# Stonebridge Preferred Securities

*Market Report*

Second Quarter, 2017

## MARKET RECAP

The preferred and hybrid securities markets performed well during the second quarter and first half of 2017. Fixed-income markets were supported by a flattening yield curve, as longer-term interest rates remained stable to slightly lower and shorter-term rates continued to increase. The Federal Reserve (Fed) hiked short-term interest rates by 0.25% in June as economic data showed an improving labor market and low inflation numbers, as well as steady but mixed growth in both the U.S. and Europe. This helped drive 3-month LIBOR[1] higher during the quarter by 0.15% to 1.30%. While the Fed continues to signal that further rate hikes are likely to occur later in 2017, the broader market has been reducing its expectations of further Fed tightening given the more mixed economic picture. In the U.S., political progress on tax and healthcare reform has been slower than expected, but the continued progress in reducing regulatory burdens in many sectors of the economy, including financials, have helped drive increased corporate profit expectations. As a result, equity markets reached all-time highs during the quarter. Despite higher front-end rates, longer-term interest rates drifted slightly lower during Q2; 10-year Treasury yields fell by 0.08% (to 2.31%), while 30-year Treasury yields dropped by 0.15% (to 2.84%).

In the preferred and hybrid securities space, stable interest rates, limited new issuance and strong investor appetite for yield led to all parts of the market performing well. This drove credit spread tightening in the broader fixed-income markets as well as the preferred and hybrid securities market. In 2Q17, the total return of the retail preferred securities market, as measured by the Bank of America Merrill Lynch Core Plus Fixed Rate Preferred Securities Index (P0P4)*, was 3.5%, while the institutional hybrid securities market, as measured by the Bank of America Merrill Lynch U.S. Capital Securities Index (C0CS), also returned 3.5%. This was in contrast to the overall 1H17 performance, where the retail market outperformed the institutional market 9.1% to 7.1%, respectively. The European-dominated Bank of America Merrill Lynch Contingent Capital Index (COCO) returned 4.1% for 2Q17 and 9.0% for 1H17, as new issue volumes remained limited and European economic and credit sentiment improved for financials, despite several small bank failures.

The preferred securities market also performed well in the first half of 2017 relative to all other fixed-income asset classes, notably outperforming high-yield bonds, investment-grade corporate bonds, 10-year and 30-year Treasuries, mortgage securities and municipal bonds. The equity securities market, as measured by the S&P 500 Index, was the only asset class that outperformed the preferred sector in 1H17.

**Figure 1. Hybrid Preferred Securities Yield & Total Return Performance Relative to Other Indices.**

| Index | Ticker | Average Rating | Effective Duration+ 2Q2017 | Current Yield 2Q2017 | Total Return 2Q17 | Total Return 1H17 | Total Return FY2016 |
|---|---|---|---|---|---|---|---|
| **BAC-ML Core Plus Fixed Rate Preferred** | **P0P4** | **BBB3** | **3.88** | **5.95%** | **3.48%** | **9.08%** | **1.40%** |
| **BAC-ML Preferred Stock Fixed Rate** | **P0P1** | **BBB2** | **4.18** | **5.59%** | **3.35%** | **8.73%** | **2.32%** |
| **BAC-ML U.S. Capital Securities** | **C0CS** | **BBB2** | **6.02** | **5.65%** | **3.54%** | **7.11%** | **5.21%** |
| **BAC-ML Contingent Capital Index - Hedged** | **COCO** | **BB2** | **3.75** | **6.38%** | **4.12%** | **8.99%** | **7.78%** |
| BAC-ML US Corporate | C0A0 | A3 | 7.21 | 3.82% | 2.42% | 3.88% | 5.96% |
| BAC-ML US Cash Pay High Yield | J0A0 | B1 | 4.05 | 6.23% | 2.16% | 4.93% | 17.34% |
| BAC-ML US Current 10 Yr Treasury | GA10 | AAA | 8.85 | 2.35% | 1.29% | 2.08% | -0.16% |
| BAC-ML US Current 30 Yr Treasury | GA30 | AAA | 20.26 | 2.90% | 4.21% | 5.53% | 0.89% |
| BAC-ML US Mortgage Backed Securities | M0A0 | AAA | 4.69 | 3.41% | 0.90% | 1.37% | 1.67% |
| BAC-ML US Municipal Securities | U0A0 | AA3 | 6.87 | 4.31% | 1.98% | 3.40% | 0.44% |
| S&P 500 | SPX | NA | NA | 2.03%** | 3.09% | 9.34% | 11.96% |

Source: Stonebridge Advisors LLC, BofA Merrill Lynch Research;**Dividend yield. Past performance is no guarantee of future results.

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

*Please note that effective January 1, 2017, we are using the Bank of America Merrill Lynch Core Plus Fixed Rate Preferred Securities Index (P0P4), to represent the $25 par retail preferred securities market. We believe that this index is a more accurate representation of the retail preferred securities market than the Bank of America Merrill Lynch Preferred Stock Fixed Rate Index (P0P1), that we previously used given that P0P1 now has material exposure to the $1000 par institutional preferred securities market. We continue to use the Bank of America Merrill Lynch U.S. Capital Securities Index (C0CS), to represent the institutional preferred securities market.

+Effective duration – A measure of a fixed-income security's sensitivity to changes in interest rates reflecting the expected change in price given a 100 basis point rise in rates, including the impacts of embedded options.

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Duration was a modest driver of performance during the quarter within the preferred and hybrid securities markets and across fixed-income asset classes as the interest rate curve continued to flatten. Credit spread tightening was also a material driver of performance, which helped asset classes such as preferreds, high-yield bonds and high-grade corporate bonds. Within the overall preferred securities market, longer-duration securities performed better than shorter-dated securities. This was most prevalent in the retail preferred securities market, which continued its rebound from a weak 4Q16 with a strong rally in 1H17. The institutional market, dominated by fixed-to-floating rate structures, showed solid performance across all duration bands driven more by spread tightening than by overall interest rate movements. Floating-rate securities with coupons benchmarked off of three-month LIBOR also showed strong performance.

**Figure 2. Performance by Effective Duration Bands-2Q2017.**

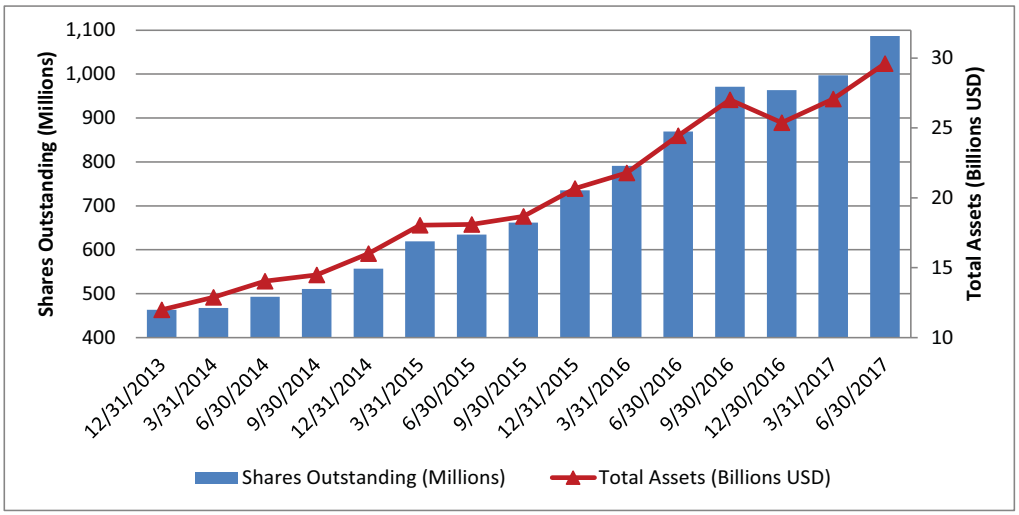
| | P0P4 Retail Index | | C0CS Institutional Index | |
|---|---|---|---|---|
| **Duration Bands** | **Weighting** | **2Q 2017 TR** | **Weighting** | **2Q 2017 TR** |
| 0-3 Years | 45.81% | 1.98% | 17.77% | 1.72% |
| 3-5 Years | 15.39% | 3.20% | 25.07% | 2.92% |
| 5-8 Years | 28.04% | 4.35% | 35.98% | 3.22% |
| 8-12 Years | 10.55% | 5.63% | 19.94% | 6.04% |
| >12 Years | 0.21% | 8.02% | 1.25% | 0.00% |
| **Grand Total** | 100.00% | 3.48% | 100.00% | 3.54% |

Source: Stonebridge Advisors LLC, BofA Merrill Lynch Research. Past performance is no guarantee of future results.

## Passive Preferred Securities ETF Assets Rebound in 1H17 After Losses in Q416 but Variable and Active ETFs Show Growth

The growth in passive preferred securities ETF assets continued to support the retail preferred securities market in Q2 2017. The total assets of the six widely followed preferred securities ETFs increased by over $2.5bn, or over 9%, during 2Q17 after growing by $1.7bn, or 6%, during 1Q17 (see Figure 3). These strong quarters followed a decline in assets during Q4 2016 after Trump's surprise election win and the subsequent spike in interest rates. This decline represented the first quarter of negative growth in preferred securities ETFs since 2013. However, as interest rates stabilized in 2017, the assets of preferred securities ETFs reached all-time highs. Of these six ETFs, five are passive ETFs that track various preferred indices. It is worth noting that two of the ETFs in the group (FPE and VRP) experienced strong and steady inflows during both the fourth quarter of 2016 and through the first half of 2017, likely because they are less interest-rate sensitive and in the case of FPE, also actively managed. On the other hand, the other 4 ETFs in the Figure 3 chart are passively managed and purely index funds with high concentrations of interest sensitive fixed-for-life preferreds.

**Figure 3. Growth of Leading Preferred ETFs Since 2013.**




Source:Shares outstanding from Bloomberg as of 6/30/2017. Includes shares in PFF, PGX, PSK, VRP, PGF, and FPE (see footnote 2 below).

[2]Includes iShares U.S. Preferred Stock ETF (PFF), PowerShares Financial Preferred Portfolio (PGF), PowerShares Preferred Portfolio (PGX), PowerShares Variable Rate Preferred Portfolio (VRP), SPDR Wells Fargo Preferred Stock ETF (PSK) and First Trust Preferred Securities and Income ETF (FPE).

## New Issuance Recap

New issuance volumes of U.S. dollar (USD) preferred and hybrid securities totaled $16.3 billion for the second quarter of 2017, which was a decline of almost $5 billion compared to 1Q17's issuance volume of $21.3 billion. However, this was almost $1.7 billion higher than 4Q16. In the second quarter, 71% of this new issue volume was in the institutional $1,000 par market, predominantly fixed-to-floating rate securities and largely by non-U.S. issuers. Many of these new issues (particularly from Asian issuers) are targeted to foreign investors in USD securities and many are unavailable to U.S. domestic investors in the new issue market. Only 29%, or $4.8 billion, of issuance in 2Q17 was retail-structured issues, mostly fixed-for-life preferred securities. Although this was higher than the $2.9 billion issued in 1Q17, it is still one of the lowest retail issuance quarters in recent years. Given the uncertain outlook for interest rates, we expect $25 par retail issuance will remain relatively low by historical standards for all of 2017.

Redemptions totaled approximately $22.4 billion in the 2nd quarter, which was almost $10.4 billion higher than the first quarter of 2017. In the retail market, redemptions totaled about $4.6 billion, compared to new issuance of almost $4.8 billion, signaling a small net increase in the size of the retail market. In general, we continue to expect large international $25 par issues will be redeemed over the next few years and new $25 par issues will likely be smaller deals from lesser known or unrated domestic U.S. issuers. In the institutional market, redemptions exceeded new issues by about $6.3 billion. This was a substantial change from the $14 billion net institutional issuance seen in the first quarter of 2017 and has been a major factor contributing to tightening credit spreads given substantial investor demand for new issues. Most institutional redemptions have been obsolete, legacy capital instruments from non-US banks and insurers that are replacing called issues with contingent capital securities and other hybrids that meet new regulatory standards. We expect further redemptions of these older issues but also expect limited issuance needs among large U.S. and European banks may depress new issuance volumes somewhat for the rest of 2017. Outside of the U.S., many Asian banks and companies issue USD-denominated securities targeted to Asian investors. Most of these issues are not available for sale to U.S. investors, which has provided strong technical support for USD-denominated securities traded in the U.S. These tight market supply conditions and strong U.S. investor demand for yield in a favorable credit environment are major reasons why we continue to expect more relative spread tightening for preferred and hybrid securities for the second half of 2017.

**Figure 4. Top 10 Retail and Institutional USD New Issues for 2Q 2017 (by $ AMT).**

| 2Q17 | | | | | |
|---|---|---|---|---|---|
| ISSUER | SECURITY DESCRIPTION | COUPON | COUPON TYPE | PAR AMOUNT | DEAL SIZE ($MM) |
| **RETAIL** | | | | | |
| WELLS FARGO & COMPANY | WFC 5 5/8 PERP | 5.625 | FIXED | 25 | $690 |
| QWEST CORP | CTL 6 3/4 | 6.75 | FIXED | 25 | $660 |
| SCE TRUST VI | EIX 5 PERP | 5 | FIXED | 25 | $475 |
| NUSTAR ENERGY LP | NSUS 7 5/8 PERP | 7.625 | VARIABLE | 25 | $385 |
| COLONY NORTHSTAR INC | CLNS 7.15 PERP | 7.15 | FIXED | 25 | $345 |
| PUBLIC STORAGE | PSA 5.15 PERP | 5.15 | FIXED | 25 | $280 |
| VALIDUS HOLDINGS LTD | VR 5.8 PERP | 5.8 | FIXED | 25 | $250 |
| NGL ENERGY PARTNERS LP | NGL 9 PERP | 9 | VARIABLE | 25 | $210 |
| FIRST REPUBLIC BANK | FRC 5 1/8 PERP | 5.125 | FIXED | 25 | $200 |
| DEL MONTE PACIFIC LTD | DELMSP 6 5/8 PERP | 6.625 | VARIABLE | 10 | $200 |
| | | | | | |
| **INSTITUTIONAL** | | | | | |
| HSBC HOLDINGS PLC | HSBC 6 PERP | 6 | VARIABLE | 1000 | $3,000 |
| NANYANG COMMERCIAL BANK | NANYAN 5 PERP | 5 | VARIABLE | 1000 | $1,200 |
| CK HUTCHISON CAPITAL 17 | CKHH 4 PERP | 4 | VARIABLE | 1000 | $1,000 |
| SUNTRUST BANKS INC | STI 5.05 PERP | 5.05 | VARIABLE | 1000 | $750 |
| CREDIT BANK OF MOSCOW (C | CRBKMO 8 7/8 PERP | 8.875 | VARIABLE | 1000 | $700 |
| CREDIT BANK OF MOSCOW (C | CRBKMO 7 1/2 10/05/27 | 7.5 | VARIABLE | 1000 | $600 |
| BANK OF EAST ASIA LTD | BNKEA 5 5/8 PERP | 5.625 | VARIABLE | 1000 | $500 |
| CCB LIFE INSURANCE | PANLIZ 4 1/2 04/21/77 | 4.5 | VARIABLE | 1000 | $500 |
| LEGAL & GENERAL GROUP | LGEN 5.55 04/24/52 | 5.55 | VARIABLE | 1000 | $500 |
| WOORI BANK | WOORIB 5 1/4 PERP | 5.25 | VARIABLE | 1000 | $500 |

Source: Stonebridge Advisors LLC, Bloomberg

## Investment Outlook

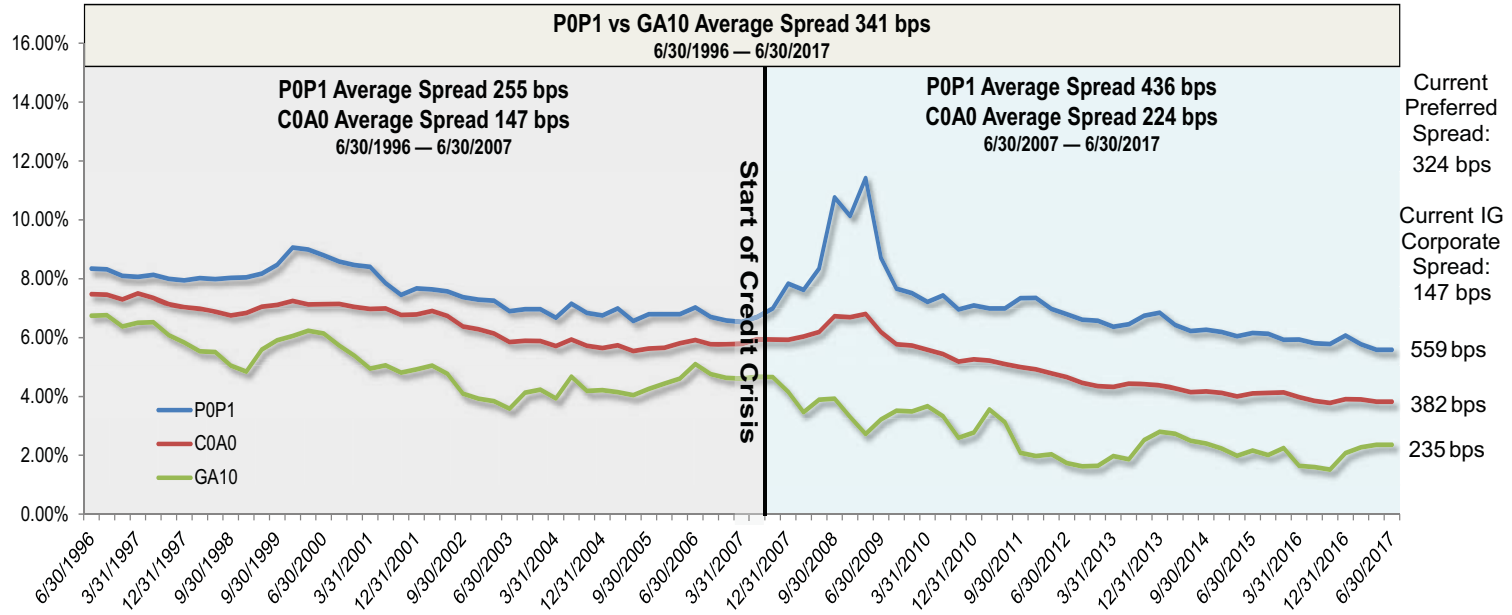
First half economic data in the U.S. has generally been more bullish for growth, investment and employment than we saw in 2016. While the results of the U.S. election in November increased market expectations for the economy, rising uncertainty in terms of U.S. government policy and more mixed economic data has tempered U.S. fixed-income market enthusiasm in the first half of 2017. While the stock market has continued to rally in the first half of 2017 close-up, medium- and long-term interest rates have dropped slightly even as the Fed continues to hike short-term interest rates. Outside the U.S., economic growth and sentiment has improved most sharply in Europe, driven by a bullish French election result and an improved GDP growth outlook. While market interest rates have risen modestly in Europe and Japan, they remain very low compared to the U.S., effectively limiting the speed and magnitude of further U.S. tightening.

We continue to believe that the yield curve is likely to remain flat, as short-term rates are likely to increase and may push long-term rates higher. We have long anticipated, and positioned for, a rising rate environment, and we continue to hold the view that this process will be gradual. U.S. fiscal policy and potential tax and regulatory changes have the potential to boost economic growth but we also believe this impact is likely to be muted and slow given political uncertainty and the likelihood that any changes will likely be phased in over time. In this overall low rate environment, despite strong tightening in the first half, credit spreads remain fairly wide by historical standards, supported by the stable to positive credit fundamentals we see in most issuers (Figure 5).

The credit fundamentals of the global bank and insurance sector continued to improve in 2Q17, driven by a more favorable rate environment, reduced regulatory pressure, and the successful resolution of several troubled banks in Europe. In the U.S., modifications to the Dodd-Frank regulations and eased implementation of periodic stress tests and capital restrictions are allowing banks to increase dividends and repurchase stock. In general, we also expect banks to be allowed more latitude to make loans and trade securities but we expect currently high regulatory capital requirements to remain in place. In the European financial sector, we saw a small, troubled Spanish bank and several small, troubled Italian banks fail and get sold, with government assistance, to larger banks, while protecting senior creditors. The market viewed these events as a positive test of the system and, as a result, the hybrid capital securities of most of the larger European banks rallied in response. Despite this rally, European hybrid structures continue to look attractive given a positive credit and economic outlook and limited supply of new issues. On the political front, the recent French election appears likely to stimulate structural economic reform there and a more favorable environment for French issuers.

Given the outlook for gradually rising interest rates in 2017, we have maintained our conservative stance on interest rate risk by remaining overweight less interest-rate sensitive securities than our benchmarks. With the potential for further rate volatility, we believe it is prudent to actively manage duration, particularly if we can do so while paying income comparable to or better than the benchmark yield. We believe the quality and stability of our duration is better than the benchmark given our lower exposure to negatively convex securities (such as securities trading at negative yield-to-calls and low coupon fixed-rate-for-life structures). As a result, we believe our portfolios should continue to show more resilience in a market downturn and potentially outperform in a rising rate environment.

**Figure 5. Historical Spread of Preferred Securities vs High Grade Corporate Bonds and the 10-Year Treasury.**




6/30/1996 - 6/30/2017

Preferred Securities are represented by the BofA Merrill Lynch Fixed-Rate Preferred Securities Index (P0P1) which tracks the performance of fixed-rate U.S. dollar-denominated preferred securities issued in the U.S. domestic market.

Investment Grade Corporate Securities are represented by the BofA Merrill Lynch US Corporate Index (COA0) which tracks the performance of US dollar denominated investment grade corporate debt publicly issued in the U.S. domestic market.

10-Year Treasuries are represented by the BofA Merrill Lynch Current 10-Year U.S. Treasury Index (GA10) which is comprised of the most recently issued 10-year U.S. Treasury note.

Source: Merrill Lynch, Bloomberg, Stonebridge Advisors LLC

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



*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.*