Spectrum Asset Management

Principal Asset Management℠

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Preferreds and CoCos – Uncommon values

The background (Preferreds):

- The CoCos market and the US Bank AT1 preferred stock market are intended to provide capital protection to their immediate senior capital class (i.e., sub debt) and they do; just as common equity provides loss absorption protection to its most immediate senior capital class—CoCos and US Bank AT1.
- Liquidity and risk to liquidity drive the confidence in the financial system and confidence drives the cost of capital. The Fed (and other central banks) manipulate the cost of capital with policy rates and balance sheet exercises that can cause negative feedback loops when rates rise materially and quickly.
- Central banks will usually pause or reverse course when the strain of their actions creates so much friction that it sparks warning flares that the system is getting clogged—the *first flare* was the UK pension losses, and the *second flare* was Silicon Valley Bank (SVB).
- The SVB problem of concentrated deposit flight was specific to that bank, but it created such a psychology of fear that other banks having the same underwater securities (i.e., USTs & mortgages) were suddenly repriced which impelled more fear to run the deposits more broadly across the regional US banking system (as SVB was a regional bank) repricing common equity because of fear of crystalized losses.

The takeaway:

- Fed's Bank Term Funding Program eliminates forced sales of available-for-sale securities and eliminates the risk of any liquidity freeze in the US banking system. The implication is this improves the integrity of the US system. There is uncommon value of 7%-9% current yields available in US bank preferred stock AT1—especially regional banks.

The background (CoCos):

- There is a similar integrity to the European Banking System because of the *third flare* which was the CoCo based bail-in of Credit Suisse.
- Spectrum is not disappointed with CoCo performance at its core (i.e., helping to credit CET1 to aid in a bail-in resolution), but the problem is that something of this magnitude cannot happen without the entire sector repricing as the market mood becomes aggressively negative.
- The CS problem is contained within Credit Suisse and UBS under a recapitalized cushion—this is a painful event not only for CS, but also for the entire CoCo market that repriced down even though the system is now healthier for it.
- This Bank Confidence Crisis is very unlike the Great Financial Crisis because over-levered bad mortgage assets are not broadly held in the system this time. But rather, a single systemically important bank (i.e., CS with festering repeated governance issues) was forced from the funding markets when the market mood could not tolerate more bad news of operating stress specific to CS.

The takeaway:

- CS being potentially unfundable was the core problem to the financial system—now CS obligations will be funded and will clear the system with the help of the AT1 bail-in to UBS. The global banking system is better for it. CoCos with yields at 8%-11% represent an uncommon value.

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