Stonebridge Preferred Securities

Market Report

Fourth Quarter, 2018

MARKET RECAP

Following a strong third quarter in 2018 for the entire preferred and hybrid securities market, returns were negative in the fourth quarter as volatility increased across financial markets. The retail $25 par market led the underperformance as significant outflows from large, passive exchange-traded funds (ETFs) pressured exchange-traded securities. After lagging for most of the year, the European contingent convertible market (CoCos) outperformed all other parts of the preferred and hybrid securities market during the fourth quarter.

Fixed-income markets experienced significant volatility during the fourth quarter as global growth fears, central bank policy and continued headline risk across the U.S., Europe and Asia weighed on financial markets. As investor sentiment waned, investment outflows across fixed-income asset classes caused credit spreads to widen within the preferred and hybrid securities market. In the U.S., economic growth and labor market strength led the Federal Reserve (Fed) to guide short-term rates higher by 25 basis points (bps) in December 2018, while recession fears and decreased expectations for future economic growth among investors pressured longer-term yields. As a result, the U.S. Treasury yield curve continued to flatten, with the 2-year and 5-year Treasury yields briefly inverting during the fourth quarter. Furthermore, comments from Fed Chairman Powell greatly diminished expectations for future short-term rate hikes, as the market began pricing in a pause in the Fed's tightening cycle throughout 2019.

In Europe, the new populist government in Italy agreed on a budget deal with the European Union (EU). However, uncertainty regarding BREXIT remained as the vote on British Prime Minister Theresa May's BREXIT deal was delayed while the deadline to exit the EU looms in early 2019. Meanwhile, the tariff war between the U.S. and China remained at the forefront as the two countries agreed on a 90-day "ceasefire" amid continued negotiations. However, the fallout from the trade war began to appear in earnings outlooks and global growth projections around the world.

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

Index	Ticker	Average Rating	Effective Duration[1] 4Q2018	Current Yield 4Q2018	Total Return 4Q2018	Total Return FY2018
ICE BofAML Core Plus Fixed Rate Preferred Securities[2]	**P0P4**	**BBB3**	**6.80**	**6.40%**	**-4.36%**	**-3.70%**
ICE BofAML Fixed Rate Preferred Securities	**P0P1**	**BBB2**	**5.88**	**6.03%**	**-4.56%**	**-4.34%**
ICE BofAML US IG Institutional Capital Securities[2]	**CIPS**	**BBB2**	**4.44**	**5.90%**	**-3.97%**	**-4.52%**
ICE BofAML USD IG Contingent Capital[2]	**COCU**	**BBB3**	**3.54**	**6.43%**	**-2.35%**	**-3.57%**
ICE BofAML US HY Instl Capital Securities	**HIPS**	**BB1**	**3.88**	**6.40%**	**-6.47%**	**-6.27%**
ICE BofAML US Corporate	C0A0	A3	6.89	4.08%	-0.06%	-2.25%
ICE BofAML US Cash Pay High Yield	J0A0	B1	4.20	6.75%	-4.64%	-2.26%
ICE BofAML US Current 10-Yr U.S. Treasury	GA10	AAA	8.49	3.00%	3.86%	-0.03%
ICE BofAML US Current 30-Yr U.S. Treasury	GA30	AAA	19.34	3.14%	4.11%	-2.71%
ICE BofAML US Mortgage Backed Securities	M0A0	AAA	4.86	3.57%	2.04%	1.00%
ICE BofAML US Municipal Securities	U0A0	AA3	7.02	4.32%	1.56%	1.04%
S&P 500	SPX	NA	NA	2.15%*	-13.52%	-4.39%

Source: Stonebridge Advisors LLC, ICE Data Services; *Dividend yield. Past performance is no guarantee of future results.

[1] 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.

[2] Please note that effective January 1, 2017, we are using the ICE BofAML Core Plus Fixed Rate Preferred Securities Index (P0P4), to represent the $25 par retail preferred securities market. We believe that this index is a more accurate representation of the retail preferred securities market than the ICE BofAML Fixed Rate Preferred Securities Index (P0P1) that we previously used given that P0P1 now has material exposure to the $1000 par institutional preferred securities market. We also now use the ICE BofAML U.S. IG Institutional Capital Securities Index (CIPS) to represent the $1000 par institutional preferred securities market. For Q1 2018, we changed the Contingent Convertible Index from CoCo to CoCu, the ICE BofAML USD Investment Grade Contingent Capital Index. This index is 100% USD CoCo securities, which we believe is a more representative sample of our investible universe than CoCo, which contains multiple currencies.

IN THIS ISSUE:

Highlights:

- Large preferred and hybrid ETFs experienced over $3 billion in redemptions during the fourth quarter, which put significant pressure on the retail $25 par retail market. These outflows, coupled with tax-loss selling, created a negative market technical throughout the quarter.
- Valuations within the preferred and hybrid market (P0P1) ended the period at their lowest level in five years with the average % of par trading at only ~95%.
- CoCo securities outperformed all other parts of the preferred and hybrid securities market during the quarter. This was due to strong earnings from European banks, reduced tail risk from Italy, limited new supply and attractive valuations at the end of the third quarter.
- The interest rate curve continued to flatten as the difference between the 2-year and 10-year Treasuries tightened to 20 bps from 25 bps during the quarter.
- Current yield spreads of preferred and hybrid securities (P0P1) versus 10-year Treasuries (GA10) widened by over 25 bps during the quarter.
- Fundamentals within the U.S. and global banking system remain strong. Bank capital ratios, liquidity and leverage all show substantial improvement compared to pre-crisis levels.
- Results from the Bank of England stress tests highlighted the ability of UK banks to withstand severe crisis scenarios and still maintain adequate capital, liquidity and lending capabilities.

New Issuance—Net Negative Issuance in both Retail and Institutional Markets

- **Market shrinkage during 4Q18.** The retail and institutional markets saw net negative issuance during the fourth quarter with retail shrinking by $2.6 billon (bn) and institutional by $6.9bn. This was driven by a combination of a few sizeable CoCo redemptions that had already been pre-financed in previous quarters and some new deals getting delayed in the weak market environment.
- **Large deals replaced by smaller deals.** The $25 par retail market in particular had a few sizable security redemptions that didn't need to be refinanced with a new deal. This was partially offset by a number of new deals; however, they were typically much smaller in size. Additionally, throughout 2018 there were redemptions in the retail space that were refinanced with institutional securities, driving further shrinkage in the net market supply.
- **Slowdown of institutional issuance.** Approximately only 10% of the year's gross institutional issuance came in the fourth quarter, with the majority having unattractive structures. Despite this slowdown, the institutional market still ended up with positive net issuance for the year.
- **Retail ends the year with net negative issuance.** The $25 par retail market has been on a shrinking trend over the past few years. As mentioned above, the retail space was deeply affected by the redemptions of large deals that didn't need to be refinanced. Throughout 2018, six retail preferred securities over $1bn in size were redeemed, while only two of that size were issued. These six redemptions, totaling $14.2bn, accounted for half of the total amount redeemed in the retail space during 2018. Additionally, since none of these deals were refinanced, all $14.2bn was a net supply reduction.
- **Net Issuance should remain relatively flat over 2019.** We expect gross issuance in 2019 to be relatively flat compared to 2018, but most of it will be refinancing existing securities. As a result, we expect the trend of modest net supply growth to continue into 2019. In regard to financials, which are the largest issuers in our space, the majority of U.S. banks have filled their capital needs; however, we could see modest net supply growth. Yankee banks still have regulatory capital needs to fill, but wide spreads in the CoCo market may impact the timing of some new issuance.

Investment Outlook

We continue to believe that strong fundamentals in the financial sector and attractive valuations should be supportive of performance in the preferred and hybrid securities market in 2019. We see attractive yields compared to other fixed-income asset classes, as well as relatively wide credit yield spreads over U.S. Treasuries. We will continue to position our strategies through active management to protect against what we believe are the largest risks in the market, which includes geopolitical events, potential interest-rate shifts and unexpected increases in new issuance supply.

Geopolitical Events:

- **Headline risks in Europe persist into 2019.** BREXIT remains the top political risk in Europe as we begin 2019. March 29th is the deadline for the UK to exit the European Union (EU), according to Article 50. Potential outcomes include a UK parliament which would vote in favor of Prime Minister May's agreement, a no-deal exit, a new election, a second referendum, an extension of Article 50 or a revocation of Article 50. We expect other political headlines from France (riots) and Italy (budget) to take a back seat unless/until the BREXIT outcome is resolved.

- **Trade war risks may be tipping to the upside.** As global growth has slowed and both U.S. and Chinese financial markets have experienced significant volatility, the rhetoric coming out of the Trump Administration has become more optimistic of reaching a trade agreement by March. Should a deal be reached by March, we would expect an uptick in economic growth expectations. However, a failure to reach a trade deal remains a major risk factor in the market.
- **U.S. election cycle and political power struggle to gain momentum.** The 2020 elections are already grabbing headlines, with Elizabeth Warren announcing her intention to run for President. We expect the media to allocate more time to the upcoming primaries, but the more relevant headlines to the markets could come from power struggles between the Trump Administration and House Democrats (i.e. the government shutdown).

LIBOR Update:

- There were no notable regulatory developments on LIBOR[3] during 4Q18, as regulators continued to solicit feedback from market participants on several key initiatives for a smooth transition to a replacement for LIBOR. More recently, Bloomberg reported that the U.S. Treasury is soliciting primary dealer comments on the potential for LIBOR's anticpated replacement, SOFR (Secured Overnight Financing Rate) based issuance. We did see two institutional senior deals priced in the market using SOFR, but the pace of acceptance in the market remains underwhelming. While regulators target year-end 2021 to phase out LIBOR, progress has been slow in developing the SOFR market. In addition to very few deals having been priced using SOFR, a term structure has yet to develop and we have seen unusual volatility in SOFR over the past few weeks. Given the complexity of LIBOR's phase-out, the target date may be extended beyond 2021 to allow for a more orderly transition.
- Following the initial LIBOR phase-out announcement in July 2017, our credit research team read through the prospectuses of every security we own with LIBOR as the floating benchmark and identified a minority of securities that contained potentially unfavorable LIBOR language. We have held discussions with all of the issuers of these securities in order to better understand their intentions. We have factored the LIBOR language into all of our investment decisions since then, and have been closely monitoring new developments from regulators and issuers.

U.S. Treasury Yield Curve & Interest Rates:

- After witnessing significant flattening in the U.S. yield curve in the second half of 2018, followed by a dovish pivot by the Fed in recent weeks, we see a higher probability of a modestly steepening U.S. interest rate curve in 2019. The recent slowdown in global growth and decreased inflation expectations in 4Q18 persuaded the Fed to shift its tone, and may serve to delay rate hikes for the foreseeable future. A rebound in economic growth and inflation data could prompt the market to price in higher rate-hike probabilities as the year progresses. We believe that with a modestly steepening interest-rate curve, preferreds should perform well in this environment with yield spreads at historically wide levels.

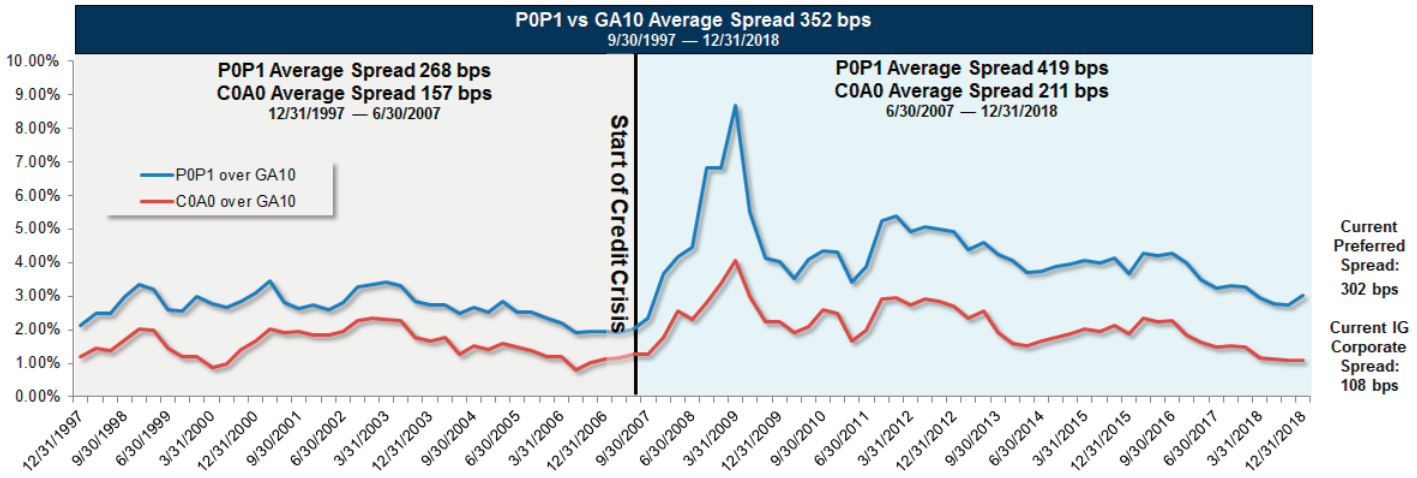
Preferred and Hybrid Securities Valuation:

- **Net new supply likely to be limited in 2019.** Expectations for a lean new issue calendar in 2019 should provide a positive technical that is supportive of the market. The majority of issuers are likely to only issue to replace existing higher cost funding, but we are not likely to see much preferred and hybrid issuance in the way of capital increases. We will continue to be very selective on new issues as the majority of the new issuance has not provided much, if any, concession to the secondary market.
- **Credit fundamentals are strong.** We believe global bank fundamentals in particular will remain strong in 2019. Revenue and earnings trends are back to pre-financial crisis levels for most major U.S. and European banks, while average equity capital ratios have generally doubled during the same time period. Asset quality remains strong across the majority of issuers of preferreds and hybrid securities and the average credit quality of issuers is A- at the senior debt level.
- **Yields and spreads are attractive.** Absolute yields and yield spreads of preferreds and hybrids relative to U.S. Treasuries and other credit spread products widened in 4Q18. Based on our analysis, which includes the assessment of security structure, relative yields and credit, we see attractive value across both retail $25 pars and institutional $1000 par securities, especially in the 0-5 year part of the credit curve.
- **Preferred and Hybrid market trading at lowest % of par since 2013.** At year-end, the broad preferred and hybrid securities market, based on P0P1, was trading at 95% of par. Historical analysis shows that, since 1992, when preferreds are trading at 95-100% of par, the average 1-year forward total return is 7.57% (Figure 3). Additionally, the only period where the 1-year forward return was not positive with prices starting below par was during the credit crisis of 2007-2008. As we have noted, the recent sell-off appears to be technically driven and not credit related, which we believe may lead to positive performance in 2019 for the preferred and hybrid securities market.

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

Figure 2. Historical Spread of Preferred Securities vs Investment-Grade Corporate Securities and the 10-Year Treasury

Attractive Spreads Offer Potential for Total Return – Preferred current yield spreads over Treasuries are wider than pre-crisis averages, offering the potential for some continued capital appreciation along with an attractive level of current income.



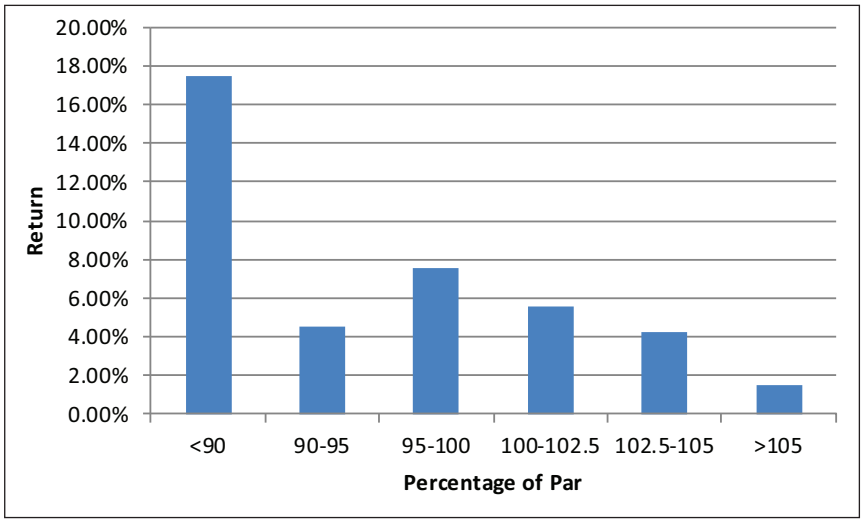
12/31/1997–12/31/2018

Preferred Securities are represented by the ICE BofAML 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 ICE BofAML US Corporate Index (COA0) which tracks the performance of U.S. dollar denominated investment grade corporate debt publicly issued in the U.S. domestic market. 10-Year Treasuries are represented by the ICE BofAML Current 10-Year U.S. Treasury Index (GA10) which is comprised of the most recently issued 10-year U.S. Treasury note.

Source: ICE Data Services, 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.

Figure 3. 1 Year Average Forward Returns Based on Percent of Par



Percent of par data is based on the ICE BofAML Fixed-Rate Preferred Securities Index (P0P1) dating back to 1992. The percent of par is determined by using month-end prices for the index. Returns are calculated using the 1-year forward looking total return from each month-end period.

Source: ICE Data Services and Bloomberg

Past performance is not indicative of future results and there can be no guarantee historical trends will continue into the future.

The fourth 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.