Stonebridge Preferred Securities | Market Report

Fourth Quarter, 2022

HIGHLIGHTS

- **Flows into preferred and hybrid ETFs were negative in the fourth quarter but much improved compared to the prior two quarters, ending the period with ~$425 million of outflows.**
- **The preferred and hybrid market continues to trade at historically wide valuations,** with very attractive YTW valuations and an average discount to par around 86%.
- **Credit fundamentals across the preferred and hybrid issuer base remain strong in the face of monetary policy and geopolitical risks,** reflecting mostly investment grade issuers in highly regulated industries.
- **The preferred and hybrid market offers one of the highest yields across the fixed income universe** with potential for higher yields in 2023 as variable rates reset higher or are refinanced at higher coupon levels.
- **Active management is more critical than ever** given the potential for continued rate volatility and macro uncertainty.

MARKET RECAP

The preferred and hybrid securities market bounced back modestly during the fourth quarter after registering negative returns in the first three quarters of 2022. The period began with continued volatility from Liz Truss's budget proposal in the UK, which culminated with the Bank of England (BOE) intervening to stabilize spiking 10-year Gilt yields amid pension concerns. This resulted in the 10-year Treasury yield peaking at around 4.25% in late October, before falling as low as 3.42% on recession concerns and cooling inflation prints for October and November. The Federal Reserve (the Fed) contributed to concerns over a slowing economy as it maintained its hawkish monetary policy stance and boosted its expectations for the terminal rate on the Federal Funds Target Rate above 5%. However, a policy shift by the Bank of Japan (BOJ) in late December and the loosening of COVID restrictions in China prompted a selloff in 10-year Treasuries into year-end. Performance during the period was also driven by significant technical pressures, including tax loss selling, which contributed to the underperformance of the $25 retail market relative to the $1000 institutional market. All segments of the $1000 par institutional market were higher for the quarter, led by contingent convertible capital securities (CoCos), which returned 7.24%. CoCos entered the period trading at attractive valuations after underperforming in 3Q22 and rallied significantly after the resolution of the UK budget crisis and replacement of Liz Truss by the new Prime Minister, Rishi Sunak. Investment grade (IG) $1000 par securities returned 3.31% while non-investment grade (non-IG) $1000 par securities returned 1.51%. The longer duration $25 par exchange-traded retail market continued to be volatile during the period and was the only market segment to achieve negative performance, returning -4.64%.

ETF fund flows into the preferred and hybrid market continued their trend in the fourth quarter of 2022, with $966MM of outflows, totaling over $4.75bn for the year. Passively managed funds, which are mostly concentrated in longer duration $25 par retail securities, had about $930MM of outflows during the period. Actively managed ETFs, which tend to provide exposure to the $1000 par institutional market, had only $35MM of outflows. Year-end tax loss harvesting also had an effect on flows and valuations in the market, especially in the $25 par exchange-traded segment. The preferred market ended the period trading with relatively high yields compared to other fixed income asset classes and strong credit fundamentals across the issuer base. As we potentially enter an economic slowdown in '23, we believe that the credit strength of the issuer base and the historically wide valuations in the market today provide a very compelling investment rationale. Although rate volatility is likely to remain elevated as the Fed continues its hawkish monetary policy stance, we think that the preferred and hybrid market is set up longer term for outperformance.

INVESTMENT OUTLOOK

Issuance and Supply Expectations:

Preferred market issuance decreased meaningfully during 4Q, while new issuance coupons continued moving higher. 4Q22 saw $5.75bn in gross issuance and -$9.25bn in net issuance, down from $13.81bn and $5.93bn respectively the prior quarter. The significant decrease in net issuance was driven by the institutional market, which saw -$7.25bn. The sharp decline in net issuance during 4Q22 led to net issuance finishing the year at -$7.16bn, while gross issuance came in lower than expectations at $40.81bn, due to market volatility. This was the first year of net negative issuance in the past 10 years. New issuance continued to price at attractive levels, with the average new issuance coupon increasing to 8.79%, up 173bps from the previous quarter. Looking forward, we forecast a modest increase in supply above fairly muted levels last year in the coming months.

Macroeconomic & Geopolitical Trends:

Despite lower inflation in the fourth quarter, concerns of recession risk rose. Most inflation metrics across both the U.S. and Europe fell during the fourth quarter, which was certainly welcomed by the financial markets. Following a jump early in the quarter, forward inflation expectations and 2023 quarterly inflation surveys also fell across both the U.S. and Europe. Concurrent with the drop in inflation, dollar strength eased, relieving global economic/market pressures. Notably, the Japanese Yen and British Pound strengthened, the latter of which was primarily the result of confidence expressed in the current UK prime minister. Despite these positives experienced during the fourth quarter, investors have focused their attention on recession risk in 2023. We view the ability of central banks to orchestrate soft landings in their economies as the main risk factor in 2023. The length of time during which rate hikes will stay at peak terminal levels is arguably as important, or more important, than actual peak terminal rates. As a result, economies could suffer recessions even if inflation drops throughout 2023. In our view, even a hard landing in U.S. and European economies should be a soft landing for preferred market credit due to the favorable credit composition of preferred market issuers.

Preferred Securities

Encouraging signs that geopolitical risks and commodity price pressures are receding. While tensions remain high in certain regions globally, the geopolitical tail risk has subsided. There is no sign the Russia/Ukraine war is near a conclusion, however it appears as though risk of material Russian escalation has declined. US/China tensions related to trade and Taiwan are likely to persist throughout 2023, but the risk of China following Russia's exact strategy and tactics is seeming less likely. The spike in Covid cases following China's reversal on their Zero Covid policy is already overwhelming their hospital system, delaying the economic recovery that the policy reversal should eventually bring. On the commodity front, it seems like Russia's appetite to ramp up their commodity trade war with the West has receded a bit. In spite of Russia cutting off EU natural gas exports, the EU managed to fill up their inventories before the winter began. This, combined with a mild start to the winter, has brought European natural gas prices back down to pre-war levels. The crude oil market has been very focused on looming recessionary demand fears, with oil prices near a T12M low. Cushioning demand fears, OPEC+ has remained very united and shown a strong willingness to support prices by cutting their own production.

Interest Rates & Monetary Policies:

Fed rate hikes and increasing recession fears caused further curve inversion during 4Q. Interest rate volatility persisted throughout the fourth quarter, albeit in a much more contained range compared to the prior quarter. The Fed continued hiking short-term rates by another 125bps during the 4Q22, bringing the total to a historic 425bps of rate hikes during 2022. As a result, front end rates moved higher in 4Q22, while rates along the 5-10yr part of the Treasury curve were mixed. The 5-year yield finished 9bps lower on the quarter at 4.01%. The 10-year yield increased by 4bps during the fourth quarter, finishing at 3.88% after reaching a peak of 4.24% in late October. This led to further curve inversion with the 2s/10s spread reaching a wide of 84bps in early December before finishing at 55bps. Looking forward to 2023, the increasing fears of a hard landing and geopolitical uncertainty should continue to cause interest rate volatility, but we view the overall direction of rates as more balanced than in 2022.

Central bank focus shifting to "how long" in addition to "how high". The fourth quarter saw continued central bank rate hikes both in the U.S. and globally. As the quarter drew to a close, a number of central banks, including the Fed, ECB and BOJ, increased their hawkish rhetoric for 2023. The general message was that terminal rates could go higher than expected, but perhaps more importantly, the Fed tried to dispel views that rate cuts could be possible in 2023. We viewed the main message from central banks in 4Q22 to be that rates could be higher for longer. In our view, the big wildcards will be inflation and employment trends throughout 2023. On a positive note, we continue to view it as a welcoming long term sign to see the ECB move farther away from its negative interest rate regime.

Credit:

U.S. Banks are well-positioned to withstand an economic downturn. U.S. banks have ample capacity to endure an economic downturn between increasing revenues, substantial capital buffers, and strong loan loss reserves. To date, loan quality trends have yet to deteriorate across the banking sector. The major U.S. banks' average non-performing loans (NPLs) have decreased each of the past four quarters and loan loss reserves on average cover over 4x the current NPLs. While we anticipate credit losses to normalize higher in 2023, the U.S. banks are well-prepared to withstand this. Even if we get a hard landing economically, we expect it to be a softer landing for the banks.

European banks enter 2023 with positive momentum. Despite a challenging year defined by high inflation, slowing growth, ECB rate hikes and a war in Ukraine, European banks finished FY22 with some rather positive signs. First, the median FY22 EPS revision for major European banks throughout the year was +10%. Second, European bank credit spreads saw significant tightening during 4Q22. Third, European bank equities finished the year outperforming the broad index in Europe by over 700 bps. In our view, this reflects the major tailwind of the ECB exiting a negative interest rate regime, which is fueling significant net interest income growth. European banks also benefit from very strong capital levels and excess loan loss reserves that were put in place, but mostly unutilized, during the pandemic. These reserves can now be allocated to potential future loan loss deterioration. To date, loan quality has yet to deteriorate across European banks. Overall, similar to our view on U.S. banks, even if Europe experiences a hard landing economically, we would expect a softer landing for European banks.

Insurance remains mostly insulated from the macro and broadly stable. Higher interest rates are positive for most insurers. On the other hand, with credit quality expected to normalize, some insurers could experience downgrades within their investment portfolios and/or losses, but they are well capitalized for this. 2022 included approximately $115bn in aggregate insured losses, with Hurricane Ian accounting for over half of said losses. The 2022 insured losses were generally within most company's earnings and thus did not degrade capitalization. 2022 was the second consecutive year of industry insured catastrophe losses of over $100bn, and as a result, insurance premium pricing is expected to rise strongly in 2023 which is a positive for P&C stakeholders.

Credit fundamentals remain strong for non-financial preferred-issuing sectors. In spite of volatile commodity prices, Midstream continues to be well positioned with de-leveraging balance sheets, positive ratings momentum, and a lack of material direct exposure to commodity price movements. Utilities should remain a defensive sector, in spite of the higher rate environment. Telecom holdings, while consumer facing, should continue to act more akin to staples as opposed to cyclicals. The Aircraft Lessor environment is very bullish. Lastly, Stonebridge does not have any direct exposure to Media/Advertising, Tech, Software or Retail sectors, where we expect relatively more credit pressure to be focused this year.

Market Structure:

LIBOR transition on track as regulators continue to address risks for legacy securities. The federal government has passed a bill that allows for the use of a replacement rate to LIBOR on all US securities. Additionally, the UK's Financial Conduct Authority (FCA) has recommended continuing to publish a synthetic LIBOR through the end of 3Q24 for non-US governed securities, calculated in the same way as the replacement rate from the federal government's bill. This will ensure a smooth transition to an alternative floating rate index for all legacy securities that reference LIBOR. However, the rates and method for conversion may vary depending on prospectus language and terms.

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

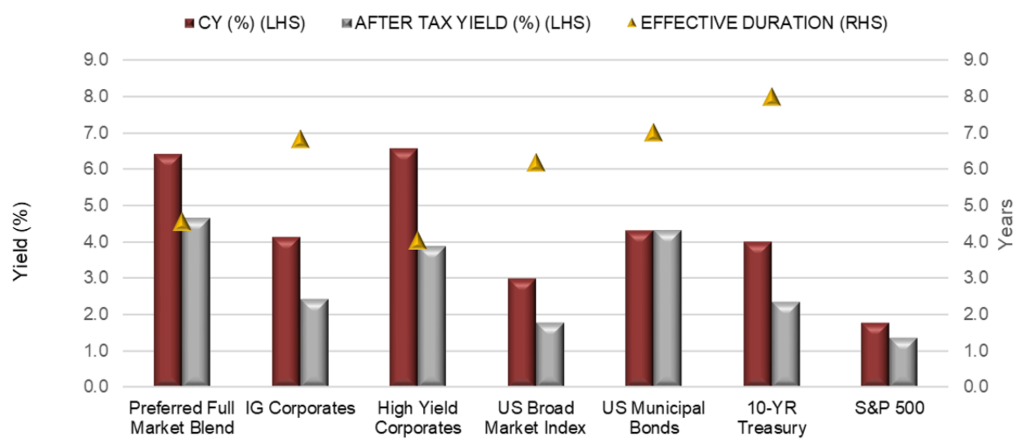
Valuation and Portfolio Positioning:

Preferreds offer incremental yield and spread over other asset classes. The preferred and hybrid market has among the highest current yield (6.42%) and after-tax yields (4.66%), as well as one of the lowest durations (4.57 effective duration) compared to other asset classes. As shown in Figure 1, the absolute yield pick-up in preferreds over the US broad market index is approximately 3.4%. We believe the potential exists for higher yields in preferreds in 2023 as variable rate securities either reset to higher yields or 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.

Compared to other credit spread products, we believe that the high relative yields coupled with comparable issuer credit quality will provide support to current valuations on a relative basis. The yield advantage of preferreds over investment grade corporate bonds is over 200 basis points. Additionally, relative to high yield corporate bonds, preferred investors achieve a similar yield on both a taxable and after tax basis, but preferred and hybrid securities may be provided more credit protection in an economic downturn. High Yield bonds carry an average issuer rating of B+, while preferreds are BBB- at the security level and average A- at the issuer level.

Current valuations of preferreds are at historically attractive levels. The full preferred and hybrid market based on a blended index of $1000 par and $25 par securities is trading at one of the widest yield-to-worst levels on record since inception of the full market index on 12/31/2013 (Figure 2). Additionally, based on percent of par, it is trading at 86.11% of par as of year-end, which is among the deepest discounts to par seen over the past decade. Historically, when the preferred and hybrid market has traded at similar valuation metrics, it has signaled a buying opportunity as one year forward returns have been over 17% on average.

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 QTD	-2.18%	-5.11%	-0.69%	-4.86%	-3.62%	-6.19%	-4.88%
Total Return YTD	-15.65%	-18.33%	-14.58%	-14.68%	-12.56%	-16.83%	-23.87%

Source: Stonebridge Advisors LLC, ICE Data Services, Bloomberg L.P. as of 12/30/2022.

*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.

FIGURE 2: FULL MARKET BLEND YIELD-WORST (YTW) (%) (12/31/13 - 12/30/22)

Source: ICE Data Services and Stonebridge LLC

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. Calculation based on monthly data points.

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

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Valuation and Portfolio Positioning:

Portfolio positioning. In terms of positioning, we believe the risk reward balance has improved in regards to interest rate risk and that provides opportunities across the entire yield curve within the preferred and hybrid market. We especially favor select longer duration variable rate securities and securities trading at deep discounts that have the potential to pull to par. We also see opportunities in securities in the $25 par retail market, where rate volatility, year-end tax harvesting and fund flow technicals have created pricing dislocations, while we expect to remain selective on low coupon fixed rate preferreds. A dearth of new supply has limited our investment in new issuance, although recent new issuance has priced at attractive coupons and a concession to the secondary market.

Performance outlook. As we look ahead in 2023, our base case for the next 12 months is for the market to perform positively with some capital appreciation in addition to income. We consider the largest risks to our outlook may come from central bank induced rate volatility, the potential for a recession and to a lesser extent geopolitical tensions. However, we believe the preferred market may be better positioned than other asset classes to withstand potential risks to the financial markets. Valuation metrics for preferreds are at historically attractive levels with high yields relative to other fixed income asset classes coupled with market prices trading at historically deep discounts to par. We believe in a "pull to par" effect for many of the discounted securities that have a high likelihood of pulling to par as they approach their first call dates. Moreover, we expect all major preferred sectors to continue exhibiting lower economic cyclicality and sensitivity to a recessionary environment. Although we may continue to see near term market volatility, high credit quality coupled with the high income profile and historically attractive valuations sets up the preferred market for relative outperformance in 2023.

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.