Preferreds Market Weekly Review: Implications Of A Lower End-Of-Cycle Policy Rate

ADS Analytics

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This article was first released to Systematic Income subscribers and free trials on Oct. 31.

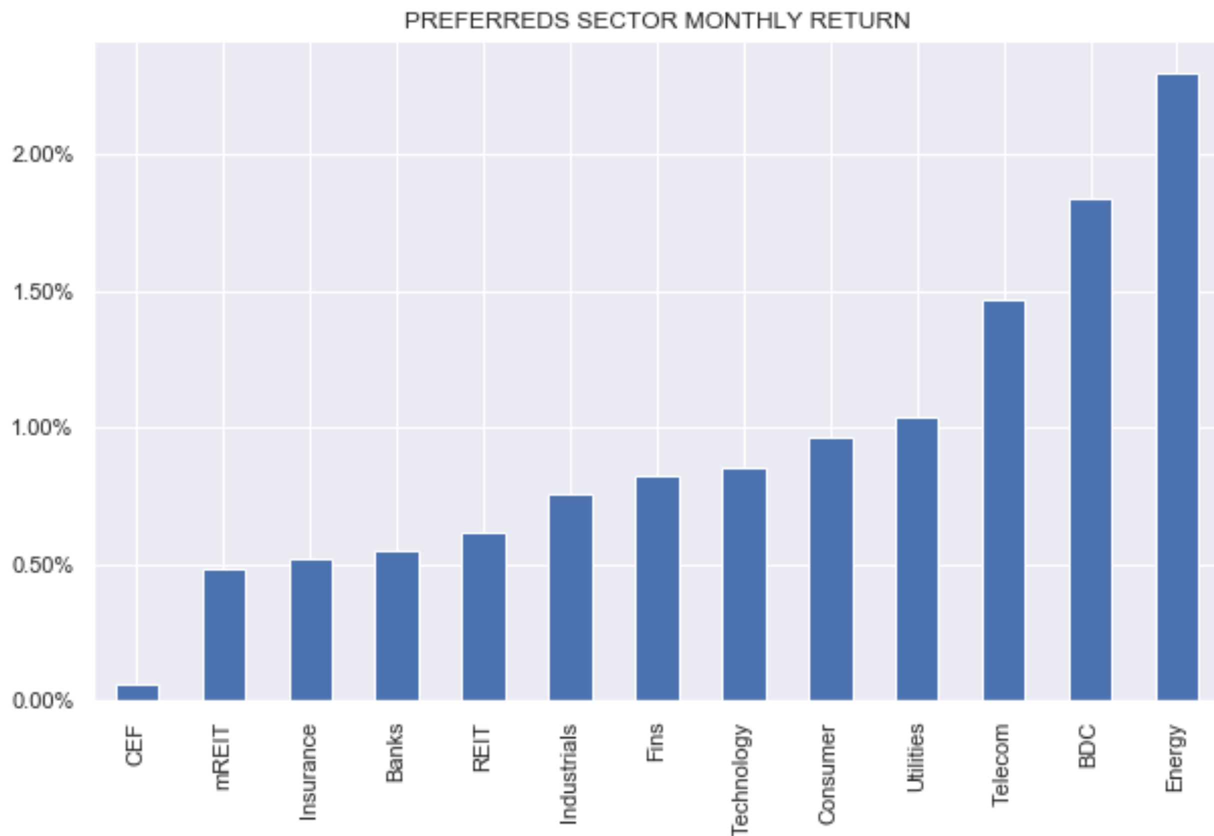
Welcome to another installment of our Preferreds Market Weekly Review where we discuss preferreds and baby bond market activity from both the bottom-up, highlighting individual news and events, as well as top-down, providing an overview of the broader market. We also try to add some historical context 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 last week of October. Be sure to check out our other weekly updates covering the BDC as well as the CEF markets for perspectives across the broader income space.

Market Overview

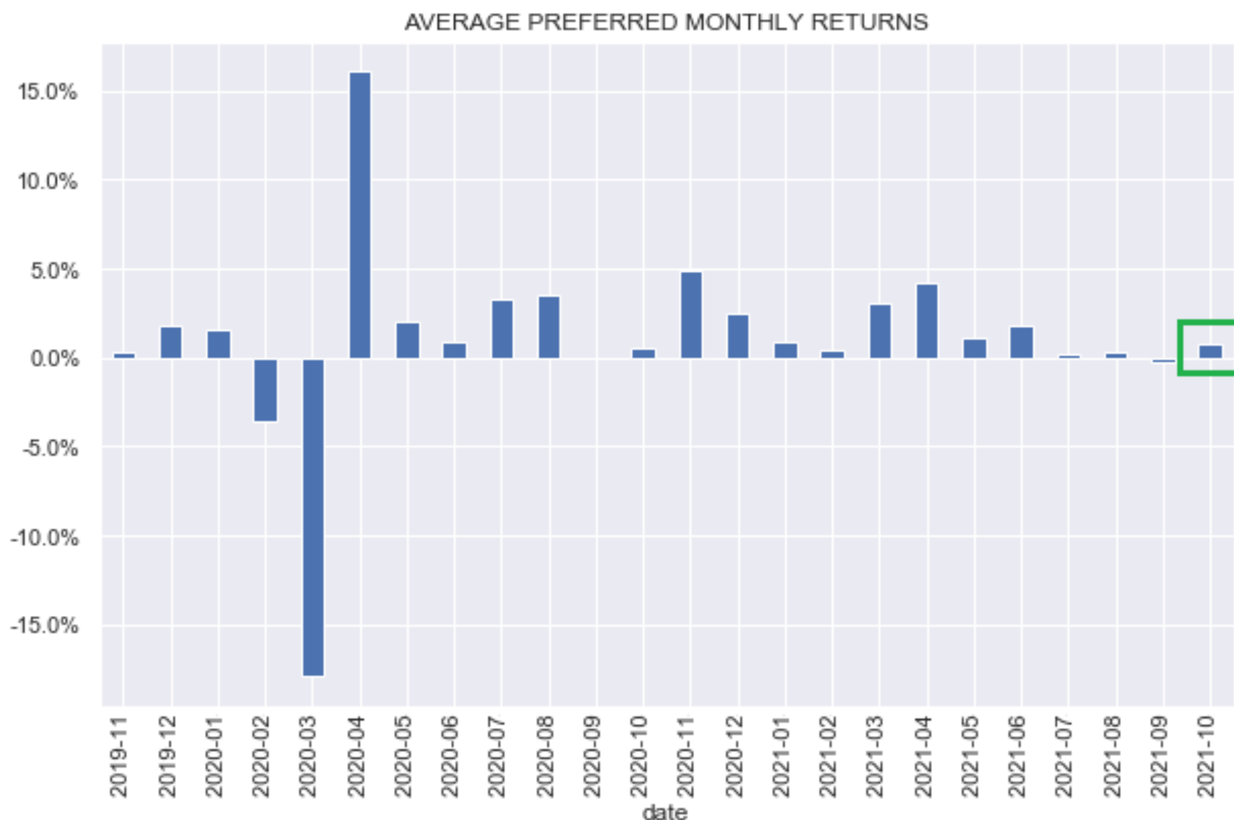
The preferred market had a strong October, supported by higher equity prices and a drop in longer-end Treasury yields. Energy led the pack, supported by continued rise in oil and commodities as well as what looks to be a fairly sticky inflation picture.



Source: Systematic Income

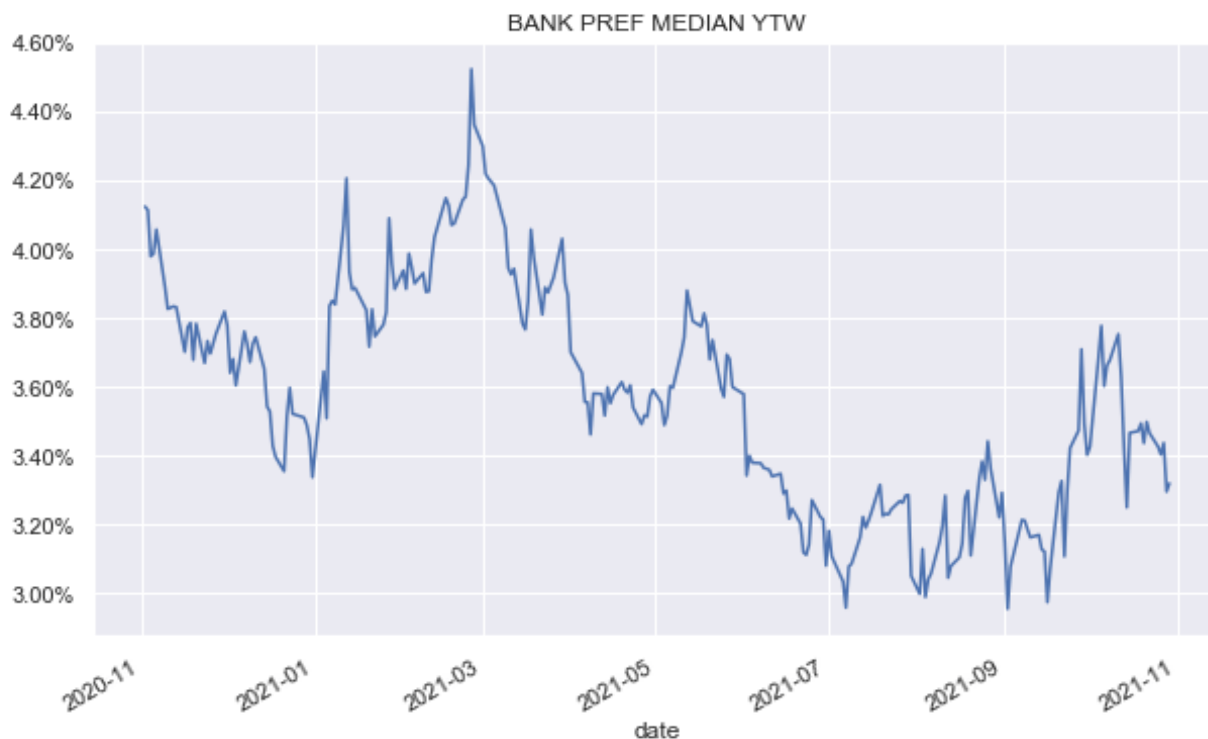
The preferred market made little headway over the previous three months with negative net price (excluding dividends) returns, a trend

which has paused in October.



Source: Systematic Income

Some of the higher-quality sectors such as Banks have seen their yields fall back quickly due the flattening of the Treasury yield as the long end of the curve fell sharply with the long bond yield lower by 0.15%.



Source: Systematic Income

Market Themes

With inflation looking stickier than most analysts anticipated earlier in the year, many are bringing forward their first hike calls as well. This means that Libor will get off the ground sooner and move higher, mostly tracking the Fed policy rate. This is welcome news for investors holding Libor-linked fix-to-float securities that will, unless redeemed, boast a higher floating-rate coupon post redemption than they would have had Libor remained near zero where it still is now.

However, while the initial hike will be welcome for fix-to-float holders, the key question is less when Libor starts moving higher and more where it ends up at the end of the hiking cycle. This is because the vast majority of fix-to-float securities have not yet begun to float.

In order to understand the dynamics of floating-rate coupons, investors have to understand that first, floating rate spreads tend to be set at a level roughly equal to the security's fixed coupon at the

time of issuance. And secondly, when most Libor-linked fix-to-float securities were issued, Libor was at a much higher level than now. For instance, roughly between 2018 and 2019 Libor traded mostly north of 2%.

What this means is that a security that was issued with a 6% fixed coupon when Libor was trading at 2% would have set its floating-rate coupon around Libor + 4%. So, if Libor remains near zero, its coupon will step down from 6% to around 4.12% (3m Libor is now 0.12%). The consequence of this is that Libor would have to rise back up to 2% (equivalent roughly to 8 Fed hikes) in order for its floating-rate coupon not to step down after redemption (unless the security is redeemed).

The key risk for investors is that the broader economy cannot handle the move in the policy rate prior to its pre-COVID level with the Fed only able to make a few hikes.

For instance, this is recent commentary from PIMCO referencing this dynamic.

> The Fed was able to raise the fed funds rate to a target range of 2.25% to 2.5% in late 2018 and at the time thought it had some way further to go. But cracks in the financial markets forced the Fed to reverse course and cut its target rate back down to 1.5% to 1.75% in 2019 - even before the pandemic and subsequent emergency actions. Financial market dominance may again make it difficult for the Fed and other central banks to tighten policy significantly in the next five years.

Source: PIMCO

A longer-term perspective on this is the following chart which shows that over the last 40 years, the Fed Funds rate made repeatedly

lower highs. This points to the US economy evolving to be increasingly sensitive to policy rate hikes. There is a good chance that the next hiking cycle may stop well shy of the 2.25-2.5% level of the previous cycle.

Source: FRED

There are two ways to think about this risk. One is to say that everything is already priced into the market and that the current yields of Libor-linked fix-to-float preferreds have already baked in the risk that Libor may remain low. In other words, the yields-to-call / stripped yields are higher now than they would have been in a scenario where the US economy was easily able to digest high levels of Libor. However, not all investors will be happy with this view, particularly those who prefer dividend stability.

These investors should carefully review their holdings across individual securities as well as any sector tilts they may have. For instance, the agency-focused mREIT preferred sub-sector is heavily tilted to Libor-linked fix-to-float securities with only one fixed-rate security.

AGENCY-FOCUSED MREITS	STRUCTURAL					
	Call Date	Type	Current Coupon	Float Index	Float Spread	Cle Pri
AVERAGE ISSUER						
AGNCM	2024-04-15	Fix/Float	6.875%	3mL	4.330%	25.
AGNCN	2022-10-15	Fix/Float	7.000%	3mL	5.110%	25.
AGNCO	2024-10-15	Fix/Float	6.500%	3mL	4.993%	25.
AGNCP	2025-04-15	Fix/Float	6.125%	3mL	4.697%	25.
ARR-C	2025-01-28	Fix	7.000%			25.
DX-C	2025-04-15	Fix/Float	6.900%	3mL	5.461%	25.
IVR-B	2024-12-27	Fix/Float	7.750%	3mL	5.180%	25.
IVR-C	2027-09-27	Fix/Float	7.500%	3mL	5.289%	25.
NLY-F	2022-09-30	Fix/Float	6.950%	3mL	4.993%	25.
NLY-G	2023-03-31	Fix/Float	6.500%	3mL	4.172%	25.
NLY-I	2024-06-30	Fix/Float	6.750%	3mL	4.989%	26.
TWO-A	2027-04-27	Fix/Float	8.125%	3mL	5.660%	26.
TWO-B	2027-07-27	Fix/Float	7.625%	3mL	5.352%	25.
TWO-C	2025-01-27	Fix/Float	7.250%	3mL	5.011%	25.

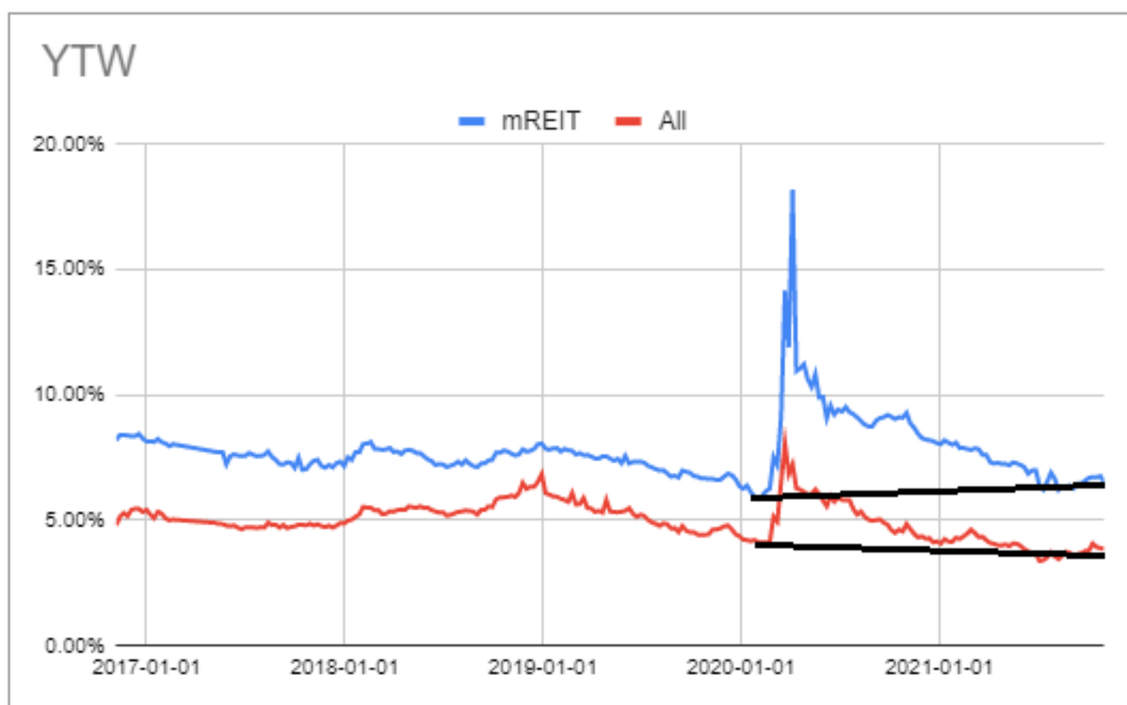
Source: Systematic Income Preferreds Tool

Apart from holding some fixed-rate securities, investors should also be on the lookout for securities with decent reset yields i.e. those with later call dates and / or higher floating-rate spreads as well as resets linked to the CMT i.e. Treasury yield over which the Fed has less control.

Market Commentary

We have already touched on mREIT earnings from the perspective of preferreds investors in a separate article so we won't rehash this. One comment that is worth making, however, is that with all the daily noise in the markets, it can be difficult to keep an eye on the bigger picture such as relative value in the sector. For instance, the mREIT preferreds sector yields are still trading above their pre-COVID level while the broader market yield has moved lower. This is in the

context of significant deleveraging in the sector as well as clear support from the Fed of the broader fixed-income market. Keeping an eye on relative pricing in the sector can allow investors to squeeze out additional income levels without taking on additional risk.



Source: Systematic Income Preferreds Tool

In the new issue space, the Ba2-rated (BB equivalent in S&P/Fitch speak) Bank OZK 4.625% Series A (OZKKV) started trading right around "par" at a 4.63% yield. The bank has $26bn of assets with presence primarily in Arkansas, Georgia and Florida. The preferred provides a decent pick-up over the higher-yielding non-convertible investment-grade rated bank preferreds such as (COF.PL), (NYSE:BAC.PQ), (JPM-M) which are trading in the yield range of 4-4.25% and looks like an attractive diversifier for investors who may be overweight mega bank preferreds.

The COMSovereign Holding Corp. 9.25% Series A (NASDAQ:COMSP) opened weak and is now trading at $23.55 and a 9.82% yield. The company is operating with a negative net income

which has grown (i.e. become more negative) over the past year. And while equity / liquidation preference coverage is high, the trajectory of the common share price as well as the income statement leave this one firmly in the speculative bucket.

The Hennessy Advisors 4.875% 2026 Notes (HNNAZ) opened strong and are now trading at a 3.63% yield. The company is a small mutual fund manager with a bit over $4bn AUM which has ticked higher after four years of drops from a high of $6.7bn to $3.5bn in 2020. The 16% uptick in AUM this year is likely due to the strong performance of the equity market rather than organic inflows so further AUM declines remain a key risk for this relatively small player.