Stonebridge Preferred Securities | Market Report

Second Quarter, 2022

HIGHLIGHTS

- **Flows into preferred and hybrid exchange traded funds (ETFs) were negative during the second quarter of 2022, ending the period with over ~$1.77 billion of outflows,** contributing to the market selloff.
- **The preferred and hybrid securities market ended the period trading at historically wide valuations,** with the full market trading below 90% of par.
- **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 continued rate volatility.

MARKET RECAP

The preferred and hybrid securities market earned negative returns during the second quarter of 2022, as volatility remained elevated across financial markets. Interest rates continued to be the largest driver of performance with inflation data failing to show a clear peak in 2Q22. In response, the Federal Reserve (Fed) announced multiple historically aggressive hikes to the Federal Funds Target Rate and a clear commitment to price stability. This backdrop, along with the continued geopolitical instability in Europe and persistent COVID-related lockdowns in China, helped to deteriorate investor sentiment and increase the odds of an economic recession. Although rates once again moved sharply higher during the period, the 10-year Treasury ended well off its highs, closing the period at 3.01% as recession fears priced into the market. Contingent convertible capital securities (CoCos) from non-US banks were the top performer during the period, returning -7.38%, due to their shorter duration profile. Investment grade (IG) $1000 par securities were the second best performing market segment during the quarter, returning -7.47%, benefiting from their high credit quality in the face of a potentially looming recession. The longer duration $25 par exchange-traded retail market continued to be the most volatile segment during the quarter, but recovered off its lows during the second half of the period, returning -7.61%. Finally, non-IG $1000 par securities were the worst performers, earning -10.28%.

ETF fund flows into the preferred and hybrid securities market remained negative during the second quarter of 2022. Passively managed funds, which are mostly concentrated in longer duration $25 par retail securities, had nearly $1.37 BN of outflows during the period. Actively managed ETFs, which tend to provide exposure to the $1000 par institutional market, had around $400MM of outflows. These outflows applied additional pressure on the preferred and hybrid securities market, contributing to valuations, measured by % of par, falling significantly below par. However, 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, coupled with historically attractive valuations, provides an increasingly compelling investment rationale for the preferred and hybrid securities market and sets the market up to outperform going forward.

INVESTMENT OUTLOOK

Issuance and Supply Expectations:

- **The preferred market witnessed another drop in gross issuance and a meaningful increase in new issuance coupons.** Compared to the previous quarter, gross issuance decreased by nearly 41%. However, we witnessed new issuance pricing at very attractive levels. For instance, the average new issuance coupon in our space increased by 172 basis points (bps) to 6.79% compared to the previous quarter. Based on our redemption and refinancing forecasts, and with the repricing in the markets, we expect the trends to remain the same in the near future.

Macroeconomic & Geopolitical Trends:

- **Macro risk factors escalated and persisted throughout 2Q22.** Two major macroeconomic and geopolitical risk factors, inflation and war, continued pressuring the financial markets throughout the second quarter of the year. Inflation in particular escalated to a new multi-decade high of 8.6% in May. While forecasts still point to a drop in the second half of the year, CPI may not drop below 6% until next year. Meanwhile, the war in Ukraine showed no signs of easing, pointing to continued macroeconomic pressures. Overall, these pressures are pointing to lower forward inflation expectations, but this is due in large part to rising concerns of slower economic growth and recession risks. We expect the market to remain focused on these major macro risk factors during the third quarter before shifting focus to the U.S. midterm elections later in the Fall.

Preferred Securities

- **The crude market is still very tight, but the market is starting to price in some recessionary demand retracement.** The crude oil market is still well undersupplied, drawing on already low global inventories, and prices are still historically high in spite of the big sell-off in early 3Q22. With the sell-off to <$100, the market is starting to price in recessionary demand declines that offset a good bit of those supply concerns. Russia's invasion of Ukraine has caused a lot of countries and international oil buyers to shun their oil, but less oil has actually come off the global market as was expected with China and India stepping up as big buyers. With the EU proposing a total ban on Russian oil imports by year-end 2022 and the G7 contemplating a Russian oil 'price cap', there is still plenty of supply-side geopolitical risk for prices. Additionally, with President Biden visiting Saudi Arabia soon to request a ramp up in production, we would expect OPEC to acquiesce to the extent they have the capacity.

Interest Rates & Monetary Policies:

- **Treasury yields rose sharply during the second quarter, but the curve remained mostly flat.** A confluence of macro factors drove significant rate volatility during the second quarter, including rate hikes/forecasts, Fed tapering expectations, continued high inflation prints and the Russia/Ukraine war. The 10-year Treasury yield ranged from 2.34% at the end of 1Q22 to as high as 3.47% during the second quarter, before closing 67 basis points (bps) higher at 3.01%. The 2-year and 5-year Treasury yields were up 62 basis points (bps) and 58 basis points (bps) during the quarter, respectively, resulting in slight steepening across that part of the curve. Meanwhile, 3-month LIBOR[1] increased 132 bps as the Fed hiked short-term rates, with the spread vs. the 10-year Treasury finishing the quarter 65 bps flatter at 73 bps. We expect rate volatility to continue throughout the third quarter, as all the same macro drivers still remain.
- **Higher inflation leaves little room to manuveur central bank policy.** Previous forecasts called for inflation to have started falling by the end of the second quarter, but new recent highs in CPI have forced the Fed to accelerate the pace of rate hikes. Market expectations point to the Fed potentially reaching the terminal Fed Funds rate close to year-end. The Fed started balance sheet reduction during May. Meanwhile, the European Central Bank (ECB) remains slower to react to inflation trends due to energy/economic pressures from the war in Ukraine. We expect a more hawkish tilt from the ECB during the third quarter, but also expect the ECB to lag the Fed in rate hikes and balance sheet reduction.

Credit:

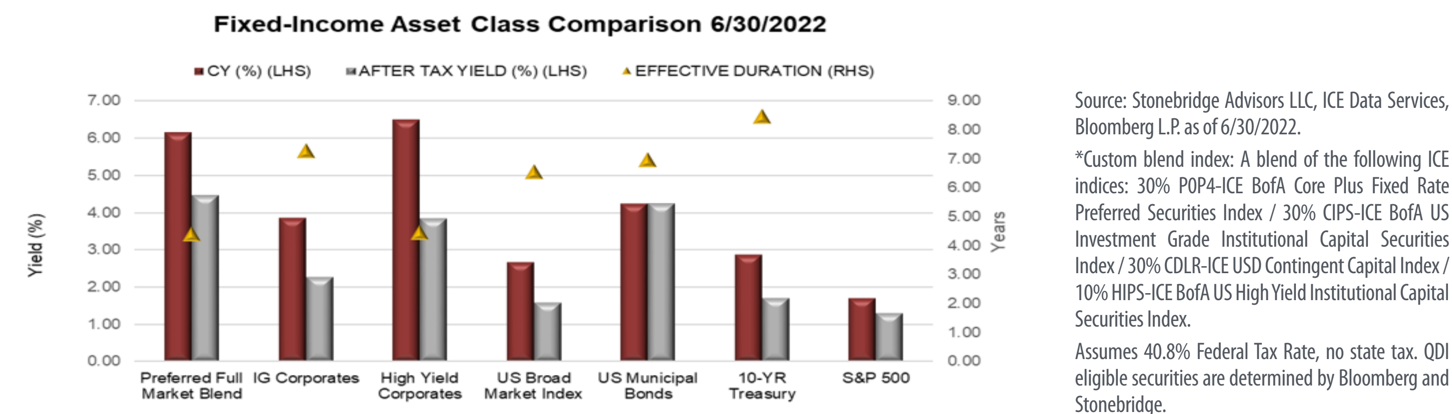
- **Exposure to Russia/Ukraine remains minimal.** Stonebridge maintains no direct investments in Russian or Ukranian securities. Most issuers owned in portfolios have little to no exposure to Russia, and Stonebridge does not foresee ratings or coupon payment risk for the few issuers with direct exposure to Russia.
- **U.S. Banks outlook remains strong.** 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. Furthermore, the results of the 2022 stress test demonstrated the banking sectors ability to withstand a severe economic recession, as all banks remained well above their minimum capital requirements throughout the 9-quarter timeframe.
- **European banks are up to the task to face new challenges.** In Europe, banks entered 2022 in their best shape in years, having come out of the pandemic successfully battle-tested. Signs of this include the European bank equity index still trading inline with the broad index and the median equity analyst EPS forecast for FY22 down less than 2% YTD across the major European banks. Excluding some charges already taken in 1Q22 for Russian exposures, estimates call for positive earnings growth overall, as European banks benefit from significantly higher interest rates. Seeing European interest rates exit negative territory has been certainly welcomed by the banking sector. These revenue tailwinds will help to buffer the challenges that inflation and the war in Ukraine present to the broad economy.
- **Strong credit profile outlooks remain for Midstream and Utilities, in spite of weaker macro outlook.** The vast majority of Stonebridge's Midstream exposure is not directly exposed to commodity price moves. So in spite of the oil and natural gas market price volatility, Midstream should stay in a positive free cash flow and de-leveraging position, with continued positive ratings momentum. We do not 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.

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 1.91% to over 3.47%. 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 225 bps, which is over 50 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.

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

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 2Q2022	-7.73%	-6.71%	-9.92%	-4.56%	-3.30%	-4.92%	-16.10%
Total Return 1H22	-13.77%	-13.93%	-13.99%	-10.33%	-9.28%	-11.34%	-19.96%

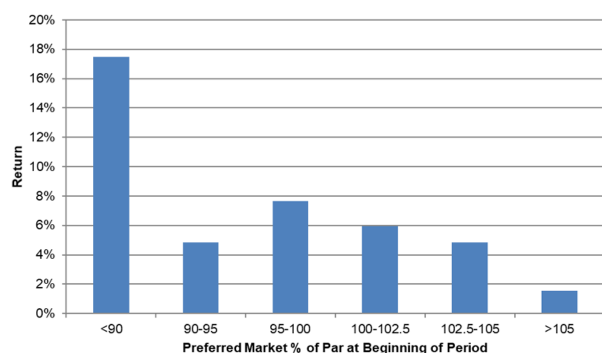
Source: Stonebridge Advisors LLC, ICE Data Services, Bloomberg L.P. as of 6/30/2022.

*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 89.43% of par, which is the lowest price levels since March of 2020. The $25 par segment of the preferred and hybrid securities market is trading at 87.14%, while the $1000 par segment is trading at 90.51% of par. The $1000 par segment has outperformed $25 pars primarily due to its 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 below 90% was 17.47% 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 remain elevated. We believe valuation metrics for preferreds are at the most attractive levels since the onset of the pandemic. High yields relative to other fixed income asset classes coupled with market prices trading at a healthy discount to par provide an improved risk reward balance for preferreds and hybrids relative to the beginning of the year. In addition, the high quality credit fundamentals and sector concentrations in highly regulated industries could help to insulate the asset class in a recessionary environment and against current geopolitical risks. U.S. and European banks are well capitalized and coming from a position of strength in the face of economic headwinds, while other major sectors like insurance, utilities, and REITs offer lower sensitivity to inflation.

  Market dynamics and interest rate volatility have increased the importance of active management when it comes to portfolio positioning for clients. Given recent market repricing, we see opportunities across the entire yield curve, favoring select variable rate securities trading at a discount to par that we believe have the greatest upside potential. We also see opportunities in securities in the $25 par retail market, where rate volatility and fund flows have created pricing dislocations, while we expect to remain highly selective on longer duration variable rate securities and low coupon fixed-rate preferreds. 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. Stonebridge is committed to continually improving portfolio composition and positioning to perform well in the current environment while protecting against the greatest threats.

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 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.

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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