WHAT IS THE CAUSE OF THE RECENT SELL OFF IN PREFERRED AND HYBRID SECURITIES?

Although the global financial markets have come under pressure recently, the rather sharp sell-off in the preferred and hybrid markets over the last week has many investors scratching their heads. With the exception of a few one-off situations, issuer credit fundamentals in the preferred and hybrid market have been improving with strong balance sheets, stable earnings and increasing equity capital cushions to support preferred and hybrid dividend and coupon payments. Preferred and hybrid spreads and yields remain relatively attractive compared to other asset classes and inflows into preferred dedicated products have been steady. This leaves investors, including many long-standing investors in the preferred and hybrid market, asking "What is the cause for the swift move lower?"

There are a few factors that drove the preferred and hybrid market lower, but the major catalyst was fear over Deutsche Bank's ability to make their coupon payments after pre-releasing a 2015 loss of EUR 6.8bn. Investor fears that contagion could spread to other banks and hinder their ability to meet coupon payments on AT1 instruments drove prices lower across the board. This was compounded by fears over a possible U.K. exit or "BREXIT" from the European Union, and increased concerns over credit quality issues resulting from commodity, energy and emerging market exposure. We think the market reaction to these concerns in the preferred and hybrid markets was overdone.

Deutsche Bank has since announced that they will meet their AT1 coupon and dividend payments for 2016 with sufficient capacity for 2017, but advised this will be dependent on 2016 results. We remain cautious on Deutsche Bank longer term, but feel the severity of the sell-off was unwarranted as a coupon cancellation does not appear to be a substantial risk currently.

Fears of a BREXIT are also exaggerated, in our opinion, as it does not appear likely to result in a capital event or structural changes for financial services companies. The majority of the impact, if a BREXIT does occur, would be at the macro level for the UK economy and may even be positive.

Pricing pressures in commodities and energy related markets have weighted on the financial markets in general, however, exposure appears minimal for the majority of issuers of preferreds and hybrids. Most banks and financial services companies in the preferred and hybrid market have manageable credit exposure to energy and commodity sectors. Emerging market exposure exists but does not present a systemic threat to the market.

There is a technical component to this selling pressure that involves non-dedicated investors to the preferred and hybrid market that had previously rotated into preferred and hybrid securities to offset volatility in other asset classes, who are now selling to meet fund redemptions or to move back into other asset classes. At the same time, dealer desks are taking less balance sheet risk per regulatory changes, which has reduced liquidity in the fixed income markets. As a result, prices have fallen to unjustified levels that we would not have expected given the strong underlying fundamentals in preferred and hybrid issuers. Our view of this being more technical than fundamental in nature leads us to believe that this selling pressure is temporary. We think the improvement in relative value of preferred and hybrid securities presents an attractive entry point for investors.

The views expressed are current as of the date indicated and are subject to change in the future.

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