Stonebridge Preferred Securities | Market Report

Second Quarter, 2023

HIGHLIGHTS

- **The preferred and hybrid market continues to offer appreciation potential in addition to income,** with very attractive yield to worst (YTW) valuations and spreads and an average discount to par around ~88%.
- **The preferred and hybrid market outperformed all other fixed income markets in 2Q23.**
- **Credit fundamentals across the preferred and hybrid issuer base withstood idiosyncratic risks faced by a number of banks.** Stonebridge continues to adjust exposures for recession risks.
- **Flows into preferred and hybrid ETFs remained muted in 2Q23,** ending the period with only $47MM of net inflows.
- **Active management remains critical** given the potential for continued rate volatility and recession risks.

MARKET RECAP

The preferred and hybrid securities market bounced back in 2Q23 after a volatile first quarter, outperforming all other fixed income asset classes during the period. Year-to-date returns ended slightly positive, earning back all of the losses from the Credit Suisse AT1 wipeout and the regional bank failures in the US. This all occurred despite the fact that the 10-year Treasury rate edged higher by nearly 40 basis points (bps), reflecting the resiliency of the preferred and hybrid market and the idiosyncrasy of the events from 1Q23. The yield to worst spread of the preferred and hybrid market versus BB HY and IG corporates tightened during the period as economic data and bank earnings generally outperformed expectations and fears surrounding regional banks subsided. However, yield to worst spreads remain well above historical averages. With the rebound in sentiment, performance was positive across all segments of the preferred and hybrid market during the period. Contingent convertible capital securities (CoCos), which were the worst performing market segment in 1Q23, earned 3.84% in 2Q23. Non-investment grade $1000 par securities earned 2.26% while $1000 par investment grade securities returned 2.04%. The longer duration $25 par exchange-traded retail market underperformed in 2Q23, returning 0.64%, but remained the best performing segment YTD.

ETF fund flows into the preferred and hybrid market were modestly positive during the quarter, totaling approximately $47MM. The outsized volatility experienced in 1Q23 seemed to keep many investors on the sidelines despite the historically attractive valuations at the start of the period. The preferred and hybrid securities market continues to offer high income in addition to the potential for price appreciation given the large discounts to par in the market. Although volatility is likely to remain elevated as the Fed continues its hawkish monetary policy stance and the economy may enter a recessionary environment, we think that the preferred and hybrid market is set up longer term for outperformance given its relative valuations and spreads and underlying credit fundamentals.

INVESTMENT OUTLOOK

Issuance Trends:

The preferred market witnessed a significant decrease in both gross and net issuance in 2Q23. The halt in new issuance began at the end of the previous quarter after the increase in market volatility, as issuers have been reluctant to enter the market at such high coupon rates. 2Q23 saw $2.4bn in gross issuance vs $11.94bn in 1Q23, and -$10.17bn in net issuance vs -$769mm in 1Q23. Both the $1000 par institutional and $25 par retail markets witnessed very little issuance with a significant number of redemptions, while coupons remained attractive with the average new issuance coupon settling at 7.88%. 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:

Investors question recession risks as economic data holds firm. Despite significant rate hikes around the world, as well as persistently high inflation, recessions have yet to surface in the U.S. or Europe. As 2023 approached, a recession by this time was a major concern. Now at the midpoint of the year, those concerns have been pushed toward year-end or 2024, if at all. Consumer and corporate credit have not yet shown cracks, and the labor market remains tight. However, even when rate hikes end and core inflation drops, economies could enter recessions from the latent impact of aggressive central bank actions. Also, commercial real estate pressures remain a major risk that could affect overall credit availability. We continue to view inflation prints and employment data in the coming months as the most important datapoints to guide central banks.

Geopolitical tail risk seems to have subsided a bit; 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 continued diplomatic tensions between China/US have kept tensions high. The recent inner turmoil in Russia has optically weakened Putin, but unfortunately, that increases his need to be successful in Ukraine, which could increase tail risk. While Taiwan has been in the news less recently, it continues to be a potential powder keg between China and the US. Iran continues to be active on the antagonistic front, recently attempting to, or successfully executing Saudi oil tanker seizures. On the commodity front, OPEC+ again demonstrated their commitment to supporting oil prices sub-$70 by announcing a production cut extension. The market will likely continue to press on that commitment as China weakness fears persist.

10 Westport Road | Wilton, CT 06897 | (203) 762-0004

Preferred Securities

Interest Rates & Monetary Policies:

Interest rates rise into quarter-end after a benign start to the quarter. Interest rates trended higher during the second quarter with the front-end outpacing the long-end, further inverting the curve. Additionally, we saw the Fed hike short-term rates another 25bps at the May meeting, before pausing rate hikes in June. The 2-year started off flat for the first half of the quarter, but rose sharply during the second half on concerns surrounding the debt ceiling and reduced rate cut expectations, finishing 87bps higher at 4.90%. The 10-year similarly was mostly unchanged during the first half of the quarter, before finishing up 37bps at 3.84%. As a result, the 2s-10s inversion increased 50bps to close the quarter at 106bps. Looking forward, we believe that rates risks are more balanced, as we experience tightening lending standards combined with geopolitical uncertainty.

Central bank policies generally leaned tighter despite a pause by the Fed. The main event in monetary policy in the second quarter was the Fed's decision to pause its rate hiking cycle without giving any indication of what may occur in the July meeting. This decision was in contrast to other major central banks, notably the ECB and BOE in Europe, which both decided to continue hiking rates in June. Looking forward, market expectations are pricing in a skip instead of a pause, with odds now almost fully favoring a Fed rate hike in July, along with additional hikes at the ECB and BOE in their next meetings. As noted above, stubbornly high core inflation in both the U.S. and Europe continue to hamstring central bank policy, forcing the hands of central bank officials to remain hawkish. Additionally, the ECB is considering increasing balance sheet reduction, while the BOE is considering outright bond sales to accelerate balance sheet reduction. Market expectations begrudgingly priced out hopes for rate cuts by the end of the second quarter. To start off the third quarter, any odds of rate cuts have now been moved out almost a year.

Credit:

U.S. Banking sector concerns subside in the latter half of the quarter. Fears surrounding the U.S. banking sector continued into the second quarter as we witnessed another large regional bank, First Republic (FRC), enter FDIC receivership at the end of May then get taken over by JP Morgan. After FRC was taken over, bank equities started to rally as some credit positive moves by other higher risk names left the market content that there were no other banks posing immediate risks. Additionally, the 2023 Fed stress test results demonstrated the banks' capital still remains resilient to severe economic case scenarios. Stonebridge's own stress test had yielded similar results.

European banks moved on from the Credit Suisse takeunder with a strong earnings season. The shock from the Credit Suisse takeunder subsided during the second quarter, as the market viewed Credit Suisse as an idiosyncratic situation. First quarter earnings season for European banks was one of the better quarters in recent years, as all banks away from the Swiss beat consensus estimates. The tailwind of rising rates in Europe has provided significant net interest income growth for most European banks due to the exiting of the negative interest rate regime. Loan quality remained benign. As a result, analysts progressively revised up their full year earnings estimates. Through the end of the second quarter, the median consensus FY23 earnings estimate revision for European banks was up almost 15% year-to-date.

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 with demonstrated intent to hold their securities to maturity. P&C 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 lease rates being buoyed by recovering air travel demand and persistent supply chain issues slowing new aircraft deliveries. Lastly, Stonebridge does not have any direct exposure to Media/Advertising, Tech, Software or Retail sectors, where we could see relatively more credit pressure.

Market Structure:

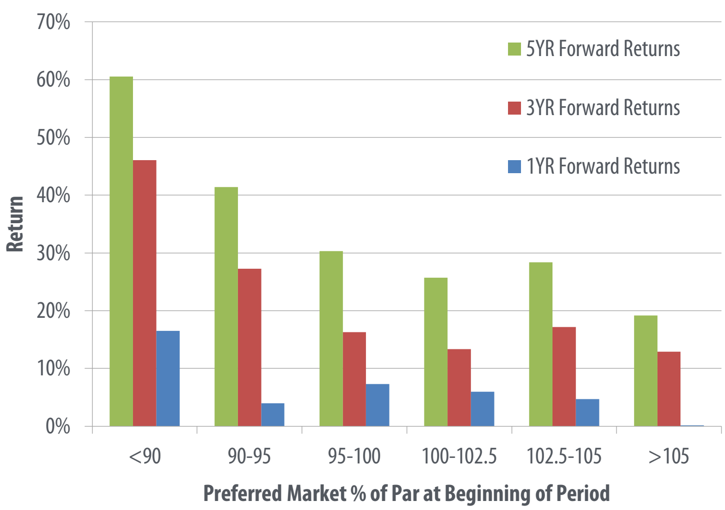
U.S. officially transitions off of LIBOR. The end of 2Q23 marked the official end of LIBOR as the Secured Overnight Funding Rate (SOFR) took over as the market standard floating rate benchmark. As expected, the vast majority of banks utilized their ability from the government's transition bill to shift from LIBOR to SOFR for the reference rate on their preferreds. However, we did see a few surprises, both positively and negatively, as a few companies' legal determination was their prospectus language didn't qualify to use the transition language. This included Morgan Stanley, who announced their LIBOR-based preferreds would remain at the initial fixed rate coupon for the life of the preferred. Wells Fargo on the other hand determined their language required fixing the coupons at the initial coupon plus the back-end spread after the first call date.

VALUATION AND PORTFOLIO POSITIONING

Valuations of preferreds remain at attractive levels. Valuations remain at wide levels, but have tightened compared to late March and early May. Even after tightening, the market YTW is at 7.70% while prices remain discounted at 87.96% of par. YTW spreads versus BB HY and IG corporates remain well above historical averages. In our opinion, the preferred and hybrid market continues to price in recession risks above and beyond other parts of the fixed income market.

As of 6/30/23, current yields across the full preferred securities market are trading at 6.33%. Given the increase in front end yields, many investors have found money market yields of 5.11% to be a compelling risk free alternative to credit spread products. We do not disagree that current yields are attractive in money market funds, however, given the current point in the interest rate cycle, investors may be leaving a significant amount of returns on the table by not investing in preferreds at current valuations. When preferreds have traded less than 90% of par like they are currently, the average 1-year forward return has been nearly 17% higher than money markets, reflecting the inherent reinvestment risk that exists in short-term instruments. Preferreds also offer 2.52% excess yield to worst over money markets. On an after-tax basis, preferreds offer 1.55% excess current yield over money markets.

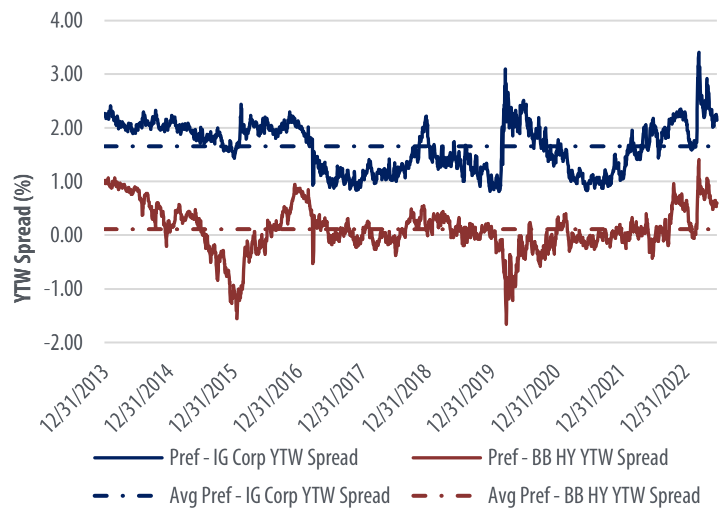
FIGURE 1: Historical Performance of Preferreds Based on Percent of Par (12/31/1992 – 6/30/2023)



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). 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.

FIGURE 2: Yield to Worst Spread Comparison of Preferreds vs. Other Asset Classes (12/31/2013 – 6/30/2023)



*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. **Average calculated since index inception in 12/31/2013. Source: ICE Data Services and Stonebridge Advisors LLC based on daily data.

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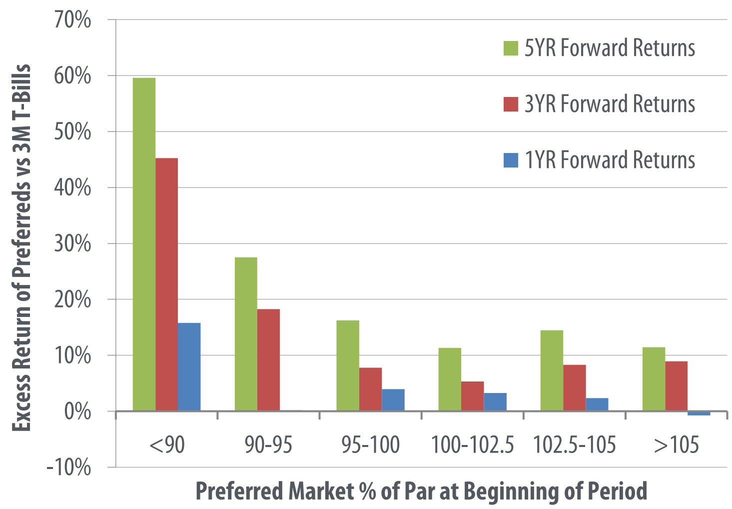
Portfolio positioning. Stonebridge has been actively repositioning for a weaker economic environment which includes being very selective on companies with elevated exposure to weaker commercial real estate sectors and to subprime consumers. In our view, the financial sector, which comprises the majority of the preferred market, is well prepared to manage through a recession given the strong fundamentals built up in prior years. That being said, we continue to be selective on US regional banks, which remain a very small percentage of the preferred market and Stonebridge managed portfolios. We have also been actively reducing our underweight to duration compared to the market with a bias towards high current yielding securities with call protection, which ties in with our target of increasing portfolio yields.

Performance outlook. Over the near-term, our base case for the preferred and hybrid securities market is for a carry environment where price upside may be limited by a lack of fund inflows due to the volatility experienced earlier this year and historically high risk free yield alternatives. As noted above, headwinds persist for the preferred market in terms of interest rate volatility, recession risks and bank credit concerns. While volatility may continue, the preferred market continues to price in a significant amount of risk compared to other fixed income asset classes, as evidenced by its elevated YTW spreads. High yields coupled with the potential for modest appreciation, like we experienced in the second quarter, could result in positive returns by year end. Longer term, investors face a compelling entry point given the discounted prices and elevated YTW in the market. We believe active management may provide additional upside potential for investors through duration management and security selection based on relative value and credit analysis.

FIGURE 3: Preferred Market Performance vs. Money Market Funds (12/31/2013 – 6/30/2023)



*Money market funds represented by the ICE BofA US 3-Month Treasury Bill Index (G0O1). 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). The $25 par retail market is represented by the ICE BofA Core Plus Fixed Rate Preferred Securities Index (P0P4). Source: ICE Data Services and Stonebridge Advisors LLC based on monthly data.

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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.