting up military bases in the Philippines are two other recent events that have increased anxieties. While there is no sign the Russia/Ukraine war is near a conclusion, it appears as though risk of material escalation has declined. On the commodity front, OPEC+ again demonstrated their commitment to supporting oil prices by announcing a surprise production cut, which boosted WTI oil prices back above $80. In spite of this implicit 'floor' that OPEC has placed, the crude oil market will likely continue to be focused on looming recessionary fears.

***Interest Rates & Monetary Policies:***

**Economic uncertainty and flight to quality drives interest rates lower during March.** Interest rate volatility persisted during 1Q23, particularly on the front end of the curve. After trending lower to start the quarter, interest rates reversed during February then dropped sharply to end the quarter. The Fed hiked short-term rates by another 50bps during 1Q23, bringing the total to 475bps in a little over a year. The 2-year reached above 5% in early March as inflation fears persisted, but the banking sector volatility led to a combination of a flight to quality and lower forward rate projections, driving the 2-year yield lower by more than 1% from the peak. The 10-year yield decreased by 45bps during the quarter, finishing at 3.47% after peaking at 4.06% in early March. As a result, the 2s-10s inversion finished unchanged at 55bps despite reaching as high as 108bps on March 8th. Looking forward, we believe that rates are undergoing a consolidation phase driven by tightening lending standards and geopolitical uncertainty.

**Central banks seek to balance between price stability and financial stability.** Concerns of financial stability in banking systems in the first quarter led to uncertainty regarding the magnitude of additional rate hikes by central banks. For most of the quarter, stubbornly high core inflation prints in both the U.S. and Europe led investors to price in higher and higher rate cuts, which also drove higher interest rates across the curve. This all changed in the middle of March with the failure of Silicon Valley Bank, and concerns of deposit flight and tightening credit lending conditions introduced the view that these factors could provide additional tightening on behalf of central banks. As a result, rate hike expectations fell as quickly as they had spiked higher just days before the liquidity shock experienced in the U.S. banking system. However, despite calls to stop rate hikes, both the Fed and ECB, as well as other central banks, continued with rate hikes later in March. The message to the market was that rate hikes were necessary to address price stability (inflation), while central banks would use their balance sheets to address financial stability (liquidity to the banking systems). Still, market expectations for rate hikes have fallen, which makes for a potential showdown between central banks and the markets later this year. The trajectories of inflation prints in the coming months could be the deciding factors.

***Credit:***

**U.S. Banking sector strength helps withstand idiosyncratic risks faced by a few banks.** As noted above, Silicon Valley Bank's (SVB) failed capital raise in March led to a liquidity shock that drove some U.S. regional banks to face pressure from deposit outflows during the quarter, exacerbated by a combination of fears surrounding uninsured deposits and from attractive yields in alternative products, such as money market funds. Bank runs of unprecedented speed at SVB Financial (SIVB) and Signature Bank (SBNY) resulted in both banks being taken into receivership by the FDIC. The government stepped in quickly to provide liquidity backstop programs to ensure banks did not have to sell securities and realize the losses, and liquidity needs slowed towards quarter-end. Investors continue to heavily scrutinize both unrealized losses within the securities portfolios and the level of uninsured deposits at regional banks. These unrealized losses stem from the decrease in securities value as interest rates increased sharply during 2022 and into 2023, some of which have since reversed as rates fell during March. The vast majority of the securities held by the banks are U.S. Treasuries and government guaranteed MBS, which do not have a credit risk component, making this a very different situation than in 2008-09. In our view, the strong credit profiles across the banking sector provided the necessary capacity to manage through the idiosyncratic risks faced by SIVB and SBNY. Looking forward, we expect to see continued asset quality normalization, coming off historically low levels of loan losses and non-performing assets. The potential for tightening lending standards and weaker economic conditions could weigh on certain areas of the loan portfolio, such as commercial real estate and subprime consumer lending. However, banks have significant experience managing through a credit cycle of this nature, and are heavily stress tested for these specific risks by regulators. We would expect resilience from the banking sector in this scenario, driven by the sectors strong capital buffers and loan loss reserves levels.

**European banks withstand the shock from a Credit Suisse takeunder.** The first quarter for European banks was marred by the takeunder of Credit Suisse by UBS. The Swiss government hastily pushed the merger of the two banks, and in the process secretly passed an ordinance to grant the regulator the ability to write down CS's AT1s to zero. This action was taken despite UBS agreeing to pay over $3bn for the bank's equity, and in spite of CS maintaining adequate capital, a view that the government continues to hold today. Bondholders groups have formed to pursue litigation. Following this event, the ECB, Bank of England and numerous other bank regulators distanced themselves from the Swiss, stating that their jurisdictions would respect the normal priority of claims in which AT1s rank senior to common equity. These statements, along with the view that the European banking system is now more stable with CS being acquired, led European bank equities and AT1s to rebound from the lows. European bank valuations remain well off the best levels of the year due in part to lingering concerns of global banking system risk, elevated inflation, and rising recession risks. However, European banks still benefit from strong capitalization, improved interest margins from Europe exiting a negative rate regime and a low base of nonperforming loans on balance sheets. Interestingly, the median revision for full year earnings across major European banks is still up ~7% YTD. Lastly, the AT1 issuers in the USD market tend to be the large national champion banks in each country. In our view, these banks would likely attract deposits from smaller banks in a period of deposit flight to quality. In summary, while increasing recession risks call for some tiering of credit risk assumption in AT1s, we view most USD AT1 issuers as well positioned to manage through a deeper economic downturn.

**Insurance remains mostly insulated from the macro and broadly stable.** While higher interest rates are better for most insurers, the industry has also operated successfully in lower rate environments. Investment portfolios are generally high quality and diversified including conservatively underwritten commercial real estate which they have a very long and positive experience with. As the general economy slows we expect some insurers will experience credit rating downgrades within their investment portfolios and/or losses, but they are

well capitalized for this. The industry currently has interest rate driven unrealized losses in their investment portfolios, but the sector generally matches their security maturities to their liability durations as well as having the demonstrated ability and intent to hold their securities to maturity. 2022 included approximately $125bn in aggregate global insured losses, which were generally within most company's earnings and thus did not degrade capitalization. Meanwhile, insurance premium pricing continues to rise strongly in 2023 which is a positive for P&C stakeholders.

**Credit fundamentals remain strong for non-financial preferred-issuing sectors.** In spite of volatile commodity prices, Midstream continues to be well positioned with de-leveraging balance sheets, positive ratings momentum, and a lack of material direct exposure to commodity price movements. Utilities should remain a defensive sector, in spite of weaker macro fears. The Aircraft Lessor environment is very bullish, with recovering air travel demand and aircraft supply limited due to persistent supply chain issues. Lastly, Stonebridge does not have any direct exposure to Media/Advertising, Tech, Software or Retail sectors, where we expect relatively more credit pressure this year.

***Market Structure:***

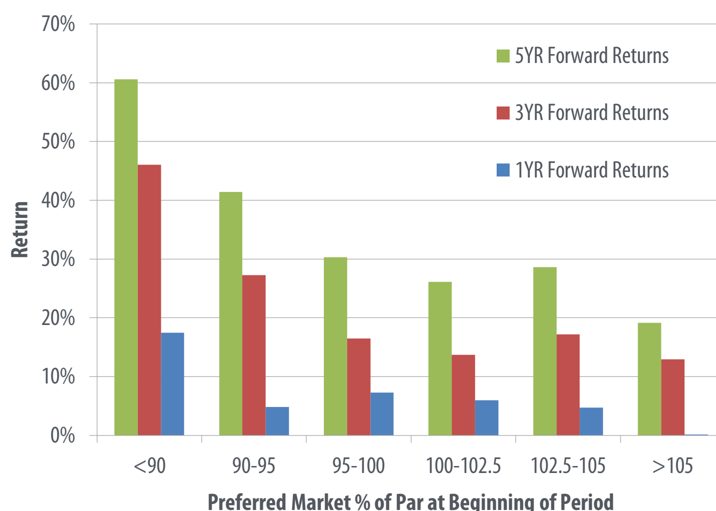
**U.S. banks begin announcing their LIBOR transition plans.** During 1Q23, we saw some U.S. banks, including Citigroup, Bank of America and JP Morgan, officially announce their transition plan for legacy LIBOR-based securities. Each bank will use the replacement rate methodology laid out in the federal government's LIBOR transition bill. We expect other issuers to come out announcing the same plan in the coming months with LIBOR's cessation date at the end of 2Q 2023.

## VALUATION AND PORTFOLIO POSITIONING

**Valuations of preferreds are at historically attractive levels.** Valuations in the preferred and hybrid securities market remain at wide levels on both an absolute and relative basis given the recent market volatility. As of 1Q23, current yields across the full market are trading at 6.43% as compared to a year-end current yield of 6.42%, based on a blended index of $1000 par and $25 par securities*. Another useful valuation metric to look at is the discount or premium to par value for the preferred market. As of 1Q23, the discount to par in the market is 87.89% of par, which breaks down to 84.14% of par in the $25 par retail market and 88.84% of par in the $1000 par institutional market. This compares to a year-end percent of par for the market of 86.11% (78.93% of par for $25 pars and 89.72% of par for $1000 pars). Past performance is not a predictor of future returns, but historically speaking, on average, a percent of par under 90% has led to positive cumulative forward returns over 1-, 3- and 5-year periods.

On a YTW basis, the preferred securities market is trading at 7.70%, which is 11 bps tighter than the 7.81% on 12/31/22. YTW Preferred Securities spreads vs Investment Grade (IG) corporates (C0A0) have widened significantly, currently sitting at 245 bps; substantially wider than the average level since 2013 of 164 bps. Similarly, preferred securities YTW spreads vs BB High-Yield bonds (HY) (H0A1) are trading at 91 bps compared to the average level since 2013 of only 9 bps. We believe this means that preferred securities are pricing in a significant amount of risk compared to other fixed-income asset classes. Although we believe that volatility is likely to continue in the near-term, this may offer an attractive entry point for longer-term investors.

**FIGURE 1: Historical Performance of Preferreds Based on Percent of Par (12/31/1992 – 3/31/2023)**




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. The $25 par retail market is represented by the ICE BofA Core Plus Fixed Rate Preferred Securities Index (P0P4). The $1000 par institutional market is represented by a 45/40/15 blend of the ICE BofA Investment Grade Institutional Capital Securities Index (CIPS), the ICE USD Contingent Capital Index (CDLR), and the ICE BofA US High Yield Institutional Capital Securities Index (HIPS), respectively. Source: ICE Data Services and Stonebridge Advisors LLC based on monthly data.

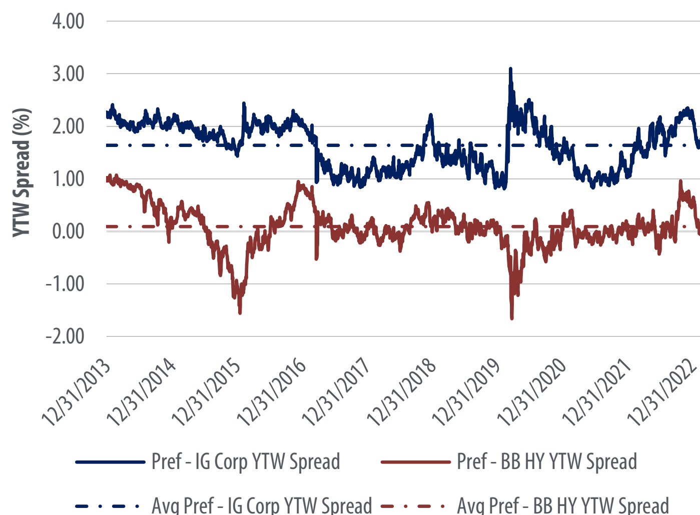
**Past performance is not indicative of future results** and there can be no guarantee historical attractive % of par valuations will continue into the future.

**Portfolio positioning.** Stonebridge continues to position for a weaker economic environment which includes being very selective on companies with elevated exposure to weaker commercial real estate sectors and to subprime consumers. In our view, the financial sector, which comprises the majority of the preferred market, is well prepared to manage through a recession given the strong fundamentals built up in prior years. That being said, in response to the recent banking sector woes, Stonebridge has adjusted exposure to regional banks in the U.S., with a focus on eliminating preferred securities in regional banks that we believe may pose near-term risks to the portfolios. In fund portfolios that hold additional tier 1 capital CoCos (AT1s), we have substantially reduced our Swiss bank exposure. We are also continuing with the repositioning we started in 2022, by reducing exposure to issuers that we believe may underperform in a recessionary environment. We are seeking to increase portfolio yields through recent high coupon issuance and variable rate securities that are resetting to higher coupons. We are also taking advantage of market pricing dislocations and discounted securities that we believe have pull to par upside potential to help improve portfolio compositions.

**Performance outlook.** The preferred market has proven to be resilient over the years, with sell-offs like the most recent one presenting attractive entry points for investors. We find the recent market reaction to be supportive of this, with orderly trading and investor discipline separating idiosyncratic risks from the broader market resulting in limited asset class outflows. Near-term volatility may persist, but we believe current valuations are pricing in the risks to the preferred securities market. Additionally, the recent repricing of the preferred market may have forerun a future recessionary environment, whereas other parts of the credit market await their fate.

If history is any guide, the preferred market may be poised to rebound from the average deep discounts to par and achieve attractive returns going forward. High yields coupled with the potential for modest appreciation could result in a return to positive returns by year end. Additionally, we believe active management will be rewarded through security selection based on relative value and credit analysis. We adhere to our view that a "pull to par" effect for select discounted securities will occur as they approach their first call dates and are either called out of the market or extend and reset to higher coupons.

**FIGURE 2: Yield to Worst Spread Comparison of Preferreds vs. Other Asset Classes (12/31/2013 – 3/31/2023)**




*Preferred Securities are represented by a blend of ICE indices (30% P0P4 / 30% CIPS / 30% CDLR / 10% HIPS). All negative YTC securities are removed from the index for the purposes of YTW calculations. BB High Yield is represented by H0A1 and IG corporates are represented by C0A0. Please see Index Definitions in the back of the presentation. **Average calculated since index inception in 12/31/2013. Source: ICE Data Services and Stonebridge Advisors LLC based on daily data.

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

**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.

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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.