STONEBRIDGE
Advisors LLC

Stonebridge Market Comment, November 17, 2016

Key Takeaways:

1) **The unexpected victory of Donald Trump in the U.S. Presidential Election on November 8, has resulted in increased market expectations of additional fiscal stimulus, tax cuts and lower regulatory costs which could lead to higher economic growth, rising inflation and potential interest rate increases by the Federal Reserve (Fed).**
2) **In response, the U.S. equity market has rallied sharply while U.S. Treasuries have sold off. Since November 8, yields on 10yr and 30yr U.S. Treasuries have widened approximately 35 basis points (bps).**
3) **In response to rising longer term Treasury yields, a steepening yield curve, and fear of higher Fed fund rates in December, the $25 par retail preferred securities market has seen substantial selling by both retail investors and passive exchange-traded funds (ETFs) facing increased redemptions.**
4) **The institutional preferred and hybrid securities market has seen only modest selling because that sector is less exposed to retail ETF flows and dominated by less interest rate sensitive fixed-to-floating rate securities, compared to the $25 par retail preferred securities market.**
5) **We believe that interest rates will gradually move higher in the medium term but that the rate moves since Nov. 8 have been excessive. There still remains considerable uncertainty regarding how pro-growth and inflationary the policies of the new Republican-led administration will be.**
6) **Stonebridge has long anticipated a rising interest rate environment and is maintaining its lower duration focus vs peers by overweighting institutional vs retail securities (where possible) and overweighting less interest rate sensitive fixed-to-floating and variable rate securities vs. more rate sensitive fixed-for-life structures.**

Why are USD interest rates rising now?

The success of Donald Trump and the Republican Party in taking the U.S. Presidency and maintaining control of the U.S. Congress has increased market expectations for higher economic growth and rising inflation driven by increased infrastructure and military spending, reduced government regulation, and lower income taxes. The market also expects the Fed to hike short-term rates by 25bps in December.

By how much have interest rates risen?

Between November 8 and 15, 10yr U.S. Treasury yields have increased from 1.86% to 2.22% and 30yr U.S. Treasury yields have risen from 2.62% to 2.96%. The last time Treasury rates were at these levels was early January 2016. Over the same period, the Treasury curve has also steepened with 2s/10s increasing 22bps and 2s/30s increasing 20bps. 3 mos. Libor increased only 3bps since November 8 showing how the rate curve has steepened.

What is Stonebridge's view on interest rates and has it changed?

We have long held the view that while interest rates would remain low relative to historic levels, they would gradually rise in the future as monetary policy in the U.S. reverted to a more normal posture compared to the excessively loose policies of the past few years. We have also expected that the rate curve would remain positively sloped but could flatten slightly as the Fed increases short term rates. Our view that rate increases will be gradual and measured also reflects the fact that global rate levels, particularly in Europe and Japan, are extremely low and that will temper the risk of higher rates in the U.S. That broad view has not materially changed since the election. However, we now think that a more bullish growth outlook in the U.S. will lead to gradually higher rates sooner than we previously thought. Despite this view, we think the immediate market move of the past week has been excessive given that there is still substantial uncertainty with respect to the policies of the new U.S. administration, which will take 3-6 months to clarify.

What has happened to the preferred securities market since November 8?

The sharp rise in longer term Treasury yields led to a decline in the prices of preferred securities since the November 8 election. While all parts of the market declined, the retail $25 par preferred market declined more sharply than the institutional $1,000 par preferred and hybrid securities market driven by direct selling, as well as, selling from passive retail preferred index ETFs facing redemptions from investors. The retail preferred securities market, as measured by the Bank of America Merrill Lynch Fixed Rate Preferred Securities Index (P0P1), showed returns of -4.04% for the November 8-14 period. The institutional preferred securities market, as measured by the Bank of America Merrill Lynch US Capital Securities Index (C0CS), showed returns of -1.32% over the same period.

Why has the institutional preferred securities market outperformed the retail market in this sell-off?

There are several reasons why the retail market has underperformed the institutional market. First, most institutional preferred securities are structured as fixed-to-floating rate instruments which generally have lower duration and interest sensitivity than fixed-for-life securities. In contrast, a much larger portion of the retail preferred securities market is composed of fixed-for-life perpetual preferred instruments which are more exposed to price drops in a rising interest rate environment. Secondly, most passive preferred ETFs invest almost exclusively in the retail preferred securities market and account for a large percentage of the total outstanding shares in the retail market. This means that in a weaker preferred securities market environment, ETF selling of the underlying index securities adds further selling pressure to the retail preferred securities market as a whole.

How have structural differences between different preferred securities affected performance?

In short: A LOT! Traditional fixed-for-life perpetual preferred securities contain the highest amount of interest rate risk in a rising interest rate environment and have exhibited the weakest relative performance in this downturn. In contrast, fixed-to-floating rate securities with 3-10 year fixed periods have substantially less interest sensitivity than fixed-for-life issues, and have performed better in the recent sell-off. Finally, higher coupon securities, both fixed-for-life and fixed-to-float, generally exhibit less interest volatility and have also performed relatively well during the selloff. Stonebridge's strategy, for a long time, has been to control interest rate risk by overweighting fixed-to-floating rate securities with good structures and less sensitive higher coupon securities with good call protection in our various strategies.

Do the results of the election increase or reduce credit risk in the preferred securities market?

On balance we believe that the change to a Republican-dominated U.S. administration is a modest positive for credit in the banking and insurance sectors which account for the bulk of the issuers in the preferred securities market. Higher interest rates, higher gross domestic product (GDP) growth and less regulation, are bullish for bank and insurance profitability. We believe that regulatory burdens will ease, particularly for banks, but that core regulations mandating substantially higher capital and liquidity requirements will remain protective of credit ratings and the size of the equity cushion supporting the preferred securities market. Where banks are likely to see greater regulatory flexibility is in terms of their product offerings and trading restrictions. There has been much speculation that the Dodd-Frank banking regulatory law will be repealed entirely by the new administration. For practical and political reasons we think it is much more likely to only be modified in part in ways that would not harm the credit outlook for financials.

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