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Preferred Securities Market Insight | December 2024

Election Results Boost Sentiment for the Financial Sector

Key takeaways

- Investment-grade credit spreads rallied to fresh year-to-date tights following election results. Market exuberance faded in the second half of the month amid softer equity performance and elevated new-issue supply.
- Preferred securities finished lower, with the ICE BofA Fixed Rate Preferred Index declining 0.14% in November to take total return to 9.03% for the year.
- Primary supply was again focused on hybrid securities, with November issuance adding to record totals for the year.
- Election results could delay pending changes to capital requirements, supporting profitability for the financial sector.

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Recap

The ICE BofA Fixed Rate Preferred Securities Index finished 0.14% lower in November as post-election euphoria subsided over the month. The primary market resumed where it left off, with further US hybrid supply adding to record totals for the year. Financials outperformance faded in the second half of the month, but policy changes should benefit sector fundamentals going forward. Historically high yields in preferred securities should continue to attract demand after outperforming alternatives in fixed income in 2024.

Sentiment regarding the incoming administration impacted rates and credit spreads throughout November. The 10-year Treasury finished the month 12 basis points (bps) lower. Investors looked past a weak but hurricane-impacted monthly payrolls number, instead focusing on potential policy ramifications. Investment-grade (IG) credit spreads tightened to fresh year-to-date lows following the election results, with lower-quality credits outperforming. As perceived beneficiaries of a more business-friendly climate, financials saw immediate outperformance in equities and bond spreads.

Market exuberance faded in the second half of the month amid weaker equity performance and elevated new-issue supply in corporates. IG issuance during the week following the election was the largest since September. Headlines regarding the French budget and geopolitics weighed on European risk sentiment, contributing to underperformance for Yankee banks (non-US banks that issue dollar debt). Retail $25 par securities underperformed, with the ICE BofA Core Plus Fixed Rate Preferred Index declining 0.16% in November. $1,000 par preferreds, measured by the ICE US Institutional Capital Securities Index, ended the month 0.74% higher.

Primary supply was again focused on hybrid securities in November. Utilities issued securities with 6.625% and 6.55% coupons. An integrated energy company and an infrastructure investor priced securities with 6.125% and 6.75% coupons, respectively. One GSIB bank issued a 6.75% preferred in the month, but supply remains limited in that corner of the market. In $25 par securities, a regional bank with less than $100 billion in assets issued a preferred for the first time since August at 7.625%, while a private equity-owned insurer issued a 7% fixed-for-life security.

Looking ahead

For the financials sector, proposed changes to capital requirements, known as Basel III endgame, could be delayed indefinitely. While more stringent requirements can be a positive for credit investors, bank capital as of Q3 had already reached the highest levels since the global financial crisis. Increasing capital requirements lowers return on equity, all else equal, without addressing the specific issues that plagued the regional bank sector in the spring of 2023. A more tailored approach could be more effective in mitigating risk without limiting bank lending capacity and profitability.

Furthermore, turnover at the FTC could spur an increase in M&A activity. The merger arbitrage premium for a pending credit card merger notably declined following election results. Mark-to-market losses, as well as higher valuations, will still limit bank consolidation. But a broad pick-up in corporate dealmaking would boost fee income for capital markets-focused banks.

Valuations reflect strong fundamentals and an outlook for continued economic expansion. Surging hybrid supply should continue next year as utilities expand capital investment and adapt to updated ratings agency methodology. Going forward, returns in preferreds could approach historical averages, driven primarily by coupon income, after total return in 2024 reached near double digits. Combined with the tax benefit for qualified dividend income, the asset class remains a compelling alternative to traditional fixed income.

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42513 | 11.30.2024 | RO 4111564