Stonebridge Preferred Securities | Market Report

Third Quarter, 2023

HIGHLIGHTS

- Long-term valuations continue to offer appreciation potential in addition to income, but active management remains critical given continued rate volatility and recession risk.
- The preferred and hybrid securities market managed to produce positive returns in 3Q23 desite rising rates.
- While preferred and hybrid market credit quality remains strong overall, Stonebridge continues to adjust exposures for recession risks.
- ETF fund flows into the preferred and hybrid market were modestly positive during the quarter, totaling approximately $64MM.

MARKET RECAP

The preferred and hybrid securities market managed to produce positive returns in 3Q23, with mixed results across market segments. Year-to-date returns remain slightly positive, exhibiting the resilience of the preferred and hybrid market in the face of sharply higher interest rates and losses from the Credit Suisse AT1 writedown and the regional bank failures in the US. High current yields, generally strong earnings from the preferred issuer base and spread tightening helped to buoy returns in the preferred and hybrid market in 3Q23. Looking forward, yield to worst spreads remain well above historical averages compared to both BB high yield and investment grade corporate bonds and prices remain deeply discounted. The best performing segments of the preferred and hybrid market in 3Q23 were led by the highest yielding and shortest duration components, including non-investment grade $1000 par securities and contingent convertible capital securities (CoCos), which earned 2.06% and 1.93%, respectively. $1000 par investment grade securities returned 0.37% while the longer duration $25 par exchange-traded retail market underperformed for the second straight quarter, returning -1.98%.

ETF fund flows into the preferred and hybrid market were modestly positive during the quarter, totaling approximately $64MM. Outflows picked up in September as financial market volatility increased, leading to ~$171MM of redemptions for the month. Flows may continue to face pressure into 4Q23 due to elevated interest rate volatility and high competing money market yields. However, 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 Federal Reserve Bank (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 and Supply Expectations:

The preferred market witnessed a meaningful uptick in gross issuance in 3Q23. 3Q23 saw $11.76bn in gross issuance vs $2.40bn in 2Q23, and -$7.58bn in net issuance vs -$10.17bn in 2Q23. Nearly all the issuance came in the $1000 par institutional market, and the average new issuance coupon remained elevated at 7.78%. Issuers have been reluctant to come to the market with the increased volatility and high coupon rates, however we did see higher quality issuers start to return to the market in 3Q23. Looking forward, we expect the current market conditions to continue into the coming months, thus we expect only a modest increase in supply.

Macroeconomic & Geopolitical Trends:

The third quarter was highlighted by higher rates. A volatile selloff in the Treasury market (see below) bled into all risk assets during the third quarter. Among the debated culprits pushing longer rates higher are increased Fed hawkishness/quantitative tightening, slow glidepath lower in inflation, fiscal funding needs, U.S. government ratings pressure and lackluster foreign buying of Treasuries. The rates selloff overshadowed a growing consensus during the third quarter that recession risks were getting pushed out well beyond this year. Now, rising rates are raising concerns of spillover effects into the macroeconomy, even though the impact of higher rates has not yet been fully realized in the economic data. During the third quarter, cracks did not surface in consumer/corporate credit or employment data, but pressures are building up in commercial real estate. Meanwhile, inflation continues to fall at a pace that is not quick enough to satisfy central banks. Putting everything together, rising rates and persistent central bank hawkishness could threaten the soft landing narrative in the coming quarters.

Focus on geopolitical issues has taken a back seat to concerns over interest rates and inflation. There is still plenty happening on the geopolitical stage in the background. However, tail risks in Ukraine and Taiwan seem to have receded in the near term. China has been focused on domestic economic issues, less so on saber-rattling in Taiwan. The omission of Ukraine aid in the latest funding bill has raised questions about the West's commitment to funding Ukraine's war efforts. The uncertainty comes at a crucial time for Ukraine, who has been stepping up their attacks in Crimea as its counter-offensive against Russia continues to grind away. Within energy markets, OPEC+ extended production cuts through the end of the year, which has driven up oil prices to near $100/bbl. While there is likely no further escalation from OPEC+, we don't expect them to add back supply anytime soon.

Preferred Securities

Interest Rates & Monetary Policies:

A jump in longer term rates grabbed the spotlight during the quarter. As expected, the Fed raised short-term rates 25 bps at the July meeting, and expectations for another 25 bps hike in either November or December have been rising. The 2-year yield stayed within a 30-bp range during the quarter, finishing up 15 bps to 5.05%. The 10-year yield was volatile to start the quarter, but then jumped by a significant 73 bps for the quarter ending at 4.57%. As a result, the 2s-10s inversion more than halved during the quarter from -106 bps to -47 bps by quarter end.

Central banks make the message loud and clear, "higher for longer". The punchline of the third quarter from central banks was that they will not take any chances with inflation and will keep rates higher for longer. The probability of a Fed rate cut in market expectations has now been pushed out until mid-2024, if not later. Over in Europe, the Bank of England (BOE) surprised the market by not hiking rates in September, but the messaging from the BOE and European Central Bank (ECB) remains similar … higher for longer. Both the ECB and BOE are also considering increasing the pace of balance sheet reduction. Looking forward to upcoming central bank meetings, market expectations are low for additional rate hikes, with market expectations pricing in the odds of another Fed rate hike at only around 30% odds in November and close to 50% before year-end.

Credit:

U.S. Banking sector continues to remain in focus for investors as CRE takes center stage. After a brief reprieve from banking sector concerns in the second half of Q2, the market's attention has turned towards commercial real estate (CRE) risks for banks. The main focus is centered around office CRE, driven by a combination of decreasing demand from the work-from-home shift and increasing interest expense for borrowers. We believe that CRE losses in the banking sector will be spread out over time as the loans mature, with the smaller banks having more risk due to higher concentrations in the loan portfolios. This will give banks time to build up reserves. While we do see some headwinds coming from CRE, we don't see it as a major risk towards the banking sector as a whole. The other main risk still looming is the impact of higher rates and yield-curve inversion. Although higher rates have helped provide net-interest-margin expansion for the banks, the negative repricing on the securities portfolio has more than outweighed that benefit. After the turmoil in March, banks took a number of steps to reduce their rate exposure including additional interest rate derivatives, reducing the duration of their securities portfolio and holding higher cash balances. As a result, we don't expect further rate increases to have as much of a negative impact on the banks as we saw earlier in the year.

European bank credit fundamentals not showing pressures despite market volatility. Second quarter earnings season for European banks was another strong quarter. The tailwind of rising rates in Europe remains a positive, as the benefit for European banks of Europe exiting a negative interest rate regime cannot be understated. Looking forward, we expect this tailwind to dissipate, but do not expect rates to become a potential negative for European banks for quite some time, if at all. As a result, the median consensus FY23 earnings estimate revision for European banks is up 20% year-to-date. However, not all is rosy, as governments have been moving forward with bank earnings windfall taxes, and the ECB is considering an increase in minimum reserve requirements. Meanwhile, capital remains stable. We generally expect loan quality to show cracks at some point, but these cracks have yet to surface and may not show up until later this year or in 2024.

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 and liability durations, plus has the demonstrated ability and 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.

Non-financial, preferred-issuing sector credit fundamentals remain strong. Midstream Energy continues to benefit from elevated and stable US production levels, driving de-leveraged balance sheets and positive ratings momentum. Utilities have seen some equity pressure from rising rates and renewables multiples shrinking. Nevertheless, they remain a solidly defensive sector from a credit perspective. The Aircraft Leasing sector continues to see strong demand and well-positioned balance sheets, buoyed by persistent aircraft OEM delays. A potentially weaker consumer, if that comes to fruition, could have less of an direct impact on the preferred market due to minimal preferred issuance from discretionary consumer sectors such as Retail, Consumer, Tech/Software, and Media/Advertising.

Market Structure:

U.S. officially transitions off LIBOR. The start of 3Q23 marked the end of LIBOR with the Secured Overnight Funding Rate (SOFR) taking over as market standard on floating rates. As anticipated, the transition has gone smoothly without any major market disruptions. Going forward, we expect variable rate issuance to be concentrated in coupons with Treasury-based reset spreads.

VALUATION AND PORTFOLIO POSITIONING

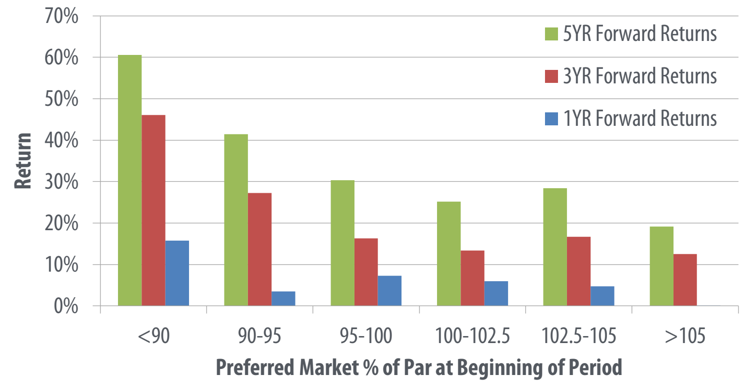
Valuations of preferreds remain at attractive levels. The full preferred and hybrid securities market is trading at an attractive yield to worst (YTW) of 7.98% when compared to other asset classes. In addition, prices remain discounted at 86.64% of par, which has historically been a buy signal for the asset class. In our opinion, the preferred and hybrid market continues to price in recession risks above and beyond other parts of the fixed income market.

FIGURE 1: Yield to Worst of Preferreds Compared to Other Asset Classes (12/31/2022 – 9/30/2023)

Ticker	Market Segment	YTW 12/31/2022	YTW 9/30/2023
BLEND*	Preferred Full Market	7.81%	7.98%
C0A0	IG Corporates	5.51%	6.08%
J0A0	High Yield Corporates	8.94%	8.88%
US00	US Broad Market Index	4.70%	5.44%
U0A0	US Municipal Bonds	3.68%	4.42%
GA10	10-YR Treasury	3.83%	4.58%
G001	Money Market Index	4.25%	5.33%

*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. Please see Index Definitions in the back of the presentation. Source: ICE Data Services.

FIGURE 2: Historical Performance of Preferreds Based on Percent of Par (12/31/1992 – 9/30/2023)

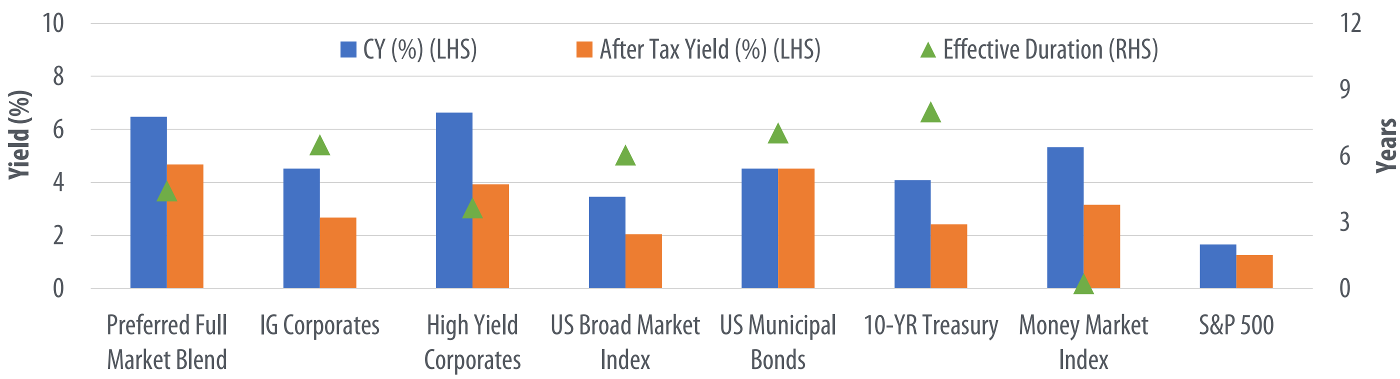


Preferred Securities are represented by a blend of ICE indices (30% P0P4 / 30% CIPS / 30% CDLR / 10% HIPS). Prior to 12/31/2013, preferred securities are represented by the ICE BofA Fixed Rate Preferred Securities Index (P0P1). Please see Index Definitions in the back of the presentation. Source: ICE 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.

Preferreds offer incremental yield and spread over other asset classes. The preferred and hybrid market has among the highest current yield (6.47%) and after-tax yields (4.69%) compared to other asset classes. As shown in Figure 3, the absolute yield pick-up in preferreds over the US broad market index is approximately 3%. We believe the potential exists for yields to continue to increase in preferreds as variable rate securities reset to higher coupons or securities are refinanced at higher coupon rates. 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.

FIGURE 3: Current Yield Comparison of Preferreds vs. Other Asset Classes



	Preferred Full Market Blend	IG Corporates	High Yield Corporates	US Broad Market Index	US Municipal Bonds	10-YR Treasury	Money Market Index	S&P 500
Ticker	BLEND*	C0A0	J0A0	US00	U0A0	GA10	G001**	SPX
Rating	BBB3	A3	B1	AA1	AA3	AAA	AAA	N/A
Total Return 3Q23	0.29%	-2.70%	0.53%	-3.18%	-3.78%	-5.15%	1.31%	-3.27%
Total Return YTD	0.40%	0.45%	5.90%	-1.12%	-1.04%	-3.53%	3.60%	13.07%

Source: Stonebridge Advisors LLC, ICE Data Services, Bloomberg L.P. as of 9/30/2023. Assumes 40.8% Federal Tax Rate, no state tax. QDI eligible securities are determined by Bloomberg and Stonebridge. Preferred Securities are represented by a custom index containing 30% P0P4, 30% CIPS, 30% CDLR & 10% HIPS. See Index Definitions at the end of this presentation. ** Money Market Index is represented by the US 3-Month Treasury Bill Index

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

Portfolio positioning. Stonebridge believes that income will be a key driver of performance over the near term and have been increasing distribution income across all strategies. We have also been seeking to increase portfolio liquidity and rotating towards a neutral view on duration compared to the market. In order to satisfy our goal for higher current income and extending duration to be in line with our benchmarks, we have a current portfolio bias towards increasing exposure to high current yielding securities with call protection. At the same time, we continue to position for the prospect of 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 small percentage of the preferred market and Stonebridge managed portfolios.

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, market volatility and high yielding risk-free alternatives. As noted above, headwinds persist for the preferred market in terms of interest rate volatility and recession risks. While volatility may continue, in our opinion, the preferred market is pricing in a significant amount of risk compared to other fixed income asset classes, as evidenced by its elevated credit spreads. Longer term, investors face a compelling entry point given the discounted prices and historically attractive 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.

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.