The banking crisis weighed heavily on preferred securities earlier this year but has now created a potential opportunity relative to riskier areas of the fixed-income market.

Banking stress has created a yield premium for preferred securities

Stress within the banking system has reverberated through markets in the first half of the year. Though the effects have been relatively well contained among a select few US banks whose client base was concentrated in the tech and crypto industries, the failures of these financial institutions have weighed on related securities. This includes banks' preferred securities, which make up nearly half of the preferred securities market and were recently trading at historic lows.

As investor worries around the risks of financial contagion have begun to ease, this area of the market has started to recover, with the performance of banking preferred shares on the rise since late March.

Banking preferred shares have rebounded since late March

Performance of banking preferred shares (%)

	Performance of banking preferred shares
30/12/22 - 20/3/23	-3.95
21/3/23 - 29/6/23	1.22

Source: Bloomberg, Manulife Investment Management, as of 29/6/23. Banking preferred shares represent a subsection of the Intercontinental Exchange (ICE) Bank of America (BofA) U.S. All Capital Securities Index. Past performance is not indicative of future returns. It is not possible to invest directly in an index.

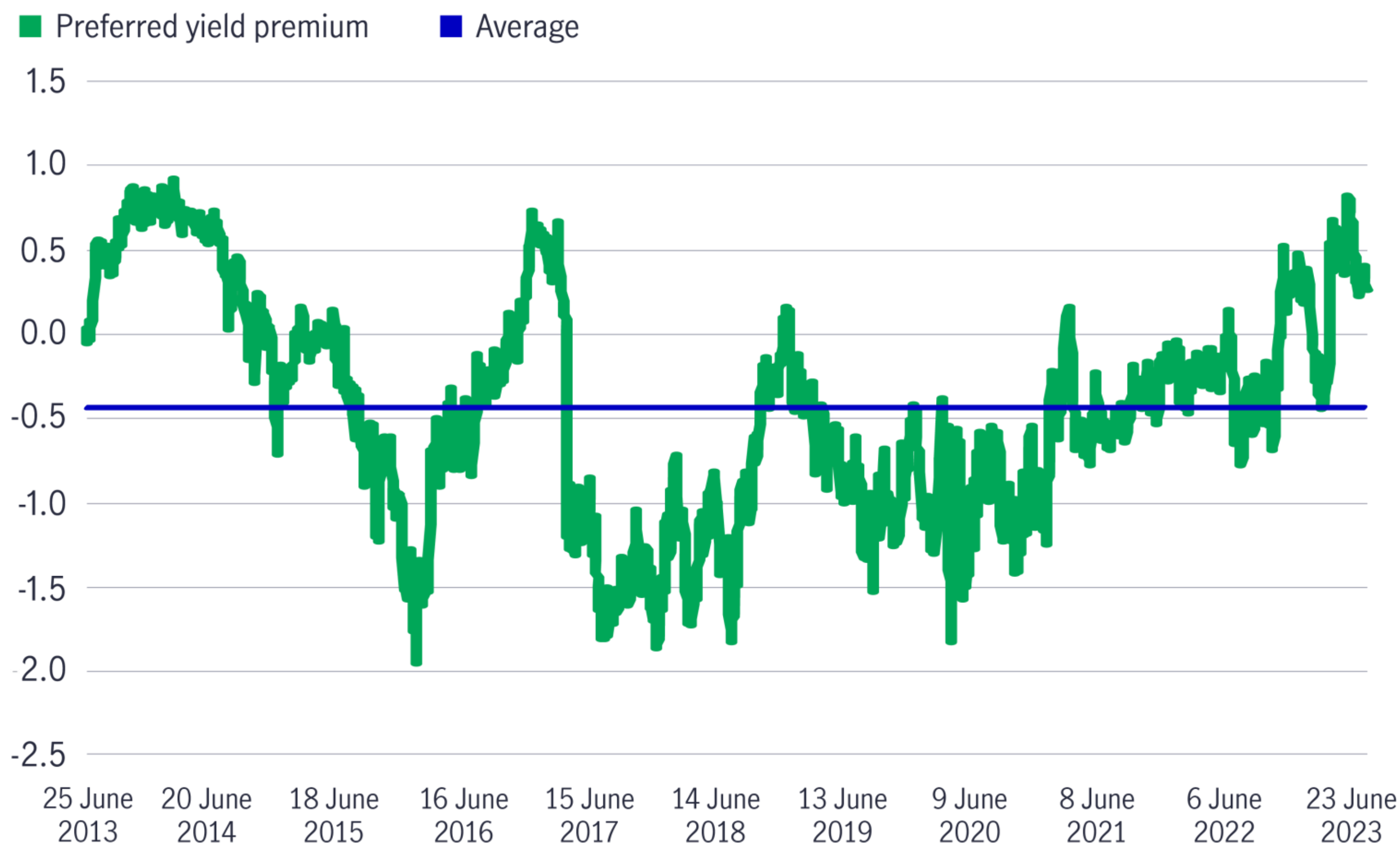
Are preferred securities equity or fixed income?

Preferred securities possess attributes of both equity and fixed income, giving them a unique risk profile. As preferred securities are subordinate to traditional bonds, they carry an increased level of risk in the event of a default. In return, preferred securities also offer a higher level of income. This characteristic makes them comparable to riskier parts of the fixed-income market, such as high-yield bonds.

Both preferred securities and high-yield bonds have seen yields rise sharply off multi-year lows since late 2021. However, preferred securities now appear to be offering investors a spread over high-yield bonds that has reached as high as 0.8% in recent weeks.

Preferred securities are yielding more than junk bonds

Preferred securities yield spread over BB-rated high-yield bonds (%)



Source: Bloomberg, Manulife Investment Management, as of 23/6/23. The preferred yield premium is the yield to maturity (YTM) of the ICE BofA U.S. All Capital Securities Index less the YTM of the ICE BofA BB U.S. High Yield Index. Positive distribution yield does not imply positive return. It is not possible to invest directly in an index.

On average, preferred security yields are lower than those of BB-rated high-yield bonds, suggesting that the current yield advantage offered by preferreds presents a potential investment opportunity for investors.

Softening economic conditions

Looking ahead, we believe that macroeconomic conditions will continue to soften, but we still maintain a favorable view on preferred securities due to their tendency to perform well in recessionary environments. We see strong evidence that the US Federal Reserve (Fed) tightening has continued to flow through the economy since the central bank began to raise rates in early 2022 and is now affecting consumers and businesses alike.

So far, the impact to earnings and balance sheets has been uneven, but we believe this effect will broaden out in the months ahead. This earnings deterioration will put pressure on companies as demand for goods wanes and inflationary pressures continue to affect margins.

Considering the economic picture, we believe that higher-quality corporate debt should be able to withstand these weakening economic conditions. However, companies of lower credit quality will have to carefully navigate worsening conditions while also being required to pay higher required rates of return by the financial markets.

Given these weakening economic conditions along with starting yields' positive relationship to forward returns, we feel that investors might possibly benefit from shifting high-yield allocations toward preferred securities. With their high-quality nature, we believe that preferred securities remain well positioned for the market ahead, particularly if a recession takes hold.

Fed pause could bode well for preferreds

Though the Fed has signaled further rate hikes ahead, the central bank decided to hold off on further tightening in its June FOMC meeting, an event that might also create an advantage for preferred securities relative to high yield. Since 1997, the Fed has paused its hiking cycle four times, with a terminal rate ranging from 2.5% to 6.5% depending on the timeframe. Though history can't be used as a predictor of future performance, looking back at how institutional preferreds, retail preferreds, and high yield have been affected by a prior Fed pause can help us to understand the potential for relative performance moving ahead.

Forward performance after a pause in Fed policy hikes

ICE BofA US All Capital Securities Index forward returns

Month of last hike	3 months	6 months	9 months	12 months
Dec 2018	6.43%	11.13%	14.94%	17.78%
Jun 2006	4.86%	6.95%	8.40%	7.31%
May 2000	6.89%	5.91%	16.08%	21.11%
Mar 1997	4.86%	10.26%	15.95%	17.58%
Average	**5.76%**	**8.56%**	**13.84%**	**15.95%**

ICE BofA Fixed Rate Preferred Securities Index forward returns

Month of last hike	3 months	6 months	9 months	12 months
Dec 2018	8.71%	11.98%	15.40%	17.71%
Jun 2006	5.70%	8.50%	10.46%	8.58%
May 2000	7.31%	9.88%	14.40%	16.78%
Mar 1997	2.81%	5.35%	8.63%	9.70%
Average	**6.13%**	**8.93%**	**12.22%**	**13.19%**

ICE BofA US High Yield Index forward returns

Month of last hike	3 months	6 months	9 months	12 months
Dec 2018	7.40%	10.16%	11.50%	14.41%
Jun 2006	4.05%	8.44%	11.39%	11.75%
May 2000	3.48%	-4.49%	5.45%	3.72%
Mar 1997	5.01%	9.60%	12.26%	15.60%
Average	**4.99%**	**5.93%**	**10.15%**	**11.37%**

Source: Bloomberg, Manulife Investment Management, as of 16/6/23. Past performance is not indicative of future returns. It is not possible to invest directly in an index.

Though performance leadership varies across each timeframe, the average return for each asset class across all four time periods shows that both retail and institutional preferred securities have historically done better than high-yield securities in the months following a Fed pause.

Preferreds have historically outperformed high yield following a Fed pause

Average returns after four prior Fed pauses	3 months	6 months	9 months	12 months
ICE BofA U.S. All Capital Securities Index	5.76%	8.56%	13.84%	15.95%
ICE BofA Fixed Rate Preferred Securities Index	6.13%	8.93%	12.22%	13.19%
ICE BofA U.S. High Yield Index	4.99%	5.93%	10.15%	11.37%

Source: Bloomberg, Manulife Investment Management, as of 16/6/23. Past performance is not indicative of future returns. It is not possible to invest directly in an index.

If market conditions deteriorate and lead the Fed to extend its pause on any further rate hikes, this relative performance advantage for preferred securities could repeat, further highlighting their tendency to do well in recessionary environments due to their high-quality nature.

Tilting toward large banks could further reduce risk

Continued action by the Fed, however, could keep putting pressure on the banking sector. Despite these risks, we remain constructive on certain parts of the preferred market, including significant financial institutional (SFI) banks and superregional banks.

SFI banks are large and have already benefited from the fallout triggered by the banking crisis, seeing increased levels of deposits in the months since. These financial institutions have also been subject to the most stringent capital and liquidity rules and provide a wide range of services to a diversified group of clients, lowering their risk. Meanwhile, superregional banks have been preparing for stricter regulatory requirements, leaving them well capitalized. Risks to these banks are also mitigated due to several factors, including increased profitability, a tradition of strong loan underwriting, and diversified revenue streams.

As storm clouds continue to gather over the outlook for the market ahead, we believe that opting for an actively managed preferred securities strategy can provide a benefit for investors. Having the flexibility to tilt toward SFIs and superregional banks could help to dampen some of the risks that persist in the market environment. Active management can also allow investors to receive the attractive yields and forward return potential currently being offered within the market while retaining the flexibility to adjust to shifting market conditions and monetary policy.

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