Stonebridge Preferred Securities

Market Report

Fourth Quarter, 2021

Highlights

- **Flows into preferred and hybrid exchange-traded funds (ETFs) slowed in the fourth quarter of 2021, ending the year with nearly $7bn of inflows,** supporting secondary prices and reducing volatility.
- **The preferred and hybrid securities market is likely to see a decrease in gross and net issuance in 2022,** providing a positive technical backdrop to the preferred and hybrid securities market.
- **Credit fundamentals across the preferred and hybrid issuer base remain strong,** buffering the coupon paying capacity of issuers.
- **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 will be criticial in 2022** given the potential for increased rate volatility.

MARKET RECAP

The preferred and hybrid securities market earned slightly negative returns during the fourth quarter of 2021 as income mostly offset price declines during the period. Although the 10-year Treasury yield was relatively unchanged during the period, the Treasury curve flattened significantly as 2-year and 5-year yields moved sharply higher after the Federal Reserve (the Fed) announced plans for an accelerated taper and the potential for rate hikes in 2022. Investment-grade (IG) $1000 par securities were the worst performing market segment during the quarter, returning -0.54%, while non-IG $1000 par securities returned -0.12%, outperforming IG institutionals for the 5th consecutive quarter. Tighter valuations entering the period and weaker security structures, particularly those issued in 3Q21, drove the underperfomance of IG versus non-IG institutionals. The longer duration $25 par exchange-traded retail market was the most volatile segment during the quarter, but managed to outperform during the period, returning 0.60%, as strong inflows, limited tax loss selling and the year-end equity rally drove the $25 par market higher at the end of the period. Finally, contingent convertible capital securities (CoCos) from non-US banks returned -0.10% for the quarter.

ETF fund flows into the preferred and hybrid securities market continued to be strong during the fourth quarter of 2021. Actively managed ETFs saw inflows of $678mm during the period, with the First Trust Preferred Securities and Income ETF (FPE), capturing over 1/3 of all ETF flows in 4Q21, including both passive and actively managed ETFs. Passively managed funds, which are mostly concentrated in longer duration $25 par retail securities, had $673mm of inflows. Compared to other fixed-income asset classes, preferreds continue to offer relatively high yields, potential tax advantages due to Qualified Dividends Income (QDI) eligibility for qualified securities and strong credit fundamentals across the issuer base. We expect that this will continue to drive demand into the space and support market technicals. Also, preferreds continue to offer a relatively low to intermediate duration profile due to the availability of variable rate coupon structures, which offer a component of rate protection for investors wary of rising interest rates.

Investment Outlook

Issuance and Supply Expectations:

- **In 4Q21, the institutional market saw an increase in the average new issuance coupon, while the retail market witnessed a slight decrease.** New issues in the $25 par retail market experienced an average coupon of 5.32% in 4Q21 vs 5.47% in 3Q21, while the institutional market averaged 4.72% in 4Q21 vs 3.98% in 3Q21. Given the competitive order books and lack of concessions witnessed over the past few months, Stonebridge remains disciplined within the primary market, but has selectively found opportunities in some newly issued securities.
- **The $25 par retail market shrunk in the first three quarters of 2021, but grew slightly in 4Q21.** Net $25 par retail issuance in 4Q21 stands at $362mm, a significant improvement compared to 2Q21 (-$4.98bn) and 1Q21 (-$1.48bn). YTD net issuance stands at $29.81bn, which includes +$36.51bn from the institutional market and -$6.69bn from the $25 par retail market.
- **Stonebridge anticipates a meaningful drop in gross and net issuance in 2022.** 2021 saw $108.54bn in gross issuance and $29.81bn in net issuance. Stonebridge estimates gross and net issuance well below $100bn and $20bn, respectively, in 2022. Based on our redemption and refinancing forecasts, we expect to see modestly lower net issuance over the coming months as well. This should provide a positive technical backdrop and should be supportive of secondary prices.

Macroeconomic & Geopolitical Trends:

- **Political discussions reach standstill ahead of midterms.** The Biden administration was unable to pass either an infrastructure bill or tax policy changes during 2021. The administration continues to pursue legislation ahead of midterm elections later this year, but these negotiations now remain more in limbo. Potential tax policy implications on the preferred securities market, if any, remain uncertain. All else equal, higher tax rates increase the QDI benefit offered by many preferred securities.
- **Oil outlook continues to be bullish with supply restraints, recovering demand and low inventories.** The outlook for oil prices continues to be bullish, in spite of an expected slight oversupply in Q1. For the full year, however, we will likely still be undersupplied as OPEC+ struggles to meet their current quota and demand continues recovering from the pandemic. As a backdrop, global and domestic oil inventories continue to be near their 5-yr lows, which provides little cushion to an already tight market. Overall, we see additional upside in global oil prices.

Interest Rates & Monetary Policies:

- **Treasuries treaded water in the fourth quarter, but the curve flattened.** Treasuries traded within a generally narrow band during the fourth quarter. After closing at 1.49% at the end of June, the 10-year Treasury yield traded within a range of 1.35% to 1.70% before closing the quarter at 1.51%, only 2 basis points (bps) higher on the quarter. Meanwhile, the Treasury curve flattened significantly as 2-year and 5-year yields moved sharply higher, up 45 bps and 30 bps, respectively, during the fourth quarter. We continue to see a confluence of events that may fuel rate volatility in the first quarter of 2022, including anticipated Fed tapering, speculation of rate hikes in the coming months and economic/inflation prints.
- **Powell renomination brings central bank policy change back into the spotlight.** Fed Chairman Powell's renomination in December, followed by a more hawkish tone by the Fed, shifted investor focus from board composition to monetary policy. The Fed announced in its December meeting plans to double the bond purchase taper pace in order to complete the taper in March. This has led investors to speculate on sooner than anticipated rate hikes, as early as March. Speculation has also surfaced of potential Fed balance reduction this year, either in addition to or in lieu of rate hikes. Over in Europe, the Bank of England has also taken a more hawkish tone, including a rate hike in last month's meeting. Meanwhile, the European Central Bank (ECB) has remained intently dovish, with no plans to taper bond purchases or hike rates.

Credit:

- **U.S. Banks outlook continues to strengthen.** U.S. banks reported another strong quarter in 3Q21 with over 95% beating consensus earnings estimates. We continue to see reserve releases from the vast majority of banks as more economic clarity drives loan loss forecasts lower. We'd expect to see this trend continue as the median equity analyst EPS estimate for 2022 rose by over 10% last year. U.S. Banks still remain well protected against future losses with strong capital levels and loan loss reserves.
- **Expect European bank positive momentum to continue into fourth quarter earnings season.** In Europe, all but one of the major banks beat consensus estimates during the third quarter. We expect this strong performance to continue into 4Q21 earnings season coming up in a few weeks. Looking forward, the median equity analyst EPS estimate increase across European banks for full year 2022 earnings rose by over 20% last year. As previously announced by the ECB, the ECB lifted the cap on dividend/buyback payout ratios at the end the third quarter, which led to more share buyback announcements in the fourth quarter. We view financial performance and regulatory developments as positive reflections of strong credit profiles among European banks.
- **Improving credit trends and a bullish outlook for oil laying out another strong year for Midstream.** While the vast majority of Stonebridge's Midstream exposure is not directly exposed to commodity prices, a positive macro backdrop is bullish for the sector nonetheless. More importantly however, several Midstream credits cut their common dividends materially during the pandemic, solidifying their positive free cash flow positions, which can be used for de-levering the balance sheet over the next few years. The current outlook for select Midstream credit profiles are decisively improving and Stonebridge continues to see value opportunities in these names. Two of our Midstream credits have already seen credit ratings upgrades since the beginning of the pandemic.

Market Structure:

- **Regulators stress importance of smooth LIBOR[1] transition.** During the fourth quarter the House overwhelmingly passed legislation that allows for the use of a replacement rate to LIBOR on all U.S. securities, which is now awaiting the Senate vote. In the first quarter of 2021 we saw

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

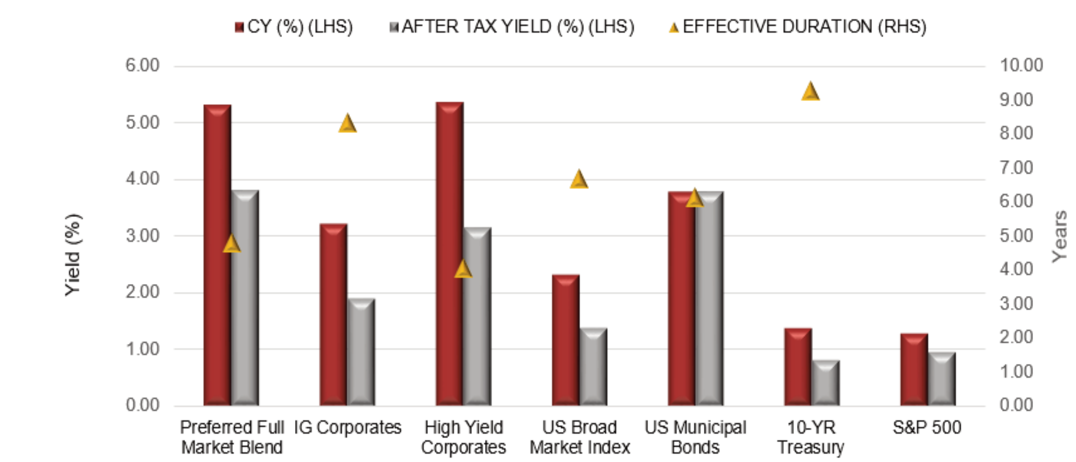
a similar bill passed by the state of New York, addressing only those governed under New York law. Additionally, as of YE2021, U.S. banks are no longer allowed to issue debt tied to LIBOR.

- **Stonebridge remains highly focused on LIBOR-based exposure.** Stonebridge has gone through and identified the potential outcomes of each security if LIBOR is no longer available. This analysis has been utilized in all portfolio decisions, particularly towards eliminating exposure to those with potential adverse outcomes. Stonebridge has been reducing LIBOR-based exposure as a whole, shifting into securities with Swaps and Treasury based back-ends.

Valuation and Portfolio Positioning:

- **Preferreds offer incremental yield and spread over other asset classes.** As shown in Figure 1, the absolute yield pick-up in preferreds over other investment-grade rated asset classes ranges from 1.45% to over 2%. For taxable investors, the tax-advantaged QDI offered by many preferred securities increases the value of the after-tax yield of preferred securities, as shown in the table. Additionally, the current yield spread of preferreds versus investment-grade corporate bonds is approximately 200 bps, which is over 25 bps wide of the historical average going back 25 years. We believe that the additional pick up in yield spread versus investment-grade corporate bonds will provide support to current valuations on a relative basis. Issuers of preferred securities have a similar credit risk profile as issuers of investment-grade corporate bonds, while the average rating differentials at the security level are due to the subordination of preferreds.

Figure 1. Yield Comparison of Preferreds vs Other Fixed-Income Asset Classes



Ticker	Blend*	C0A0	J0A0	US00	U0A0	GA10	SPX
Rating	BB3	A3	B1	AA1	AA3	AAA	N/A
Total Return 4Q2021	-0.02%	-0.95%	5.29%	-1.58%	1.83%	-3.68%	11.03%
Total Return YTD	3.59%	-0.17%	0.71%	0.09%	0.84%	0.75%	28.71%

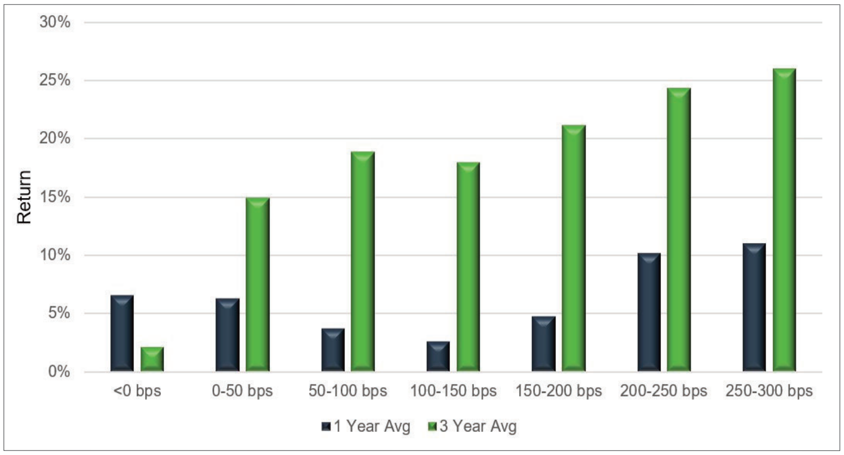
Source: Stonebridge Advisors LLC, ICE Data Services, Bloomberg L.P. as of 12/31/2021.

*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.

- **Attractive spreads offer the potential for total return.** Yield spreads of preferred securities over 10-year Treasuries ended 2021 at approximately 388 bps, which is about 70 bps tighter for the year. Nonetheless, Stonebridge believes that the wide spreads are likely to provide a cushion for preferreds if we do see a rise in rates on the long end. History has demonstrated that preferred spreads generally tighten as the yield curve steepens and Stonebridge analysis on over 25 years of data has shown that, as the yield curve steepens, forward returns on a 1-year and 3-year basis for the preferred securities market have been positive on average (See Figure 2 on next page).

Figure 2. Historical Forward Returns of Preferreds Based on 2yr/10yr Treasury Curve Steepness



Source: ICE Data Services, Bloomberg L.P.

Preferred Securities are represented by the ICE BofA Fixed-Rate Preferred Securities Index (P0P1) from 12/31/1996 – 12/31/2013. From 12/31/2013 – present, preferred securities are represented by a blend of ICE Indices (30% P0P4 / 30% CIPS / 30% CDLR / 10% HIPS). See Index Definitions.

The curve steepness is calculated by the 10-year Treasury yield less the 2-year Treasury yield. Returns are calculated using the 1-year and 3-year forward looking total return from each month-end period. **Past performance is not indicative of future results** and there can be no guarantee historical trends will continue into the future.

- **Performance outlook and portfolio positioning.** As 2022 unfolds over the next 12 months, both challenges and opportunities are likely to arise in the preferred and hybrid market. The biggest challenge we see is the market adjusting to Fed board's hawkish tone and anticipated policy changes, which could lead to further interest rate and market volatility. The opportunities will come from the benefit of actively managing preferred securities portfolios to not only mitigate risks in the market but also take advantage of likely relative value opportunities created by volatility, if it occurs.

  Over the near term, we would anticipate that preferreds and hybrids are likely to perform well relative to other credit risk asset classes due to the high yields, combined with the high credit quality of the issuers and intermediate to low duration profile. These characteristics may help to insulate against potential interest rate movements and allow for spreads to compress resulting in less of an impact to the preferred asset class over lower yielding, higher duration credit based asset classes. Valuations are once again near fair value in our opinion, after rallying in December and given potential risks in the market, we would expect that the majority of returns over the near term to be in the form of income.

  As a result of our current outlook, we have become much more selective in seeking out value in preferreds across the entire interest rate curve, and continue to have a bias towards the shorter end along with securities that contain a component of rate protection, such as variable rate securities. Selectively investing in new issuance and taking advantage of dislocations in the $25 par segment are specific areas where we believe we can deliver more return for clients in 2022. We will also focus on continually adjusting the composition of managed portfolios by reducing exposure to higher risk security structures and targeting relative value swaps in favor of improving security structure combined with improved valuation.

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 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.