



Stonebridge Preferred Securities

Market Report

Second Quarter, 2021

Highlights

- **Flows into actively-managed preferred and hybrid exchange-traded funds (ETFs) increased significantly during the second quarter of 2021**, supporting secondary prices and reducing volatility.
- **The preferred and hybrid securities market is likely to see a meaningful drop in gross issuance in second half of 2021**, providing a positive technical backdrop to the preferred and hybrid securities market.
- **Credit fundamentals across the preferred and hybrid issuer base remain strong**, cushioning 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 critical in 2021** given tighter valuations due to spread tightening and the potential for rate volatility.

MARKET RECAP

The preferred and hybrid securities market rebounded during the second quarter of 2021 as 10-year Treasury yields moved lower and the rate curve flattened. As rates stabilized during the period, yield investors increased their risk appetite, causing current yield spreads versus 10-year Treasuries to tighten materially. Non-investment grade (non-IG) \$1000 par securities were the top performing market segment for the third consecutive quarter, returning nearly 4%, while IG \$1000 par securities remained the laggard for the quarter and the year. The longer duration \$25 par retail market also performed very well, driven by inflows into the space after a volatile first quarter of 2021. Finally, contingent convertible capital securities (CoCos) from non-US banks continued to perform, returning nearly 3% for the quarter.

ETF fund flows into the preferred and hybrid securities market were very strong during the second quarter of 2021. Actively managed ETFs saw inflows of around \$750MM during the period, while passively managed funds, which are mostly concentrated in longer duration \$25 par retail securities, had over \$2BN of inflows. 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. Also, preferreds continue to offer a relatively low to intermediate duration profile due to the availability of variable rate coupon structures, which offer a component of rate protection.

Issuance

- **The retail market shrunk by \$5bn in 2nd quarter 2021.** In contrast, net issuance in the institutional market more than doubled compared to last quarter. Net issuance ended the quarter at \$8.2bn, which consisted of \$13.2bn from institutional and -\$5.0bn from retail.
- **The average new issuance coupon increased modestly.** Although rates tightened during the 2nd quarter, the average new issuance coupon increased by 8 bps, to 5.10%. The increase was more noticeable in the retail market, which increased by nearly 30 basis points (bps) compared to last quarter. The institutional market saw a modest increase of 5 bps.
- **Stonebridge anticipates a meaningful drop in gross issuance for the remainder of 2021.** Based on our redemption and refinancing forecasts, we expect to see modestly lower net issuance as well. This should provide a positive technical backdrop and be supportive of secondary prices.

Investment Outlook

Macroeconomic & Geopolitical Trends:

- **Political headlines shifted from elections to policy.** As discussed in our last newsletter, the Biden administration is currently pursuing an infrastructure bill and tax policy changes at both the corporate and personal level. Negotiations remain fluid, and the final form may take shape in the third quarter. Potential tax policy implications on the preferred market, if any, remain uncertain. All else equal, higher tax rates increase the QDI benefit offered by many preferred securities.
- **Global oil market balance remains very bullish as demand returns while OPEC+ remains supportive.** The most recent OPEC+ meeting ended without a market-expected increase in August production, which pushed WTI oil prices to a six-year high. However, the market is pricing in a good probability of an eventual agreement. U.S. demand has snapped back faster than expected, as gasoline and diesel demand are effectively now flat with 2019 levels. Jet fuel demand is still ~22% below 2019 levels and will likely take longer to recover. But as long as OPEC+ remains supportive and demand continues to recover, inventories should continue to draw down and prices should remain healthy for U.S. producers.

Interest Rates & Monetary Policies:

- **Treasury yields cooled off in the second quarter.** Treasuries rebounded in the second quarter following a dramatic selloff in the first quarter. After reaching 1.75% at the end of March, the 10-year Treasury rate fell back down below 1.50% to end the quarter at 1.47%, and consolidated around this level for a month. While a summer slowdown is typically expected, we observe that the Treasury market has had a tendency to experience volatility during this time. We see a confluence of events that could move rates in the coming months, including inflation prints, the Federal Reserve's (the Fed) Jackson Hole meeting in late August that could include more signaling on tapering, and fiscal policy by way of infrastructure/tax legislation, to name a few.
- **Central banks may signal policy changes in the third quarter.** Central banks continued to hold firm on loose monetary policy in the second quarter, but the Fed opened the door to discussing a taper of QE bond purchases. This leads us to expect some increase in messaging of tapering throughout the course of the third quarter. As noted above, the Jackson Hole meeting from August 26th to 28th could drive some headlines. Meanwhile, over in Europe, the European Central Bank (ECB) has not yet signaled any intention to reduce bond purchases.

Credit:

- **U.S. Banks have capital restrictions lifted after strong stress test performance.** U.S. banks continued their positive performance during the 1Q21 earnings season with over 95% beating consensus earnings estimates again. This was in part driven by the reserve releases from every bank, reflecting improving loan loss forecasts amid the economic recovery. Additionally, the average capital ratio has increased ~12% year-over-year (YoY). The strong credit position of the U.S. banks was reiterated by the 2021 stress test results with all banks under coverage maintaining capital well above their minimum requirements. As a result, the Fed lifted all capital restrictions on the banks, leading to a number of common dividend increases.
- **European banks built on positive momentum in the second quarter.** In Europe, over 90% of banks beat consensus estimates when reporting 1Q21 results, leading to a median EPS estimate increase of 22% for full year 2021 earnings. The strong performance led a number of ECB officials to announce that the ECB plans to lift the cap on dividend/buyback payout ratios at the end of the third quarter. We view this development, which followed the lifting of payout restrictions at the beginning of the year, as a positive reflection of their strong credit profiles. Most European banks have already reinstated dividend and/or share buyback programs.
- **Bullish oil market trends coupled with dividend cuts lay out positive credit outlook for Midstream.** While the vast majority of Stonebridge's Midstream exposure is not directly exposed to commodity prices, a positive macro backdrop is bullish for the sector nonetheless. More importantly, several Midstream credits cut their common dividends materially during the pandemic, solidifying their positive free cash flow, which will be used for de-levering. The current outlook for select Midstream credit profiles are decisively improving, and Stonebridge continues to see value opportunities in these names. Two of our Midstream credits have already seen credit ratings upgrades since the beginning of the pandemic.

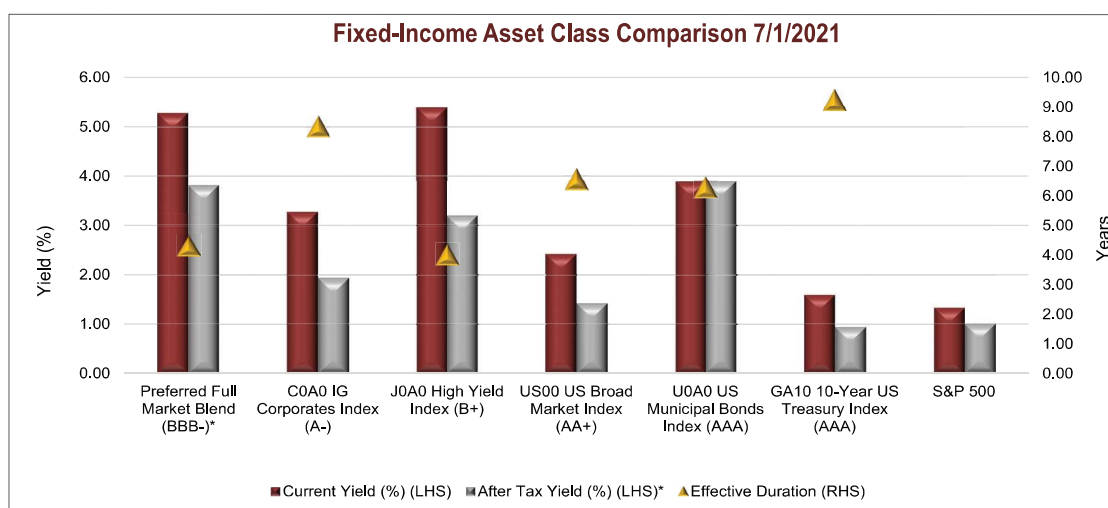
Market Structure:

- **Regulators stress importance of smooth LIBOR¹ transition.** In the first quarter, New York state officially passed legislation that allows for the use of a replacement rate to LIBOR on securities governed under New York law. Following the passing of New York's bill, U.S. bank regulators met with members of Congress and stressed the importance of passing a similar bill at the federal level to address all U.S. securities. Additionally, U.S. regulators are working with the banks to quantify all LIBOR-based exposure and create a plan for addressing any exposure that matures after the June 30, 2023 LIBOR end-date.
- **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. Additionally, Stonebridge has been reducing LIBOR-based exposure as a whole, shifting into securities with Swaps and Treasury based back-ends.

Valuation and Portfolio Positioning:

- **Preferreds offer incremental yield & spread over other asset classes.** In spite of tighter valuations, we continue to believe preferreds offer better relative value than most other credit risk asset classes due to the high yields combined with the high credit quality of the issuers and intermediate to low duration profile. 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 2%. Additionally, the current yield spread of preferreds versus investment-grade corporate bonds is approximately 200 bps, which is about 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 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. One final advantage for taxable investors is the tax-advantaged QDI offered by many preferred securities, which increases the value of the after-tax yield of preferred securities, as shown in the table.

Figure 1. Yield Comparison of Preferreds vs Other Asset Classes



Source: Stonebridge Advisors LLC, ICE Data Services, Bloomberg L.P. as of 6/30/2021.

*Custom blend index: A blend of the following ICE indices: 30% POP4-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.

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

- **Portfolio outlook and portfolio positioning.** Spreads on preferred securities have tightened significantly due to strong demand for the product, driven by the relatively attractive yields and the move lower in longer term interest rates. This move tighter in spreads has led to the preferred securities market approaching fair value, in our opinion. Given our view on valuations, we believe that the majority of total return performance for the second half of the year will be driven by income. Additionally, the recent move tighter in U.S. Treasuries in the face of improving economic data has proven it is very difficult to predict where interest rates will end up by year end. However, if volatility in U.S. Treasuries increases in the second half, we believe that the relatively high yields of preferreds, the credit strength of the underlying issuers and limited net new supply are likely to provide a cushion against higher rates.

Active management will continue to be beneficial to investors in terms of portfolio positioning and creating value in the face of potential interest rate volatility. Given the confluence of factors potentially affecting interest rates, we have selectively sought out value in preferreds across the entire interest rate curve, but maintain a bias towards the shorter end along with securities that contain a component of rate protection, such as variable rate securities. We will continue to focus on improving composition of managed portfolios by reducing exposure to higher risk security structures (such as those tied to unfavorable LIBOR transition language), and targeting relative value swaps in favor of improving security structure combined with improved valuation.

Index Definitions:

POP4 – 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.

COAO – 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.

JOAO – 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.

UOAO – 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 information presented is not intended to constitute an investment recommendation for, or advice to, any specific person. By providing this information, neither First Trust nor Stonebridge are undertaking to give advice in any fiduciary capacity within the meaning of ERISA, the Internal Revenue Code or any other regulatory framework. Financial professionals are responsible for evaluating investment risks independently and for exercising independent judgment in determining whether investments are appropriate for their clients.

The second 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.