Parametric

Preferred Securities Market Insight | November 2024

Higher Rates Stall the Preferreds Rally in October

Key takeaways

» Preferred indexes receded from year-to-date highs as interest rates pushed higher in October.

» Credit spreads continued to tighten, and investment-grade spreads hit new post-financial crisis lows.

» Banks reported robust third-quarter results, highlighted by strength in capital markets activity and solid credit performance.

» Early November election results buoyed the financials sector, a perceived beneficiary of lighter regulation.

Parametric
800 Fifth Avenue
Suite 2800
Seattle, WA 98104
T 206 694 5575
F 206 694 5581
www.parametricportfolio.com

Recap

Treasury rates rose in October after strong economic data and shifting expectations for election results, with the 10-year yield rising 50 basis points (bps). Preferreds receded from recent highs as the ICE BofA Preferred Securities Index declined 1.08% to take the year's total return to 9.17%. Banks reported another strong quarter fueled by capital markets and solid credit performance. Primary market activity slowed from September, with new issues focused in hybrid securities from utilities and nonbank financials.

A blowout 254,000 monthly jobs figure alongside 72,000 upward revisions triggered a sharp move in yields as investors reduced expectations for future rate cuts from the Federal Reserve. The yield curve flattened as short-term rates responded to a higher expected terminal rate—the level where the Fed ends the cutting cycle. As the month wore on, shifting expectations for the US election put upward pressure on yields as investors assessed the potential for inflationary pressures, higher tariffs and larger deficits.

Despite lower total return, preferreds weathered the rates move well, with credit spreads tightening in the month. Investment-grade (IG) fixed income spreads hit new post-financial crisis lows, touching 82 bps on the ICE BofA US Corporate Index. In preferreds, $1,000 par preferreds option-adjusted spread (OAS) declined 17 bps to 182, allowing the ICE US Institutional Capital Securities Index to decline only 39 bps on a total return basis. $25 par preferreds underperformed, particularly low-coupon securities, but the ICE BofA Core Plus Fixed Rate Preferred Index only declined 1.37% on the month.

A combination of strong fundamentals and technical support from limited net supply and robust demand continue to drive the relative strength of the preferreds market. Economic growth has exceeded expectations in 2024, with US GDP growth of approximately 3%, which is translating into solid credit performance and strong capital markets activity for banks.

Coming into earnings season, nitpicking investors were anticipating slowdowns in net interest income for larger, more asset-sensitive banks and potential signs of weakness in areas such as consumer lending, based on recent comments at an industry conference. But banks largely outperformed expectations, with fee income from capital markets, such as debt underwriting, boosting results. Industry-wide, loan net charge-offs and provisioning showed little change from the previous quarter, and credit spreads for consumer lenders outperformed the broader financials category in October following results.

High yields continue to attract investors to the preferreds asset class, with ETF inflows in October of nearly $400 million, bringing the total for the trailing 12 months above $3 billion. The supply of new preferreds in 2024 already exceeds the combined 2022 and 2023 total. However, net of called securities, supply is negative in the retail $25 par market and across bank preferreds in the $1,000 par market. High demand and limited supply supports prices, in addition to the financials outperformance we've seen in IG corporate bonds this year.

New issue supply slowed in October from last month but was focused in two growing subsectors: US hybrids and Canadian limited recourse capital notes (LRCNs). Updated ratings methodology is incentivizing nonbanks to refinance perpetual preferreds with hybrid securities, which pay interest instead of a dividend. A utility priced their third hybrid of the year in October with a 6.7% coupon, while asset managers issued hybrids with 6.00% and 6.625% coupons, taking total hybrid issuance over $20 billion USD for the year. A GSIB bank in Canada issued a 6.35% coupon LRCN with a 225 bps reset spread, a new low for that market. The security underperformed in secondary market trading, and a second bank issuer priced a 6.95% security with a 283 bps reset spread at the end of the month. US banks refrained from preferred issuance following earnings as issuers await clarity on future capital requirements.

Looking ahead

Election results boosted equities in the financials sector, with investors anticipating a more favorable outlook for M&A, capital requirements and corporate tax rates. Higher profitability could benefit credit spreads as well as continued economic growth. While credit spreads are through historical averages, valuations reflect strong fundamentals and a constructive economic outlook. Historically high yields should continue to attract inflows to preferreds, with coupon income being the primary driver of near-term returns.

About

Parametric Portfolio Associates® LLC ("Parametric"), headquartered in Seattle, is registered as an investment advisor with the US Securities and Exchange Commission under the Investment Advisers Act of 1940. Parametric is a leading global asset management firm providing investment strategies and customized exposure management directly to institutional investors and indirectly to individual investors through financial intermediaries. Parametric offers a variety of rules-based investment strategies, including alpha-seeking equity, fixed income, alternative and options strategies. Parametric also offers implementation services, including customized equity, traditional overlay and centralized portfolio management. Parametric is part of Morgan Stanley Investment Management, the asset management division of Morgan Stanley, and offers these capabilities through offices located in Seattle, Boston, Minneapolis, New York and Westport, Connecticut.

Disclosures

This material may not be forwarded or reproduced, in whole or in part, without the written consent of Parametric. Parametric and its affiliates are not responsible for its use by other parties.

This information is intended for informational purposes and details investment strategies and opportunities identified by Parametric. Opinions and estimates offered constitute our judgment and are subject to change without notice, as are statements of financial market trends, which are based on current market conditions. We believe the information provided here is reliable but do not warrant its accuracy or completeness. This material is not intended as an offer or solicitation for the purchase or sale of any financial instrument. The views and strategies described may not be suitable for all investors. Past performance is not indicative of future results. Investing entails risk, and there can be no assurance that Parametric will achieve profits or avoid incurring losses. Preferred securities are subject to interest rate risk. They generally decrease in value if rates rise and increase in value if rates fall. Parametric and Morgan Stanley do not provide legal, tax or accounting advice or services. Clients should consult with their own tax or legal advisor prior to entering into any transaction or strategy described herein. Additional information is available on request.

Charts, graphs and other visual presentations and text information were derived from internal, proprietary or service vendor technology sources or may have been extracted from other firm databases. As a result, the tabulation of certain reports may not precisely match other published data. Data may have originated from various sources, including, but not limited to, Bloomberg, MSCI/Barra, FactSet or other systems and programs. Parametric makes no representation or endorsement concerning the accuracy or propriety of information received from any third party.

Source of all data: Bloomberg, 10/31/2024. Bloomberg is a trademark and service mark of Bloomberg Finance LP ("Bloomberg"). "Barclays" is a trademark and service mark of Barclays Bank Plc, used under license. Bloomberg Finance LP and its affiliates (collectively "Bloomberg") or Bloomberg's licensors own all proprietary rights in the Bloomberg Barclays indexes. Neither Bloomberg nor Barclays Bank Plc or its affiliates (collectively "Barclays") guarantees the timeliness, accuracy or completeness of any data or information related to the Bloomberg Barclays indexes. This strategy is not sponsored or endorsed by Bloomberg or Barclays, and each makes no representations regarding the content of this material.

References to specific securities and their issuers are for illustrative purposes only and are not intended to be and should not be interpreted as a recommendation to purchase or sell such securities. Any specific securities mentioned are not representative of all securities purchased, sold or recommended for advisory clients. Actual portfolio holdings vary for each client, and there is no guarantee that a particular client's account will hold any or all of the securities identified. It should not be assumed that any of the securities or recommendations made in the future will be profitable or will equal the performance of the listed securities.

Parametric is located at 800 Fifth Avenue, Suite 2800, Seattle, WA 98104. For more information regarding Parametric and its investment strategies, or to request a copy of the firm's Form ADV or a list of composites, contact us at 206 694 5500 or visit www.parametricportfolio.com.

PAST PERFORMANCE IS NO GUARANTEE OF FUTURE RESULTS. INDEX PERFORMANCE IS SHOWN FOR ILLUSTRATIVE PURPOSES ONLY AND NOT MEANT TO DEPICT THE PERFORMANCE OF A SPECIFIC INVESTMENT.

42513 | 9.30.2024 | RO 4025040