# Stonebridge Preferred Securities Market Report

*Third Quarter, 2016*

## *Market Recap*

The preferred and hybrid securities markets performed well during the third quarter of 2016 despite U.S. economic data that continued to show mixed results. Positive indicators such as improving consumer sentiment and employment data were partially offset by slower U.S. investment spending and continued concerns about global economic growth. While the Brexit vote (where U.K. voters chose to leave the European Union (EU)) on June 23 generated some short-term market volatility, the overall response was benign due to further stimulus from central banks and investor realization that the impact on the U.K. and EU economies would be less than initially feared. These factors led the Federal Reserve (Fed) to elect not to increase short-term interest rates in September in a decision that included three dissenting votes. The front end of the interest rate curve, particularly the London Interbank Offered Rate (LIBOR), continued to increase over the quarter while longer-term rates (10yr and 30yr Treasuries) ended the quarter only slightly higher than at the end of Q2. The flattening of the yield curve that we saw earlier in the year continued, but at a more modest rate.

In the preferred and hybrid securities space, the increase in interest rates led to the retail preferred securities market, which is dominated by fixed-for-life securities, underperforming the institutional hybrid market for the first time in 2016. In 3Q16, the total return of the retail preferred securities market, as measured by the Bank of America Merrill Lynch Fixed Rate Preferred Securities Index, P0P1, was 1.2%, while the institutional hybrid market as measured by the Bank of America Merrill Lynch U.S. Capital Securities Index, returned 3.8%. This resulted in performance for the first nine months of 2016 of 6.4% for the retail preferred index and 7.74% for the institutional hybrid index. Finally, the European-dominated contingent capital index (COCO) returned 5.3% in 3Q16 despite concerns about Deutsche Bank's credit quality. Unlike the prior Deutsche Bank scare in February 2016, the impact this time was largely isolated to Deutsche Bank's own securities and did not result in a broader market sell-off.

+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.

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

| Index | TICKER | AVG. RATING | EFFECTIVE DURATION+ 3Q2016 | Current Yield 3Q2016 | Total Return 3Q2016 | Total Return YTD |
|---|---|---|---|---|---|---|
| **BAC-ML Preferred Stock Fixed Rate** | **P0P1** | **BBB2** | **4.34** | **5.78%** | **1.22%** | **6.37%** |
| **BAC-ML U.S. Capital Securities** | **C0CS** | **BBB2** | **5.96** | **5.68%** | **3.84%** | **7.74%** |
| BAC-ML Contingent Capital Index - Hedged | COCO | BB1 | 3.57 | 6.85% | 5.27% | 4.21% |
| BAC-ML Contingent Capital Index - Unhedged | COCO | BB1 | 3.57 | 6.85% | 5.17% | 3.86% |
| BAC-ML US Corporate | C0A0 | A3 | 7.21 | 3.77% | 1.44% | 9.11% |
| BAC-ML US Cash Pay High Yield | J0A0 | B1 | 4.28 | 6.43% | 5.50% | 15.21% |
| BAC-ML US Current 10 Yr Treasury | GA10 | AAA | 9.24 | 1.51% | -0.75% | 7.13% |
| BAC-ML US Current 30 Yr Treasury | GA30 | AAA | 22.34 | 2.28% | 0.02% | 16.95% |
| BAC-ML US Mortgage Backed Securities | M0A0 | AAA | 3.49 | 3.40% | 0.61% | 3.72% |
| BAC-ML US Municipal Securities | U0A0 | AA3 | 6.77 | 4.21% | -0.31% | 4.09% |
| S&P 500 | SPX | NA | NA | 2.14% | 3.85% | 7.84% |

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

Other fixed-income risk assets, such as U.S. high-grade corporate bonds and U.S. high-yield bonds, outperformed the retail preferred index (P0P1) during 3Q16. However, preferred and hybrid securities solidly outperformed higher quality fixed-income asset classes such as U.S. mortgages and municipal bonds. During the quarter, all duration bands in both the retail and institutional preferred and hybrid securities indices showed positive performance despite the modest increase in Treasury rates. For the most part, longer-duration preferred and hybrid securities showed better total return performance, partly because credit spreads rallied during the quarter (which more than offset the slight weakness in Treasuries).

**Figure 2. Performance by Duration Band.**

| | P0P1 | | C0CS | |
|---|---|---|---|---|
| **Duration Bands** | **Weighting** | **3Q 2016 TR** | **Weighting** | **3Q 2016 TR** |
| Eff Dur[0 - 3] | 35.33% | 0.87% | 18.97% | 0.03% |
| Eff Dur[3 - 5] | 25.61% | 0.64% | 13.82% | 2.54% |
| Eff Dur[5 - 8] | 29.16% | 1.63% | 44.48% | 4.22% |
| Eff Dur[8 - 12] | 9.67% | 2.91% | 21.02% | 5.15% |
| Eff Dur[ >=12] | 0.22% | 2.49% | 1.71% | 4.81% |
| **Grand Total** | 100.00% | 1.22% | 100.00% | 3.84% |

Source: Stonebridge Advisors LLC, BofA Merrill Lynch Research;
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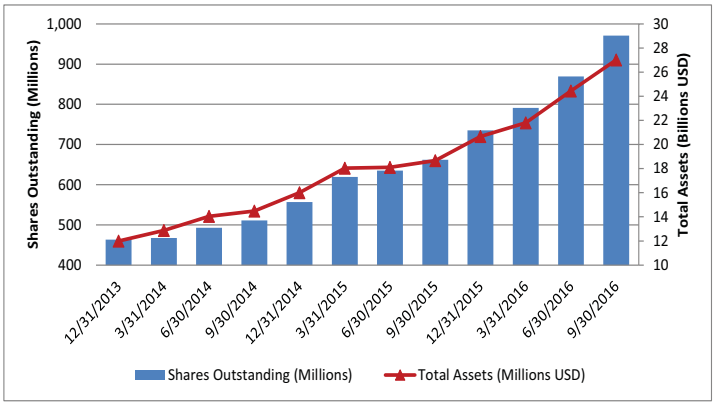
**In This Issue:**

One factor which we believe continues to support the retail preferred market, is the strong growth in preferred ETF assets. The total assets of the six largest preferred ETFs increased by $2.5bn (or 11.6%) during 3Q16 and followed several quarters of rapid growth (see Figure 3 below). Of these six ETFs, five are passive ETFs that track various preferred indices. This rapid growth, combined with net negative retail preferred issuance during 3Q16, was a positive technical factor which supported retail preferred total performance during the quarter.

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




Source:Shares outstanding from Bloomberg as of 6/30/2016. Includes shares in PFF, PGX, PSK, VRP, PGF, and FPE (see footnote 1 below).

## *New Issuance Recap*

New issuance volumes of USD preferred and hybrid securities totaled $35.5 billion for 3Q16, which is about $17 billion higher than 2Q16 and the largest issuance quarter in the last two years. Unlike the recent past quarters, 77% 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 at foreign investors in USD securities and many are unavailable to U.S. domestic investors. Approximately 23%, or $8.1 billion, of issuance in 3Q16 was retail-structured issues, mostly fixed-for-life preferred securities, which was nearly identical to the volume of retail issuance in the first two quarters of 2016. Despite this heavy volume of issuance, the net impact on the overall market has been limited because of the large amount of redemptions of $25 par retail securities.

Redemptions totaled approximately $24.8 billion in the 3Q16, which is substantially higher than either quarter in the first half of 2016. In the retail market, redemptions exceeded issuance by $4.3bn, providing a strong technical factor supporting the $25 par retail market. Many of the redemptions in the retail market this year have been $25 par issues from European banks who are replacing obsolete forms of Tier 1 capital with new issue contingent capital securities (CoCos) in the institutional market. In the institutional market, new issues exceeded redemptions by approximately $15bn. Low rates in Europe and Asia continue to drive strong non-US investor participation in USD deals, driven by absolute yield differentials and the relatively strong U.S. dollar. Non-US issuers find the USD institutional market favorable because of the depth of investor demand and relatively tighter credit spreads compared to EUR-denominated securities.

**Figure 4. Top 10 Retail and Institutional USD New Issues for 3Q 2016 (by $ AMT).**

| 3Q16 | | | | | | |
|---|---|---|---|---|---|---|
| ISSUER | SECURITY DESCRIPTION | ID | COUPON | COUPON TYPE | PAR AMOUNT | DEAL SIZE ($MM) |
| RETAIL | | | | | | |
| QWEST CORP | CTL 6 1/2 | CTBB | 6.5 | FIXED | 25 | 978 |
| DOMINION RESOURCES INC | D 5 1/4 | DRUA | 5.25 | FIXED | 25 | 800 |
| SOUTHERN CO | SO 5 1/4 | SOJB | 5.25 | FIXED | 25 | 800 |
| CAPITAL ONE FINANCIAL CO | COF 5.2 | COF/PG | 5.2 | FIXED | 25 | 600 |
| LEGG MASON INC | LM 5.45 | LMHB | 5.45 | FIXED | 25 | 500 |
| ARCH CAPITAL GROUP LTD | ACGL 5 1/4 | ACGLP | 5.25 | FIXED | 25 | 450 |
| ENTERGY ARKANSAS INC | ETR 4 7/8 | EAI | 4.875 | FIXED | 25 | 410 |
| PUBLIC STORAGE | PSA 4.95 | PSA/PD | 4.95 | FIXED | 25 | 325 |
| AMTRUST FINANCIAL SERVIC | AFSI 6.95 | AFSI/PF | 6.95 | FIXED | 25 | 288 |
| ANNALY CAPITAL MGMT | NLY 7 5/8 | NLY/PE | 7.625 | FIXED | 25 | 288 |
| | | | | | | |
| INSTITUTIONAL | | | | | | |
| CHINA CINDA ASSET MGMT | CCAMCL 4.45 12/29/49 | QZ6141886 | 4.45 | VARIABLE | 1000 | 3,200 |
| ROYAL BK SCOTLND GRP PLC | RBS 8 5/8 12/29/49 | 780097BB6 | 8.625 | VARIABLE | 1000 | 2,650 |
| DAI-ICHI LIFE INSURANCE | DAIL 4 12/29/49 | LW8904960 | 4 | VARIABLE | 1000 | 2,500 |
| STANDARD CHARTERED PLC | STANLN 7 1/2 12/29/49 | 853254BA7 | 7.5 | VARIABLE | 1000 | 2,000 |
| SOCIETE GENERALE | SOCGEN 7 3/8 12/29/49 | QZ4822180 | 7.375 | VARIABLE | 1000 | 1,500 |
| ALLIANZ SE | ALVGR 3 7/8 12/29/49 | QZ3880916 | 3.875 | FIXED | 200000 | 1,500 |
| BARCLAYS PLC | BACR 7 7/8 12/29/49 | QZ3177313 | 7.875 | VARIABLE | 1000 | 1,500 |
| TRANSCANADA TRUST | TRPCN 5 7/8 08/15/76 | 89356BAB4 | 5.875 | VARIABLE | 1000 | 1,200 |
| UBS GROUP AG | UBS 7 1/8 12/29/49 | QZ1261762 | 7.125 | VARIABLE | 1000 | 1,100 |
| ICBC ASIA LTD | ICBCAS 4 1/4 12/29/49 | LW8113018 | 4.25 | VARIABLE | 1000 | 1,000 |

Source: Stonebridge Advisors LLC, Bloomberg

## *An Update regarding Deutsche Bank and its Impact on the Market for European Bank Hybrids*

In mid-September, Deutsche Bank (DB) announced that the U.S. Department of Justice (DOJ) was seeking a $14bn legal settlement with the bank related to improperly sold mortgage securities in the U.S. prior to 2009. Other U.S. and European banks have settled for much smaller sums and this amount was substantially larger than the market was expecting. The opening request was $14bn and we expect the final amount will be in the $5-7bn range; however, this news reawakened market concern regarding DB's capital strength and ability to continue to pay coupons on some of its hybrid securities.

Prices of DB's senior, subordinated and hybrid securities dropped sharply even though the bank has substantial liquidity.

[1]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).

Unlike when credit concerns regarding DB roiled the market in February 2016, the price dislocation was largely confined to DB's own securities and weakness in other European bank hybrids was modest and short-lived. While some other European banks also still need to settle outstanding legal claims regarding U.S. mortgages, most banks have prepared for it by holding higher amounts of capital and/or larger legal reserves than DB.

While we believe that DB is keen to continue to make its coupon payments and has some options to both raise capital and offset losses in the short run, we remain concerned about the longer-term credit trends of the bank. DB's largest business areas, investment banking and German commercial banking, exhibit weak and volatile profitability; we believe these trends are likely to persist and require major restructuring. However, it is important to note that the weaknesses of DB are somewhat unique when compared to many other European banks. Most major European banks have better capital ratios, stronger core domestic retail and traditional banking franchises and/or low risk wealth and asset management businesses to support the stability of their credit fundamentals.

## *Investment Outlook*

Recent economic data in the U.S. shows modest strength and low inflation while the rest of the world continues to show weak growth with markets supported by accommodative monetary policies. Although U.S. interest rates moved slightly higher in 3Q16, they still remain very low by historical standards and we expect that they will remain "lower for longer" than we expected early in 2016. In this overall low-rate environment, credit spreads in general remain fairly wide, supported by the stable credit fundamentals we see in most issuers. Furthermore, the historically wide yield spreads of preferred and hybrid securities relative to both U.S. Treasuries and other credit spread products should help drive positive performance in the asset class, in our opinion (Figure 5 on next page).

Despite the experience of select names such as DB, credit fundamentals in the financial sector remain stable and should continue to support the preferred and hybrid securities market over the next year, even if earnings and margins weaken slightly. We also expect that the volatility in European hybrid securities earlier this year will lead to further modifications in European bank capital rules, reducing risks of coupon stoppage, which should prove supportive to all hybrid security investors.

We expect issuance in the preferred and hybrid securities market for the fourth quarter to be subdued relative to the first part of the year for U.S. issuers and somewhat more active for non-U.S. names. Large U.S. banks have issued enough to reach target levels of additional tier 1 (AT1) in their capital structures, although they and other issuers may opportunistically issue in the $25 par retail market to lock-in relatively low fixed coupons. European and Asian financials and non-financials may continue to support the institutional hybrid issuance volumes. Most of the new hybrid supply from Europe will be used to redeem older hybrid issues by the same issuers that no longer count as regulatory capital, so net new issuance should be modest to perhaps even negative. Also, we believe the wide interest rate spreads in the institutional market should ensure that any new fixed-to-floating securities are likely to be attractively structured in terms of back-end reset spreads. Even though the technical support of the retail market remains strong, we have become more selective on new retail preferred deals as low interest rates, the "reach for yield" and limited supply have driven the market to new highs.

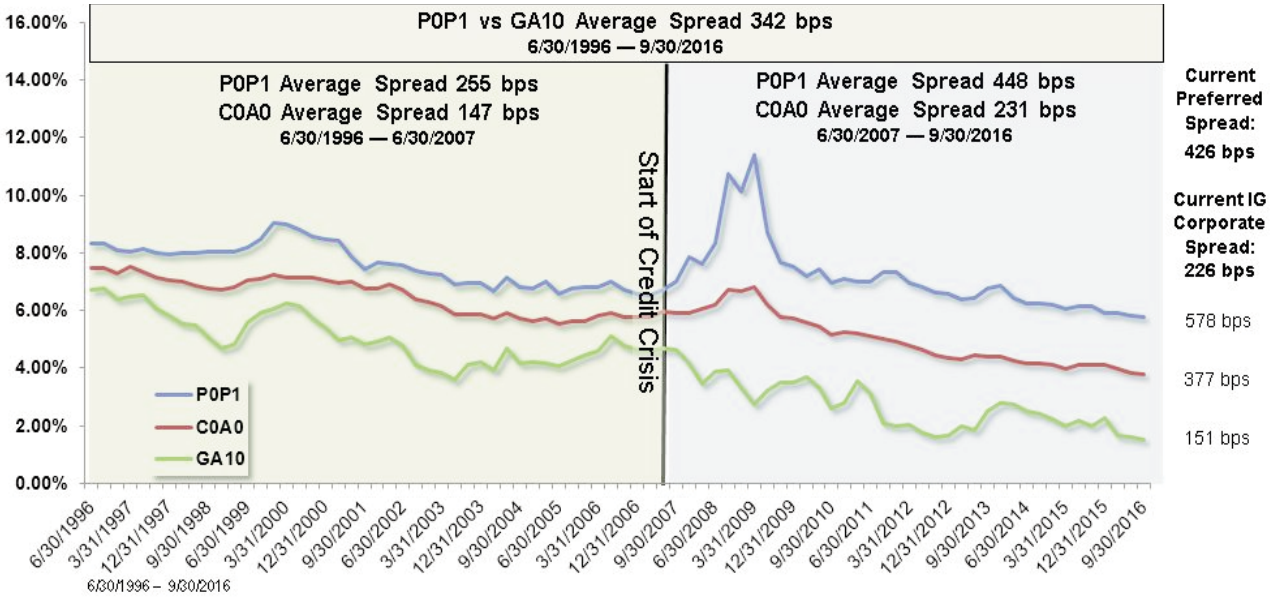
Despite our expectation that rates remain fairly low by historical standards, we have maintained our conservative stance on interest rate risk by remaining overweight less interest rate-sensitive securities than our benchmarks. Given the expectation of rate volatility, we believe it is prudent to maintain durations shorter than the benchmark, 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 show more resilience in a market downturn and potentially outperform in a rising rate environment.

As a result, we continue to favor structures with good rate protection and high current yields. In the institutional market, we favor non-call 5-year and 10-year fixed-to-floats with high reset margins. High reset margins are important because they potentially limit extension risk past the first call date and may reduce price volatility in the event of extension due to higher reset margins. We prefer fixed-rate securities with high current yields that we believe the issuer could refinance at a substantially lower cost of capital and that have attractive yield–to-calls (varies depending on the call date). We also remain overweight legacy tier 1 regulatory capital securities issued by U.S. and European banks that are likely to be called in the next few years that have high current yields and attractive yield-to-calls relative to senior debt securities in the same credits. Between now and 2020, we expect to see many of these older tier 1 securities get called and replaced with AT1 fixed-to-floating rate Coco securities, structures which are not issued in $25 par retail

market. In the institutional AT1 Coco market, we have been very selective and own issues with high back-end reset protection issued by banks with stable to positive credit profiles.

Geographically, we maintain our largest core exposure to U.S. issuers which are fundamentally stronger than most non-U.S. peers. In Europe, despite concerns regarding Brexit and the potential legal risks of names like DB, we have focused our holdings on large and financially strong issuers with attractive hybrid structures and limited extension risk. We also believe that certain U.S. and international non-financial hybrid issuers which show strong credit fundamentals and provide diversification away from the bank and insurance sectors are attractive holdings as well.

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




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 (COAO) which tracks the performance of US dollar denominated investment grade corporate debt publicly issued in the US 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 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.