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04 March 2022

Hybrid Capital Outlook

Sanlam Fixed Income

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- **The combination of macro and geopolitical risks has driven credit market valuations year to date causing a material market repricing**
- **Some negative sentiment in the legacy debt space following comments from certain banks in relation to their approach to the rules has cheapened up that sub sector to very attractive levels**
- **We fully expect some further short-term volatility, but the combination of valuations and supportive outlook of higher interest rates for earnings leaves us with a constructive outlook on a 12-to-18-month basis.**

Specific thoughts on valuations and yields:

- The most credit-sensitive sectors are AT1 (c. -5 % YTD) and US Preferred Stock (c.-9% YTD). However, the higher-quality Tier 2 space has also suffered, largely from rates/duration as much as anything. For example, UTMOST 4% Tier 2 is trading at 91/92 (with a 5% yield) and UTMOST 6.125% Tier 1 is trading at 94/95 (c. 7% yield). Both bonds priced at 100 in the last year. This has happened despite the fact that this is a sound business, with no change in its ability to pay etc.
- In terms of current valuation, mainstream AT1 debt is now back to a 5-6.5% range yield and anything slightly 'off the run' is back to a 6-7.75% range.
- Preference shares are back to the 6.5-8% range – even for high-quality cumulative paper.
- The legacy book – that is, bonds falling out of the regulatory framework due to rule changes – has been under a bit of pressure. In our view, this legacy debt is now a great store of value with good upside potential in 2022/23.
- The new issue (primary) market has been closed for a month, but this is just about ready to re-open, and we expect new issue premiums to be very generous in order for issuers to get deals away successfully. These will continue to provide attractive opportunities for the Fund.
- Importantly, we have no single names with anything approaching credit issues or with any question marks over their ability to pay on time and in full.

In summary, we believe the hybrid market to be in a similar position to the early 2019 with a lot of value in the market attractive yields to buy and hold, but enough uncertainty to prevent any very near-term catalysts for huge performance.

However, timing that change in outlook is pretty much impossible, so we have stayed invested. We can see a path to 2 to 3-year annualised returns of 5-6 % p.a. in any normalisation and this includes whatever the Fed or Bank of England may choose to do on interest rates. Obviously, the continued extreme geopolitical risks will affect the timing of any returns.

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Data source: Bloomberg
As of: 02/02/2022

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