Preferred Securities Market Update First Quarter 2010

Market Overview

The preferred securities market got off to a strong start in 2010 with a continued trade-up in the first quarter. The Merrill Lynch U.S. Preferred Stock, Fixed Rate $25 Par Index returned 5.60% and the Barclays Capital Securities U.S. Dollar Tier1 Index returned 8.60%.

Review of January Investment Environment

During January, the Merrill Lynch U.S. Preferred Stock, Fixed Rate $25 Par Index returned 0.98% and the Barclays Capital Securities U.S. Dollar Tier1 Index returned 3.53%.

There is an old market proverb that says "as January goes, so goes the market for the year." The Stock Trader's Almanac proclaims this phenomenon to be accurate over 90% of the time since 1950, with only six false signals (last year being one of them). We believe this axiom's predictive power will be not more than a coin flip over the coming years because the investment environment for U.S. stocks is undergoing a permanent climate change – a warming trend for increasing U.S. fixed income allocations which should bode well for preferred securities. This, in turn, should lead to a cooling trend for U.S. equity allocations. Here, the propensity to save more when job prospects are low and cut costs more when debt burdens are high is the natural human response to slowing domestic growth. But the contrary is true for citizens of China whose GDP expanded by 10.7% and growth in manufacturing expanded at its fastest pace in five years. Now confronted with global competitors who are innovating quickly, U.S. policy makers must solve multiple dilemmas such as a jobless recovery, unsustainable social programs and record budget deficits.

After 10 straight months of jubilation, U.S. stock investors sided with caution in January because of the sobering reality of these challenges and only growth constricting solutions. At the same time, there is a populist flare from the Obama Administration this month to punish the bankers for the financial crisis even though it was the politicians who had the lead hand in the policies that encouraged it.

The proposed fees on bank liabilities and surtaxes on banker bonuses to pay for taxpayer losses are two examples of

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political dysfunction. The election of Scott Brown in Massachusetts was indeed a blow to the Obama Administration that could have further repercussions in limiting social expansion after the elections this November.

Preferred securities investors, despite a more sobering macro economic backdrop that led to the decline in stocks, did quite well during January. This is further evidence of the preferred securities market returning to a historically more normal pattern of trading like bonds rather than like stocks. There were some helpful research reports during the month that supported the secondary market bid for preferred securities. One report justified a liability management exercise by the Royal Bank of Scotland that called for a large scale preferred stock tender. Another report predicted below investment grade tier-1 hybrids would outperform high yield debt. Santander also excited investors with a tender for a few series of its subordinated debt. In fact, there was so much exuberance in the preferred market that not even a dividend omission could hold prices down in Bank of Ireland paper where the added possibility of an exchange for common equity caused a 40% rally in the bank's preferred securities.

There were no new issue preferred securities this month.

Review of February Investment Environment

During February, the Merrill Lynch U.S. Preferred Stock, Fixed Rate $25 Par Index returned 2.42% and the Barclays Capital Securities U.S. Dollar Tier1 Index returned 0.63%.

The preferred market was focused on the sovereign risks of the European Union during February as the European Union's response to Greece's fiscal excess set the tone for preferred securities prices – as well as for equity prices and credit, overall. In order to explain why Greece matters, it is important to provide a backdrop: the single European currency created a union of sovereign countries (the "EC" members), each agreeing to fiscal disciplines through the central monetary plan of the European Central Bank. Each EC member would then facilitate this plan through its own National Central Bank (NCB). The keys to the plan's sustainability are: regulation of low inflation, fiscally balanced economic progress and sound purchasing power – all three must prevail in harmony.

In Greece, the harmony has been broken by excessive government debt (relative to its ability to service that debt) in exchange for euros so it can fund government sponsored growth and social services. As no member of the EC has control over sovereign money creation without increasing debt, each individual country has lost control over the traditional "fix-all" via currency devaluation which facilitates increased production of more domestic goods in order to earn more foreign currency to retire domestic debt. Importantly, if Greece were to have its ratings cut, its funding would be at risk because NCBs wouldn't accept Greek bonds as collateral. This could lead to Europe's version of a "sub-prime crisis" where confidence in the Eurosystem breaks down and contagion leads to a bear raid on the next biggest risk (e.g., Portugal, Italy, Ireland and Spain).

We believe the European Central Bank knows that Greece is "too important to fail" because the second order shocks on funding costs from one country to the next could send the entire Eurosystem into a depression. Ultimately, the International Monetary Fund (IMF) may have to play a role diffusing the polarizing political stress among EC sovereign interests. These Euro-zone fiscal issues have been smoldering for some time and will continue to challenge European policy makers as long as social progressivism permeates Europe. Preferred securities prices traded off to lows for the quarter in light of the Greece concerns and the trade-off was more notable in the foreign sector of capital securities due to the large extension-risk concentration in this sector.

Away from the sovereign concerns, there were a number of notable rating agency actions that were favorable, which is of particular note due to the 18 month rout in quality ratings since the Lehman collapse. S&P raised hybrid ratings on Barclays & DnB NOR Bank as both reinstated ordinary common stock dividends. Moody's affirmed the ratings of ING as the restructuring initiatives progressed and also raised the ratings on Citigroup's preferred stock to Caa1 from Ca, perhaps suggesting anticipated success in the U.S. government's sale of its equity stake. Some good news in ratings notwithstanding, Moody's did continue its notching process by downgrading Citigroup's trust preferred one notch to Ba1. There were a number of other notching initiatives during the month, but the market did not react negatively as the indices closed higher by month end.

There were no new issue preferred securities this month.

Review of March Investment Environment

During March, the Merrill Lynch U.S. Preferred Stock, Fixed Rate $25 Par Index returned 2.10% and the Barclays Capital Securities U.S. Dollar Tier1 Index returned 4.24%.

March accelerated the rally that February kicked off after the Greece concerns abated following some reasonable suggested solutions and apparent commitments to not allow the country to fail. The EU Commission president was quoted as saying the "Greece problem is completely over." He also believed that no other country in the EU will suffer a similar fate. The market became somewhat risk complacent in March and chose to ignore that Greece's sovereign debt spread moved wider by month end.

In preferred securities specifically, Moody's continued with ratings notches around the globe that have been well advertized over the past few months as being probable. The big four banks of Australia were notched down to A3, Deutsche Bank was notched to Baa2 and Standard Chartered was dropped a notch to Baa3. Overall, the banks are performing adequately on a fundamental basis. We saw a general "grab-a-thon" in preferred securities this month aided by some constructive Federal Reserve speak on inflation (or lack of inflation) and on continued monetary support for another 4-5 months. The breadth of buy interest was remarkable as high yield investors lifted capital securities that are typically better rated and higher yielding than the BB high yield indices. We also saw the insurance company bid return to the dated sector of hybrid preferred securities. There were a number of other constructive events and initiatives that fostered a favorable tone including: Royal Bank of Scotland announcing its intentions to tender for an array of preferred securities to augment tangible common equity; International Lease Finance issuing senior paper which sparked a rally in its preferred securities; Lloyds Bank stating that it expects to be profitable in 2010; Hartford Financial paying down its TARP money; Comerica announcing it will repay its TARP money; and Citigroup issuing a large retail $25 par deal that was structured for institutions with a five year fixed-to-floating coupon. Notably, the common equity rally has helped to support the euphoria in credit as the U.S. financials index (XLF) broke through a major resistance level ($15 ½) that marked the onset of bank bailouts (i.e., TARP) in 2008.

Two new hybrids were issued in March: US$2.3 billion (Ba1/BB-) Citigroup Group Cap 8.5% $25 par; and US$150 million (A3/A-) Entergy Louisiana 6.0% $25 par.

Strategy & Outlook

We have a constructive outlook on credit, a constructive outlook on regulatory reform in financial services and a constructive outlook on the U.S. economy. Credit fundamentals are supported by cost cutting initiatives and the steep yield curve (which should persist) as well as by a clear resurgence in external liquidity sources that have fostered TARP repayments. Regulatory reform should foster counter-cyclical capital requirements that call for more reserves during good times and thicker core capital.

We expect realignment of bank capital that should lead to new hybrid products like contingent capital and affirmation of trust preferred and non-cumulative preferred stock – all for the purpose of improving bank solvency and the “going concern.”

The U.S. economy is beginning to show signs of self-sustainability in production and services which should bode well for an upturn in employment. We are moving into a more normal credit cycle and investment environment as discount prices are slowly evaporating and causing investors to be more cognizant of spread.

The steepness of the yield curve should continue to make preferred securities a compelling asset class as declining return expectations in equities (due to increasingly muted quarterly EPS comparison by second half of 2010 against the second half of 2009) could foster a rotation into more defensive dividend sectors where income will be the dominant contributor to long run total rate of return expectations.

Hybrid preferred securities spreads should tighten (as they have in past cycles) and help to offset modest increases in U.S. Treasury yields by the end of 2010. Most of this risk will be on the front end of the yield curve (having little impact on preferred securities) rather than the back end as we expect a 2004-type flattening experience in 2011. Preferred spreads would have another 105 basis points to tighten before they mark their tight spreads (posted in 2007) relative to the senior debt of financials.

More positive ratings actions should affirm the improved economic and market environments that are now underway.

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