NATIONAL BANK OF CANADA
FINANCIAL MARKETS

Preferred Shares

Research Services

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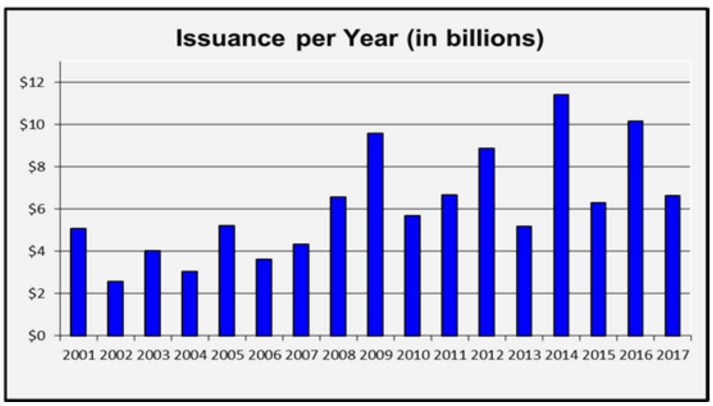
December

Preferred Shares – A Look Ahead to 2018

New Issues Review

In this report we take a quick look at what to expect for 2018. In 2017, we saw issuers raise $6.82 billion of which 86% was perpetual rate-resets, 11% perpetual fixed-rates and two small issues of other structures. Once again financial led the way with 52% of the issuance (over 60% the previous three years), 17.5% for utility/power companies, 18.3% for energy companies and the remaining came from real estate issuers. The quality of new issuance was more diverse than previous years, Pfd-2 led the way with 32.2% issues, Pfd-3 (high) 22%, 16.1% for Pfd-2L and Pfd-3 and the remaining from the 3 other ratings.



Source: NBF

New Issues Outlook

In 2018, 25 perpetual rate-reset will hit their anniversary date for call or reset. That represents $5.479 billion in potential rate-reset refinancing and $678 million in floating reset. The issuer has to call both series, it can't just call the fixed or the floater. The average reset spread of those issues is 269bps, which is below the current average and spreads, however if rates rise, many of those issues could get called. Banks will have $1.51 billion of Non-Viable Contingent Capital (NVCC) reset ($678 floating and $835 reset) that will reset and with its eventual non capital qualification have a higher call probability even with its below average reset spread. Adding to this a phasing out of another 10% of non-NVCC securities, leads to expect bank to issue between $2-3 billion in 2018. Another issuer we expect to issue in 2018 is Enbridge as they have approximately $4 billion hybrid securities or preferred shares to be issued prior to the end of 2018. The preferred market would be able to absorb at a maximum $1 billion from Enbridge but they would have to pay 5-10bps above market rate in our opinion as they are already the largest issuer in the market with $7.675 currently in the market. At current prices, a flat or rising 5-year Canada, existing discounted Enbridge rate-reset over better value. Overall we are expecting an average year in term of new issuance, ranging between $6.5-7.5 billion (10 year average $7.72 billion)

Interest Rate outlook

On December 6th, the Bank of Canada left the overnight rate at 1.00%. The central bank acknowledged growth remain above potential in the second half of 2017 and recognized that the recent uptrend in core inflation reflects "the continued absorption of economic slack". While the central bank recognised strong employment growth and rising wages, it still sees some slack in the labour market "albeit diminishing". The Bank of Canada maintained their more dovish tone than expected. NBF Economic and Strategy believes this statement did not set the table for a January move, one can't rule out such outcome if, as we think, the labour market remains firm, wage inflation continues to percolate, core inflation moves up gradually, and Q4 shows continuing momentum. It's possible that January's MPR shows growth upgrades to reflect recently announced fiscal stimulus at the provincial level. NBF Economic and Strategy continues to think that monetary policy is too loose. They believe one would be hard-pressed to find prior instances outside of a recession with a similar combination of a near-zero output gap and a negative real overnight rate. The Bank of Canada is facing an uneasy arbitrage in the coming months. How to adjust monetary policy when the unemployment rate has fallen to 5.9%, one tick above its 40- year low, and NAFTA remains a bag of uncertainties. The output gap has closed in Canada. The Bank sees the economy growing above potential in 2018 and inflation accelerating to 2%. Yet the overnight rate, at 1.0%, is being kept below the current inflation rate of 1.4%, blowing a tailwind on increasing household debt. So some withdrawal of monetary-policy stimulus is obviously justified under current conditions.

Canada

Quarters	Overnight	3 Mth Bill	2YR	5YR	10YR	30YR
12/01/17	1.00	0.90	1.52	1.69	1.91	2.20
Q4	1.00	0.96	1.51	1.71	1.97	2.28
Q1/18	1.25	1.42	1.67	1.95	2.23	2.56
Q2	1.50	1.68	1.95	2.17	2.50	2.84
Q3	1.75	1.90	2.09	2.30	2.64	2.95
Q4	2.00	1.96	2.26	2.38	2.70	2.98
Q1/19	2.00	1.96	2.31	2.57	2.86	3.13
Q2	2.00	2.18	2.35	2.61	2.92	3.18
Q3	2.25	2.21	2.48	2.74	3.02	3.26
Q4	2.25	2.21	2.55	2.77	3.05	3.29

ETF

Asset under management in preferred share ETFs grew 51.84% in 2017 (up to December 1st). Nine new preferred share ETFs were launched with only Dynamic iShares active preferred shares ETF (DXP) being the only one making an impact and attracting funds with $330 million in AUM. With a little over $7 billion in asset under management in ETFs (~8.7% of market) and higher percentage of the daily flow, the evolution of the preferred share ETF market with significant inflows or outflows will have noteworthy impact on the overall performance of this market. With approximately $2 billion in new inflows into the preferred ETF market, the largest impact would be felt in passively managed ETFs since their asset purchase just follows the methodology; whereas actively managed ones can be more prudent and selective. Large inflows will have an impact in the actively managed ones, just a lower shock. Although ZPR (passive) is the largest preferred ETF, its inflows have slowed and investors have tuned to the actively managed ETFS we have been recommending (ETF HPR, HFP, DXP and RPF). These inflows have help support the reset market but in the past we have seen it also accentuates selloffs. We recommend managed ETFs, HFP currently being our favorite, with DXP, HPR and RFP also being interesting ETFs. We favor these ETFs not only for their outperformance but mostly due to them being actively managed. Preferred shares do not trade in an efficient market making passive ETFs in our opinion a less than optimal selection. Long term, actively managed has outperformed in this market. As we expect rates to slowly rise, we prefer for the moment ETFs with lower fixed-rate exposure.

ETF	Y-T-D Total Return*
Passive	
iShares S&P/TSX Canadian Pref. Share (CPD)	12.64%
BMO Laddered Preferred Share Index (ZPR)	13.54%
Active	
Horizons Active Preferred Share (HPR)	14.69%
Horizons Active Floating Rate Pref. HFP)	16.28%
RBC Canadian Preferred Share (RPF)	15.27%
Dynamic iShares Active Pref. Shares* (DXP)	12.99%

Source: Bloomberg
* since January 25, 2017
* Y-T-D up to December 11, 2017

Date	CPD	ZPR	HPR	RPF	DXP	Total
2016-05-31	1,191	1,280	675			3,643
2016-06-30	1,185	1,226	691			3,607
2016-07-29	1,185	1,260	736			3,710
2016-08-31	1,214	1,228	775			3,756
2016-09-30	1,199	1,228	817	7		3,797
2016-10-31	1,229	1,312	846	32		3,987
2016-11-30	1,216	1,402	851	82		4,147
2016-12-30	1,278	1,611	940	147		4,612
2017-01-31	1,322	1,828	1,001	208	9	5,010
2017-02-28	1,349	1,926	1,022	272	56	5,284
2017-03-31	1,379	2,012	1,075	330	82	5,581
2017-04-28	1,411	2,036	1,088	373	104	5,741
2017-05-31	1,376	1,995	1,099	401	112	5,700
2017-06-30	1,421	2,210	1,185	439	154	6,163
2017-07-31	1,450	2,239	1,240	462	178	6,342
2017-08-31	1,452	2,213	1,276	489	216	6,423
2017-09-29	1,484	2,234	1,362	537	240	6,673
2017-10-31	1,505	2,211	1,414	595	280	6,850
2017-11-30	1,500	2,166	1,477	645	330	7,003

Source: NBF
Total includes all preferred
share ETFS

A look a head

Perpetual Fixed-Rate Preferred Shares

In 2017, four perpetual fixed-rate preferred shares were issued, all from insurers (including Power Financial), although we are not expecting many issues in 2018, 1-3 issues should be expected. Insurers have different funding needs and tend to do a lot of asset/liability matching and most probably if we get a new issue it would be from this industry. Historically fixed-rate preferred shares performed poorly in a rising interest rate market given they are perpetual in nature (no maturity) and thus have a long duration. This creates an inverse relationship with interest rates. Although fixed-rates have a long duration, historically in a non-depressed rate environment, this structure has been correlated with 10-year bonds. 10-year Canada bonds opened the year at 1.736% peaked at 2.134% and currently stand 1.85% (December 11). Rates rose this year but not proportionally and we saw the yield curve flatten. Performance in this structure was relatively strong but saw some weakness in Q3 when rates were at their highest. With projection having 10 years rising 75bps next year this structure should remain on the backburner of investors. For the most part, fixed-rates are more than fairly valued and we envision better entry in mid-2018.

Perpetual Fixed-reset Rate Preferred Shares

Perpetual Fixed-resets have become the dominant structure within the preferred share world. It has grown to be approximately 75% of market and over 80% of new issuance. With contraction in other structures and robust investor demand, we do not see anything changing for 2018. With 5-year Canadas rates have the largest impact on this structure, relatively speaking as this rate rises (or projected) resets should follow. This benchmark rate opened the year at 1.155%, peaked at 1.82% and currently sits at 1.67%. NBF's Economic and Strategy project this rate rising 70bps in 2018, which if occurs will be very beneficial for the secondary market. The average current yield on fixed-rate is currently 4.76%, however this does not tell the entire story. Fixed-rates are a complicated structure and reset, spread, the date/year they will reset and the issuer quality will have an important role. The market is currently priced for a 1.55% rate environment thus for the most part priced at market and not pricing in much rise in 5-year Canadas. We analyse this structure within scenario analysis and if we see rates rise to the 2% range, the market on average should see 5% price appreciation. All non-financial issued after August 2015 carried a minimum rate guarantee with has now become the standard and have removed most of the yield downside. 2015-2016 issues carry above average reset spreads and thus have a very high call probability. These high spread, high call probability rate-resets should be analysed on a yield-to-call (y-t-c) and currently trade at an approximately 75bps spread to comparable bonds. Although at first sight, these returns do not stand out and trade at significant premiums (capital loss if called), the dividend taxation advantage added with the low volatility makes these decent investment for investors looking for low risk preferred shares. The spread over corporate bonds on these issues should be maintained in 2018. If spreads contracting on higher rates, Q3-Q4 2017 new issues do not have those very high spreads, lower call probability and should be analysed on both a current yield and y-t-c. Going forward into 2018, we expect spread to continue to contract and call probability on new issues to decrease.

If the market is more or less fairly valued are resets interesting? We believe there is still currently value in mid/late 2018 and 2019 rate-resets. We run scenario analysis to look for the value and down side risk. Our base case scenario is 5-year Canadas are at 1.50% (below where they are), and our base case indicates the market would be little changed under that scenario. Although preferred shares are equity in terms of balance sheet placement, the asset category they fall under is fixed-income, therefore for the most part we are investing significantly more for income than capital appreciation, thus in our base case the market accomplishes what it should. Economics and Strategy have 5-year Canadas projected to be significantly above 2% for most of 2018-2019, we use 2% as our best case scenario as rate projections have historically been difficult to predict. Having said that, economic data continues to be projected with Canadian economy doing better thus making monetary stimulus less needed. The rising consumer debt levels remain a concern increasing our confidence that rates will continue to slowly trend upwards. We look at 2018-2019 rate-resets a the sweet part of the market for two reasons: 1) rate projections or economic projections too difficult to predict 2 years out 2) 2010 issued reset had low spread and were reset in a historically low rate environment in 2015 thus making them much less interesting on a yield basis and 2015 issued reset have high spread and high call probability. The 2018-2019 for the most part trade at a discount, offer close to market rate yield and if rate reach our best case scenario (2%), offer a very intriguing total return.

The table below is a summary of the average current yield if reset under the different rate scenarios.

Year	Current	1.00%	1.25%	1.50%	1.75%	2.00%
2018	4.65%	4.05%	4.32%	4.60%	4.87%	5.15%
2019	4.83%	4.11%	4.38%	4.66%	4.93%	5.20%
2020	4.35%	4.07%	4.36%	4.65%	4.94%	5.23%
2021	4.66%	4.74%	5.04%	5.33%	5.63%	5.92%
2022	5.12%	4.50%	4.77%	5.04%	5.31%	5.59%

Sources: NBF

Perpetual Floating and Reset-Floating Preferred Shares

Prime floating rate and 91 days floating-reset preferred were the two structure the performed the best in 2017. Floating preferred shares help protect investors in rising rate environment. The gains seen in these two structures where partly due to rising short term rates but they also started from an undervalued position. These structures are more than fairly valued and although will benefit from rising rates they do not offer the best value. There is currently a minimal price differential (0.6%) between the fix and floating reset section and given the income differential and the lower liquidity, we recommend rate reset over floaters. Our current position is at conversion date, we recommend investors stay with the fixed versus converting into the floater.

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