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Spectrum Asset Management

Principal Asset Management℠

2025 OUTLOOK

Global preferred and capital securities remain attractive

MACRO AND CREDIT OUTLOOK with Joe Urciuoli, executive director and head of research
MACRO AND U.S. MARKET OUTLOOK with Phil Jacoby, executive director and chief investment officer
EURO-DENOMINATED CAPITAL SECURITIES OUTLOOK with Manu Krishnan, deputy chief investment officer

Overview

Macro and credit

TAKEAWAYS:

- **Credit outlook:** Remains stable, underscored by a robust U.S. economy.
- **Systemic risks:** Manageable, with financial companies continuing to be fundamentally sound.
- **Banking recovery:** Major banking systems have largely recovered from past crises. U.S. regional banks stabilized after 2023 disruptions through recapitalizations, mergers, stable earnings, and improved loan quality.
- **Insurers:** Expected to sustain robust capitalization and strong balance sheets in 2025.
- **Deregulation:** Trump's planned deregulation will benefit the banking sector but is likely to have only a limited effect on insurers.
- **Utility industry:** The U.S. utility industry will continue record capital investment to support electric reliability, affordability, and sustainability, including expanding renewable infrastructure. This growth is expected despite increased fossil fuel production as part of Trump's energy agenda.
- **Utility hybrids:** A growing source of funding, beneficial for preferred securities.
- **Trump tariff and immigration policies:** Could negatively affect GDP, inflation, and fiscal stability.
- **European outlook:** Less certain due to tepid economic growth, high deficits, limited fiscal space, and unclear U.S. trade policies.
- **U.S.-China trade tensions:** Likely to escalate if planned tariffs are implemented.
- **Geopolitical policies:** The incoming Trump administration may reassess NATO commitments and take a cautious approach to Taiwan and Ukraine while maintaining strong support for Israel.

Macro and U.S. market

TAKEAWAYS:

The Federal Reserve (Fed) should be cutting rates more in 2025, but most likely not before a pause to assess the policy footings of the returning Trump Administration; expect the yield curve to steepen which should benefit the rolling hybrid price behavior as base treasury yields roll lower on a positive slope as time ages; choice of higher fixed-to-refixed hybrids foster an advantage of indifference if the yield curve were to twist lower or rates were to stay elevated for some time; hybrid values relative to more senior financials can pay off when held for long periods; there is risk of wider credit spreads, but that would be a driver for lower rates which should support even better relative values.

Rate cuts should be on pause to start the year, then continue: Inflation is still trending down, but the pace of its decline has slowed materially since mid-2023. Federal funds yield about 1.75% more than inflation

(i.e., the core personal consumption index) and balance sheet reductions should continue to pressure economic velocity in favor of disinflation. Fiscal demands should ease due to expected government efficiency cuts which should help offset some cost push inflation from import tariffs. As the year progresses, increased production and supply of American fossil fuels should also help to reduce inflation and give the Fed confidence that inflation can be sustained closer to its longer-term goal of 2%.

The outlook is constructive for hybrids next year because credit fundamentals are sound and yields are still somewhat elevated despite spreads being tighter than average. We do expect there to be some equity corrections coming in the wake of economic policy pivots because the needed changes (e.g., fiscal cuts; import tariffs) are unlikely to be executed without slowing growth in the near term. Consequently, some risk-off periods seem plausible and when they happen, it's likely to be among the few chances left to buy a combination of high income and/or spread in hybrids for some time because as fiscal pressures subside, real rates should decline along with inflation – which means higher bond prices. This backdrop should give the Fed the confidence it needs to cut rates more given that fiscal policy should be better aligned with the Fed's goal to moderate inflation. The U.S. Treasury (UST) market should evolve into a better technical position as well because we expect gained fiscal efficiencies and funding rebalancings to temper new supply pressures and flatten refunding waves.

Euro-denominated capital securities outlook

TAKEAWAYS:

- Our outlook for return in EUR Capital Securities is constructive despite several headwinds facing the Eurozone.
- Projected growth for the Eurozone in 2025 is anemic. This, along with other weakening economic indicators such as manufacturing and labor should allow the European Central Bank (ECB) to be more aggressive with rate cuts relative to the U.S. Fed.
- ECB rate cuts should help stimulate lending in the Eurozone which should be positive for Financials. Rate cuts, will bolster underlying economies and support bank asset quality. It will also ultimately be supportive of valuation for Bank Tier2 and AT1.
- Credit is strong, NPLs and inflation should be contained.
- The market is pricing in a steep yield curve as a result of ECB rate cuts. This should be supportive of bond prices as they roll down the yield curve. A steep yield curve will be constructive for demand for the product as we would expect capital to exit the short end of the curve and look for yield in strategies such as ours.
- Absolute yields are still near decade long highs despite recent spread tightening. Coupon income should continue to be elevated despite a Central Bank easing regime. Bonds that are callable in 2025 were issued at a time when interest rates were lower than today and spreads higher. Therefore, these bonds should get called and replaced with higher coupons thereby growing income. This would position our strategies in the unique position of being able to grow coupon income in a Central Bank easing cycle.
- As a note of caution, credit spreads could come under pressure if European economies are stressed by the imposition of tariffs by the incoming Trump administration. A deflationary environment due to tariffs for instance, could result in spreads widening into lower rates. European economies will be faced with a difficult choice if the U.S. withdraws its support to NATO. Europe will be forced to spend more on defense, and this will affect fiscal balances. Consequently, the Eurozone will be forced to run fiscal deficits far more than its 3% limit. The ECB could help fund this by embarking on another asset purchase program. Such a scenario will be constructive for credit spreads and total return.
- Given lower projected growth rates in the Eurozone, supply expectations for 2025 are mostly muted. Therefore, we do not expect there to be a supply driven drag on credit spreads.

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Macro and credit outlook

JOE URCIUOLI, executive director and head of research

U.S. election uncertainty is over

With a Republican-led Congress and Donald Trump returning to the presidency, initiatives such as tax cuts, tariffs, deregulation, strict immigration controls, and a focus on energy independence are likely to take center stage. While these measures could have negative effects on GDP, inflation, and fiscal stability, we expect the U.S. economy to remain robust. The European outlook is exacerbated by a weak economy and political volatility, especially in France and Germany, high deficits, and a fragile fiscal position. In addition, European industries, like the automotive and chemical sectors, reliant on exports to the U.S. could be impacted by Trump tariffs. Despite these uncertainties, our credit outlook remains stable.

Geopolitical challenges

Ongoing conflicts in the Middle East and Ukraine, coupled with rising tensions over Taiwan, are reshaping global geopolitics, economies, and defense strategies. The incoming U.S. administration has reaffirmed its support for Israel but may reassess NATO commitments and take a more cautious stance on issues regarding Taiwan and Ukraine. U.S. global trade wars are likely, especially with China, if Trump's tariffs are implemented as planned.

Financial stability

As noted in our 2024 outlook, systemic risks are manageable and financial companies remain fundamentally sound. Since 2023, the banking industry has stabilized through recapitalizations, mergers, and strong loan quality. Deregulation under the new administration should have a limited effect on insurers but would benefit banks.

Utilities and energy policy

While the administration's prioritization of fossil fuels may present challenges to the development of clean energy, utilities are likely to continue growing renewable generation to provide low-cost power.

Trump's return: A new era of economic policy and uncertainty

President-elect Donald Trump's agenda seeks to support domestic industries and safeguard U.S. interests. Policies like deregulation and tax reforms are intended to drive short-term economic growth, but other, more protectionist, measures such as immigration restrictions and tariffs, may pose long-term risks including fiscal strain, supply chain disruptions, and labor market shortages.

Continued high budget deficits and rising national debt, coupled with the potential for Mr. Trump to interfere with the Fed's autonomy, could undermine investor confidence. These could place the U.S. in the crosshairs of "bond vigilantes," potentially driving up borrowing costs, thus exerting downward pressure on sovereign ratings.

The administration plans to extend the 2017 Tax Cuts and Jobs Act (TCJA), aiming to make individual tax cuts permanent and lower the corporate tax rate from 21% to 15%, surpassing the TCJA's scheduled expiration at the end of 2025. However, this could add trillions of dollars to the national deficit, making such a long-term plan less feasible. A shorter, more fiscally conservative extension is the likely outcome.

With a Republican-controlled Congress, the administration is well-positioned to push its agenda, though the narrow GOP majority in the House could make passing legislation more challenging. Bipartisan initiatives, like President Biden's CHIPS and Science Act to boost the domestic semiconductor industry, might face resistance to repeal. Similarly, while some parts of the Inflation Reduction Act (IRA) could be rolled back, clean energy investments—especially given economic benefits for Republican-led states—are likely to stay in place. Despite some potential pushback, congressional gridlock is expected to be minimal, paving the way for progress on Trump's economic priorities.

Bank deregulation

Anticipated deregulation policies are expected to benefit U.S. banks and credit fundamentals. The administration is likely to revise Basel III Endgame (B3E) rules, which were designed to strengthen capital requirements but have faced criticism for limiting lending. Key initiatives may include simplifying bank merger processes and reducing regulatory burdens to promote economic growth and increase bank profitability.

Potential rollbacks could involve:

- Legislative changes to the Dodd-Frank Act including relaxing capital rules and the Volker Rule, which would lift limitations on proprietary trading and risky investments.
- Easing stress test requirements largely for regional banks.
- More M&A, especially between small banks struggling with compliance costs.

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Additionally, reforms to or elimination of the Consumer Financial Protection Bureau (CFPB) and adjustments to executive compensation restrictions could lower compliance costs.

Deregulation impact on utilities, energy, and the environment

The Trump administration's agenda is expected to significantly affect the utilities sector, particularly in energy policy and environmental standards. A strong emphasis on fossil fuels—oil, natural gas, and coal— can potentially slow renewable energy growth while promoting traditional energy investments.

Key policy changes may include:

- **Expanded domestic energy production:** Easing restrictions on drilling, fracking, and offshore exploration while lifting the pause on liquefied natural gas (LNG) exports and streamlining permitting processes.
- **Relaxed emissions standards:** Weakening carbon regulations, potentially reversing initiatives like the Clean Power Plan, albeit potentially lowering utility cost burdens.
- **Paris Accord withdrawal:** Fewer international climate commitments.

The rollback effect of these policies could result in fewer federal incentives for renewables, leading utilities to navigate a changing landscape with reduced carbon emissions requirements. In addition, lighter agricultural regulations may lower operational costs but raise environmental concerns.

Consumer demand for sustainability and bipartisan support for programs like the CHIPS Act and portions of the IRA may limit the administration's ability to impede existing renewable energy investments. Utilities will need to balance short-term opportunities in traditional energy with a long-term energy transition story.

Tariffs

The objective of new tariff policies is to better safeguard U.S. industries and workers—particularly against Chinese competition—while promoting domestic production and addressing trade imbalances. However, the proposed universal 10% tariff on all imports appears overly broad, and a 60% tariff on Chinese goods – affecting U.S. sectors like auto and technology – is excessively high and likely ineffective. In addition, the administration plans to impose 25% tariffs on goods from Mexico and Canada, the largest trading partners of the U.S. Such measures, if implemented, would likely harm GDP, drive inflation, and further strain global trade relations.

There are no winners in aggressive trade wars. High tariffs may provoke retaliatory actions which could harm key U.S. markets, such as agriculture exports to China and the European Union (EU), and disrupt global supply chains. Financial markets could face heightened volatility due to policy uncertainties and eroding investor confidence. Small businesses, which have benefited from deregulation and tax cuts, could encounter rising operational costs stemming from tariffs and ongoing labor shortages. A more targeted approach, focusing on fair trade agreements and selective tariffs – rather than a one-size-fits all strategy – could be more effective in avoiding increased costs for consumers and industries reliant on trade.

Immigration

The incoming administration plans to implement strict immigration policies, including deporting millions of undocumented immigrants, reinstating travel bans, restricting legal immigration, and continuing the construction of the U.S.-Mexico border wall. These measures aim to reduce illegal crossings, enhance national security, and protect domestic labor markets.

The deportation of undocumented immigrants with criminal records is a reasonable starting point, but a significantly broader approach could lead to unintended consequences such as labor dislocations in key sectors like agriculture, construction, manufacturing, and technology. Hiring U.S. citizens may not be the most cost-effective way for businesses. The result would be higher production costs, reduced profitability, and increased consumer prices — ultimately slowing economic growth.

A balanced approach to undocumented immigration could enhance security and maintain economic stability. Investments in advanced border technologies, like drones and surveillance systems, offer cost-effective alternatives to physical barriers while creating jobs. Streamlining legal immigration, such as expedited work visas, would address labor needs and reduce illegal crossings.

U.S. foreign policy

President-elect Trump's foreign policy agenda emphasizes an "America First" approach, focusing on recalibrating U.S. commitments to traditional alliances. Central to his campaign is a critique of NATO, which he views as overly dependent on U.S. contributions. Trump has threatened to reduce support from NATO if allies fail to meet the 2% GDP defense spending target. In addition, he has questioned why the U.S. is providing more funding than Europe for Ukraine's defense. While these points are valid, the U.S. could focus on renegotiating a more equitable balance of responsibilities to maintain global security.

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In the Middle East, Trump remains pro-Israel, vowing unconditional support for its military efforts and a commitment to rebuilding U.S. alliances in the region, as well as pressuring Iran. Regarding China, Trump has promised a tougher stance, including revoking China's Most-Favored-Nation trade status, restricting Chinese investments in U.S. real estate, and pursuing economic independence. His position on Taiwan focuses more on defending U.S. economic and strategic interests, raising questions about the future of U.S. presence in the Indo-Pacific.

Trump's foreign policy vision reflects a broader effort to redefine U.S. global engagement, prioritizing national interests while challenging international norms. While these strategies aim to strengthen America's global standing, they also introduce significant uncertainty for geopolitical stability and U.S. relations with key allies.

Banks

Financial risks should be modest this year. Major banking systems have largely recovered from past crises. U.S. regional banks stabilized after 2023 disruptions via recapitalizations, mergers, stable earnings, and improved loan quality. However, economic uncertainties persist, including geopolitical conflicts and potential trade wars fueled by U.S. tariffs.

The turmoil of 2023 in U.S. and European banking stemming from the collapse of Silicon Valley and First Republic, and the Swiss Government-assisted merger of troubled Credit Suisse with UBS, is over. These failures were specific to each bank – with no implications or impact on the core financial systems in the U.S. and Europe.

Financial risks should be modest this year. Major banking systems have largely recovered from past crises.

Since then, significant progress has been made, and much of it has been positive. The Fed's swift and substantive support for the financial system had its intended stabilizing effect. Troubled U.S. banks have been resolved through self-help measures or mergers, and the Credit Suisse/UBS integration is progressing well. Banks' earnings, asset quality, and capital remain solid. Concerns about a commercial real estate (CRE) meltdown, particularly in the office segment, have been overstated, and funding conditions have normalized.

The preferred stock/AT1 securities market has rebounded strongly, aided by lower short-term rates driven by the Fed and ECB easing, along with substantial U.S. fiscal stimulus, which we expect to continue under the pro-cyclical economic policy of the incoming Trump administration. Lower U.S. interest rates have also helped accelerate the self-correction of mark-to-market deficits in U.S. banks' high-quality securities portfolios – a plus – and supported borrowers and their collateral, including CRE values.

What's next?

There are several items to watch that could affect banks and their customers, driven by the U.S. election of Donald Trump.

› Running the U.S. economy 'hot'

Demand-driven inflation could rise due to potentially high fiscal stimulus (higher spending and tax cuts) as well as more costly imported and domestic goods due to higher tariffs. Inflation would also push up interest rates, especially at the long end. That said, a positive yield curve is generally good for U.S. banks as they borrow at the short end and lend at the medium to long end. The risk is that long rates rise too high and impair collateral values and stem economic growth. This stimulated economy is also a likely plus for banks' loan demand and investment banking businesses. For European banks, U.S. stimulus and a more growth-focused economy could boost European exports (depending on tariffs) but could also challenge European businesses, which need to invest, and energy costs and availability.

› High federal debt

The debt of the U.S. Government (and of many other national governments) has ballooned in recent years, reaching substantial levels. We do not expect government debt to fall in the near term and potentially could rise in Europe. Whether bond vigilantes take control is difficult to predict, and such uncertainty could provoke volatility, shifts in government policy, and economic dislocations – all of which would have material effects on banks' earnings and loan quality.

Recession

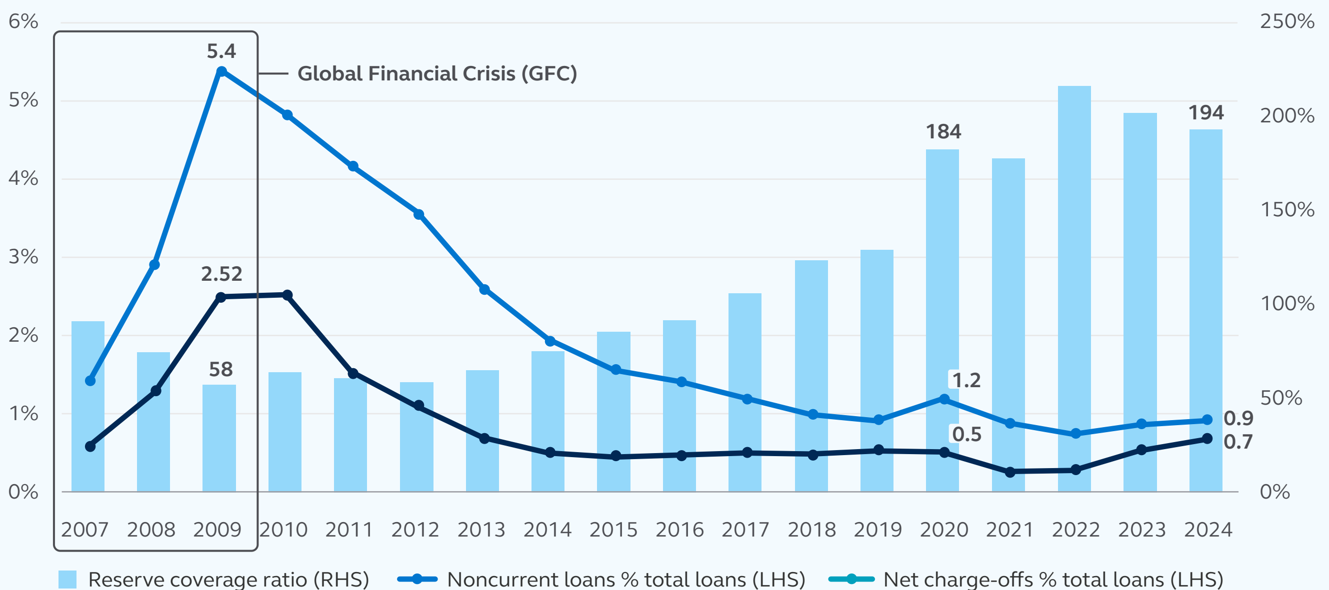
A U.S. recession – even a mild one – is possible despite the 'run it hot' fiscal policy. Recessions hurt banks, whereby loan quality and loan demand weaken, reducing net interest income after provisions. Fee revenues also tend to shrink. Near term we do not expect a recession. There are recession worries in Europe underscored by a struggling German economy given energy and industrial challenges, and a greater need for structural economic changes.

Loan quality

Loan losses, and their effects on earnings, capital and ultimately solvency, tend to be driven by the economy and employment, with banks' lending concentrations and risk governance also playing important roles. In addition, banks' risk governance, and regulators' ability to monitor and enforce good risk governance, are much improved. Periodic stress tests of large banks have proved to be accurate risk indicators, helping banks to monitor these challenges. Post-Great Recession regulation and changes in risk appetite have also resulted in lower concentrations and reduced loan risks.

CRE worries are understandable. However, in most cases, banks have limited CRE exposures, with most being properties other than Office, which has been the main quality concern. Work from home trends and demand for green buildings have pressured occupancy, but exposure scale and tenant lease terms help banks manage losses.

EXHIBIT 1: U.S. bank asset quality trends



Source: FDIC. As of June 30, 2024. Reserve coverage ratio: loss reserve as a % of noncurrent loans.

Expenses

This is a key focus for global banks, driven by inflation, regulatory and compliance efforts, sourcing and retaining qualified personnel, and the ongoing transition to digital finance. Banks' capacity to successfully compete is increasingly dependent on their ability to manage costs. Because digital and compliance costs are often fixed, size increasingly matters, and these economic facts will continue to drive consolidation. Well-executed, such mergers should help larger, acquiring banks (on which we focus) to further solidify their franchises and spread out their costs. Furthermore, the many years of digital investment are beginning to pay off, and banks' cost/income ratios should improve. This consolidation will likely accelerate in the U.S. under the Trump administration with Europe following to position their banks competitively.

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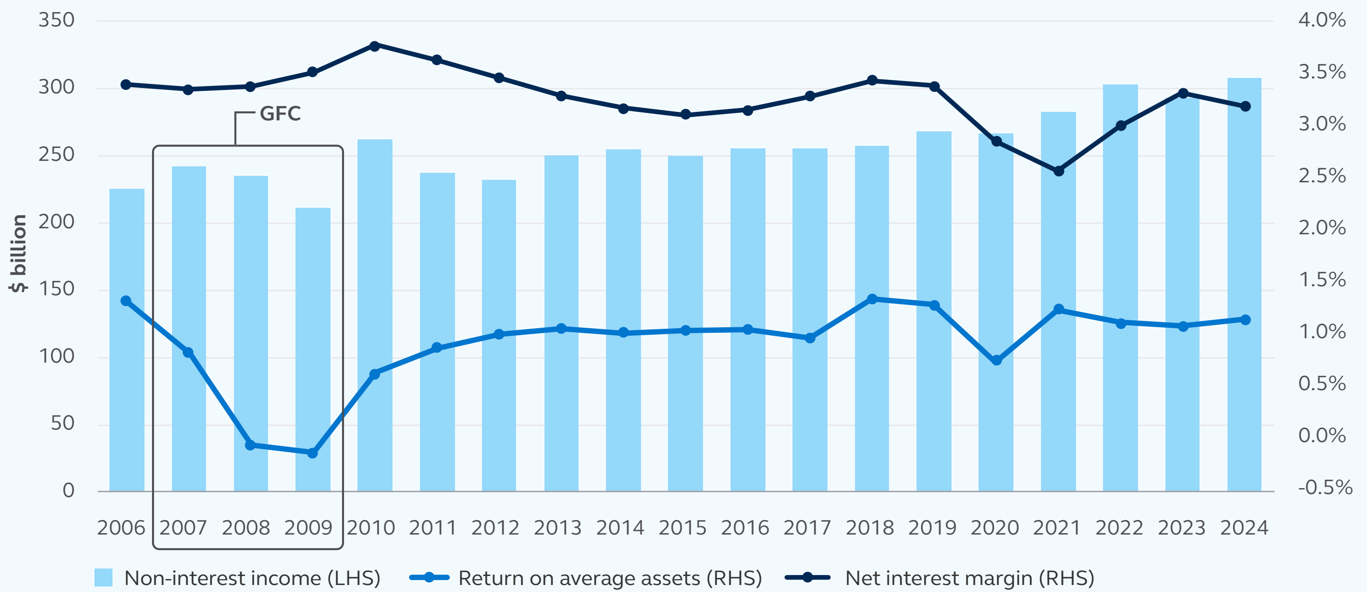
EXHIBIT 2: U.S. bank profitability



Source: FDIC. As of June 30, 2024.

› Deregulation

The so-called B3E is the last leg of the wave of more stringent regulation stemming from the GFC. B3E is now being finalized in various jurisdictions. The initial B3E proposal by U.S. regulators faced strong opposition from banks and is now being revised in a softer form. How soft is unclear, especially given the more deregulatory thrust of the new Trump administration. However, it is likely that regulatory stress tests, which have proved stabilizing and effective, are expected to occur annually for all large banks (>$100 billion in assets). Moreover, these banks will likely mark-to-market securities values when calculating regulatory capital. However, enforcement actions should be less stringent, and overall regulatory policies more relaxed.

European regulators are monitoring U.S. B3E implementation to remain competitively aligned. In the U.S., it's important to note that 'People Are Policy,' meaning that those in authority have significant discretion over enforcement and interpretation of regulations, regardless of the final rules. We do not expect any U.S. regulatory changes will weaken banks credit fundamentals. Also, this regulation cycle should not restart unless there is a fundamental bank crisis. Recall that the Global Financial and Sovereign crises sparked the Basel regulatory reforms, which are now concluding.

› More U.S. bank M&A

The Trump administration's leniency toward bank M&A, including expedited approvals, is beneficial for banks. Larger banks can spread fixed costs like digitalization and compliance more effectively, boosting efficiency. Size also enables geographic and business diversification, leading to greater stability and improved credit ratings. Increased M&A activity results in fewer, larger banks issuing securities, likely concentrating securities issuance and altering market dynamics. This consolidation enhances financial resilience and operational scalability for banks.

For Europe, significant bank M&A remains unlikely in the near term. Select cross-national transactions will continue but remain concentrated on smaller, bolt-on deals. Domestic bank consolidation has mostly run its course. While large scale, cross-national bank mergers make sense from cost saving and compete-with-the-Americans perspectives, the EU will need to make progress on items such as EU-wide deposit insurance and bank regulation.

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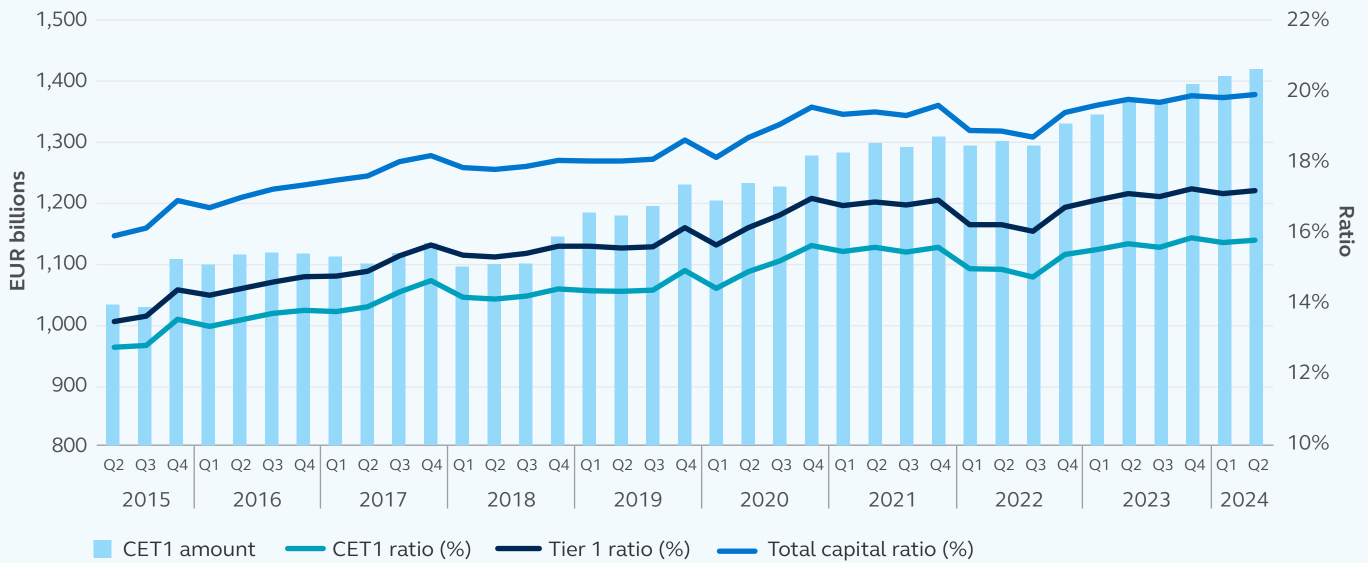
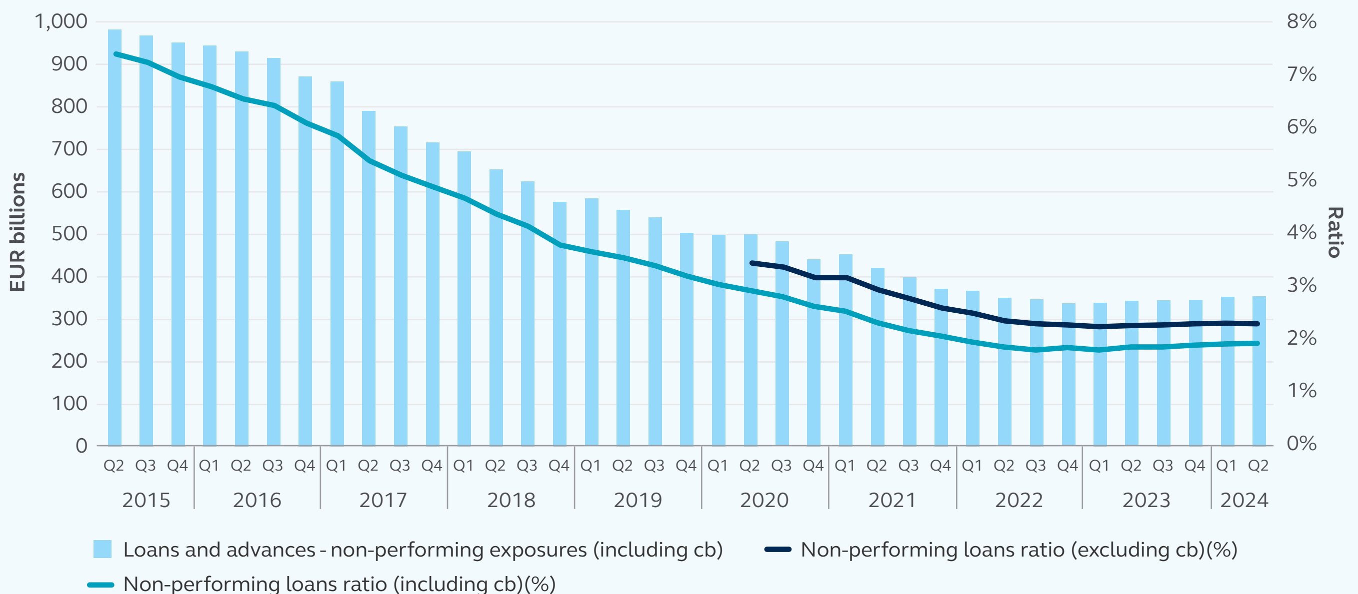
EXHIBIT 3: ECB: Capital ratios and CET1 amount by reference period



Source: European Central Bank. As of June 30, 2024.

EXHIBIT 4: ECB asset quality: Non-performing loans by reference period



Source: European Central Bank. As of June 30, 2024. CB: Cash balances at central banks and other demand deposits.

Insurance

We expect Insurers will sustain robust capitalization and strong balance sheets in 2025. Property & casualty (P&C) re/insurers continue to navigate challenges from natural disasters, economic inflation, and legal system abuse ("social inflation"). Life & annuity (L&A) insurers benefit from strong liquidity due to long-term policyholder reserves, supporting their high quality, albeit increasingly illiquid investment allocations. The new U.S. administration is unlikely to have a major effect on insurers as U.S. regulation is primarily state based.

However, second-order factors such as higher inflation can pressure P&C insurers, while rising interest rates and steeper yield curves are positive for fundamentals.

P&C re/insurers remain well positioned with sound pricing power and adept underwriting practices to manage risks. Increased legal awards, driven by well-funded plaintiff lawyers and societal changes, have impacted corporate policyholders in sectors like commercial trucking and via third party liabilities arising from harmful environmental/ health exposures (e.g., PFAS). This "social inflation" has

materially increased casualty claims. The challenges of reserve building for these uncertain/long-tailed payouts, alongside high catastrophe losses (over $100 billion/year) and a post-COVID-19 spike in repair costs have been offset by good product diversification and aggressive re-underwriting/pricing strategies. Emerging global risks have fostered growth in product lines like cyber insurance. However, the market for cyber coverage remains largely untested by a major loss event.

L&A insurers have achieved record annuity sales due to aging demographics and favorable product pricing, supported by higher interest rates and improved investment returns, including from structured and private credit (PC) allocations. The PC market has grown significantly, addressing gaps created by stricter post-GFC bank regulations. However, risks may arise from highly leveraged borrowers and lighter PC market regulation. We are cautious of the rapid growth in alternative/private equity (PE) owned insurers with significant offshore business and outsized structured/private credit exposures (Exhibits 5, 6). And while certain offshore insurance regulators are reputable, others with less established track records are attracting capital. Traditional insurers are also growing PC/structured allocations, and although PC default rates remain low, loan modifications may be delaying losses. U.S. regulators are adjusting policies to curb riskier activities while Solvency II in Europe already restricts outsized PC structured investments. Life insurance commercial real estate exposures remain good quality.

EXHIBIT 5:
PE-owned U.S. insurer's total investments

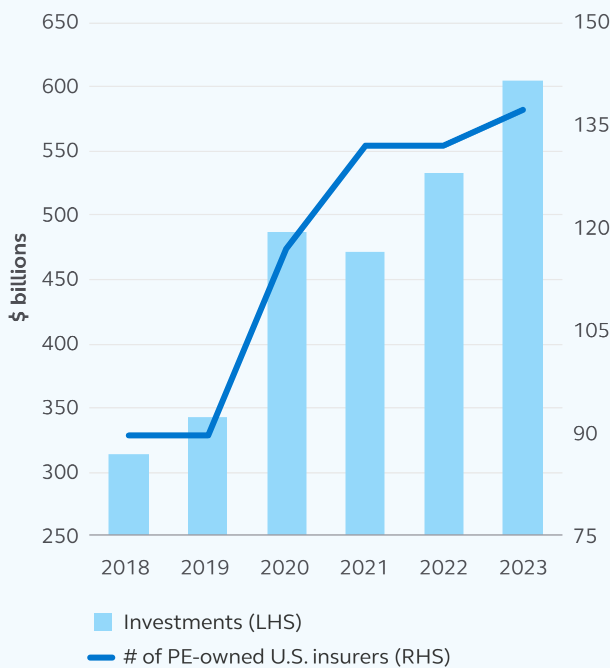
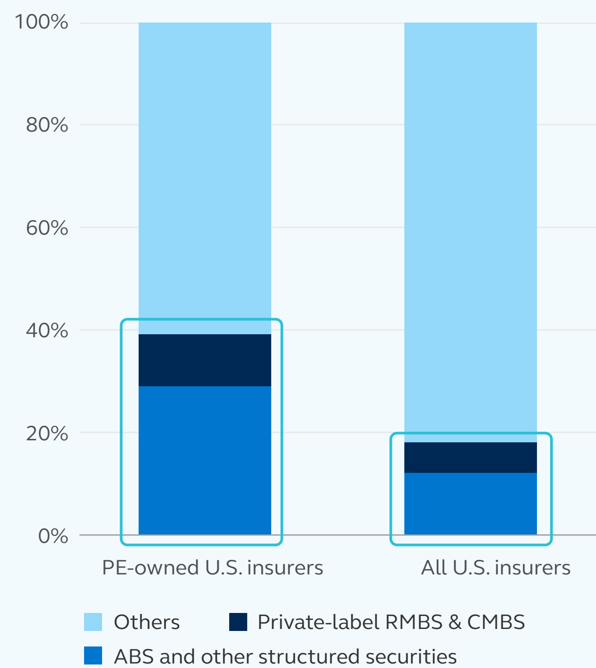


EXHIBIT 6:
2023 bond investments breakdown comparison



Source: NAIC. As of December 31, 2023.

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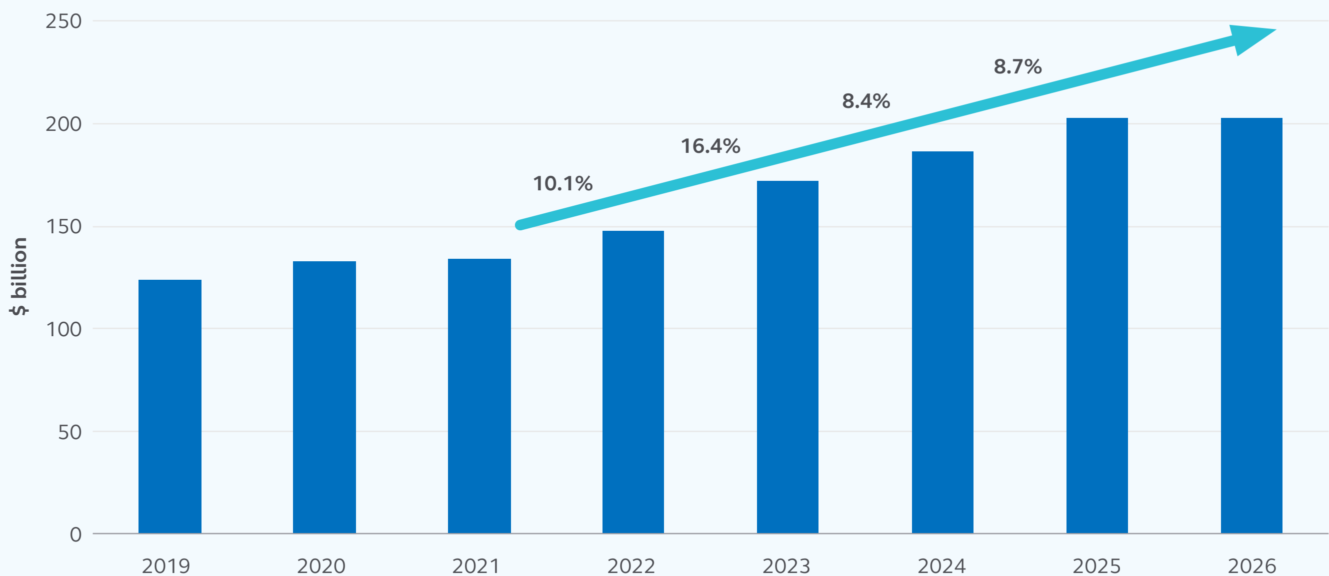
Utilities

The U.S. utility industry will continue with record capital investment to support electric reliability, affordability, and sustainability due to:

- A forecasted increase in power demand to supply U.S. industrialization, including data center growth.
- A transition to low-cost clean energy though this could be offset by lost tax credits if repealed by Congress.
- Extreme weather and wildfire risks.

Utilities are issuing more hybrids to support balance sheets and agency ratings amidst record capital investments.

EXHIBIT 7: U.S. utility industry capital expenditures



Source: EEI. As of July 2024. The data from 2024 to 2026 are projections.

Growing data center demand is driving significant growth in power and grid capacity needs, with a single ChatGPT query consuming up to 10 times more power than a standard Google search. Data center power consumption can rival that of some cities and is expected to accelerate utility growth after decades of stagnant demand due to efficiency gains. Utilities are developing frameworks, such as multi-year data center commitments, to protect existing stakeholders from unforeseen costs. While data center owners seek low-carbon power, wind and solar intermittency limits 24/7 availability, leading some tech firms to sign deals with nuclear generators. The revival of retired nuclear plants may offer incremental solutions, but utilities consider new reactors a long-term and costly proposition. Given national interests, nuclear growth is likely to rely on federal support.

The IRA has boosted wind and solar power through substantial tax credits, helping to meet growing energy demands. While there are concerns about repeal under the incoming Trump administration, it is unlikely that key clean energy provisions will be eliminated, as many Republican-led states are benefiting. Moreover, many states support renewable energy initiatives, further safeguarding these policies.

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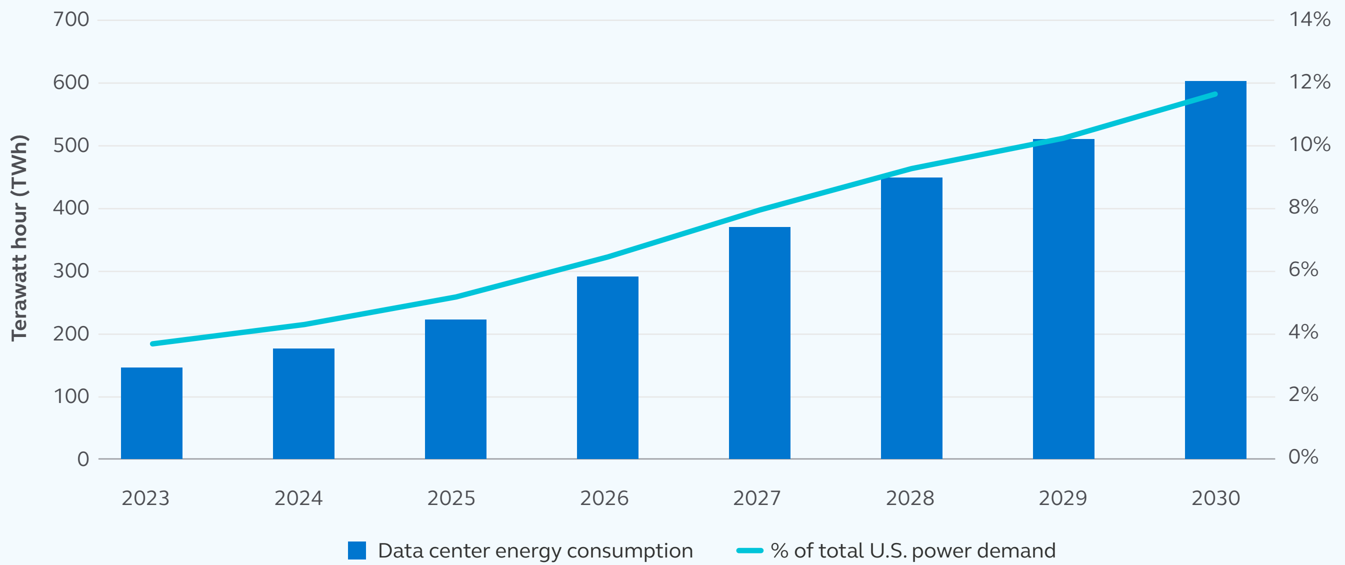
EXHIBIT 8: U.S. data center power demand growth forecasts



Source: McKinsey & Co. As of October 2023. Data from 2024-2030 are projections.

Extreme weather and wildfires have prompted utilities to enhance grid resilience by collaborating with regulators and lawmakers to improve wildfire mitigation and recovery frameworks. Despite strict liability laws, California has spearheaded state initiatives like wildfire funds and liability caps following Pacific Gas & Electric Company's 2019 bankruptcy. Other states may adopt similar measures.

Utility hybrid securities are a growing source of funding. In 2024, Moody's increased the equity credit that hybrids receive, making them more attractive for issuance. These hybrids, along with existing utility debt/equity investors and private capital, can help fund substantial power and grid investments. Growing the rate base and earnings through more credit-friendly measures, supported by favorable regulation, should be positive for utility fundamentals.

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Macro and U.S. market outlook

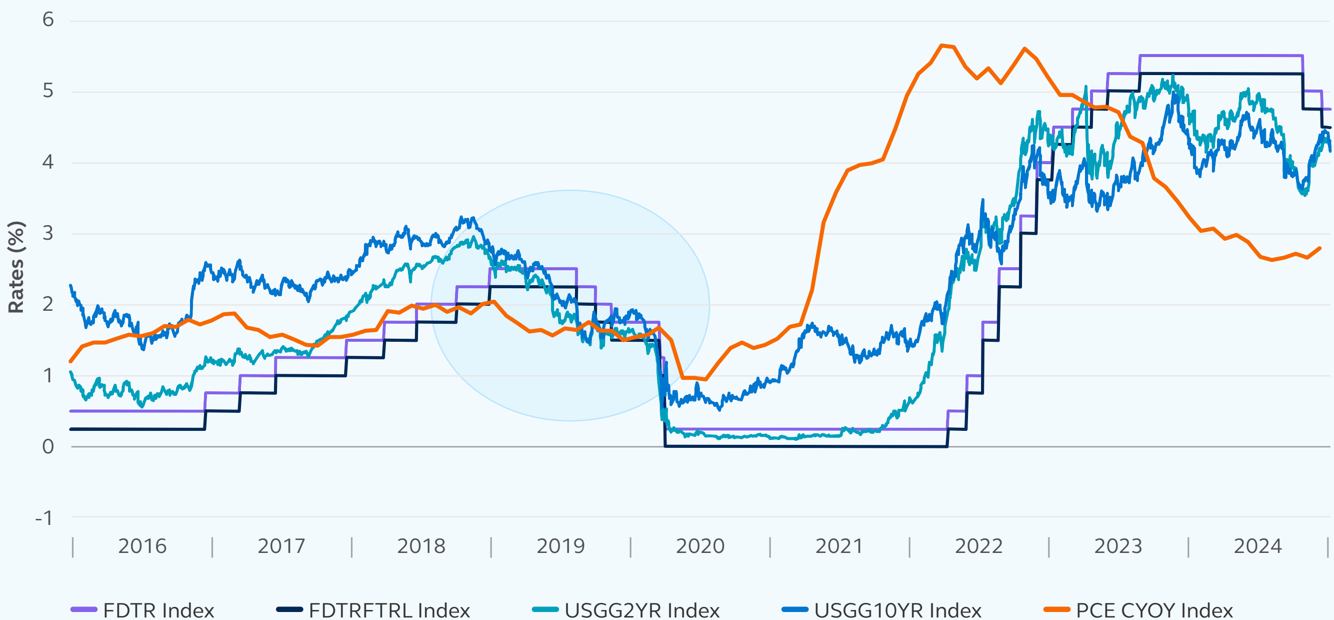
PHIL JACOBY, executive director and chief investment officer

Tracking the gap

Exhibit 9 shows the federal funds bound (FDTR) and the PCE Deflator Index (orange line) with a highlight in 2019.

- Over the past few years, you have heard us say, "watch the gap" because the gap between the PCE Deflator and the federal funds rate will always converge based on the direction of the challenge and policy actions. Chairman Jerome Powell had been steadfastly determined to create a positive real federal funds rate by restricting growth to cut inflation. But extreme excess fiscal spending has been trading against the Fed's desire to dampen inflation because spending means consumption. To this day, massive deficit spending is trading against the Fed.
- Core inflation to start 2024 (3.04%) was lower than the year before, but still well above the Fed's long-run goal of 2%, so we expected the Fed to stay on pause at 5.50% until at least September – that's exactly what happened. The bond market backed off through April as strategists changed their views to fewer cuts only to reverse completely during the summer when the Fed signaled it would be intolerant of further cooling in the labor markets, which only drove bonds to be just as irrationally exuberant by September as they were last December.
- In 2025, we expect the Fed to pause until May (after cutting another 25 basis points (bps) to 4.25%-4.50% this December) and then cut three more times every other meeting to 3.50% on the lower bound as expectations of fiscal cuts and lower energy prices begin to take hold in the real economy.

EXHIBIT 9: Prior Fed rate cycles



Source: Bloomberg. As of November 29, 2024. FDTR Index: Federal Funds Target Rate - Upper Bound; FDTRFTRL Index: Federal Funds Target Rate - Lower Bound; USGG2YR Index: U.S. Generic Govt 2 Year; USGGT10Y Index U.S. Generic Govt TII 10 Year; PCE CYOY Index: U.S. Personal Consumption Expenditure Core Price Index YoY SA.

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Key questions for Fed policy:

1. How much more do they go?

ANSWER:
3.50% –3.75%

RISK:
3.25% – 3.50%

2. How fast do they go?

ANSWER:
Slowly beginning in May – every other meeting.

RISK:
Steper yield curve from a funding shift skewed from UST-Bills into more 4-10-year term funding.

The Fed had inverted the gap with a high positive real funds rate to make short-term interest rates sufficiently restrictive in 2023 so that by the time the Fed paused, the gap between funds and the PCE Deflator was decidedly positive – and it trended more positive as inflation waned over the Fed's 14 month pause until September 2024. Even still, with the real federal funds rate being about 1.75% (after 75bps of cuts this fall), Chairman Powell wants to sustain the positive real federal funds rate for an extended period and does not want to repeat the errors of the 1970s, which saw inflation reignite by the Fed becoming too easy too soon.

Why the gap matters: the Fed always gets what the Fed wants (once it knows), but sometimes it will still make a mistake in getting it.

- We said, "track the gap" in our 2024 outlook – but don't get too impatient thinking the Fed will cut rates at the first sign of labor weakness when weakness is the goal. Due to inflation's breadth from the Fed's late start, which helped to permanently embed higher prices into a global economic framework, we believed that the Fed would move slowly to allow time for assurance of a trend rather than a head-fake on its continued weakness – this is basically where we are now. We expect another cut in December because that's where the very late year median expectation is according to "the dots". Indeed, the gap is still generous, and it would certainly help the high cost of government funding to add another cut (though the Fed would never admit political motivation).
- The election is over: Donald Trump won the election on both the Electoral College and the popular vote. During President Trump's last term in office, the Fed was on a rate hike campaign for most of his term, yet the gap was negative (i.e., the real funds rate was stimulative) as inflation was only 2% at its maximum. So, keep tracking the gap because the Fed has 100bps of room to cut the funds rate if the generous 75bps real gap in 2019 was indicative of being a lead toward neutral or eventually cutting even more to no gap. Furthermore, we expect fiscal spending cuts engineered by the Department of Government Efficiency to be disinflationary along with increases in American energy production.

What does a "data dependent" approach mean to a Fed intent on getting to a neutral rate (i.e., a rate that doesn't bias inflation up or down)?

- The Fed will need to stay the course for credibility in its messaging and convictions on disinflation – especially after getting its "transitory" inflation conviction dead wrong three years ago. Keeping rates "higher for longer" was the resounding message for much of 2023-2024.
- In 2025, the message is most likely to be "data dependent", which was summed up by Chairman Powell as, "We are prepared to adjust our assessments of the appropriate pace and destination as the outlook evolves" and, "We are not declaring victory, obviously … the story of inflation on a downtrend is intact and a couple of data-points – whether good or bad – won't really change the pattern this far down in the process." So, the Fed seems to feel pretty good about inflation being on the right trajectory – that is, slower and lower.
- Importantly, once the Trump Administration takes over in January, the Fed should no longer need to keep a generously restrictive positive bias because the force of a very expansive deficit spending will be experiencing friction – which leads to the rest of the story…

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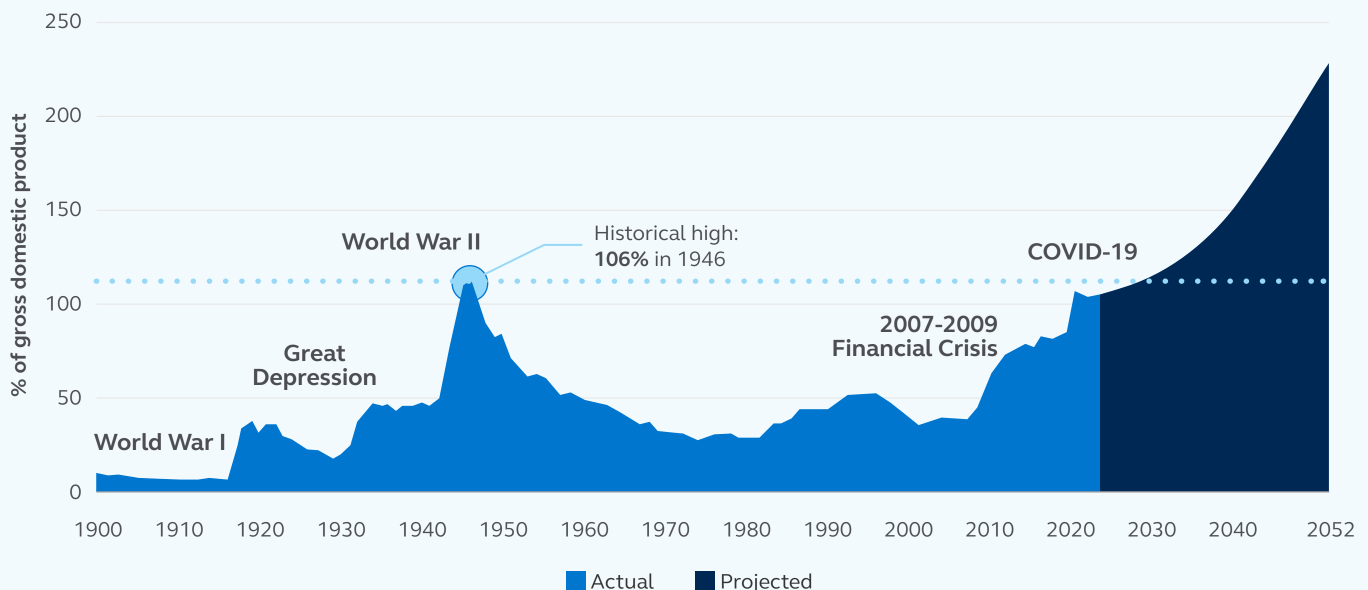
The big picture: U.S. Government spending still gone wild

- When the UST spends more than it collects in taxes it must issue debt to fill its spending void. If it's spending too much, the borrowing demand can crowd out capital from other asset classes causing credit spreads to tighten because the Treasury has to offer increasingly competitive rates compared to corporate issuers – this crowding out effect has been happening in mass since the $5.9 trillion deficit from COVID-19 between 2020-2021, which the Fed monetized with Quantitative Easing (QE) and a Zero Interest Rate Policy (ZIRP). Indeed, deficit spending has been consistently trending since 2001 when military spending zoomed after the 9-11 attacks, then again after the GFC. More recently, deficit spending has become a hedonistic policy tool – for example, Donald Trump's first administration accumulated a deficit of $2.43 trillion in the three years (2017-2019) before COVID-19, while President Joe Biden's administration accumulated a deficit of $5.11 trillion in the three years (2022-2024) after COVID-19.
- In Exhibit 10, the debt-to-GDP ratio goes up when spending goes up faster than the economy is growing – the projections are astoundingly troubling; and is no way to run an economy lest hyper-inflation is the goal.
- Back in the late 1990s when we had a series of government surpluses, rates were higher, yet total debt held by the public was only about 39% of GDP. Recently, so much of the zooming national debt held by the public (97% of GDP) is financed with T-bills (82%) plus 2- to 3-year notes (7%) that rolling existing debt at higher rates (in addition to financing new debt at high rates) is putting massive pressure on annual net interest expense (i.e., expense that isn't paying itself like it does for Social Security) which could reach over $1 trillion by 2029.
- Note that in the late 1990s just 58% of debt was financed with UST-bills.
- By 2052, net interest spending is projected to reach 7.9% of GDP (compared to an average 2.8% in the 1990s); and that assumes a constant finance rate of 3.95%. As 60% of the national debt matures within the next four years it becomes essential that Treasury finance at rates lower than 3.95% though the whole belly of the curve is about 35bps higher than that now. The UST bond market has some bullish work to do – we think it's capable.

EXHIBIT 10: Debt held by the public projected to grow faster than the GDP



Source: Congressional Budget Office data and GAO simulation. From "The Nation's Fiscal Health," an annual report to Congress, February 2024.

Why fiscal policy matters: The upward growth pressure of endless and massive fiscal excess is a chronic inflation problem if there is no political will to stop it – the spending is only going to get worse unless the Fed (and the treasury bond market) makes the cost of fiscal excess too costly for politicians to ignore. We expect the Republican majorities in congress to be up to the task as the Trump Administration has made eviscerating government waste a priority with the new Department of Government Efficiency.

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The bottom line: Extreme and unchecked fiscal spending policies will likely make it more difficult for Fed monetary policy to manage down and sustain low inflation (i.e., 2%) – especially in the face of two core economic paradigm shifts for the U.S.:

1. **Deglobalization of supply chains** – COVID-19's wake has brought a great awareness to supply chains being keys to our national security; gradually re-building them with local labor is inflationary because it consumes our labor supply in an already developed economy. This should keep the Fed's so-called "neutral rate" more towards 3% and keep real rates positive.
2. **De-carbonization or "sustainability"** – divesting the U.S. hydro-carbon industries makes our economy (the global economy too) more dependent on alternative fuels and electrification of just about everything. The inflationary implications of this shift are energy dependence; high(er) oil prices and crippled ability to earn net foreign exchange through trade surpluses on hydrocarbons. The Trump Administration's goal to increase U.S. energy product can foster lower energy costs and earn needed foreign exchange to retire debt with other country's currency. That's deflationary for the U.S. and could more than offset the risk of tariffs being somewhat inflationary.

Implications: An important fiscal pivot with a private growth kicker.

- Can the U.S. government borrow at twice the speed of the economy without crowding out other asset classes to pay for it?
  - **We think not** – something's got to give, or the U.S. government will crowd out $39 trillion of investment over a 30-year period.
- Will the Fed have to print the money again to pay for it?
  - **We think so** – the U.S. (and global) economy is dependent on new money creation to foster growth, which is the whole purpose of a 2% governor as the inflation goal. Basically, inflation expectations foster baseline growth because it compels people to buy things today before they cost more tomorrow – deflation compels people to wait, which virtually destroys economic activity – basically, if nobody wants to come see your movie, then there is nothing you can do to stop them.
- We think that a major restructuring or downsizing of the U.S. government is positive for bond markets because private efficiencies and slowing cost burdens on national debt should improve disinflationary expectations, which can help the Fed gain the confidence it needs to lower interest rates.
- We expect Scott Bessent, when confirmed as UST Secretary, to be mindful of funding more UST debt for longer terms in the next few years given his macro approach to managing hedge fund money – this should take some of the refunding burden out of the treasury market and steepen the yield curve, but at yields lower than today if disinflation plays through constructively the way we expect.

Dive deep into the U.S. fiscal health

Implications for junior subordinated capital securities

There should be ample opportunities to buy attractive hybrid yields in 2025 – in relative terms, hybrids offer higher yields than corporates and when low coupon paper rolls off to reset, we expect income from the sector to be biased upwards even if rates in the belly of the curve decline by this time next year, as we expect.

Our credit team views hybrid credit fundamentals as generally sound (see our 2025 Credit Outlook, on page 3) and the purchasing power matrix scores for hybrids offer good defense against inflation without needing to take a lot of duration risk in the institutional sectors:

EXHIBIT 11: Purchasing power matrix

	A	B	C	D=B/C	E=D/A
Purchasing Power Matrix: Financials	Modified duration	Yield to worst %	Year-over-year inflation %	Inflation coverage	Inflation coverage/ Modified duration
Retail $25 par (P0P4)	11.77	5.49	2.60	2.11	0.18
NoCos (IIPS)	4.10	6.16	2.60	2.37	0.58
CoCos (CDLR)	3.23	7.06	2.60	2.72	0.84
3-5 year U.S. financials (CF02)	3.52	4.94	2.60	1.90	0.54

Source: Bloomberg; ICE BofA Bond Indices. As of November 30, 2024. Source: Bloomberg, ICE BofA Bond Indices. Indices represented: P0P4: ICE BofA Core Plus Fixed Rate Preferred Securities Index, IIPS: ICE BofA U.S. Institutional Capital Securities Index, CDLR: ICE USD Contingent Capital Index, CF02: ICE BofA 3-5 Year U.S. Financial Index.

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- Hybrid yields are still well in excess of inflation, so the cumulative effect of compounding returns is an attractive cushion of protection against inflation risks when considering more senior financials (Exhibit 14).

EXHIBIT 12: Hybrid spreads, like corporate spreads, are below average

Source: Bloomberg. As of November 30, 2024. The ICE BofA All Capital Securities Index (I0CS; dark blue line above) represents the preferred securities market. The ICE BofA USD Contingent Capital Index (CDLR; light blue line above) represents large cap contingent convertibles (CoCos).

EXHIBIT 13: Hybrid yields are still elevated

Source: Bloomberg. As of November 30, 2024. The ICE BofA All Capital Securities Index (I0CS; dark blue line above) represents the preferred securities market. The ICE BofA USD Contingent Capital Index (CDLR; light blue line above) represents large cap CoCos.

- Despite the rally tighter in spreads, hybrid yields are still higher than at almost any time before the COVID-19 era because UST yields have behaved like an incoming tide that raises all boats.
- Given our bullish outlook for UST rates, we expect hybrid yields to decline over the course of 2025 making any period(s) of wider spreads even better absolute buying opportunities.

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EXHIBIT 14: A sample journey cumulative effect of staying invested—hybrids win over financials

Source: Bloomberg. As of November 30, 2024. The ICE BofA U.S. Capital Securities Index (IIPS; light blue line above) represents the institutional capital securities market. The ICE BofA 5-10 Year BBB U.S. Corporate Index (C6A4; dark blue line above) represents more senior financials with similar duration to institutional capital securities.

Looking back at Exhibit 12, you can see that the 5-year sample journey shown above in Exhibit 14 illustrates two credit spread cycles of peak-trough-peak-trough. Notice how total returns for both sectors start out in line until COVID-19 crushed credit spreads in 2020. Hybrids broke $6.73 more than 3-5-year financials did and it took about one year after that for the relative gains to climb back up to parity (i.e., where hybrids cross over financials). But, when the Fed hiked interest rates by 500bps, which created the second spread widening from higher rates that peaked during the first quarter of 2023, more senior financials returned to about the same well as they did during COVID-19, but hybrids were about 8 points higher because of the accumulated income differential that favored hybrids. So, the longer investors hold hybrids (whether spreads tighten or widen), the better off they can be compared to more senior financials because the income benefits of hybrids only contribute more and more to the relative game (i.e., gain).

Note that Exhibit 14 was for the institutional preferred and capital securities sector, but the same beneficial theme holds true for the retail $25par market and the CoCos market when comparing both to more similar duration investment grade (IG) corporate bonds over the same period.

The bottom line: It can pay off to stand your ground in hybrids.

- By the end of this 5-year sample period scaling two spread cycles, hybrids were 12 points ahead of more senior financials.
  - This is despite two massive spread blowouts (see Exhibit 12) and a significant rise in yields (see Exhibit 13).
  - If spreads were to widen again like during COVID-19, hybrids would still be ahead of more senior financials by about 5 points, all else being equal.
  - Indeed, it can pay off to stand your ground in hybrids.
- That notwithstanding, even if we are wrong on rates and they zoom higher from here and stay there, how bad can bad really be when the hybrid market can predominantly re-fix its coupons higher if rates go significantly higher too?
- The investment horizon for 2025 should offer a range of opportunities that should be collected and held to build generous compounding income allocations compared to more senior bond classes – consider the 5-year journey (see Exhibit 14) as a potential guide and keep in mind the sample journey was through some historic defaults (2023) period and rate hikes (2022-2023).
- As we concluded in our 2024 outlook, returns will probably turn out to be pretty good by this time in 2025 (as was the case in 2024) as markets often climb “walls of worry”.

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Euro-denominated capital securities outlook

MANU KRISHNAN, deputy chief investment officer

The big picture

Our outlook for returns in EUR-denominated capital securities is constructive despite several headwinds facing the Eurozone in 2025.

Let's consider the macro-economic environment that's facing the Eurozone in the upcoming year:

- The IMF, in its October 2024 world economic outlook, projects that the Euro area will grow by 1.2% in 2025 with Germany, France, Italy, and Spain growing at 0.8%, 1.1%, 0.8%, and 2.1%, respectively. In 2024, the Eurozone economy grew by 0.4% in the third quarter, 0.2% in the 2nd quarter, and 0.3% in the first quarter.
- The German economy is stagnating with structural problems shown by 0.2% growth in the third quarter along with a downward revision to a -0.3% contraction from -0.1% in the second quarter. The Purchasing Managers' Index (PMI) paint a picture of an economy whose services sector growth cannot offset the slumping manufacturing sector. For instance, the German auto sector is under pressure from Chinese electric vehicles (EV) and Volkswagen had to shut down plants because of eroding market share in China where consumers have taken to cheaper domestic EVs.
- The French economy was buoyed by the Olympics which should be a one-off. On the other hand, the Spanish economy grew by 3.4% in the third quarter due to a combination of immigration, tourism, foreign investment, and public spending.

These anemic projected growth rates should allow for more rate cuts by the ECB compared to the U.S. Fed in 2025.

The positives

ECB rate cuts

- Robust capital levels, healthy asset quality, and ongoing ECB rate cuts should be constructive for performance in EUR-denominated capital securities. Given the outlook for 0-1% growth in the two major European economies, namely France and Germany, the ECB will be able to cut rates deeper than the U.S. Fed which should bode well for performance in European sovereign bonds and consequently EUR fixed income. European bank shares have performed handsomely year to date with the SX7E index returning 27%. This performance in bank equity has been driven by strong banking fundamentals, a higher interest rate environment and the return of capital by banks. ECB rate cuts should be supportive of valuation for bank Tier2 and AT1. Rate cuts, while applying downward pressure on net interest margin will bolster underlying economies and support bank asset quality.
- Lower rates because of ECB rate cuts should once again stimulate mortgage lending in the EU thereby helping banks. In 2024, European banks are showing zero growth in mortgage lending because of higher rates, but this should change in 2025. Mortgages are important for banks because they account for almost half of all lending in the Eurozone.

Credit is strong, non-performing loans (NPL) and inflation should be contained

Credit profiles of banks and insurance companies are very strong. Banks are as well capitalized today as they have ever been and have been able to generate organic capital via retained earnings thanks to higher rates. Insurance companies have ample excess capital and life insurance companies have been able to diversify their investment portfolios into private credit. P&C insurance companies have been able to manage increased climate risk by diversifying risk via the use of reinsurance and catastrophe bonds. They also keep rate-setting pricing power in their markets.

- Inflation in the Eurozone has moderated and is now below the 2% target. In contrast, inflation continues to be an issue in the U.S. given the possibility of higher growth, lower taxes, and higher consumer prices due to the possible imposition of tariffs.
- According to forecasts by EY[1], business lending growth will be 3.1% in 2025 and 4.2% in 2026, up from 0.2% in 2023 and 2024, as lower rates encourage borrowing. Consumer credit growth rates are expected to rise from 0.9% in 2024 to 3% in 2025 and 4.2% in 2026. NPLs are expected to rise from 2% in 2024 to 2.3% in 2025 and 2026, well within control. For some historical context, NPLs during the European sovereign debt crisis was 8.4%.

Steep yield curve and high yields

- The market is pricing in a yield curve that steepens out as the ECB cuts rates. This should be supportive of bond prices as they roll down the yield curve.

[1] https://www.ey.com/en_gl/newsroom/2024/09/following-two-years-of-little-to-no-growth-the-eurozone-credit-cycle-is-turning-a-corner-with-strong-bank-lending-forecast-from-2025

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- Absolute yields are still near decade long highs despite the recent spread tightening. This bodes well for the asset class as investors are reaching for yield in anticipation of further ECB rate cuts. A steep yield curve will be constructive for total return as we would expect capital to exit the short end of the curve and look for yield in strategies such as ours.

On the cautionary side

- Credit spreads could come under pressure if European economies are stressed by the imposition of tariffs by the incoming Trump administration. Europe also has less fiscal flexibility and fiscal deficits are being managed lower post the pandemic spending. China continues to compete with European manufacturing while domestic demand weakness in China has hurt European exporters. Political turmoil continues to plague European economies.
- Credit spreads could also possibly widen into an environment where interest rates are falling, thereby resulting in static to muted price performance with returns being generated by coupon income. A deflationary environment due to tariffs for instance, could result in spreads widening into lower rates.
- European economies will be faced with a difficult choice if the U.S. withdraws its support to NATO. Europe will be forced to spend more on defense, and this will affect fiscal situations. Consequently, the Eurozone will be forced to run fiscal deficits far more than its 3% limit. The ECB could help fund this by embarking on another asset purchase program. Such a scenario should be constructive for credit spreads and total return.

Coupon income: Should continue to be elevated, despite rate cuts

Capital security issuance has become standardized with fixed-to-fixed reset coupon structures. This reduces duration risk in our asset class, given that the bonds will become par bonds on every call date if spreads stay constant.

As an example, coupons on EUR AT1's have gone from 6.52% a decade ago to a low of 5.13% in mid-2022 as central banks kept rates low (Exhibit 15). Since then, the coupon has climbed to about 6% today.

Most non-call bonds that are callable in 2025 and 2026 were issued in a low-rate environment with high spreads. Therefore, the call options (based on the high spread resets) are likely to stay in-the-money so the bonds should get called and replaced with higher coupons than at issuance, ceteris paribus. This would position our strategies in the unique position of being able to grow coupon income in a Central Bank easing cycle.

EXHIBIT 15: Time series of market weighted coupon in EUR AT1 CoCos

Source: ICE Data Services. As of November 30, 2024. Data representative of the ICE EUR Contingent Capital Index (CEUR) Index.

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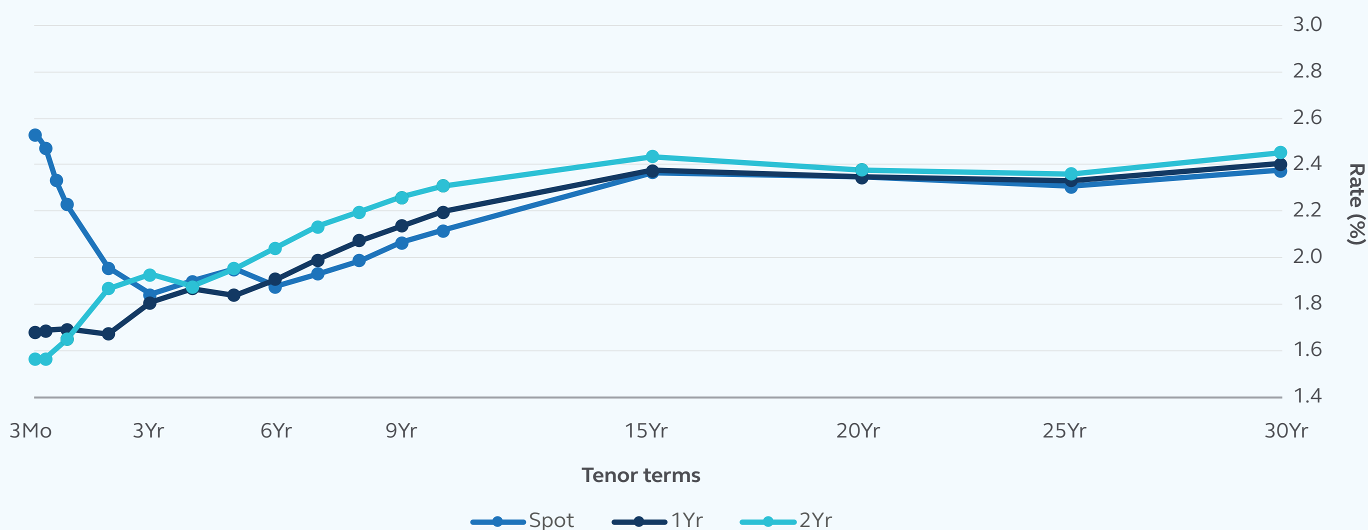
EXHIBIT 16: EUR German sovereign forward curve



Source: Bloomberg. As of December 4, 2024.

EXHIBIT 17: EUR AT1 CoCos call characteristics

Year	Amount ($)	Average coupon	Average reset spread	% of index
2025	7.9 billion	4.95	487	9.4%
2026	11.3 billion	4.98	525	13.4%
2027	13.8 billion	5.51	514	16.4%

Source: ICE Data Services, Spectrum Asset Management. As of November 30, 2024.

The 5-year rate, 6-month forward is 1.78%, 1-year forward is at 1.77%, and 2-year forward is at 1.88% as of December 4, 2024, while the current 5-year spot rate is 1.91%.

The current spread to worst on the index is at 380 bps. Therefore, if we were to make a conservative assumption that spreads remained at these tight levels, in 2025 bonds with an average coupon of 4.95% should get replaced with bonds with an average coupon of 1.77 + 3.80 = 5.57. Similarly, in 2026 we should see an average coupon of 4.98% get replaced with coupons at 1.88 + 3.80 = 5.68%.

Therefore, given that we are coming off a low-interest rate cycle and the prevalence of fixed-to-fixed reset coupon structures, our asset class is in the unique position of being able to increase coupon income despite an environment where the ECB is cutting rates.

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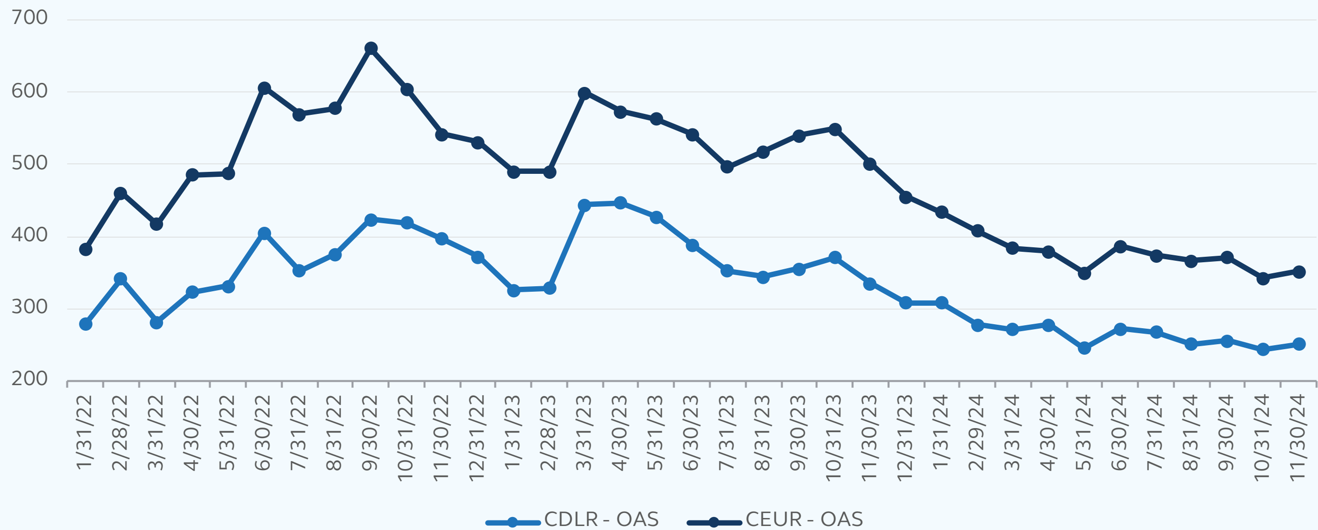
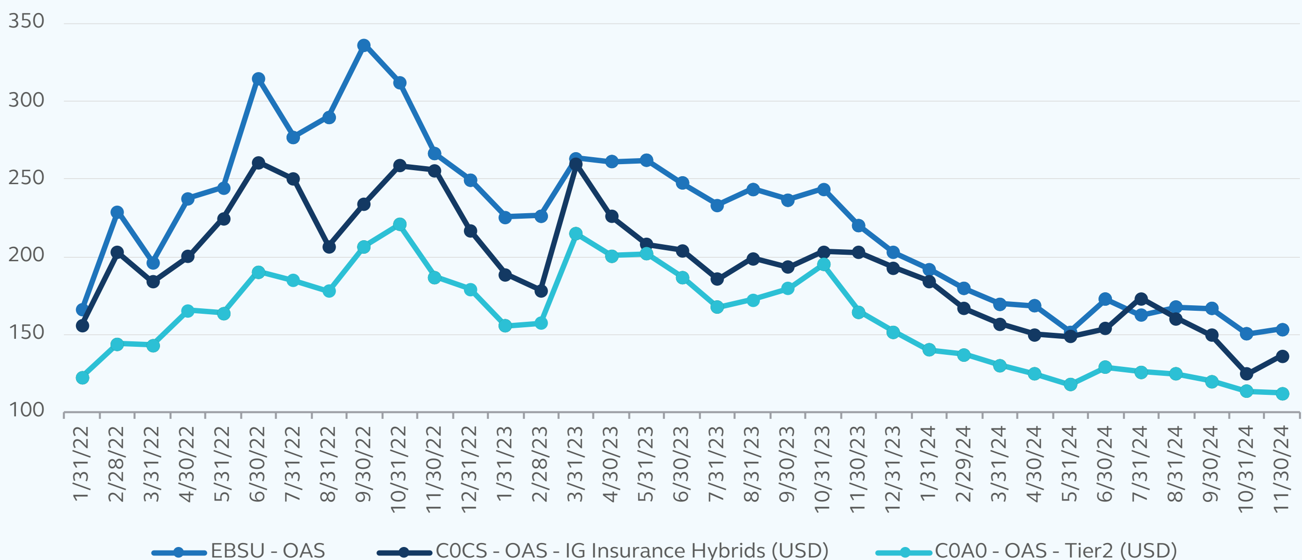
Wider spreads in EUR capital securities relative to USD: More room for relative spread tightening in EUR securities

EXHIBIT 18: Spread between EUR AT1 CoCos and USD AT1 CoCos



Source: ICE Data Services. As of November 30, 2024. Data is represented by ICE USD Contingent Capital Index (CDLR) and ICE EUR Contingent Capital Index (CEUR) Index.

EXHIBIT 19: Spreads on EUR Tier2, USD Insurance Jr Sub, and USD Bank Tier2



Source: ICE Data Services. As of November 30, 2024. Data is represented by EUR Tier2: ICE BofA Subordinated Euro Financial Index (EBSU), USD Insurance Jr Sub: ICE BofA U.S. Capital Securities Index (C0CS), and USD Bank Tier2: ICE BofA U.S. Corporate Index (C0A0).

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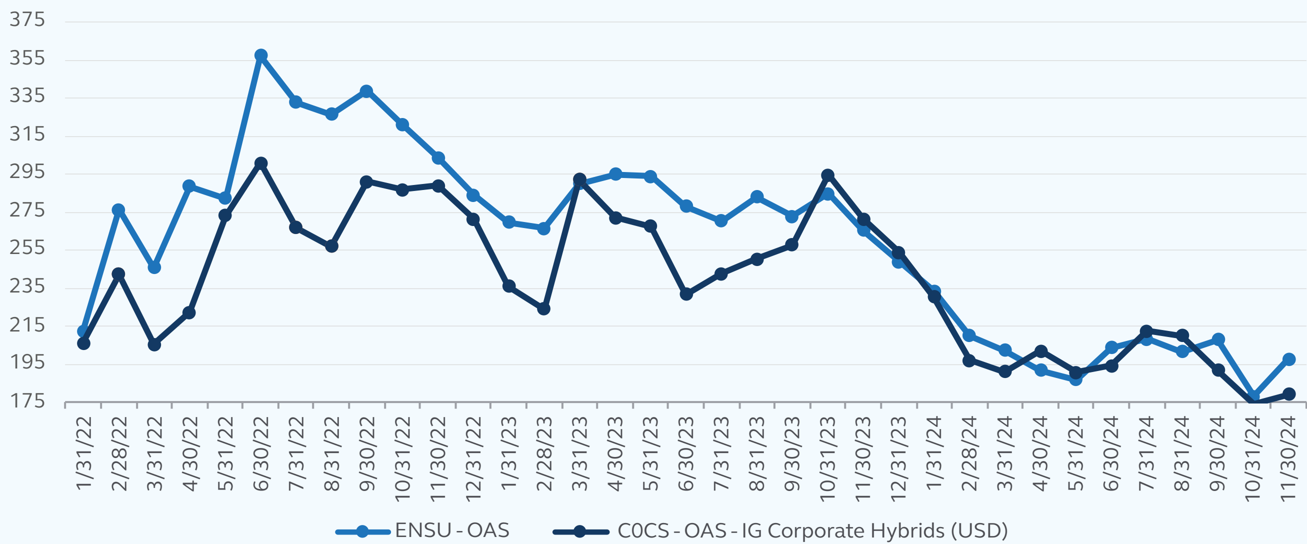
EXHIBIT 20: **Spread between EUR IG Corporate hybrids and USD IG Corporate hybrids**

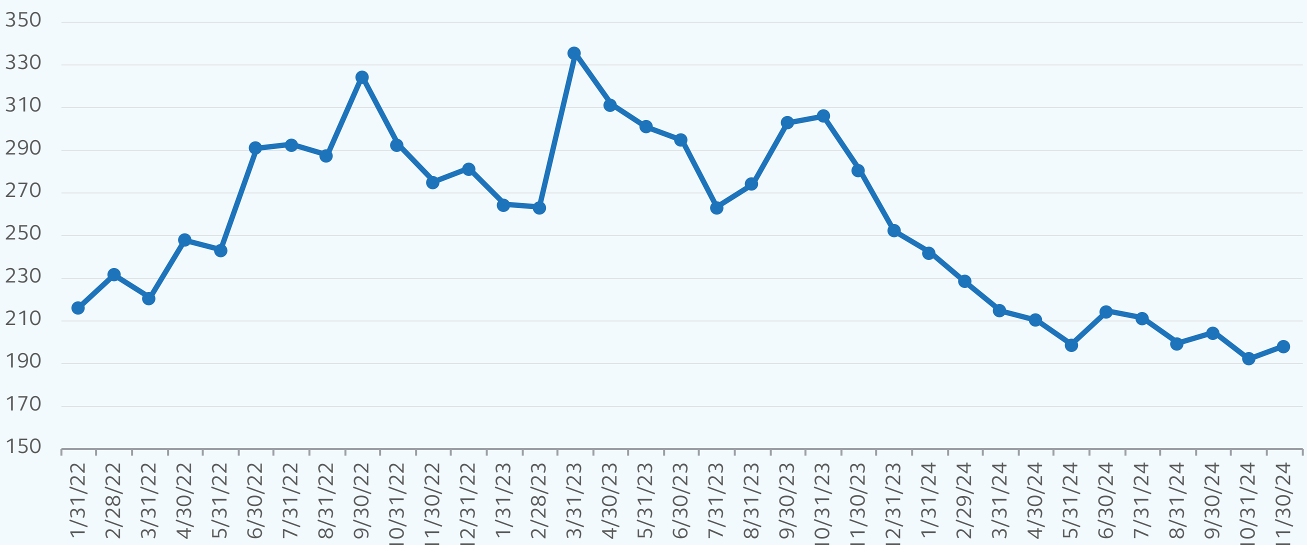


Source: ICE Data Services. As of November 30, 2024. Data is represented by EUR IG Corporate hybrids: ICE BofA Euro Non-Financial Subordinated Index (ENSU) and USD IG Corporate Hybrids: ICE BofA U.S. Capital Securities Index (C0CS).

From Exhibits 18, 19, 20, notice how there is a consistent and historical bias for higher EUR spreads relative to USD spreads in capital securities. This spread advantage should foster relative outperformance in EUR capital securities, especially in a period like now where spreads in USD capital securities are tight. There is still room for spreads to tighten in EUR.

Risk premia compression

EXHIBIT 21: **Spread between EUR AT1 and EUR Tier2**



Source: ICE Data Services. As of November 30, 2024. Data is represented by EUR AT1: ICE EUR Contingent Capital Index (CEUR) and EUR Tier2: ICE BofA Subordinated Euro Financial Index (EBSU).

Exhibit 21 shows that there has been risk premium compression between Tier2 and AT1. The spread duration of AT1 is 6.04 compared to 4.63 for Tier2, while the effective duration is 3.32 versus 3.93 respectively.

Therefore, by investing higher up in the capital structure in Tier2, one should be better off in an environment where rates are falling and spreads are widening, which could be the scenario in 2025 for EUR capital securities.

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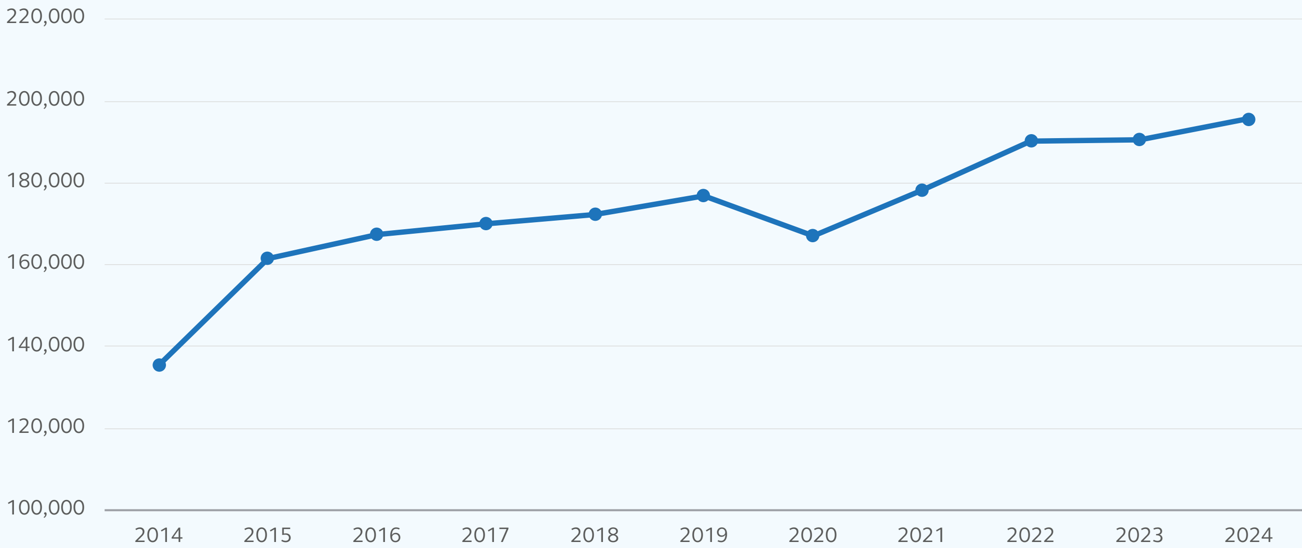
Supply expectations for 2025: Mostly flat

EXHIBIT 22: Growth for EUR Tier2 capitalization

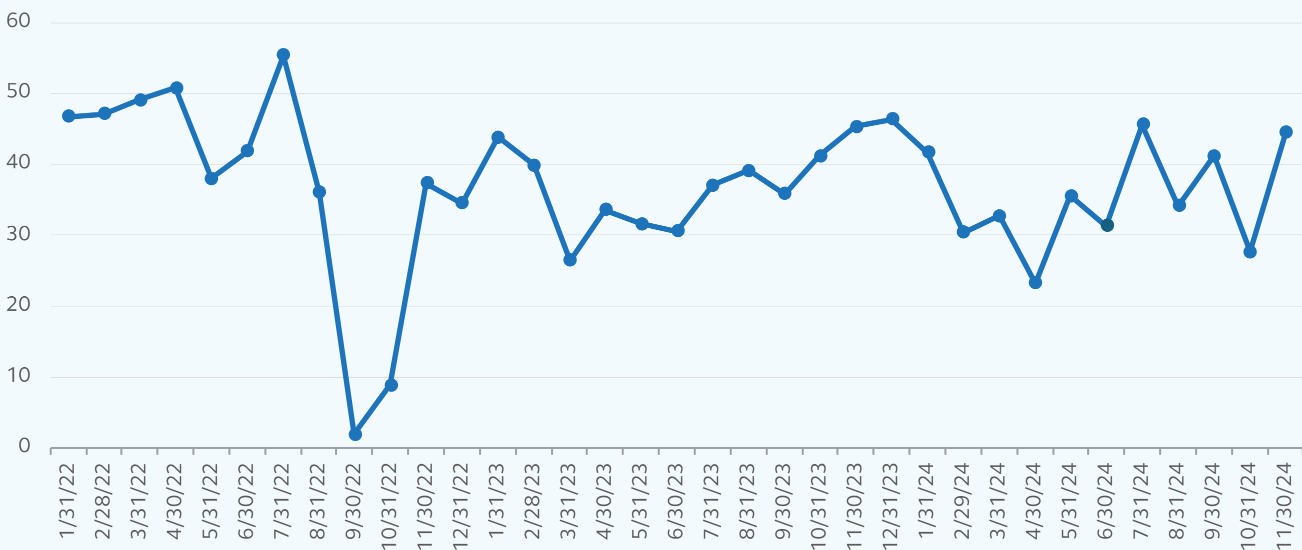


Source: ICE Data Services. As of November 30, 2024. Data is represented by ICE BofA Subordinated Financials Index (EBSU).

Given the expectation for low growth rates in the Eurozone for 2025, we would expect net growth in supply to be modest with most of the activity centered around refinancing. Therefore, supply is not expected to be a drag on spreads for 2025. That said, it can be seen from Exhibit 22 that European banks and insurers have built up capital since the dark days of the European Sovereign Debt Crisis and that the Tier2 capitalization levels are as high as they have ever been.

Corporate hybrids: Mature investment universe, diversification benefits

EXHIBIT 23: Spread advantage of IG EUR Corporate Hybrids over IG EUR Financial Tier2



Source: ICE Data Services. As of November 30, 2024. Data is represented by IG EUR Corporate Hybrids: ICE BofA Euro Non-Financial Subordinated Index (ENSU) and IG EUR Financial Tier2: ICE BofA Subordinated Euro Financial Index (EBSU).

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- The EUR corporate hybrid market has evolved into an important mature investment universe and a significant allocation within our investment strategies. It offers us the ability to pick up spread (Exhibit 23) and diversify risks away from financials.
- The risk profile of corporate hybrids has improved over the past few years:
  - Large and well diversified investor base – insurance companies to real money. Corporate hybrids have a place in investor portfolios as a means to add alpha.
  - Issuers are fundamentally sound and are committed to preserving their IG ratings.
  - Favorable structural evolution.
- Evolution of more defensive structures:
  - Changes to Moody's rating methodology have allowed for the issuance of non-call structures that have 50% equity credit at all three rating agencies. This allows for a wider investor base relative to a 60+ or perpetual maturity.
- Solid IG issuers:
  - These companies are committed to hybrid capital as a means of managing their capital structure, rating stability and market reputation.

Index of definitions

ICE BofA U.S. All Capital Securities Index (I0CS) tracks the performance of fixed rate, U.S. dollar denominated hybrid corporate and preferred securities publicly issued in the U.S. domestic market.

ICE USD Contingent Capital Index (CDLR) tracks the performance of USD denominated investment grade and below investment grade contingent capital debt publicly issued in the major domestic and eurobond markets.

ICE BofA Core Plus Fixed Rate Preferred Securities Index (P0P4) tracks the performance of fixed rate U.S. dollar denominated preferred securities issued in the U.S. domestic market.

EURO STOXX Banks Price EUR Index (SX7E) is a capitalization-weighted index which includes countries that are participating in the EMU that are involved in the banking sector. The parent index is SXXE. The index was developed with a base value of 100 as of December 31, 1991.

ICE BofA U.S. Institutional Capital Securities Index (IIPS) tracks the performance of both high yield and investment grade dollar denominated hybrid $1000 par capital corporate and preferred securities publicly issued in the US domestic market.

ICE BofA 3-5 Year U.S. Financial Index (CF02) is a subset of ICE BofA U.S. Corporate Index including all securities of Financial issuers with a remaining term to final maturity greater than or equal to 3 years and less than 5 years.

ICE EUR Contingent Capital Index (CEUR) is a subset of ICE BofA Contingent Capital Index including all euro denominated securities.

ICE BofA Subordinated Euro Financial Index (EBSU) tracks the performance of EUR denominated investment grade debt publicly issued by financial institutions in the eurobond or Euro member domestic markets.

ICE BofA Euro Non-Financial Subordinated Index (ENSU) tracks the performance of non-financial EUR denominated investment grade corporate debt publicly issued in the eurobond or Euro member domestic markets.

ICE BofA U.S. Corporate Index (C0A0) tracks the performance of U.S. dollar denominated investment grade corporate debt publicly issued in the US domestic market.

ICE BofA U.S. Capital Securities Index (C0CS) is a subset of capital securities ($1000 par preferreds) within The ICE BofA U.S Corporate Index, including fixed-to-floating rate and perpetual callable issues.

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