

Preferreds Market Weekly Review: Yield Compression Continues

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Summary

- We take a look at the action in preferreds and baby bonds through the third week of August and highlight some of the key themes we are watching.
- August is shaping up to be the weakest month for preferreds since last March.
- Yield compression remains a key theme highlighting the low opportunity cost for being up in quality.
- We discuss a number of new issues from Bridgewater and ConnectOne banks, Textainer and PennyMac Mortgage.
- Our stance continues to favor "portfolio" securities as well as pinned-to-par and "through-the-cycle" stocks such as OXSQL, ECCY, LBRDP and BPYPM.

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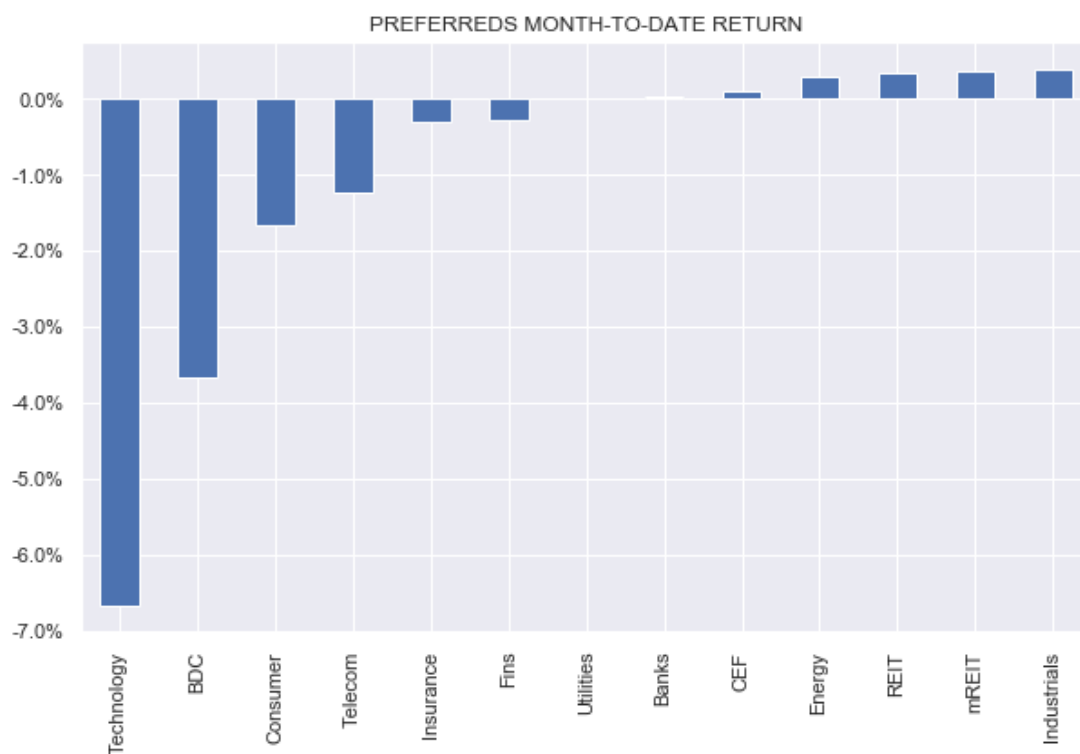
This article was first released to Systematic Income subscribers and free trials on 23-August.

Welcome to another installment of our Preferreds Market Weekly Review where we discuss preferreds and baby bond market activity from both the bottom-up - highlighting individual news and events - as well as top-down - providing an overview of the broader market. We also try to add some historical context as well as relevant themes that look to be driving markets or that investors ought to be mindful of. This update covers the period through the third week of August.

Market Overview

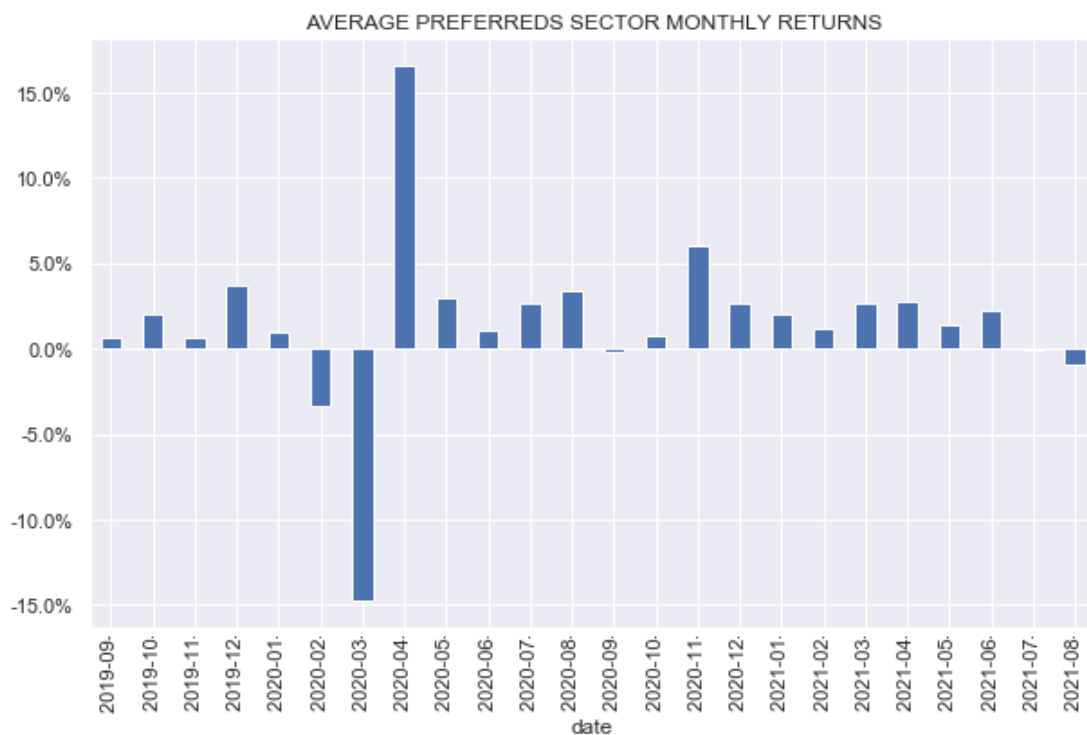
The third week of August was unusually week for the preferreds space with all but the REITs sector registering negative returns. Preferreds followed high-yield bonds lower - in sympathy with equities despite the tailwind of lower Treasury yields.

So far over August there is a significant discrepancy between average and median sector returns. There are roughly as many sectors in the green as in the red, however those in the red are "redder", so to speak.



Source: Systematic Income

From a longer-term perspective, August is shaping up to be a down month. And although July and September were very marginally down months also, they were just barely so. Low Treasury yields, tight credit spreads, anxiety about tapering as well as waning vaccine efficacy and its impact on the macro recovery are obvious headwinds for the overall market. It would be surprising to see preferreds strongly outperform their carry over the coming months so investors should expect to settle in for more mediocre returns than they may have gotten accustomed to over the last 18 months.



Source: Systematic Income

Market Commentary

We are getting closer to the full implementation of the Rule 15c2-11 that will impact the ability of investors to transact in certain OTC securities. There is some confusion as to the actual list of impacted securities. Going by those preferreds classified by OTCMarkets as Pink-No Information, Grey Market and Expect Market - the list appears to be composed of 105 stocks ([Rule_15c2-11_Prefs.xls](#)). That said, we have seen some brokerages restrict new positions in securities that are not on this list so it's fair to say that there is no clear consensus yet and the implementation of the rule is likely to be fairly messy and inconsistent.

mREIT PMT is out with a new preferred 6.75% Series C (NYSE:[PMT.PC](#)) which is right around par now, having opened fairly weak. The issuer and stock has a number of attractive features: a 0.40% yield pick-up relative to the other 2 series, a relatively idiosyncratic business model, high equity / preferred coverage resilience over 2020 and more. That said, the size of the deal is quite large which will push down coverage significantly. However, it is still worth a look as a diversifier for investors already allocated to the mREIT preferreds space. Overall, the hybrid sub-sector is fairly attractive in this environment of very tight agency spreads – hybrid book values have been more resilient over the last quarter and should remain so until agency valuations normalize.

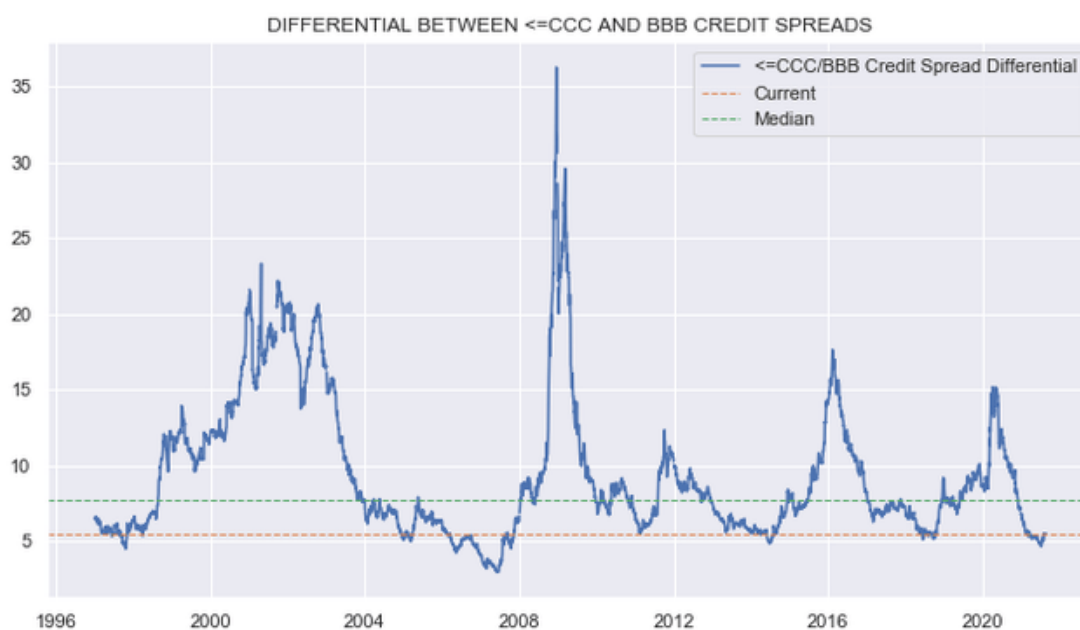
The 5.875% Bridgewater Bancshares Series A (BWBP) – a small bank in Minnesota started trading, rising quickly to \$26.20 and a 4.8% yield. Senior unsecured issuer debt is BBB from Kroll for what it's worth. Historically, local banks have been less resilient to macro headwinds (which explains why the Great Depression was that much worse in the US than in Canada where banks could operate nationally – in the US there was a restriction from operating on a nationwide basis and so the banks were much more exposed to a downturn in a single market). Now, metropolitan area (the Twin Cities in this case) are less dominated by any one business or industry so being local is less of a risk. That said, a lot of their exposure is in the local housing market. Much of the tactical juice is squeezed in the stock but it's worth a look for fans of financials who don't like to add exposure to the larger banks (that they may already hold via preferreds funds).

Textainer - a container lessor - is out with a new preferred, just a few months after its 7% Series A (TGH.PA) IPO. The 6.25% Series B (TGHPL) is a fixed-rate preferred (Series A is a 5-year CMT fix-to-float). The two new preferreds are trading in a fairly typical fashion - Series B is trading at a lower stripped yield but a higher yield-to-worst (6.30% versus 5.77% for Series A). We prefer TGHPL here, however TGH.PA may be more attractive to investors who worry about higher longer-term rates which TGH.PA would be able to digest much better.

ConnectOne Bancorp - a primarily New Jersey bank - issued a 5.25% preferred Series A (CNBOL) which has risen quickly to trade above \$26, resulting in a 4.29% yield-to-call into its Sep-2026 first call date. One attractive feature of the preferred is the reset rate linked to the 5-year Treasury bond yield, which at current yields, equates to roughly the same 5.25% coupon. Most fix-to-float preferreds reset off 3-month Libor which has three potential disadvantages. First, Libor is tightly linked to the Fed policy rate and if the Fed decides to keep rates on hold the coupon of the preferred will not rise whatever happens to inflation. Secondly, most Libor fix-to-float preferreds will see a step down in their coupons since most were issued before March of 2020 when short-term rates collapsed (the spread over the floating rate is set in such a way as to equate the then floating-rate coupon to the issued fixed-coupon). And finally, there is still some uncertainty about what happens to Libor and whether the economics of the floating-rate coupon will be maintained when delinked from Libor. Overall, in our view, there are more attractive bank preferreds such as from First Republic Bank, Capital One, JPMorgan and Wells-Fargo, in the sector - those featuring a combination of decent credit ratings and yields in the same neighborhood as CNBOL.

Market Themes

One of the key themes in today's markets is that of yield compression. Yield compression happens in a period of strong risk sentiment and a supportive market and macro backdrop. We can visualize the theme of yield compression by looking at the credit spreads of different credit ratings. The chart below shows the differential between BBB-rated bonds and those rated CCC and below. The BBB rating is the lowest investment-grade rung while those rated CCC to D are those ranging from fairly distressed to actually being in default.



Source: Systematic Income

The chart shows that the current credit spread differential between the two rating buckets (shown in red) is about 5% and is near the lowest level of the last 25 years and well below the median level over the same period of about 8% (shown in green). A yield premium of 5% may sound fairly compelling but this number is, obviously, not loss-adjusted. Investors have to remember that about a quarter of all issuers rated CCC/C default within one year - the same figure is about 0.2% for issuers rated BBB.

Over the last few months a number of negative net income companies have issued preferreds with yields in the high single-digits. And while the macro consensus is fairly upbeat, the reality is that we don't know how long the current cycle is going to last or what the next inevitable market hiccup is going to be. This suggests that investors ought to adopt a countercyclical approach to markets - improving the resilience of their portfolio when the going is good and the additional yield premium for moving lower in quality is low as it is now. This can mitigate some of the negative behavioral trading dynamics of buying high and selling low as well as giving investors an ability to move into more attractive opportunities during market drawdowns.

Stance And Takeaways

In the current environment we are keeping an eye on risk and maintain our tripartite stance of favoring "portfolio" securities such as CEF and mREIT preferreds that offer more systematic and less idiosyncratic market exposure, pinned-to-par securities with low call price risk and "through-the-cycle" preferreds - securities with decent fundamentals that are trading at attractive yields that are likely to be more resilient across the entire trajectory of a macro cycle. Preferreds and baby bonds that remain attractive in our view are the Liberty Broadband Series A ([LBRDP](#)) trading at a 5.99% yield, (NASDAQ:[BPYPM](#)) from Brookfield Property Partners, rated BB+, at 6.30% yield and the Oxford Square Capital Corp 6.5% 2024 Notes ([OXSQL](#)), trading at a 6.48% YTM.

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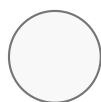
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Disclosure: I/we have a beneficial long position in the shares of LBRDP, BPYPM, OXSQL either through stock ownership, options, or other derivatives. I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it (other than from Seeking Alpha). I have no business relationship with any company whose stock is mentioned in this article.

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