Parametric

Preferred Securities Market Insight | February 2025

Preferreds Post Positive Performance in January

Key takeaways

» Despite a flurry of executive orders, tariff announcements and a brief correction in AI-related equities, interest rates and credit spreads finished the month nearly unchanged.

» The ICE BofA Fixed Rate Preferred Index rose 0.63%. California utilities underperformed as wildfires impacted the region, while earnings results drove outperformance for certain issuers in the financials sector.

» Two money-center banks headlined new preferred supply with coupons of 6.85% and 6.5%. While new-issue credit spreads remain low, securities generally performed well amid strong investor demand and valuations elsewhere in the capital structure.

» While valuations leave little room for further compression, they reflect the strong fundamentals across much of the sector.

Recap

The new year began on a positive note, with the ICE BofA Fixed Rate Preferred Index rising by 0.63% in January. California utilities underperformed due to the impact of wildfires, while earnings results drove outperformance for certain issuers in the financial sector. Investment-grade (IG) corporate credit spreads remained unchanged, and the preferred primary market experienced its most active month since September.

Interest rates and spreads showed little change in January despite a flurry of executive orders, tariff announcements and a correction in AI-related equities. The Fed will need clarity on new economic policies before determining the path for rates. However, short-term inflation expectations have recently increased, along with market-implied pricing of a higher-for-longer federal funds rate. As we outlined in our outlook, we anticipate that coupon income will be the primary driver of total return in 2025, which was the case in January, when headlines had little lasting impact on prices.

Issuer-level fundamentals drove relative performance in January. Two California utilities were the worst performers among $1,000 par securities, declining by an average of 4% and 7%, respectively. While the $21 billion California Wildfire Fund supports their credit profiles, a significant depletion of the fund without a replenishment mechanism could lead to potential downgrades from ratings agencies. Although it may not be necessary in this case, state legislatures have approved utilities to issue securitized bonds backed by rate increases to cover losses from natural disasters arising from ice storms and hurricanes. The current situation remains unresolved, but rating agencies have yet to downgrade the large public utilities in California.

Outside the utilities sector, performance was strong across financials as quarterly results highlighted positive earnings momentum. Larger banks exceeded elevated expectations for capital markets revenues, and management teams expressed confidence in their ability to return excess capital to shareholders. Credit quality remained resilient, with commercial real-estate-exposed institutions reporting provisioning and net charge-offs in line with or better than expectations. Fundamental trends were positive in consumer lending, with the best-performing $1,000 par preferreds coming from an auto lender that beat expectations and guided for a decline in charge-offs for the year.

Primary supply rebounded in January, with IG corporate volume exceeding last January's record total. Preferreds saw over $10 billion in new supply across corporate hybrid, preferred and contingent convertible securities, with coupons ranging from 6% to 7%. While spread levels hit new lows for some of these issuers, securities generally performed well due to investor demand and valuations elsewhere in the capital structure. US money-center banks led the way, with $4.9 billion across two $1,000 par securities with coupons of 6.85% and 6.5%, or back-end spreads of 246 and 215 basis points, respectively. Both traded higher in the secondary market. Outside the financial sector, a utility priced a $300 million hybrid through those levels, with a 6.25% coupon and a 193-basis-point back end. Despite the low absolute spread value, this still represented more than twice the senior spread levels.

Looking ahead

Preferreds may continue to provide attractive after-tax yields for investors in 2025. While valuations leave little room for further compression, they reflect the strong fundamentals across much of the sector. New-issue supply could surpass last year's levels, offering continued opportunities for investors. High rates and ongoing economic expansion could sustain demand for fixed income and limit volatility in credit spreads.

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