Private Bank

Fixed Income Strategy

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Preferred stocks: Come and get it

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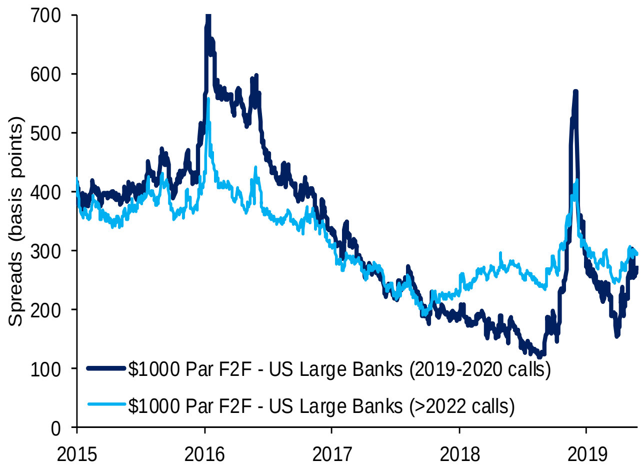
- **Summary:** Fueled by the drop in global yields, US and European preferreds have generated above average year-to-date performance. With gains in most securities now exceeding 10%, one may question the extent to how much further prices can be stretched. Indeed, these securities are callable by the issuer upon a pre-determined date, which limits the extent to how high prices can rise when yields fall (negative convexity). Still, as global rates decline and the demand for yield intensifies, the case for higher yielding preferreds strengthens. We discuss below our latest thoughts.

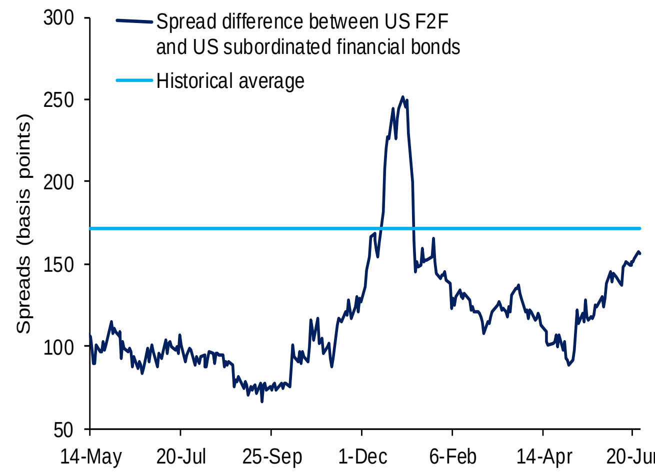
- **Wider spreads in US fixed-to-floating rate (F2F) bank preferred has increased the value proposition.**
  - Average spreads (to worst) on F2Fs from large US banks have risen ~65bp over the last few months (more so in securities with shorter call dates) and now range between +250-325bp **(Figure 1)**. At the same time, the spread pick-up over subordinated financial bonds has improved by about 65bp to 150bp **(Figure 2)**. This brings the F2F-subordinated bond relationship back to January levels, and just below its historical average of 170bp.
- **During the most recent rally in global rates, US F2F yields have not meaningfully followed suit.**
  - To be fair, US F2F yields have dropped nearly 300bp since the beginning of the year. However, with 10-year UST yields falling 50bp over the last several months, US F2F haven't moved much at all **(Figure 3)**. This is likely a result of the extreme cheapening in preferred valuations during the risk-off period late-December 2018, and the ensuing sharp rally to start the New Year. In other words, the rally in F2F's to start the year left the asset class expensive. As UST yields fell further, embedded call options kept prices stable and subsequently pushed spreads wider.
- **We raise our view on US F2F preferreds to overweight (from neutral).**
  - After gaining 11% through early April, we reduced our overweight position. The US F2F market has gained a modest 1.5% since. With spreads now wider and yields relatively more attractive, we move back to an overweight. With 75% of global bonds (ex-US) trading less than 1.0%, we believe the demand for higher yields will likely persist.
  - Reduce equity beta, following our more defensive approach amid rising trade and Fed policy uncertainties. Though preferreds have an interest rate component, the asset class holds a positive correlation to equity markets.
  - The lack of new issuance has been a significant trend for the last few years. The results of the 2019 Comprehensive Capital Analysis Review (CCAR) and the Dodd-Frank Act Stress Test (DFAST) showed all 18 bank holding companies pass, while planned capital returns will increase versus 2018 **(Figure 4)**. Results also imply that future new issuance of US F2F will remain low and only likely would replace existing securities. Some banks may chose not to replace at all. Strong bank balance sheets (low credit risk) and negative net supply, should maintain an exceptionally supportive technical environment.
  - For US investors, dividends on most US preferreds (F2F's or fixed-rate) are considered "qualified dividends" and receive favorable tax treatment. This can be beneficial under the new US tax laws which has raised the effective tax rates for many high income earners.
- **We maintain our overweight on European Additional Tier 1 securities.**
  - Since April, US dollar (USD) denominated European AT1 securities have outperformed US F2F's by 215bp and US fixed-rate preferreds by 200bp **(Figure 5)**. Even euro denominated AT1 structures have fared better than the US, despite decent exposures to Italian banks. Performance was largely driven by a 100bp drop in yield over the last month, as well as 80bp off spread tightening.
  - In our view, valuations in USD European AT1s still offer good relative value. Index spreads at 350bp are 65bp wider than US HY bonds and 110bp wider than euro HY **(Figure 6)**. Average yields near 5.8% are also in line with high yield bond markets. For income oriented investors, we still find these levels compelling. Especially in a world where yield is becoming harder and harder to come by.

Figure 1. US preferreds spreads have moved wider



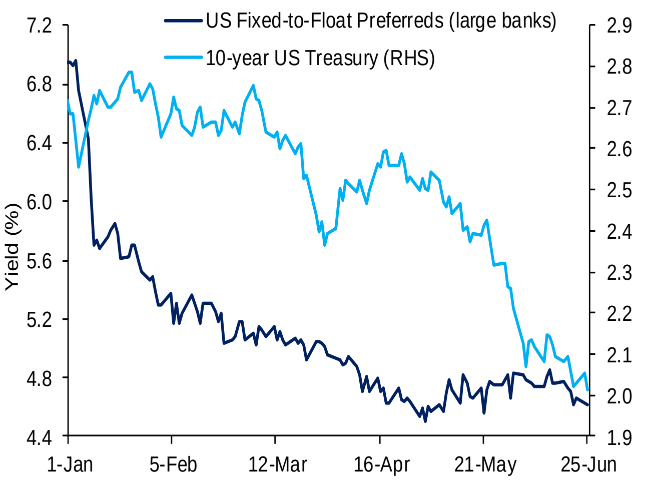
Source: Bloomberg as of June 27, 2019

Figure 2. Value vs. subordinated debt has improved



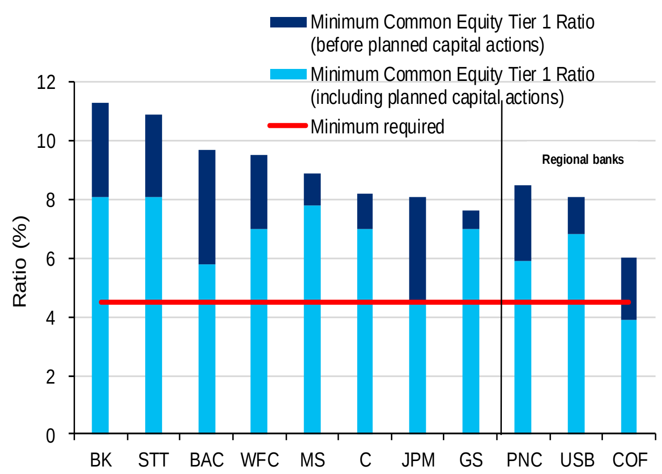
Source: Bloomberg, JPM Morgan as of June 27, 2019

Figure 3. Recent UST rally hasn't impacted US F2F's



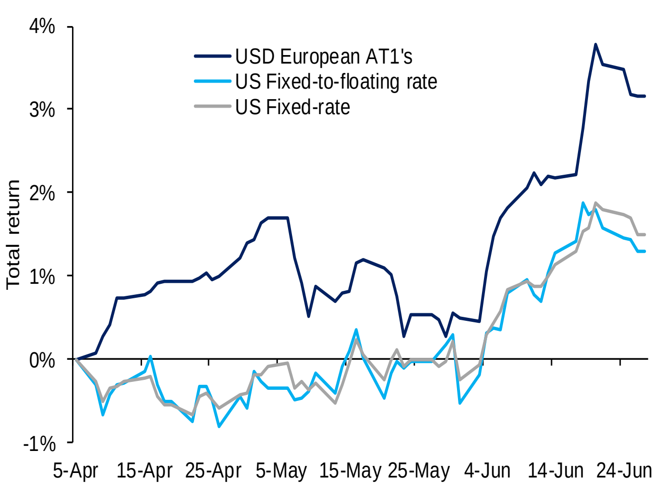
Source: Bloomberg as of June 27, 2019

Figure 4. DFAST/CCAR were positive for US banks



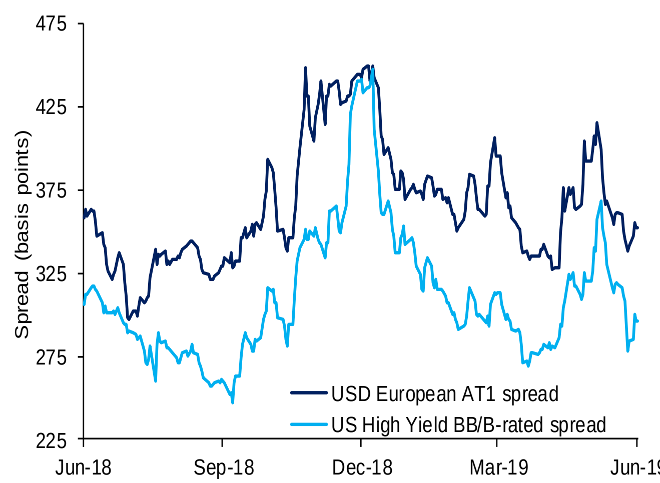
Source: Federal Reserve as of June 27, 2019

Figure 5. European AT1s have outperformed since April



Source: Bloomberg as of June 27, 2019

Figure 6. European AT1s offer value over US HY markets



Source: Bloomberg, Credit Suisse as of June 27, 2019