Stonebridge Preferred Securities | Market Report

Third Quarter, 2022

HIGHLIGHTS

- **Flows into preferred and hybrid exchange traded funds (ETFs) were negative during the third quarter of 2022 but much improved compared to the prior two quarters, ending the period with over ~$425 million of outflows,** contributing to the market selloff.
- **The preferred and hybrid securities market ended the period trading at historically wide valuations,** with the widest yield-to-worst on record since the inception of full market index on 12/31/2013.
- **Credit fundamentals across the preferred and hybrid issuer base** remain strong in the face of monetary policy and geopolitical risks, reflecting mostly investment grade issuers in highly regulated industries.
- **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 is more critical than ever** given the potential for continued rate volatility and macro uncertainty.

MARKET RECAP

The preferred and hybrid securities remained volatile during the third quarter of 2022, earning negative returns for the period. The market showed significant strength at the beginning of the period as the June consumer price index (CPI) print came in below expectations, causing interest rates to fall across the curve. However, the Federal Reserve (Fed) struck a very hawkish tone during the Jackson Hole Economic Symposium at the end of August, preceding a hotter than expected inflation reading in September. In response, 10-year yields moved sharply higher, crossing 4% during the period for the first time since the financial crisis, and 2-year yields spiked by over 130 basis points (bps) for the quarter. With the Fed's commitment to fight inflation, even at the cost of a mild economic recession, the 2/10 year Treasury curve deepened its inversion, ending the period around 45 bps. Non-investment grade (non-IG) $1000 par securities were the top performers during the period, returning 0.17%, followed by IG $1000 pars, which returned 0.95%. The longer duration $25 par exchange-traded retail market continued to be volatile during the period, returning -2.00%. Contingent convertible capital securities (CoCos) from non-U.S. banks were the worst performers, returning 4.29%, due to the continued geopolitical instability in Russia/Ukraine as well as the surprise budget announcement from newly elected UK Prime Minister, Liz Truss, in late September.

ETF fund flows into the preferred and hybrid market remained negative during the third quarter of 2022, but improved compared to the prior two quarters. Passively managed funds, which are mostly concentrated in longer duration $25 par retail securities, had about $330MM of outflows during the period. Actively managed ETFs, which tend to provide exposure to the $1000 par institutional market, had around $92MM of outflows. Compared to other fixed income asset classes, preferreds continue to offer relatively high yields, potential tax advantages due to qualified dividend income (QDI) eligibility for qualified securities and strong credit fundamentals across the issuer base. As we potentially enter a recessionary environment, we believe that the credit strength of the issuer base and the historically wide valuations in the market today provide a very compelling investment rationale. Although volatility is likely to remain elevated in the near term, we think that the preferred and hybrid market is set up longer term for outperformance.

INVESTMENT OUTLOOK

Issuance and Supply Expectations:

- **Preferred market issuance increased meaningfully during the third quarter, while new issuance coupons ticked higher.** Compared to previous quarter, the preferred market saw a 56% increase in net issuance and a 43% increase in gross issuance. The increase in net issuance was concentrated within the retail market, which jumped 116% vs. the second quarter, while net issuance in the institutional market was flat. New issuance continued to price at attractive levels, with the average new issuance coupon increasing from 6.79% in the second quarter to 7.06% in the third quarter. Looking forward, we forecast new supply to remain fairly muted over the coming months, while issuance levels continue to look attractive.

Macroeconomic & Geopolitical Trends:

- **New political risks added to inflation and war risks during the third quarter.** The third quarter brought some new political risks to go along with inflation and war risks, most notably the new UK prime minister's tax plan. The announcement brought volatility into the British pound and treasury markets. As sterling approached parity with the U.S. dollar, 10 year gilts jumped to 4.5%. Sterling and 10 year gilts settled down to end the quarter at ~$1.11 and ~4%, respectively, but not before excaberating a spike in global rates. Meanwhile, Italian general elections were held late in the quarter, with the center-right coalition beating the center-left incumbent. We await the new coalitions fiscal plans. Here in the U.S., we expect the political newsflow to increase as we approach the midterm elections. Regarding inflation, headline CPI started dropping in the third quarter, but continued rising in Europe. The culprit in Europe was the escalation of tensions with Russia on gas supplies to Europe as the winter months approach. Despite the increase in political risks, we expect inflation prints to remain the primary market catalysts during the fourth quarter.

Preferred Securities

- **Amidst near-term global oil demand concerns, recent action by OPEC+ has provided some downside protection on oil prices.** With front-month WTI prices down 25% in the third quarter, the recent focus of the futures market has been on a potential global recession and resulting weaker oil demand concerns. Additionally, China's Zero Covid policy has caused fairly material demand declines in certain Chinese regions. OPEC's most recent action of cutting the group's production quota by 2MM b/d (actual production declines of 1.0-1.1MM b/d) was in response to these demand concerns. Since OPEC discussions began getting leaked, WTI is up ~10%+. With this, OPEC has effectively provided somewhat of a 'put' on the oil market, indicating they will cut further if needed. Finally, the implications of the Russian/Ukraine war continue to be a risk for oil/gas prices. European natural gas prices will continue to be volatile due to tight supplies driven by Russian supply curbs. Finally, the G-7's oil price cap plan has the risk of pushing Russia into a unilateral production cut in retaliation.

Interest Rates & Monetary Policies:

- **Treasury yields increased during the third quarter while Fed rate hikes drove further yield curve inversion.** Interest rate volatility persisted throughout the third quarter driven by a number of factors, including the Fed hiking short-term rates by 150 bps while continuing to reduce their balance sheet, sustained high inflation prints and escalating geopolitical conflicts. The 10-year Treasury yield increased 82 bps during the third quarter, finishing at 3.83%, as yields rebounded sharply over the latter two months after dropping to a recent low of 2.57% on August 1st. The unprecedented 150 bps of rate hikes by the Fed drove further inversion on the yield curve with the 2s/10s spread widening 39 bps to -0.45%. We also witnessed a notable shift in market tone compared to last quarter, as fears that the Fed wasn't doing enough have shifted to fears that the Fed could tighten too much. With all the same macro drivers still pertinent and the risk of a hard landing increasing, we'd expect to see continued rate volatility through year-end.
- **Central bank concerns shift to "too much" from "not enough".** The third quarter showed how quickly the tide can change, as market sentiment shifted from concern that the Fed was not doing enough to slow down inflation to fear that the central bank was doing too much and will lead to a hard landing in the economy. The tone initially shifted after Chairman Powell's speech at the Jackson Hole Economic Symposium in August, and continued after the FOMC meeting in September. The debate in the market currently revolves around the terminal Fed Funds rate. Market probabilities are centered around 4.5% by early 2023. We expect upcoming inflation prints to hold significant sway in upcoming meetings, leading the Fed to becoming increasingly data dependent. Away from the U.S., central banks around the world continue to tighten policy, resulting in a rather unprecedented response from the United Nations calling on the central bank community to slow down the pace. In either case, we view it as a welcoming long term sign to see the ECB depart from its negative interest rate regime.

Credit:

- **U.S. Banks are well-positioned to withstand an economic downturn.** Recent rate increases have helped drive the major U.S. banks' FY22 median net-interest income forecast ~12% higher compared to the beginning of the year. Additionally, median analyst forecasts have FY22/FY23 net revenues at over 10x the FY22/FY23 forecasted loan loss provisions. This, along with already strong capital and reserves levels, provide the banks with ample capacity to withstand any future loan losses. To date, loan quality trends have yet to deteriorate across the U.S. banking sector.
- **European banks have some tailwinds to offset the headwinds.** After experiencing EPS estimate downgrades following Russia's invasion of Ukraine and subsequent jump in inflation, European banks have seen meaningful UPWARD EPS estimate revisions in recent months. The median FY22 EPS revision for major European banks is now approaching 4% from beginning of year levels. Analysts have made these revisions despite various headwinds in Europe. In our view, this reflects the major tailwind of the ECB exiting a negative rate regime, which is fueling significant net interest income growth. European banks also benefit from very strong capital levels and excess loan loss reserves that were put in place, but mostly unutilized, during the pandemic. These reserves can now be allocated to potential future loan loss deterioration. To date, loan quality has yet to deteriorate across European banks. We expect these trends to continue into the third quarter earnings season.
- **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. Hence, in spite of the oil and natural gas market price volatility, Midstream should stay in a positive free cash flow, de-leveraging position with continued positive ratings momentum. Utilities should remain a defensive sector to be invested in as well.
- **Insurance remains mostly insulated from the macro risks and broadly stable.** Higher interest rates are positive for most insurers. On the other hand, with credit quality expected to normalize, some insurers could experience downgrades within their investment portfolios and/or losses but they are well capitalized for these risks. Hurricane Ian was a major hurricane that has caused estimated insured losses of up to $65 Billion, but we do not forsee this being a capital event for the industry.

Market Structure:

- **LIBOR transition on track for June 30th cessation date.** The federal government has passed a bill that allows for the use of a replacement rate to LIBOR on all US securities. This will ensure a smooth transition to an alternative floating rate index for all legacy securities that reference LIBOR. However, the rates and method for conversion will vary depending on prospectus language and terms. We believe the uniqueness of this situation furthers the importance for active management as the complexity of the transition could provide some significant market dislocations.

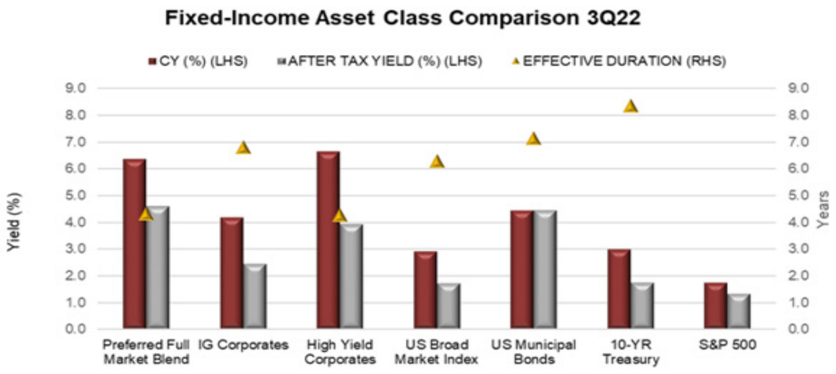
[1] The London Interbank Offered Rate (LIBOR) is a benchmark interest rate that banks charge each other for short-term loans.

Valuation and Portfolio Positioning:

- **Preferreds offer incremental yield and spread over other asset classes.** The preferred and hybrid market has among the highest current yield (6.42%) and after-tax yields (4.65%), as well as one of the lowest durations (4.34 effective duration) compared to other asset classes. As shown in Figure 1, the absolute yield pick-up in preferreds over other investment grade rated asset classes ranges from 1.97% to over 3.48%. The current yield on preferreds is also 3.5x the dividend yield on the S&P 500. In addition, for taxable investors, the tax-advantaged qualified dividend income (QDI) offered by many preferred securities increases the value of the after-tax yield of preferred securities.

  Compared to other credit spread products, we believe that the additional pick up in yield spread of over 200 bps versus investment grade corporate bonds, coupled with lower average effective durations and comparable issuer credit quality will provide support to current valuations on a relative basis. Relative to high yield corporate bonds, investors give up roughly 25 bps in current yield, but see an increase in after tax yield (~70 bps) with much higher credit quality. High Yield bonds carry an average issuer rating of B+, while preferreds are BBB- at the security level and average A- at the issuer senior level.

FIGURE 1. YIELD COMPARISON OF PREFERREDS VS OTHER FIXED-INCOME ASSET CLASSES



Source: Stonebridge Advisors LLC, ICE Data Services, Bloomberg L.P. as of 9/30/2022.

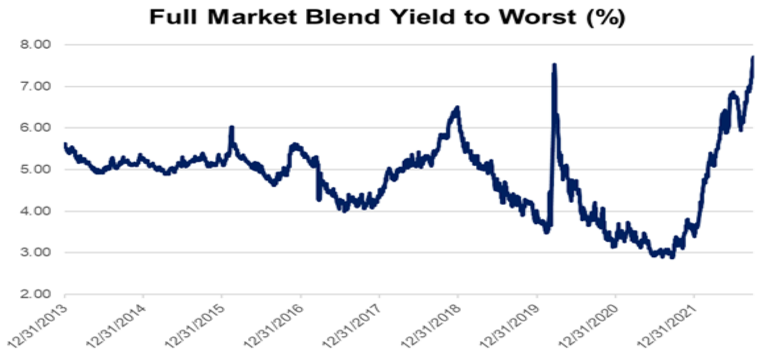
*Custom blend index: A blend of the following ICE indices: 30% P0P4-ICE BofA Core Plus Fixed Rate Preferred Securities Index / 30% CIPS-ICE BofA US Investment Grade Institutional Capital Securities Index / 30% CDLR-ICE USD Contingent Capital Index / 10% HIPS-ICE BofA US High Yield Institutional Capital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

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

Ticker	BLEND*	C0A0	J0A0	US00	U0A0	GA10	SPX
Rating	BB3	A3	B1	AA1	AA3	AAA	N/A
Total Return QTD	-2.18%	-5.11%	-0.69%	-4.86%	-3.62%	-6.19%	-4.88%
Total Return YTD	-15.65%	-18.33%	-14.58%	-14.68%	-12.56%	-16.83%	-23.87%

- **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. (Conversely, 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. FULL MARKET BLEND YIELD-WORST (YTW) (12/31/13 - 9/30/22)



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.

- **Portfolio positioning.** In terms of positioning, we believe the risk reward balance has improved in regards to interest rate risk, and that provides opportunities across the entire yield curve within the preferred and hybrid market. We especially favor select longer duration variable rate securities and securities trading at deep discounts that have the potential to pull to par. 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 we will look to take advantage of new issues pricing at attractive concessions to the secondary market.
- **Performance outlook.** Our base case for the next 12 months is for the market to perform positively with some capital appreciation in addition to income. We believe risks from inflationary pressures, rising rates and geopolitical conflicts remain elevated but are largely priced into the market. Valuation metrics for preferreds are at attractive levels with high yields relative to other fixed income asset classes coupled with market prices trading at historically deep discounts to par. We believe in a "pull to par" effect for many of the deeply discounted securities that have a high likelihood of pulling to par as they approach their first call dates. Drivers of this "pull to par" effect include variable rate securities with high resets that project much higher coupons after their first call dates, some high coupon near-term calls and a number of special situation securities. 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. Given the environment, volatility is likely to persist over the near term. However, we foresee the risk-reward dynamic progressively improving as we approach 2023, and think that the preferred and hybrid market is set up to outperform longer term.

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

Investment strategies and broad themes discussed may not be suitable or appropriate for all investors depending on their specific investment objectives and financial situation. Prior to making any investment or financial decisions, any recipients of this material should seek individualized advice from their personal financial, legal, tax, and other professional advisors that takes into account all of the particular facts and circumstances of their situation.

The information, views and opinions stated herein are current as of the date appearing in this material only, and subject to change without notice. This material may include estimates, outlooks, projections and other forward-looking statements.

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.