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Fixed Income Strategy

March 25, 2020

Preferreds stocks – Use one hand catching this knife

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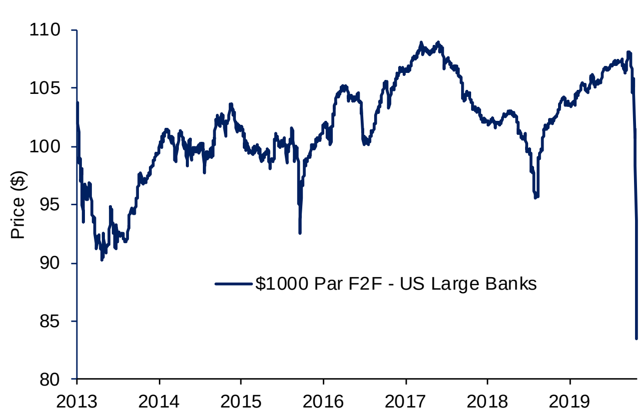
Summary

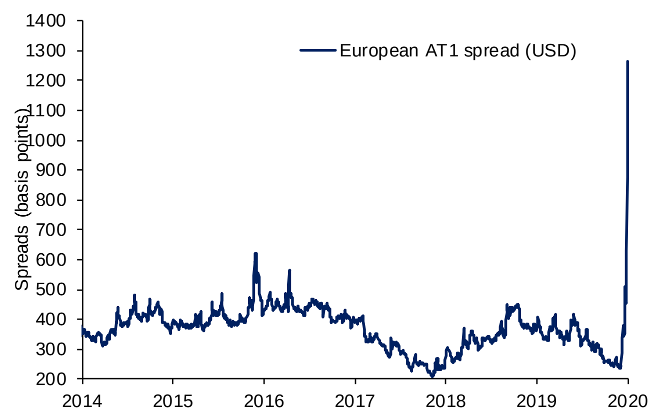
- The amazing speed of news flow over the Covid-19 virus pandemic has been equally matched by severe market declines, intense volatility and substantial policy responses from major central banks around the world. Most concerning has been the severe level of indiscriminate selling and declining market liquidity. This has created a number of market dislocations. Within, we discuss US and European preferred stocks more closely.
- The US fixed-to-float (F2F) preferred market has declined 30% over the last month, with average prices down about 25pts to the mid $80's, its lowest on record. In Europe, Additional Tier 1 (AT1) securities have lost between 23-30%, depending on issuer and structure. Higher quality banks have certain securities trading with yields near 15% **(Fig. 1 and 2)**.
- To be fair, the sell-off is partially justified. Concerns around a global recession and the ability for banks to pay dividends has crept (back) into investors' minds. Share buyback programs have stopped and US and European banks have both been told by regulators to use precious capital coffers to support continuation of credit to households and businesses. European structures have equity conversion or coupon suspension risks also creating additional nervousness.
- Fortunately, US and European bank balance sheets are starting from a position of strength. Post-Financial Crisis regulatory reforms had pushed the sector to raise significant capital to protect against future crisis. Common Equity Tier 1 ratios for most banks are well above the required threshold. Exposures to certain high-risk sectors (i.e., energy) appear manageable.
- In our view, preferred security valuations are historically attractive and offer long-term value. However, near risks remain and weakness may continue. Clarity around how severe the spread of Covid-19 virus is difficult to assess. However, the deep (though likely short natured) negative macro impact from public and factory shut downs is easier to predict. Liquidity in credit markets remains poor, though recent central policies should help.
- The largest price declines have been in recent new issues, which have low back-end spreads. Tactically, we would expect these structures to have a sharper rebound in a normalizing market scenario. For longer-term portfolio construction, we favor high quality issuers. In the US, wider back-end spreads are preferred. More important, taking an incremental investment approach would be suggested.

Figure 1. US F2F prices have dropped 25 points on average



Source: Bloomberg as of March 25, 2020

Figure 2. European AT1s have been hit hard as well



Source: Bloomberg as of March 25, 2020

US and European preferreds
Collectively, the US fixed-to-float (F2F) preferred market has declined 30% over the last month, with average prices down about 25pts to the mid-$80's, its lowest on record. Spreads (to call) reached +950bp, with average yields at 11%. Valuations vary dramatically, depending on structure. Some yields (to call) can exceed 18%.

Recent new F2F issues have suffered the most, as these structures came during a period of historically low credit spreads. Most have 5-year call options, as well as low back-end spreads (*Back-end spread refers to the premium over a base-rate for which future interest payment are made, if not called by the issuer upon its first call date*). With the Fed cutting rates to zero, the appetite for any kind of floating-rate debt has dropped. However, these structures (or any short callable structure) has been hit the hardest.

For example, the JP Morgan 4.0% callable in 2025 issued in January, with a back-end spread of +275bp, recently traded around $75 to yield 11%. This kind of pricing can be found in similar structures issued by other large banks. On the other hand, F2F structures with longer calls and higher back-end spreads have performed relatively better. For example, Bank of America 6.3% callable in 2026 with a back-end spread of +455bp over 3-month LIBOR was priced at a slight discount to near 7.0%. To be sure, even these types of F2F's have weakened significantly. This particular security traded around $120 back in February.

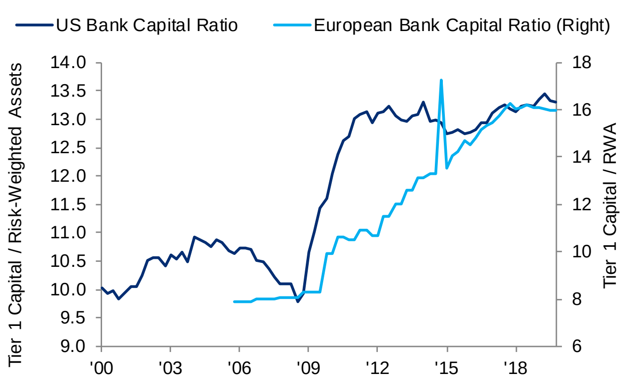
In Europe, we see a similar market reaction. Additional Tier 1 (AT1) securities have lost between 23-25%, depending on issuer and structure. Italian banks are now trading with yields close to 20%, while high quality banks offering yields between 12-15%. Some banks have AT1 securities that have fallen over 25pts in a matter of one week.

To be fair, the sell-off is justified. Concerns around a global recession and the ability for banks to pay dividends has crept (back) into investors' minds. Share buyback programs have stopped and US and European banks have both been told by regulators to use precious capital coffers to support continuation of credit to households and businesses. European preferred structures have equity conversion or coupon suspension risks also creating additional nervousness. More of a near-term concern would be if regulators forced banks to suspend preferred dividend payments, to help preserve capital. While certainly a risk, we view coupon suspensions for higher quality bank preferreds to be a much lower probability.

Fortunately, both US and European balance sheets are starting from a position of significant strength. Post-Financial Crisis regulatory reforms has pushed the banking sector to raise significant amounts of capital to protect against future crisis **(Fig. 3)**. Common Equity Tier 1 ratios for most banks are well above the required threshold. In addition, other measures of bank vulnerability like leverage ratios, liquidity coverage, and share of loans that are non-performing are all much less concerning than they were before the Global Financial Crisis. Exposures to certain high-risk sectors also appear manageable. For example, total loan exposure for the large US banks to the oil and gas sector in 2019 was between 1-2% of total assets **(Fig. 4)**.

In our view, levels being offered in the space are historically attractive and offer long-term value. However, risks remain and weakness may continue. Clarity around how severe the spread of Covid-19 virus is difficult to assess, though the severe negative macro impact from public shut downs is easy to predict. Liquidity also remains problematic, though improvements could occur as central banks add liquidity. Collectively, we remain cautious. Investors testing waters should do so incrementally. Legging into these markets is likely the best strategy.

Figure 3. Banks have significantly increased capital buffers



Source: Haver Analytics, Bloomberg as of March 25, 2020

Figure 4. US banks 2019 energy loan exposure

Company	Category	Loans Outstanding ($ mil.)	% of Total Loans	% of Total Assets
Comerica	Energy	2,449	4.9%	3.3%
CIT Group	Oil&Gas	1,176	3.1%	2.3%
Zions	Mining, quarrying, Oil&Gas	1,429	3.0%	2.1%
KeyCorp	Oil&Gas	2,363	2.5%	2.1%
Regions	Energy	2,172	2.6%	1.7%
Goldman Sachs	Natural Resources & Utilities	12,241	11.2%	1.2%
Huntington	Mining, quarrying, Oil&Gas	1,304	1.7%	1.2%
Capital One	Oil&Gas	3,725	1.4%	1.0%
Wells Fargo	Oil&Gas	13,562	1.4%	0.7%
Bank of America	Energy	13,369	1.4%	0.5%
JP Morgan	Oil&Gas	13,064	1.4%	0.5%
Morgan Stanley	Energy	3,460	2.6%	0.4%

Source: CreditSights as of March 25, 2020. For illustrative purposes only. This should not be construed as an offer of, or recommendation of companies discussed.

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