COHEN & STEERS

Preferred Securities and COVID-19:
Issuer Fundamentals Generally Solid; Spreads Are Pricing in Extreme Risks

Executive Summary

This is not 2008

- COVID-19 represents a powerful economic shock. We expect significant weakness in the global economy in the short term, but this downturn is not the result of economic excesses (elevated housing prices or over-extension of credit). In addition, companies are generally in healthy shape, with most featuring acceptable debt service ratios, while consumer savings rates are relatively high.
- We have already seen aggressive actions from governments and central banks, and we expect more. Given the gravity of the situation and the fact that it does not reflect imprudent risk taking (e.g., Wall Street greed), policy makers should find unanimity and be willing to act forcefully.
- Due to reforms ushered in by the global financial crisis, financial systems are strong and should continue to keep economies well oiled: Tier-1 capital ratios among major global banks are nearly double those of 2008, on average, and loan books are much cleaner due to better lending standards.
- Near-term, we expect the economy will be weak, and some segments and geographies may falter—but given the broader backdrop, we see scope for an economic rebound once the exogenous effects of COVID-19 begin to dissipate.

> We believe the selloff is creating attractive opportunities for preferred securities investors to earn high levels of income from issuers with exceptionally strong balance sheets that are well positioned to defend in a time of economic disruption.

How recession risk is affecting preferreds

- Bank profitability should fall due to the quick drop in interest rates, while the economic shock will likely lead to higher loan losses. Nevertheless, most banks are well capitalized, and we expect most to remain profitable. Asset quality is sound today, and government programs may also support borrowers.
- Insurance companies should also see profitability decline as investment portfolio yields drop, while losses from investment portfolios could increase. However, insurers should see limited impact from virus claims or increased mortality risk.
- REIT risks vary, with lodging and retail portfolios clearly more at risk, but other property types have more stable outlooks, and REIT balance sheets overall are in very solid shape
- Utility preferreds look quite attractive in this environment, in our view.

What we are doing in our portfolios

- We have been de-risking our portfolios by increasing holdings of higher-quality securities, including favoring those with high reset spreads that tend to hold their value better in volatile markets.
- We have extended duration modestly based on expectations of prolonged low interest rates
- We favor more U.S. and less Europe based on a weaker economic outlook in Europe. However, European governments are taking strong actions.
- While playing defense, we are also taking advantage of situations in which markets have "thrown the baby out with the bathwater."
- With rates as low as they are and income on preferreds much higher today, we believe there are some very attractive opportunities for investors.

This Is Not 2008

Significant disruption in the near term, but the typical recession triggers are not present. Understanding that this is a fast-evolving situation, our base-case scenario is: a) the U.S. economy experiences a sharp contraction in the second quarter, followed by a modest rebound in the third quarter, b) the Eurozone and Japan post anemic or negative growth through the first half, c) China begins to reaccelerate in response to declining new cases, and d) the global economy enters a recession, but then ramps up quickly in the second half as activity comes back online.

That being said, the risks are largely to the downside in terms of the magnitude and duration of the downturn, depending on how quickly officials gain control of the situation and provide effective economic support.

Though we anticipate the near-term economic disruption will be significant, this slowdown is not being caused by the usual recession triggers: economic overheating and monetary policy tightening. In the U.S., households have been saving more (income is greater than spending), while corporate debt service ratios tell us that companies generally are in solid shape. In addition, central banks and governments are pushing forward with aggressive monetary and fiscal offsets to help limit the damage.

Banking systems are far better capitalized to withstand an economic shock. U.S. and European regulators put large banks through substantial stress tests every year, assessing whether banks can maintain healthy capital levels under conditions of severe recession, including high unemployment (~10%) and a sharp decline in residential and commercial real estate prices. Other factors include low short-term rates and substantial declines in stock markets.

As shown in Exhibit 1 on the following page, banks have significantly strengthened their balance sheets over the past decade, nearly doubling the average common equity Tier-1 capital ratio, from 6–7% in 2008 to 10–12% today. Exhibit 2 summarizes the results of the most recent stress tests for eight of the largest banks in the U.S. and Europe. These banks have raised enough capital such that, even under the severe stress conditions of the regulator tests, capital ratios would generally be similar to those in unstressed conditions pre-financial crisis.

How Recession Risk Is Affecting Preferreds

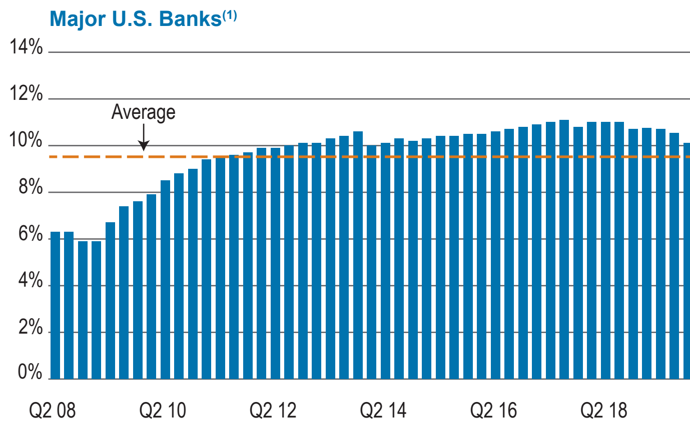
Banks: The decline in interest rates to near-zero or negative levels is placing pressure on banks' net interest margins. In addition, a negative economic shock is likely to increase loan losses. Nonetheless, we expect major banks to remain solidly profitable, while balance sheets are exceptionally strong.

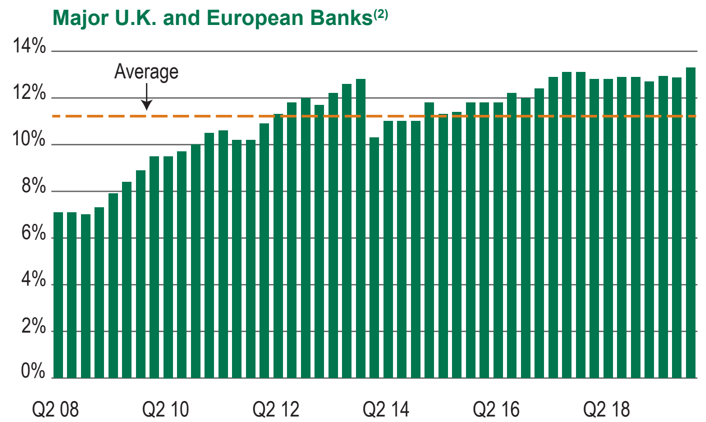
Whereas many other industries have significantly increased leverage over the past decade, banks and insurance companies have not. This is due to stricter regulation post-2008, which increased capital requirements to help keep systemic risks in check. Furthermore, banks have been dealing with low rates and higher costs of capital on riskier assets for so long that many have changed their business models, shifting to more fee-based income and limiting their exposure to riskier parts of banking, such as capital markets activity.

Banks have also adopted more prudent lending standards since the global financial crisis, and loan books generally look quite sound with historically low loan losses in recent periods. Nonetheless, non-performing loans could rise as borrowers face growing strains in a weakened economy. If these losses become great enough, certain banks could see negative earnings, which could begin to eat into capital.

As a general matter, we believe asset quality for most major banks in the U.S., Europe and Asia is strong enough that the economic disruption from COVID-19 would would need to be very severe and/or endure for several quarters in order for bad loans to result in negative earnings. We also believe that emergency government programs, such as loan guarantees and other fiscal stimulus measures, are likely to reduce risks. That said, some specific issuers and geographies, such as Italy, may be more at risk.

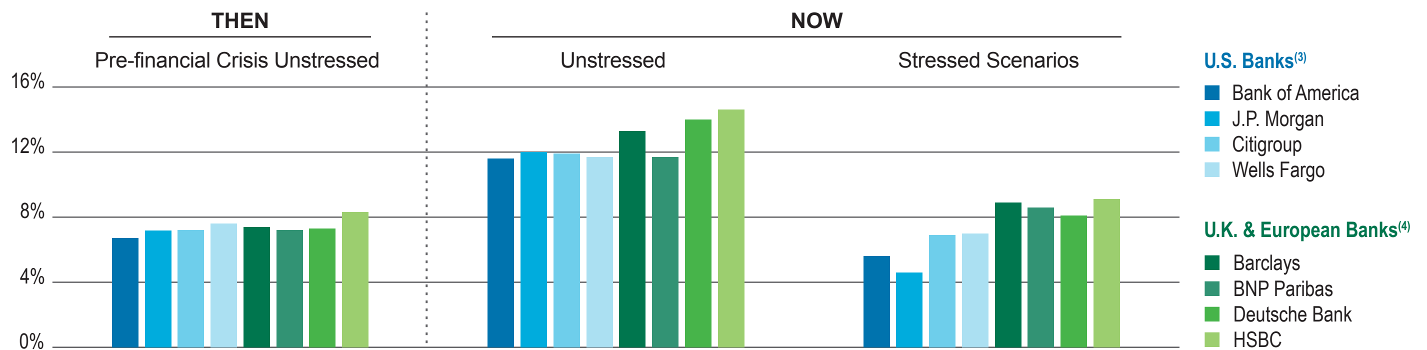
EXHIBIT 1: Bank Balance Sheets Are Exceptionally Strong
Common Equity Tier-1 Capital Ratio





At December 31, 2019. Source: SNL and Institute of Supply Management (ISM).

EXHIBIT 2: Stress Scenarios NOW Are Similar to or Better than Unstressed Scenarios in 2008
Common Equity Tier-1 Capital Ratio



Most recent data as of March 11, 2020. Source: Federal Reserve, European Banking Authority, Bank of England (BoE)

Data quoted represents past performance, which is no guarantee of future results. The mention of specific securities is not a recommendation or solicitation to buy, sell or hold a particular security and should not be relied upon as investment advice. The Common Equity Tier 1 capital is the ratio of common equity to risk-weighted assets. Banks must meet a minimum core capital requirement as dictated by local banking laws and regulations. Higher core capital ratios have helped to strengthen banks' balance sheets and to improve their credit quality. (1) Core Capital ratios based on the largest U.S. banks including Bank of America, JPMorgan Chase, Citigroup, Wells Fargo, U.S. Bancorp, PNC Financial Services Group, SunTrust Banks, BB&T, Regions Financial Corporation, KeyCorp, M&T Bank, Comerica, Synovus Financial Corp. and First Horizon National Corporation. (2) Core Capital ratios based on the following major European banks: HSBC Holdings, Deutsche Bank, BNP Paribas, Crédit Agricole, Barclays, Société Générale, Banco Santander, Royal Bank of Scotland, UBS, Credit Suisse, UniCredit, Lloyds Banking Group, Intesa Sanpaolo, Commerzbank and Banco Bilbao Vizcaya Argentaria. (3) Results for U.S. banks based on the Comprehensive Capital Analysis and Review (CCAR), the Federal Reserve's primary supervisory mechanism for assessing the capital adequacy of large, complex bank holding companies. Pre-Financial Crisis data based on 1Q 2007 asset base. The most recent reported CCAR was conducted in Feb 2019 based on 4Q 2018 asset base, published in June 2019. (4) Barclays, BNP Paribas, Deutsche Bank and HSBC are fair representations of EU banking in the period listed above. Year-end 2006 data estimated based on 2006 annual reports for each respective bank. BNP Paribas and Deutsche Bank reflect results from European Banking Authority stress test. Barclays and HSBC reflect results from Bank of England (BoE) stress test. These exercises are conducted to consistently assess the resilience of the EU and UK banking sectors and major banks in those jurisdictions to hypothetical adverse economic shocks. Pre-financial crisis data based on 4Q 2006 asset base. The latest available EU-wide and BoE stress tests used 4Q 2017 asset base. EU-wide stress test adverse scenario shows 2020 results and BOE stress test adverse scenario shows 2019 results. See pages 6–7 for index definitions and additional disclosures.

In terms of energy exposure for banks, energy-related loans make up only 2–5% of loan books for most of the major banks in our universe. We do not see energy exposure as a material risk for the bank preferreds we own, as these companies cleaned up their energy loans following the oil selloff in 2016.

Insurance companies: Life insurers tend to have lower margins in their underwriting activities, making it up with returns from investment portfolios, which leaves earnings more exposed when rates fall. Furthermore, both life and property & casualty (P&C) insurers may have risks in their investment portfolios. From an operating perspective, we expect P&C insurers to see a limited impact from potential virus claims (business interruption claims), as pandemics are typically not included under their coverage. For life insurers, COVID-19 poses a greater risk to the elderly, who are generally less likely to have life insurance, as these policies are designed to protect against unexpected death during prime working years. Thus, we expect mortality risk to insurance companies to be modest.

Pipelines: The steep decline in oil prices following the breakdown between OPEC and Russia has had a substantial effect on prices of pipeline company preferreds, with investors selling anything related to energy. We continue to favor higher-quality, regulated Canadian companies that we believe are defensively positioned based on their types of contracts, base throughputs (gas in addition to oil) and corporate structures. In our view, investors are being well compensated for the underlying risks. While there are U.S. pipeline companies that could be at much greater risk, there are also mispricing opportunities.

Real estate: Companies that own property types most impacted by disruptions in trade, travel and public activities—particularly hotels and retail—have come under material pressure. At the other end, defensive sectors such as apartments and self storage are likely to see much lower impact. Even within the lodging and retail spaces there are companies with very solid balance sheets that are much better positioned to weather the situation. We continue to favor lower-beta sectors and note that REIT balance sheets are very strong overall, with a large institutional investor base that has demanded strong metrics since the global financial crisis.

What We Are Doing in Our Portfolios

- **Increasing quality:** In times of economic uncertainty, balance sheet strength is paramount. As a general matter, we have been de-risking our portfolios, picking up higher-quality names. For example, utility preferreds prices have sold off significantly, yet their low-risk businesses should be only modestly affected.
- **Focusing on securities with higher resets:** Many preferreds pay coupons that reset at a predetermined spread above a benchmark interest rate. The higher the spread, the better the security tends to hold its value in volatile markets. This is because the issuer may be more inclined to call the security away at par value, generally keeping the price closer to par. With short-term interest rates coming down, securities with lower resets could be more at risk, so we remain largely focused on issues with spreads generally higher than 4% above their benchmark rate.
- **Extending duration:** We have modestly increased the average duration of our holdings, as we expect interest rates to remain low for an extended period.
- **More U.S., less Europe:** We believe U.S.-domiciled preferred issuers are generally more defensive, as the European economy is weaker and more reliant on trade and tourism. Nonetheless, European policy makers are taking strong actions, and we continue to like select, quality European names offering high income rates.
- **Seeing attractive opportunities in pipelines:** We have been working closely with our midstream energy and commodities teams to gain a broad perspective on the global energy market. Today, we are finding good value in regulated Canadian pipeline companies, and we are very selectively investing in U.S. pipeline companies.

What Should Preferred Investors Do?

Though the volatility in the preferred market is unsettling, a great deal of negative information is priced into the preferred market; we believe issuer fundamentals are solid and see good values. However, some issuers and securities are more vulnerable than others, underscoring the importance of selectivity.

Assuming the number of new cases peaks in the next few months and both monetary and fiscal policy are effective in providing liquidity and cushioning the blow to aggregate demand, we believe the global economy should come out of this shock with substantial pent-up demand, a tight but disrupted labor market and record easy monetary conditions. As that happens, we expect financial markets to respond quickly.

For historical perspective, in the six market corrections of 10% or more going back to the global financial crisis, preferred securities have significantly outperformed Treasuries and the broader bond market (Ex. 3). While it is difficult to identify the trough in these periods, we believe investors should remain grounded and focused on fundamentals.

EXHIBIT 3: Preferred Securities Performance Following Corrections

				Returns 3-months After the Trough Date			Returns 6-months After the Trough Date		
Cause of the Correction	**Peak Date**	**Trough Date**	**S&P 500 Selloff %**	**U.S. Treasuries**	**U.S. Bonds**	**Preferred Securities**	**U.S. Treasuries**	**U.S. Bonds**	**Preferred Securities**
"Shocktober" Worldwide Stock Market Downturn	9/20/18	12/24/18	-19.4%	3.8%	3.4%	9.5%	7.1%	6.1%	13.1%
Feb 2018 Correction	1/26/18	2/8/18	-10.1%	-0.3%	-0.4%	1.1%	0.8%	0.5%	3.2%
"The Great Fall of China" Market Selloff	7/20/15	2/11/16	-13.0%	-0.4%	1.4%	7.5%	1.4%	3.3%	11.6%
European Sovereign Debt Crisis	4/29/11	10/3/11	-18.6%	-0.3%	0.4%	4.1%	-1.8%	0.7%	10.6%
Flash Crash	4/23/10	7/2/10	-15.6%	4.7%	2.6%	8.4%	0.2%	1.2%	8.2%
Global Financial Crisis	10/9/07	3/9/09	-55.3%	-5.5%	1.0%	91.2%	-1.5%	5.8%	107.6%
Average				**0.3%**	**1.4%**	**20.3%**	**1.0%**	**2.9%**	**25.7%**
Average ex-GFC				**1.5%**	**1.5%**	**6.1%**	**1.5%**	**2.4%**	**9.3%**

At February 28, 2020. Source: Bloomberg, Cohen & Steers.

Data quoted represents past performance, which is no guarantee of future results. *An investor cannot invest directly in an index and index performance does not reflect the deduction of any fees, expenses or taxes.* U.S. Treasuries represented by Bloomberg Barclays U.S. Treasury 7–10 Year Index. U.S. Bonds represented by Bloomberg Barclays U.S. Aggregate Bond Index. Preferred Securities represented by ICE BofA Fixed Rate Preferred Securities Index. See pages 6–7 for index definitions and additional disclosures.

We understand these are unprecedented times. We will continue to provide updates as the situation evolves. In the meantime, please reach out to your Cohen & Steers representative with any questions.

Most importantly, stay healthy.

Index Definitions. *An investor cannot invest directly in an index and index performance does not reflect the deduction of any fees, expenses or taxes. Index comparisons have limitations as volatility and other characteristics may differ from a particular investment.*

The ICE BofA 7-10 Year U.S. Treasury Index is a subset of the ICE BofA U.S. Treasury Index including all securities with a remaining term to final maturity greater than or equal to 7 years and less than 10 years.

The ICE BofA Fixed Rate Preferred Securities Index tracks the performance of fixed-rate U.S. dollar-denominated preferred securities issued in the U.S. domestic market.

The Bloomberg Barclays U.S. Aggregate Bond Index is a broad-market measure of the U.S. dollar-denominated investment-grade fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, mortgage-backed securities, asset-backed securities and commercial mortgage-backed securities.

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COHEN & STEERS

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