Preferred securities

Best quarter in nearly a decade

Preferreds are off and running! In the first quarter of 2019, the preferred securities sector delivered some of its best returns in nearly 10 years. The USD 25 par preferreds gained 8.8%, while the BB rated USD 1,000 pars surged 9.4%. These are based on indices that were launched 6–7 years ago, so they represent the best returns on record for these benchmarks, and in both cases they shatter the previous records. The USD 25 pars gained 7.4% in early 2014, while the BB USD 1,000 pars returned 4.9% in the third quarter of 2016. The legacy USD 25 par index (which is less inclusive) gained 8.7% in this year's first quarter, just shy of its previous high return in the third quarter of 2010.

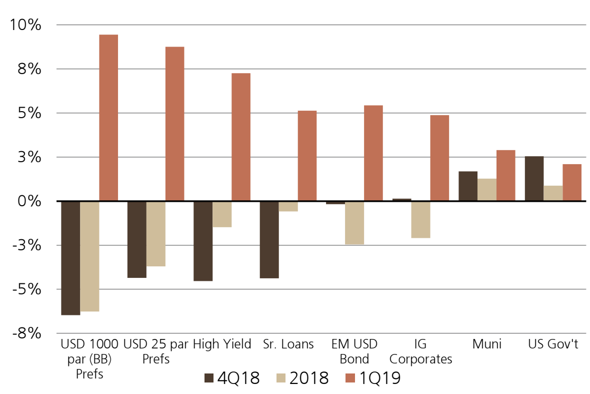
With these returns, preferreds are outperforming most other fixed income sectors so far this year. However, it is important to keep in mind that this is largely a snapback from the underperformance that we saw in the final quarter of 2018. Late last year, preferreds posted their worst returns since the financial crisis and underperformed most other sectors. The fourth quarter began with a spike in interest rates and ended with a surge in credit spreads. As a result, preferreds posted a quarterly loss of 4.4% for USD 25 pars and 6.5% for BB USD 1000 pars. So, the sector's best quarterly performance is largely a reaction to its worst. We continue to expect preferred sector performance to track a "two steps forward, one step back" pattern, although in the preceding quarters it has been more like one huge stagger back and one giant leap forward.

When considering preferred performance from here, clearly the recent trajectory will be hard to sustain. We do not expect a full-year return of 30% or more! However, the backdrop should remain supportive from both an interest rate and credit risk perspective as outlined in the lead article. In the first quarter, interest rates were remarkably stable with the 10-year Treasury yield remaining in a tight range between 2.6% and 2.75% for most of the period. The 10-year Treasury yield broke the lower bound of the range after the Fed's March meeting. At CIO, we expect the Fed to remain "on hold" through 2020, which should support a more stable rate environment.

From a credit risk perspective, we expect global growth to stabilize and rebound as we move further into 2019, so we do not foresee a material widening in credit spreads because of economic deterioration. And preferreds offer adequate compensation given the current level of yield premiums. These are in line with or above three-year averages. So while it looks as though preferred performance in 2019 will be "front-end loaded," we expect the backdrop to allow preferreds to retain and even incrementally add to the first quarter's performance, albeit with some fits and starts, such that the sector ends the year with solid returns.

From worst to best: preferreds have had a strong comeback

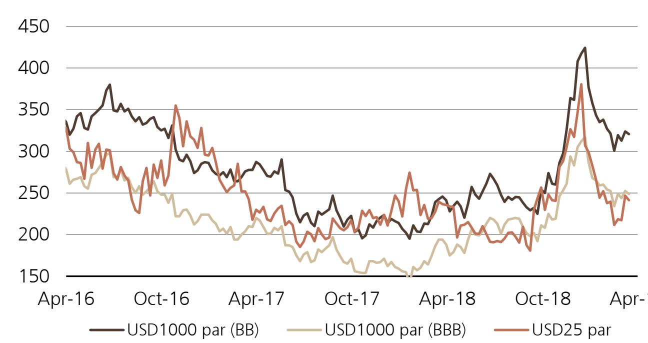
Total returns, in %



Source: Bloomberg, ICE BAML, UBS, as of 31 March 2019

Preferred yield spreads are reasonable

Yield spread over Treasuries, in bps



Source: Bloomberg, ICE BAML, UBS, as of 31 March 2019
Based on yield of ICE BAML US HY and IG Institutional Cap Securities Indexes and adjusted-yield of Core Plus Fixed Rate Preferred Index