Stonebridge Preferred Securities
Market Report

Third Quarter, 2021

Highlights

- **Flows into preferred and hybrid exchange-traded funds (ETFs) remained strong during the third 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 for the remainder 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,** 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 critical for the remainder of 2021** given tighter valuations due to spread tightening and the potential for rate volatility.

MARKET RECAP

The preferred and hybrid securities market produced modest returns during the third quarter of 2021, as 10-year Treasury yields were relatively unchanged during the period. Non-investment grade (non-IG) $1000 par securities were the top performing market segment for the fourth consecutive quarter, returning 1.61%, while IG $1000 par securities rebounded during the third quarter to return 0.95%. The hunt for yield and strong credit fundamentals helped drive the relative outperformance of non-IG versus IG during the period. The longer duration $25 par exchange-traded retail market was the laggard for the quarter, returning -0.32%, due to the ~20 basis points (bps) move higher in the 10-year Treasury yield and negative investor sentiment related to the equity sell-off during the last 2 weeks of the quarter. Finally, contingent convertible capital securities (CoCos) from non-US banks continued to perform, returning nearly 0.44% for the quarter.

ETF fund flows into the preferred and hybrid securities market continued to be strong during the third quarter of 2021. Actively managed ETFs saw inflows of over $700mm 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. We expect that this will continue to drive demand into the space and support market technicals. 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 for investors wary of rising long-term yields.

Investment Outlook

Issuance and Supply Expectations:

- **Active management is critical in the new issuance market given the increasingly competitive order books and lack of concessions on many new deals.** In 3Q21, average coupons on new issuance modestly decreased on tighter valuations. New issues in the $25 par retail market experienced an average coupon of 5.47%, while the institutional market averaged 3.98%. Stonebridge remains disciplined within the primary market, but has selectively found opportunities in some newly issued securities.
- **The $25 par retail market has shrunk in every quarter YTD.** However, most of the shrinkage occurred in the first two quarters. 3Q21 had net issuance of -$591m, which is significantly less than 2Q21 (-$4.98bn) and 1Q21 (-$1.48bn). YTD net issuance stands at $17.57bn, which includes +$24.65bn from the institutional market and -$7.06bn from the $25 par retail market.
- **Stonebridge anticipates a meaningful drop in gross issuance for the remainder of 2021.** In addition to reduced gross issuance, based on our redemption and refinancing forecasts, we expect to see net issuance decline as well. Additionally, we have noticed a gradual decrease in quarter over quarter gross issuance so far this year. This should provide a positive technical backdrop and should be supportive of secondary prices.

Macroeconomic & Geopolitical Trends:

- **Politics take center stage on policy and debt ceiling negotiations.** The Biden administration continues to pursue an infrastructure bill and tax policy changes at both the corporate and personal level. Debt ceiling negotiations have introduced additional volatility to the markets, and may come up again later in the fourth quarter as negotiations remain fluid. Potential tax policy implications on the preferred securities market, if any, remain uncertain. All else equal, higher personal tax rates increase the QDI benefit offered by many preferred securities.
- **Global oil and gas markets remain undersupplied as OPEC+ remains supportive and demand returns.** Upside price spikes are becoming a bigger risk as OPEC+ stayed the course on their planned production increases through YE21, in spite of historically low global oil and gas inventories. As demand continues to recover, we will likely continue to see inventories draw and price volatility increase as we enter winter. Domestically, inventories in the U.S. are in a better position than Europe and Asia, so we are less concerned about inflation pressures in the U.S. becoming a macro issue. Higher hydrocarbon prices domestically should continue to lend support to upstream and midstream credit profiles.

Interest Rates & Monetary Policies:

- **Treasuries sold off late in the third quarter.** Treasuries took a roundtrip during the third quarter. After closing at 1.47% at the end of June, the 10-year Treasury rate fell to a low of 1.13% in early August and then jumped to a high of 1.57% in late September before closing the quarter at 1.49%, only 2 bps higher on the quarter. We continue to see a confluence of events that may fuel rate volatility in the fourth quarter, including anticipated Federal Reserve (Fed) tapering, inflation prints, debt ceiling negotiations and fiscal policy by way of infrastructure/tax legislation, to name a few.
- **Fed board shakeup may overshadow central bank policy change signals in the fourth quarter.** Central banks, led by the Fed, finally started signaling policy changes late in the third quarter. The Fed noted in September that QE bond purchase tapering is likely to begin soon, leading investors to anticipate an official announcement in the November Federal Open Market Committee (FOMC) meeting. The European Central Bank (ECB) and Bank of England (BOE) broadcasted similarly to the market. However, uncertainty regarding Fed leadership has taken center stage recently. The odds of the renomination of Fed Chairman Powell to run another term have fallen after a number of board members resigned or announced retirement. These announcements follow controversy from trading activity conducted during the pandemic. In our view, a new Fed chair, along with high turnover on the board, would present market volatility risk in the fourth quarter.

Credit:

- **U.S. Banks outlook continues to strengthen as M&A activity remains high.** U.S. banks reported another strong quarter in 2Q21 with over 95% beating consensus earnings estimates. We continue to see reserve releases from the vast majority of banks as more economic clarity drives loan loss forecasts lower. U.S. Banks still remain well protected against future losses with strong capital levels and loan loss reserves. On the M&A front, regional banks have been very active with several smaller bank acquisitions announced YTD. The majority of these acquisitions have helped expand or strengthen the bank's presence within existing exposures.
- **Expect European bank positive momentum to continue into third quarter earnings season.** In Europe, over 90% of banks beat consensus estimates during the first half of the year. We expect this strong performance to continue into 3Q21 earnings season coming up in a few weeks. Meanwhile, the median equity analyst EPS estimate increase across European banks is now up to almost 40% for full year 2021 earnings. As previously announced by the ECB, the ECB lifted the cap on dividend/buyback payout ratios at the end the third quarter. We view year-to-date financial performance and regulatory developments as positive reflections of strong credit profiles among European banks.
- **Bullish oil market trends coupled with common dividend cuts lay out credit positive 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 however, several Midstream credits cut their common dividends materially during the pandemic, solidifying their positive free cash flow positions, which can be used for de-levering the balance sheet over the next few years. 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.

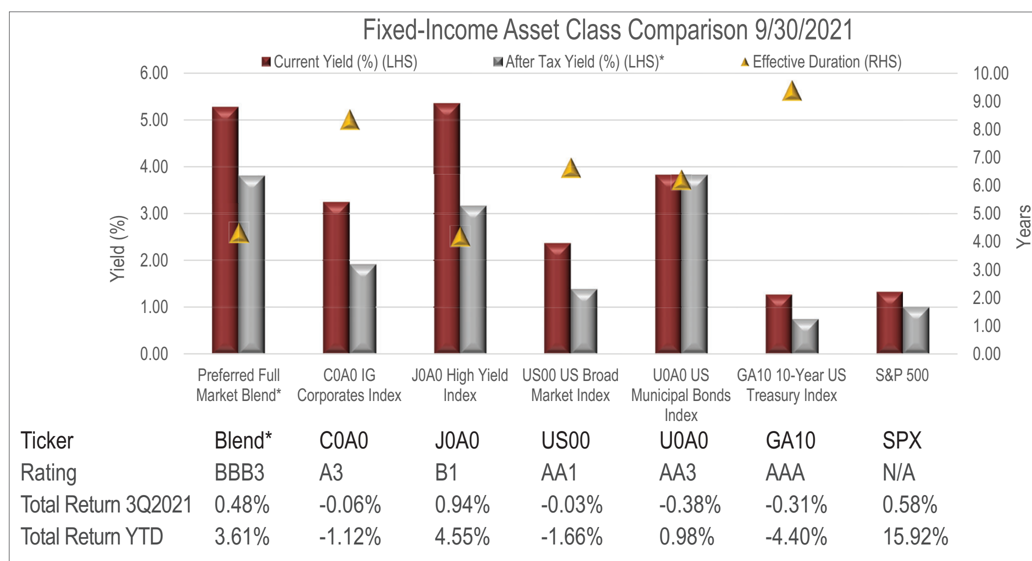
Market Structure:

- **Regulators stress importance of smooth LIBOR[1] 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 reset spreads.

Valuation and Portfolio Positioning:

- **Preferreds offer incremental yield and spread over other asset classes.** 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 1.45% to over 2%. For taxable investors, the tax-advantaged QDI offered by many preferred securities increases the value of the after-tax yield of preferred securities, as shown in the table. 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.

Figure 1. Yield Comparison of Preferreds vs Other Asset Classes



Ticker	Blend*	C0A0	J0A0	US00	U0A0	GA10	SPX
Rating	BBB3	A3	B1	AA1	AA3	AAA	N/A
Total Return 3Q2021	0.48%	-0.06%	0.94%	-0.03%	-0.38%	-0.31%	0.58%
Total Return YTD	3.61%	-1.12%	4.55%	-1.66%	0.98%	-4.40%	15.92%

Source: Stonebridge Advisors LLC, ICE Data Services, Bloomberg L.P. as of 9/30/2021.

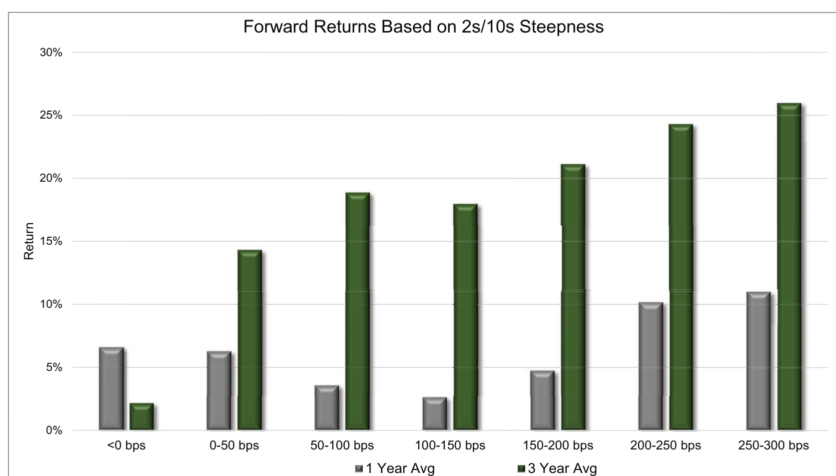
*Custom blend index: A blend of the following ICE indices: 30% P0P4-ICE BofA Core Plus Fixed Rate Preferred Securities Index / 30% CIPS-ICE BofA US Investment Grade Institutional Capital Securities Index / 30% CDLR-ICE USD Contingent Capital Index / 10% HIPS-ICE BofA US High Yield Institutional Capital Securities Index.

Assumes 40.8% Federal Tax Rate, no state tax. QDI eligible securities are determined by Bloomberg and Stonebridge.

- **Wider current yield spreads at the end of the third quarter may lessen impact of rising rates.** Current yield spreads over 10-year Treasuries widened during the quarter by about 30 bps to 396 bps, primarily as a result of the move tighter in Treasuries on the long end of the yield curve. Stonebridge believes that the wider spreads are likely to provide a cushion for preferreds if we do see a rise in rates on the long end. History has demonstrated that preferred spreads generally tighten in as the yield curve steepens and Stonebridge analysis on over 25 years of data has shown that, as the yield curve steepens, forward returns on a 1-year and 3-year basis for the preferred securities market have been positive on average. (See Figure 2 on next page).

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

Figure 2. Historical Forward Returns of Preferreds Based on 2yr/10yr Treasury Curve Steepness



Source: ICE Data Services, Bloomberg L.P.

Preferred Securities are represented by the ICE BofA Fixed-Rate Preferred Securities Index (P0P1) from 12/31/1996 – 12/31/2013. From 12/31/2013 – present, preferred securities are represented by a blend of ICE Indices (30% P0P4 / 30% CIPS / 30% CDLR / 10% HIPS). See Index Definitions.

The curve steepness is calculated by the 10-year Treasury yield less the 2-year Treasury yield. Returns are calculated using the 1-year and 3-year forward looking total return from each month-end period. **Past performance is not indicative of future results** and there can be no guarantee historical trends will continue into the future.

- **Performance outlook and portfolio positioning.** Based on relative value analysis and recent tightening in the market, Stonebridge believes that valuations are mostly fairly valued in the current market, and we expect that the majority of returns over the next 12 months are likely to be in the form of income. Although we believe preferreds and hybrids have the potential to outperform other fixed-income asset classes in a rising rate scenario, the potential for interest rates rising is probably the biggest near term risk facing fixed-income markets and the preferred and hybrid securities market in particular. There are a number of potential catalysts that could lead to higher rates including uncertainty on Powell's tenure and future Fed board replacements. We believe that a dovish tilt to the makeup of the Fed could lead to a steepening of the yield curve. Also, other catalysts for rate volatility still persist, such as QE bond purchase tapering, inflation/economic data and fiscal policy regarding infrastructure and tax legislation. 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 and targeting relative value swaps in favor of improving security structure combined with improved valuation.

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 third 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.