GLOBAL
Insight
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Wealth Management

Perspectives from the Global Portfolio Advisory Committee

June 3, 2021

Are preferred shares still preferred?

Thomas Garretson, CFA – Minneapolis

Credit market and interest rate risks are in focus this week as the Fed surprised with its plans to sell its corporate bond holdings. But amid those risks we look to a seemingly unlikely place—the preferred share market—and ask whether it can still provide portfolio income, as well as defense, in this environment.

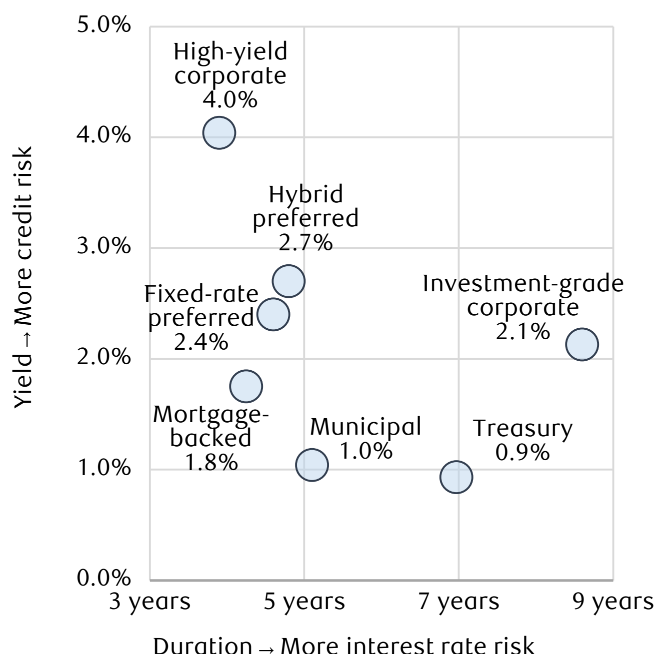
The Fed announced plans this week to begin the gradual process of selling its holdings of U.S. corporate bonds and associated exchange-traded funds (ETFs) on June 7 that were purchased as part of its emergency facilities that were launched in 2020.

While the facilities provided a much-needed backstop for markets during the depths of the pandemic, the actual purchases were quite minimal, with just $5.2 billion in individual investment-grade corporate bonds and $8.6 billion of investment-grade and high-yield ETFs ultimately ending up on the Fed's balance sheet. Put simply, we see this as a non-issue since the market no longer requires the Fed's backstop (corporate bond purchases had already ceased at the end of 2020) and because selling approximately $15 billion worth of securities is barely a drop in the bucket for a U.S. corporate bond market that now exceeds $10 trillion.

Additionally, while this development was a bit of a surprise for markets, we don't think this is a precursor to a near-term tapering of the Fed's ongoing purchases of Treasuries and mortgage-backed securities. We still see tapering beginning early next year and we don't expect that the Fed will sell those holdings into the market, as it's doing with its corporate bond holdings.

But at a time when valuations in credit markets are at historically rich levels—reflecting optimism around the economic outlook—

The U.S. fixed income landscape



Source - RBC Wealth Management, Bloomberg Barclays Indexes, ICE BofA Indexes

For perspectives on the week from our regional analysts, please see pages 3–4.

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For important disclosures, required non-U.S. analyst disclosures, and authors' contact information, see page 6.

the Fed's exit may put a focus on risks in credit markets. So how should investors be thinking about those risks within their fixed income portfolios, and where do we see opportunities at the moment in a still-low-yield world?

Hybrid preferred securities

The U.S. preferred share market is broadly split into two segments. There's the retail investor-focused $25 par fixed-rate coupon market that many may be familiar with that are issued by a wide variety of firms. Then there is the more institutional investor-focused $1,000 par fixed-to-floating rate coupon market, typically called hybrids, which are primarily issued by financial firms, and to a lesser extent, energy companies.

But our focus is on the hybrid market at the moment due to the unique coupon structure that we find attractive in this environment, and because they are largely issued by banks, a sector that we expect to outperform relative to the S&P 500.

Hybrids can also be a natural hedge against many of the concerns that investors harbor at the moment:

Worried about higher inflation? Should higher inflationary pressures persist, that will likely manifest itself in higher yields. But hybrids are uniquely positioned to benefit from higher yields, and banks tend to perform well in higher inflationary periods.

Worried about higher interest rates? If higher inflation fuels higher yields, then the fixed-to-float coupon structure should provide some defense. The coupon is fixed for a period of five or 10 years after which it becomes a floating rate coupon at a predetermined spread to various reference indexes, if not called by the issuer. Most recent new issues in the space will float off of 5-year or 10-year U.S. Treasury note yields—meaning that investors could benefit from higher rates down the road. This structure also has a lower duration—or interest rate sensitivity—than most investors typically associate with preferred shares.

Worried about credit risks? As noted, higher inflation, higher yields, and steeper yield curves are all generally positive for financial services earnings, which should support balance sheets and the credit profiles of companies which issue these securities. On top of that, last week S&P upgraded the credit outlooks for many of the U.S. banks and consumer-focused lenders to positive, reflecting improving industry-wide trends.

With little upside left, what's the downside?

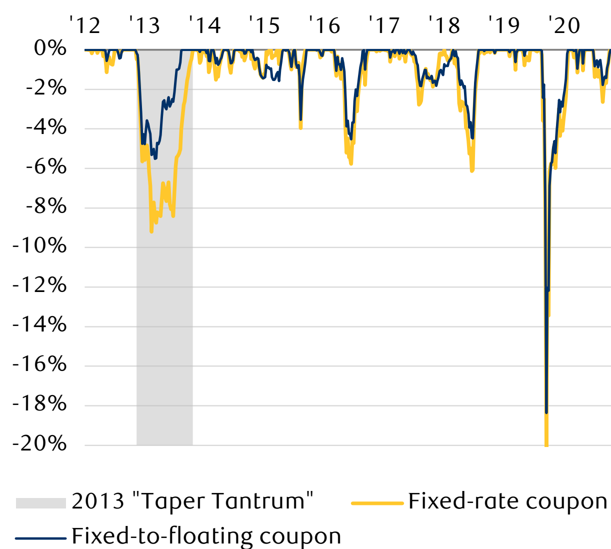
To be sure, valuations across the broad investment spectrum are quite rich at the moment. Therefore, we believe these securities are a way to add income and some defense to portfolios as total returns will be modest at best over the near term, so most investors are likely to be more focused on potential downside risks.

And since preferred shares are uniquely exposed to the two major risk factors for fixed income investors—interest rates and credit quality—the downside risks shouldn't be ignored.

But as the chart shows, the past decade has only seen about four periods of notable selloffs due to either sharply higher Treasury yields, such as in late 2016, or due to stock market corrections, as in 2018. But the period that may be most relevant at the moment would be the "taper tantrum" from 2013 when interest rates spiked following surprise talk from the Fed about ending its third quantitative easing program. We don't expect a similar scenario this time around as the Fed nears a similar point of withdrawing accommodation because Fed policymakers have been much more transparent and vocal in communicating their plans. But it does show how the hybrid structure outperformed fixed-rate preferreds in that episode, dropping by only 5.5 percent compared to nearly 10 percent for the fixed-rate variety.

Most investors may not think of turning to the preferred share market for defense during a time of heightened risks around higher inflation and rates. However, in a challenging yield environment, we believe thinking outside of the box can lead to outsized portfolio performance.

Selloffs for preferred shares typically modest and short-lived



Note: The chart shows the maximum drawdown on a total-return basis from rolling one-year index highs, based on weekly data
Source - RBC Wealth Management, ICE BofA Fixed Rate Preferred Securities Index, ICE BofA US Preferred, Bank Capital & Capital Trust Securities Index

UNITED STATES

Alan Robinson – Seattle

- **Broad stock indexes failed to push to new highs during the shortened trading week as traders booked solid year-to-date profits ahead of the typically quieter summer months**. Average monthly trading volumes have declined this year, with May volumes in the S&P 500 Index down 16% from the January peak and volumes for the first week of June down another 9% from May. Some traders cited uncertainty over the key monthly jobs report to be released on June 4 as another reason for caution.

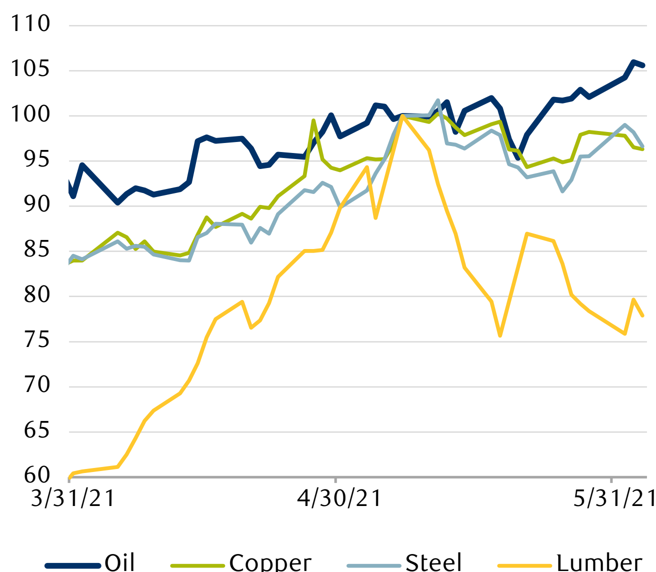
- **An exception to this subdued trading trend was found in a selection of "meme" stocks**, such as Bed Bath & Beyond (BBBY), AMC Entertainment (AMC), and GameStop (GME), that traded with extreme price swings during the week. These typically heavily shorted stocks apparently benefited from short-term traders moving out of cryptocurrency trades.

- In the wake of strong Memorial Day weekend travel trends, RBC Capital Markets, LLC Energy Strategist Michael Tran reiterated his view that **this summer is shaping up to be one of the most constructive for gasoline demand in a decade**, with automobile and aviation fuel demand near new highs. Oil has continued its steady move higher, even as other key commodities peaked in May after climbing steadily during the year (see chart).

- **While we believe this tailwind should continue to benefit Energy sector stocks, some consumer companies have less to cheer**, according to commentary from business leaders presenting at RBC Capital Markets' annual consumer conference. Freight and transportation costs were cited as a major profitability headwind by consumer company CEOs, who expect this pressure to persist into 2022.

- A number of other post-pandemic consumer themes were addressed during the conference. **While the "back to normal" trend should renew consumer spending in activities that were off limits in 2020, some "stay at home" spending habits are proving to be stickier than expected**. Management teams expect structurally higher demand for "home centricity" products and services in the garden, remodel, furnishings, and home cooking areas. Additionally, demand for activewear remains very strong even as consumers shop more for "going out" apparel.

Oil marches higher as other key commodities fade



Benchmark U.S. commodity daily closing prices, normalized with 5/7/21 = 100
Source - RBC Wealth Management, FactSet

CANADA

Carolyn Schroeder & Richard Tan, CFA – Toronto

- The last of **the Big Six Canadian banks reported quarterly results** earlier this week, and it was a clean sweep with **earnings coming in ahead of consensus expectations across the board**. The favourable results were primarily driven by better-than-expected credit provisions, and some banks released reserves back into earnings. As we head into the back half of the year, we believe **there are a number of catalysts that can push stock prices higher**, including an improving credit environment, a pickup in loan growth, stronger net interest margins, and the potential for easing capital restrictions. On average, the group's capital ratio strengthened by 30 basis points sequentially to 12.8% as of Q2 2021. If capital restrictions are lifted, we believe many banks will take advantage of share buybacks. Dividend increases are also a possibility but more likely a 2022 scenario, in our opinion. Overall, we believe the setup for Canadian banks remains attractive.

- **Canadian real GDP rose 5.6% (annualized) in Q1 2021**, below consensus expectations of 6.8%, following a 9.3% increase in Q4 2020. Despite weak household spending on services due to the COVID-19 threat over the winter months, **the Canadian economy proved resilient through the third wave of the virus** and containment measures. Federal government supports remain largely in place, and have ostensibly put a floor under household incomes. In Q1, household disposable incomes were running almost 11% above pre-shock (Q4 2019) levels and households added another CA$47 billion of savings in the quarter. Overall, **it appears that meaningful household purchasing power remains in place to support a relatively quick recovery in spending** as the virus containment measures ease. Preliminary information from Statistics Canada indicates an approximate 0.8% decline in real GDP in April, the first decline since April 2020 as COVID-19 lockdowns were extended in some regions of the country.

EUROPE

Frédérique Carrier – London

- **European economic data continued to surprise on the upside**. The IHS Markit Eurozone Composite Purchasing Managers' Index (PMI) reached 57.1 and the IHS Markit Eurozone Services PMI extended to 55.1, both marginally higher than consensus expected. The recovery in manufacturing has been evident for some time, and it is **encouraging to see the pickup in the services sector**. RBC Capital Markets points out that the latter also translated into an increase in hiring, with the employment sub-index reaching its highest level since early 2019.

- **We expect the European Central Bank (ECB) to remain dovish at its June 10 policy meeting** and keep guidance for its Pandemic Emergency Purchase Programme unchanged for Q3. **While the recovery is unfolding at a very encouraging pace, it is still in its infancy**. Moreover, ECB officials still see rising inflation pressures as transitory. RBC Capital Markets expects the ECB staff forecasts to show inflation remaining unchanged and below the 2% target at the end of the forecast horizon, which extends to 2023. Finally, we believe the ECB will want to honour its pledge to keep financial conditions loose as its rhetoric has turned substantially more dovish over the past 10 days, indicating, in our view, its reluctance to change tack at this stage.

ASIA PACIFIC

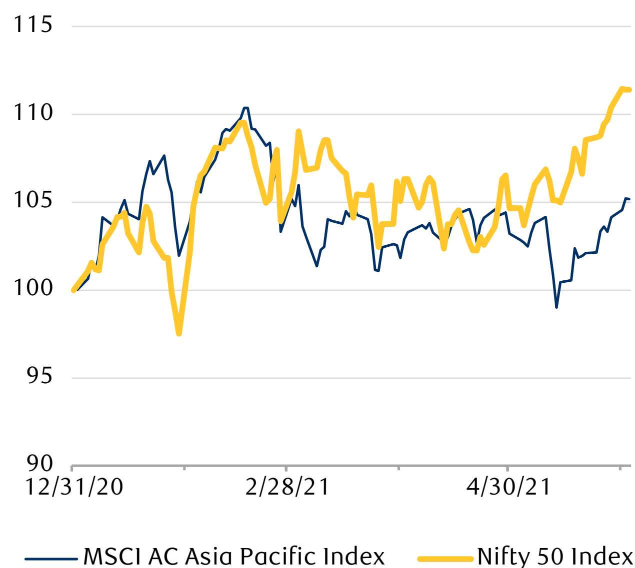
Jasmine Duan – Hong Kong & Nicholas Gwee, CFA – Singapore

- **Asia Pacific equity markets have traded higher during the week** led by the ASEAN countries (Southeast Asia). **Japan and China markets traded lower** after a strong finish in late May. Meanwhile, the MSCI AC Asia Pacific Index is again attempting to break the resistance level at US$210.

- **India's Q1 GDP was stronger than expected** (+1.6% y/y vs. +1.0% y/y Bloomberg survey). Despite the beat, **economists are increasingly pessimistic about Q2 growth prospects** following the latest wave of COVID-19 cases with the emergence of the Delta variant. As of May 31, India had recorded 28 million COVID-19 cases, second only to the U.S., and 329,100 deaths. The near-term economic outlook is weighed down by declining household incomes and jobs, and limited room for further stimulus support on the back of rising debt. Despite these headwinds, India's Nifty 50 Index is trading at an all-time high, outperforming the MSCI AC Asia Pacific Index by more than 5% YTD. We maintain our neutral view on Indian equities as we believe the prospects of earnings improvement have been largely priced in, and the market's valuation is more balanced relative to the broader emerging markets.

Indian equity market outperformed the region

Total return (year to date)



Source - RBC Wealth Management, Bloomberg; daily data through 6/2/21

- **China will allow couples to have a third child** after census data showed a continuous decline in birth rates. China scrapped its decades-old one-child policy in 2016, replacing it with a two-child limit, which has failed to lead to a sustained upsurge in births. China's declining birth rate means the population may soon begin shrinking. Because of the demographic slowdown, Bloomberg Economics estimates the population of the world's most populous country could peak before 2025. Notwithstanding the potentially limited impact from the new policy, **the news has boosted the share prices for "third child" related stocks**. Those of toy maker Goldlok Holdings (002348 CH), infant and maternity merchandise maker Jinfa Labi Maternity & Baby Articles (002762 CH), and milk powder maker Beingmate (002570 CH) have all risen more than 10% during the week.

MARKET Scorecard

Data as of June 3, 2021

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	4,192.85	-0.3%	11.6%	34.3%	52.8%
Dow Industrials (DJIA)	34,577.04	0.1%	13.0%	31.6%	39.3%
Nasdaq	13,614.51	-1.0%	5.6%	40.6%	85.7%
Russell 2000	2,279.25	0.5%	15.4%	57.0%	55.1%
S&P/TSX Comp	19,941.39	1.1%	14.4%	28.0%	24.5%
FTSE All-Share	4,039.19	0.6%	10.0%	14.4%	2.7%
STOXX Europe 600	450.79	0.9%	13.0%	22.2%	21.7%
EURO STOXX 50	4,079.24	1.0%	14.8%	24.8%	23.6%
Hang Seng	28,966.03	-0.6%	6.4%	19.1%	7.7%
Shanghai Comp	3,584.21	-0.9%	3.2%	22.6%	24.0%
Nikkei 225	29,058.11	0.7%	5.9%	28.5%	42.4%
India Sensex	52,232.43	0.6%	9.4%	53.1%	29.7%
Singapore Straits Times	3,165.00	0.0%	11.3%	17.2%	1.3%
Brazil Ibovespa	129,601.40	2.7%	8.9%	39.4%	33.6%
Mexican Bolsa IPC	50,628.77	-0.5%	14.9%	32.2%	17.4%
Gov't bonds (bps change)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. 10-Yr Treasury	1.623%	2.9	71.0	87.8	-44.8
Canada 10-Yr	1.521%	3.5	84.4	90.2	10.1
UK 10-Yr	0.841%	4.6	64.4	56.7	-2.1
Germany 10-Yr	-0.183%	0.4	38.6	17.1	1.8
Fixed income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	1.51%	-0.1%	-2.4%	-0.2%	17.1%
U.S. Investment-Grade Corp	2.13%	-0.1%	-2.9%	3.4%	23.3%
U.S. High-Yield Corp	4.04%	0.2%	2.4%	13.0%	20.3%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,870.87	-1.9%	-1.4%	10.1%	41.2%
Silver (spot $/oz)	27.44	-2.1%	3.9%	55.5%	85.6%
Copper ($/metric ton)	10,130.65	-1.1%	30.7%	84.2%	74.2%
Oil (WTI spot/bbl)	68.81	3.8%	41.8%	84.5%	29.2%
Oil (Brent spot/bbl)	71.35	2.9%	37.7%	79.3%	16.4%
Natural Gas ($/mmBtu)	3.06	2.6%	20.6%	68.2%	27.5%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	90.4820	0.7%	0.6%	-7.0%	-6.9%
CAD/USD	0.8262	-0.3%	5.2%	11.5%	11.0%
USD/CAD	1.2104	0.3%	-4.9%	-10.3%	-9.9%
EUR/USD	1.2129	-0.8%	-0.7%	8.0%	7.9%
GBP/USD	1.4108	-0.7%	3.2%	12.2%	11.4%
AUD/USD	0.7660	-1.0%	-0.4%	10.7%	9.8%
USD/JPY	110.3000	0.7%	6.8%	1.3%	2.1%
EUR/JPY	133.7800	-0.1%	6.0%	9.4%	10.1%
EUR/GBP	0.8597	-0.1%	-3.8%	-3.8%	-3.1%
EUR/CHF	1.0958	-0.3%	1.3%	1.5%	-1.8%
USD/SGD	1.3281	0.5%	0.5%	-5.0%	-2.8%
USD/CNY	6.4038	0.5%	-1.9%	-7.8%	-7.2%
USD/MXN	20.1646	1.1%	1.3%	-7.4%	2.0%
USD/BRL	5.0764	-2.7%	-2.3%	34.3%	30.6%

Equity returns do not include dividends, except for the Brazilian Ibovespa. Bond yields in local currencies. Copper Index data and U.S. fixed income returns as of Wednesday's close. Dollar Index measures USD vs. six major currencies. Currency rates reflect market convention (CAD/USD is the exception). Currency returns quoted in terms of the first currency in each pairing.

Examples of how to interpret currency data: CAD/USD 0.82 means 1 Canadian dollar will buy 0.82 U.S. dollar. CAD/USD 5.2% return means the Canadian dollar rose 5.2% vs. the U.S. dollar year to date. USD/JPY 110.30 means 1 U.S. dollar will buy 110.30 yen. USD/JPY 6.8% return means the U.S. dollar rose 6.8% vs. the yen year to date.

Source - Bloomberg; data as of 4:35 pm ET 6/3/21

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As of March 31, 2021

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Hold [Sector Perform]	559	40.68	179	32.02
Sell [Underperform]	53	3.86	4	7.55

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