GLOBAL X ETFs RESEARCH

# Preferred Stock Outlook in the Wake of the Banking Sector Shakeout

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Last year, equities and fixed income underwent a significant shift as the Federal Reserve embarked on its most potent tightening campaign since the 1980s to combat inflation levels not seen in decades.[1] In the first quarter of 2023, the results of some of these policy changes began to percolate into the banking sector specifically. A few high-profile incidents in the regional banking sector of the market began leading to depositor uncertainty. Preferred stocks became one pocket of the market investors began to zero in on as the fallout from the regional banking sector issues were analyzed by market participants. As financial institutions are the primary issuers of preferreds, in this piece, we seek to provide an update on the U.S. banking sector while delving deeper into the broader issues affecting regional banks and more specifically, our current outlook for preferreds.

## Key Takeaways

- The latest strains affecting U.S. regional banks have intensified the spotlight on the health of the country's banking sector. Relative to the past, the present status of the banking sector may be more positive than the market is giving it credit for.
- "Big Bank" common equity and preferreds have held up against regional banks, showing where investor fear is being concentrated in the markets, and in our opinion, signals low contagion risk for well diversified banks.
- The Global X U.S. Preferred ETF (PFFD) offers exposure to a broad basket of U.S. preferred stocks, an asset class that has historically offered higher yield potential compared to others. With a higher level of exposure to Global Systemically Important Banks ("GSIBs") relative to its regional bank preferred holdings, PFFD may be well positioned for the prevailing economic conditions.

## Historical Bank Failures and the Impact on Preferreds

The recent banking turmoil involving three major coastal-based banks - Silicon Valley Bank, Signature Bank, and First Republic - has sparked concern within the financial sector about whether these are contained issues or more widespread across the banking sector. Investors are evaluating the possibility of any potential contagion effects for US banks. Preferred stocks, which have typically been issued by financial institutions, specifically banks, is one pocket of the market where the fallout from specific coastal-based banks raised questions about the outlook for this asset class. Although these recent events may appear infrequent, partly due to the historically sparse number of bank failures since 2017, it is important to note that there is a precedent for bank failures, as shown in the graph below.

### Related ETFs

Please click below for fund holdings and important performance information.

PFFD – Global X U.S. Preferred ETF

PFFV – Global X Variable Rate Preferred ETF

SPFF – Global X SuperIncome Preferred ETF

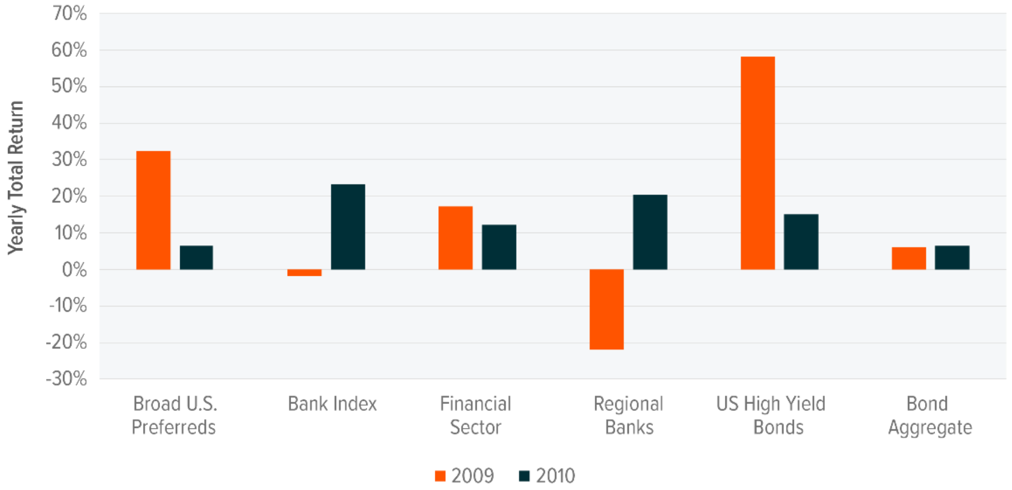
## U.S. BANK FAILURES SINCE 2001 TO 2023

Source: FDIC, data measured annually from 2001 to 5/1/2023.


During the Great Financial Crisis (GFS), bank equity performance was negatively impacted by bank closures with bank failures peaking at 157 in 2010 and only slightly less the year prior. Regional banks were not immune to the domino effect of bank failures with the regional bank index and broad bank index declining -22.06% and -1.76% in 2009, respectively.[2] Preferreds, however, as represented by the S&P U.S. Preferred Stock Index, returned 32.12% in 2009 and 6.36% the following year, indicating that preferred shares may not be as correlated to overall banking conditions compared to banks common equity counterpart.[3]

## ASSET CLASS PERFORMANCE DURING 2009 & 2010

Source: Bloomberg, data from 12/31/2008 to 12/31/2010. Broad U.S. Preferreds, are represented by the S&P U.S. Preferred Stock Index; Bank Index is represented by the KBW Nasdaq Bank Index; Regional Banks are represented by the KBW Nasdaq Regional Banking Index; US High Yield Bonds are represented by the Bloomberg US Corporate High Yield Bond Index; Bond Aggregate is represented by the Bloomberg US Aggregate Total Return Index; Financial Sector is represented by the S&P 500 Financials Index.




Upon comparing the current banking landscape to that of the Global Financial Crisis (GFC), it becomes increasingly apparent that the differences are more significant than the similarities to that period. The GFC was characterized by losses in complex derivatives and collateralized subprime mortgage-backed products. In the years leading up to the GFC, these mortgage-backed products were repackaged and assigned an investment grade rating whose issuance was primarily concentrated in the hands of large, diversified banks. However, the present predicament primarily revolves around regional U.S. banks that are confronting a challenging environment due to the

Federal Reserve's decision to increase interest rates. These hikes elevated borrowing costs and caused high-quality loans to go underwater, resulting in a decrease in profit margins. The ensuing deposit outflows caused an asset-liability mismatch and further exacerbated perceived risk. This led to more deposit outflows, culminating in bank runs at some of the most acutely affected regional banks.

## Collapse of SVB, Signature Bank and First Republic Bank

A series of major events shook the US banking industry, beginning on March 10, 2023, with the failure of Silicon Valley Bank (SVB), the 16th largest bank in the United States. This marked the largest bank failure since the GFC.[4] SVB, based in Santa Clara, California, experienced a rapid outflow of deposits that escalated into a bank run after reporting a significant sale of “held to maturity” bond assets and a failed capital raise. The bank's extensive lending to higher-risk technology startups, which were adversely affected by tightening financial conditions and reduced investments from venture capital partners, coupled with 89% of the bank's $175 billion deposits being uninsured and exceeding the $250,000 FDIC-insured limit as of the end of 2022, played a crucial role in its collapse.[5] Two days later, Signature Bank, a prominent crypto bank in California, encountered operational difficulties primarily attributed to mismanagement, including challenges related to crypto oversight, corporate governance, and a delayed response to the Federal Deposit Insurance Corporation’s (FDIC's) recommendations. These developments raised concerns among regulators, prompting depositors to increase their withdrawals amid growing apprehension about the potential for contagion risk.

In the aftermath of these two collapses, both SVB and Signature Bank entered receivership under the FDIC. However, the tremors did not end there. On May 1, 2023, First Republic Bank (FRC) in California suffered a similar fate. This time, the FDIC and California regulators announced the sale of all $93.5 billion of the bank's deposits and most of its assets to JP Morgan for $10.6 billion. The deal caused a significant loss for First Republic's investors, and is estimated to have cost the FDIC's insurance fund approximately $13 billion. While these three banks catered to different borrowers, all three had a heavy number of uninsured depositors due to their focus on high-net-worth individuals and entities.[6]

### TIMELINE OF THE BANKING DEBACLE

Source: Global X research, data as of 05/01/2023.

**10th Mar ‘23**

Biggest faliure since the 2008 financial crisis,
'Silicon Valley Bank' collapsed after a bank run on deposits.

The collapse followed by receivership by FDIC.

**12th Mar ‘23**

New York Regulators shut down 'Signature Bank',
over concerns regarding stability of the financial system

Similar to SVB, recieved receivership under FDIC.

**14th Mar ‘23**

Large U.S. banks including JP Morgan Chase,
Wells Fargo and Citigroup reported robust Q1 earnings.

First republic recorded loss of $102bn in customer deposits.

**1st May ‘23**

First republic bank (FRC) was taken over by FDIC
and immediately sold to JP Morgan Chase.

FRC turned out to be the second biggest U.S. bank crash
since collapse of Washington Mutual in 2008.

## Biggest U.S. Banks Reported Bumper Profits Amid Industry Turmoil

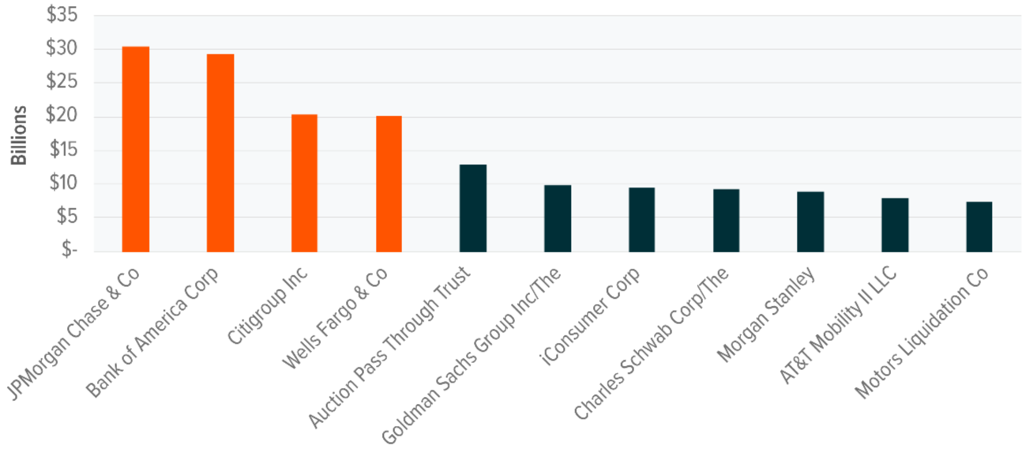
Amidst the recent failures within the banking sector, it is notable that the largest banks in the United States have emerged relatively unscathed, as demonstrated by their strong first-quarter earnings. We do believe these series of events in the regional banking space may result in larger, more diversified banks benefiting in the future due to their more diversified risk profile. Q1 2023 earnings from some of the banks may be evidence of this. Out of the nine diversified banks within the S&P 500, seven exceeded earnings expectations, with KeyCorp and US Bancorp being the only exceptions in terms of earnings per share (EPS). Both of those banks also had a market capitalization below $50 billion as of the end of April 2023. When examining the banking industry further, it becomes clear that a significant bifurcation in performance existed between regional banks and diversified banks, particularly those classified as "Too Big to Fail."

The 4 largest U.S. banks by deposits (Bank of America, JP Morgan Chase, Citigroup, and Wells Fargo), surpassed earnings expectations and all but Wells Fargo beat earnings estimates by more than 10%.[7] This trend may suggest that customers have developed a strong preference for larger institutions that follow stringent regulations aimed at preventing over-lending like the market saw with the less regulated 3 Californian regional banks during the low-interest rate environment in 2020 and 2021. Additionally, the current rise in interest rates has allowed banks to charge borrowers higher loan rates compared to what they pay depositors, exemplified by the average savings yield of 39 bps for U.S. banks. Some of the largest institutions still offering rates well below the average, such as Bank of America's savings yield of 0.01%.[8,] These factors have further solidified the position of the largest US banks following the recent crisis caused by the collapse of Silicon Valley Bank and Signature Bank.

Moreover, these large-cap and GSIB banks are also among the primary issuers of preferreds. This may aid in minimizing the impact of regional bank contagion on broad preferred markets. Interestingly, the four major G-SIBs domiciled in the US also happen to be the four largest preferred issuers. Furthermore, the diversified nature of these banks' businesses, which include business loans, credit cards, trading, investment banking, and more, may help mitigate the risk associated with any one type of lending practice, resulting in more effective risk mitigation.

### LARGEST ISSUERS OF PREFERREDS EXCLUDING FREDDIE MAC & FANNIE MAE

Source: Bloomberg, data as of 05/01/2023. Companies highlighted orange are the major Global Systemically Important Banks (G-SIBs) with G-SIB score above 3. Morgan Stanley and Goldman Sachs Group are also considered Global Systemically Important Banks but scored below 3.



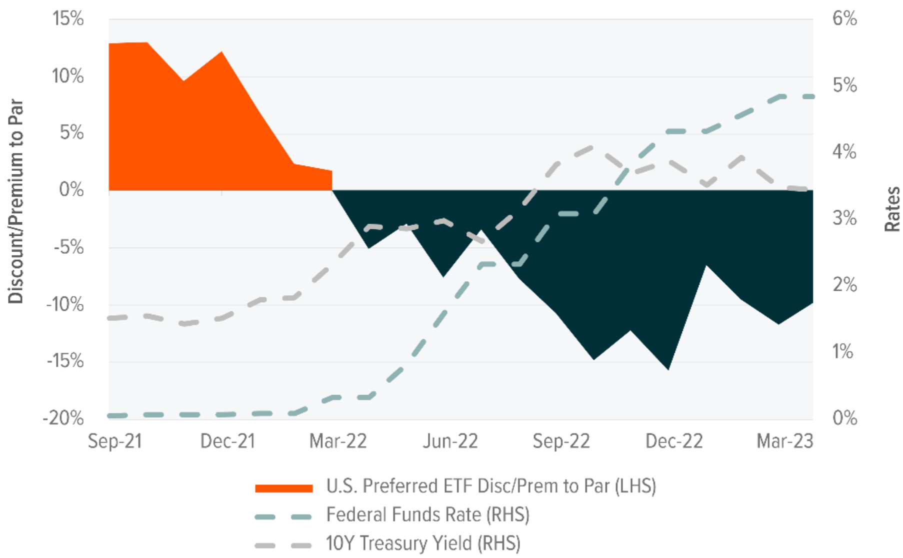
## Pendulum Shift from Interest Rate Risk to Liquidity Risk

Negative performance in 2022 occurred in broad market cap-weighted preferreds, which have a larger allocation towards large U.S. banks and other entities that, by virtue of their lower risk profile, also offer lower coupon rates. All else equal, bonds with lower coupon payments tend to be more susceptible to changes in interest rates. Given that a considerable proportion of preferred securities are perpetual, with no fixed maturity date, the duration of these securities and their associated interest rate risk are further compounded.

As depicted in the chart below, the weighted average discount to par value of preferred securities in the Global X U.S. Preferred ETF reached its peak in December 2022, which coincided with a time when the Federal Funds Rate breached the 4% level. This highlights the heightened sensitivity of preferred securities to interest rate changes during periods of rising rates.

### DISCOUNT/PREMIUM TO PAR DURING MOST RECENT RISING INTEREST RATE PERIOD

Source: Bloomberg, data from 9/30/2021 to 04/30/2023. U.S. Preferred ETF Disc/Prem to Par, represented by the weighted average discount or premium in par value of the securities held by the Global X U.S. Preferred ETF; Federal Funds Rate, represented by the US Federal Funds Effective Rate (Continuous Series) Index; 10Y Treasury Yield, represented by the US Treasury Yield Curve Rate T Note Constant Maturity Index.

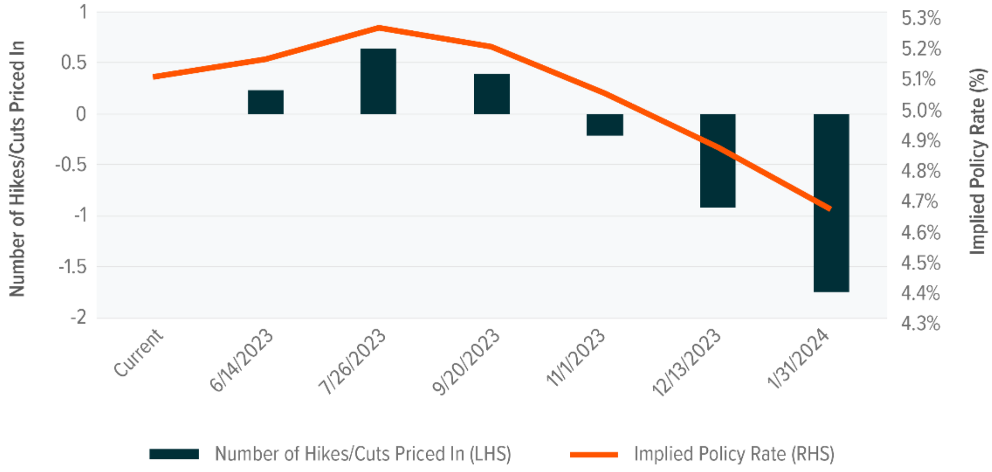



### Outlook on Interest Rates

US inflation has exhibited signs of cooling, with the April Consumer Price Index (CPI) rising by 4.9% from the previous year, marking the first sub-5% reading in almost two years.[9] This development has given the Federal Reserve leeway to potentially pause interest-rate increases or even consider cutting them if this trend continues. Federal funds futures markets are already anticipating between two to four 25 basis points cuts by the early onsets of 2024, as depicted in the chart below, and shows potential rate cuts starting 11/01/2023.

## FED FUNDS RATE EXPECTED CUTS BY EARLY 2024

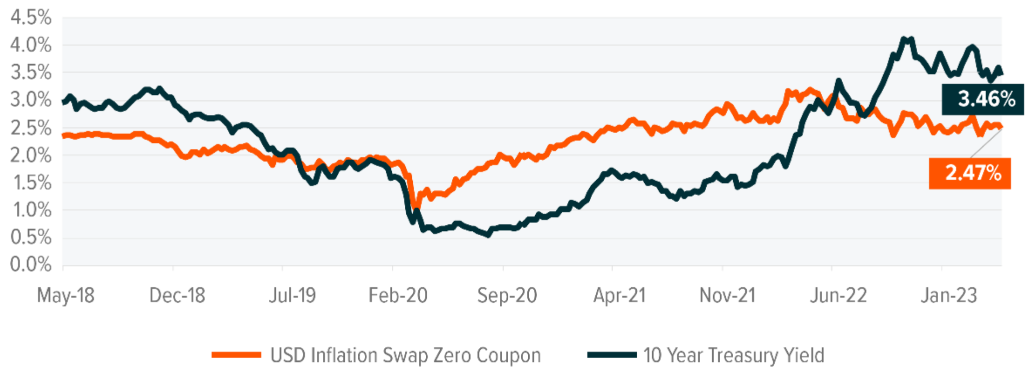
Source: Bloomberg, Federal Funds Futures data as of 06/01/2023. 1 hike or cut is equal to a 0.25% increase or decrease in the Implied Policy Rate.




When examining the 1 Year Forward Inflation Swap 10-year Zero Coupon Index, a measurement of inflation expectations, we see a similar trend with the index currently positioned 1% lower than the 10-year treasury yield, one year in the future. The high duration aspect of preferreds should benefit if the expectations are accurate, as the Federal Reserve has made it clear that inflation is the primary driver for hiking rates. The ICE BofA Diversified Core U.S. Preferred Securities Index currently has an option-adjusted duration of 7.1 years, which shows that a 1% downward movement in interest rates should cause a 7.1% upward move in performance, keeping other variables constant, such as credit risk.[10]

## 1 YEAR FORWARD INFLATION SWAP ON 10 YEAR ZERO COUPON VS. 10 YEAR TREASURY YIELD

Source: Bloomberg, data from 4/30/2018 to 4/30/2023.



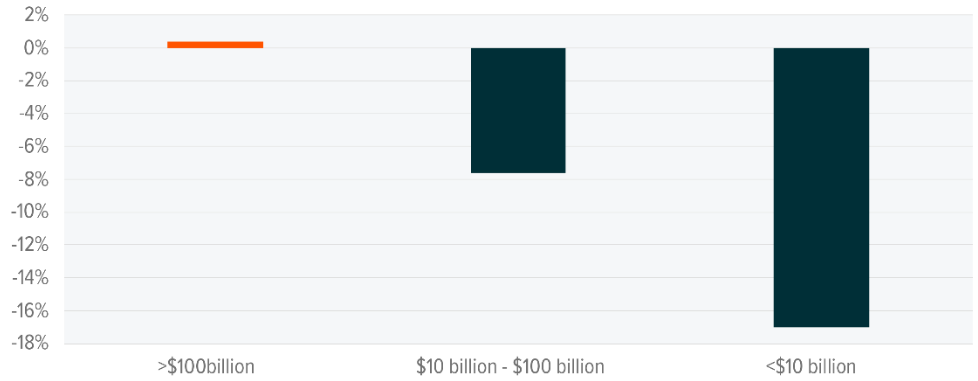

### Preferreds Issued By Large Banks Outperformed Smaller Banks

The divergent performances of preferred shares issued by different market cap buckets shows that preferreds issued by large banks have been able to withstand negative market sentiment, while smaller and less creditworthy banks have not been as fortunate. Since SVB's demise, exchange-traded preferreds by banks with a market capitalization of under $10 billion have experienced an average decline of over -17%. In contrast, preferred shares issued by large banks such as Bank of

America, Morgan Stanley, and Goldman Sachs have demonstrated a modest gain of almost +0.4% over the same period.

## PERFORMANCE OF US PREFERREDS – AS PER ISSUING BANK'S MARKET CAPITAL SINCE SVB COLLAPSE

Source: Bloomberg, data from 03/08/2023 to 5/2/2023. Note: Only includes $25 perferreds and each preferred is equal cap weighted within each bucket. Market Capitalization is based on the bank issuer, not the size of each preferred offering.



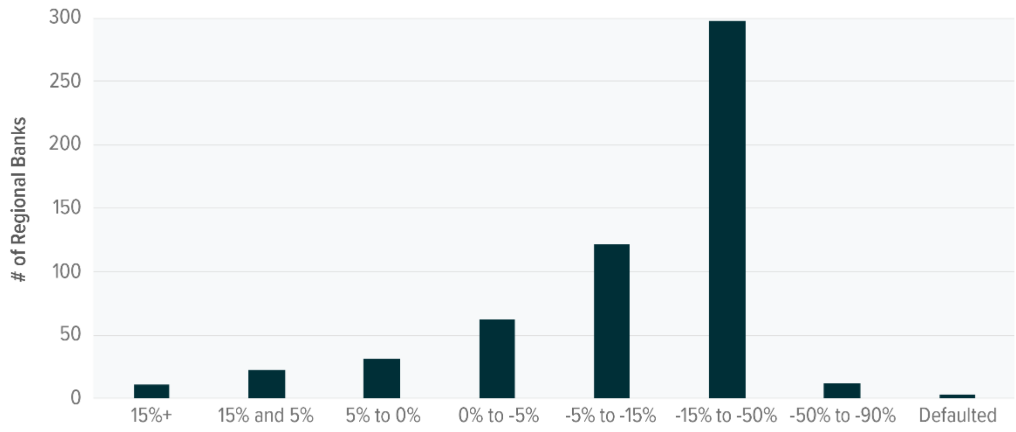

It is worth noting that small cap banks, heavily represented by regional banks that have targeted affluent clients and extended a considerable volume of loans during the period of zero-bound interest rates amid the pandemic, have exhibited prominent levels of unsecured deposits and possess loan portfolios that are more sensitive to interest rate changes. These banks have experienced a more pronounced deterioration in their performance, with PacWest Bancorp being one example, as its year-to-date (YTD) decline exceeded -70% as of May 15, 2023. To bolster its financial position, PacWest Bancorp has announced plans to divest $2.7 billion worth of assets while simultaneously exploring options for potential partners and investors.[11]

### Understanding the Performance of Regional Banks

The YTD performance of regional banks shows a left-skewed distribution, with a significant amount of these banks experiencing declines ranging from -15% to -50%. The mean YTD decline for regional banks was -17%. In contrast, diversified banks found within the S&P 500 have had a relatively muted YTD decline, amounting to -2.27%.[12]

## REGIONAL BANK YTD PERFORMANCE

Source: Bloomberg, data as of 05/03/2023. Regional Banks are measured by the S&P 500 Regional Banks Sub-Industry Index. “Defaulted” regional banks’ performance range from -90.01% to -100%. Past performance is no guarantee of future results.

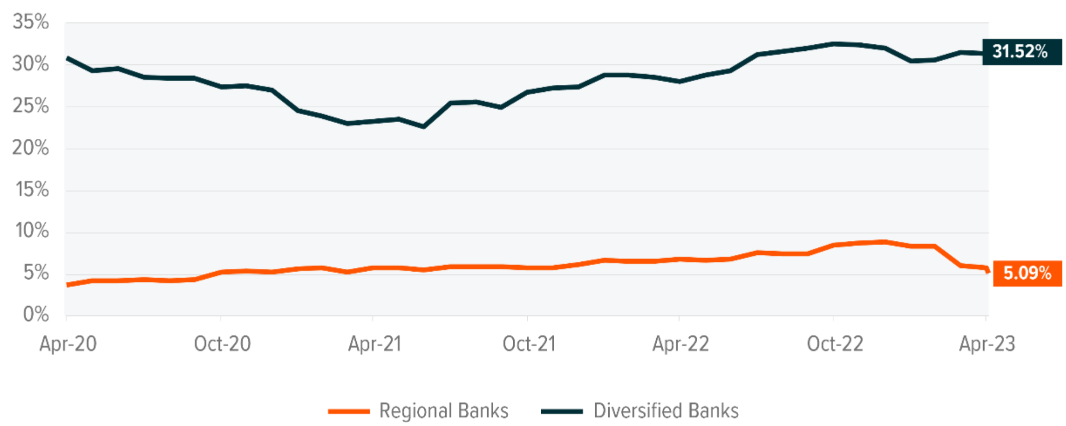



## Low Level of Contagion Risk within PFFD

The current investment climate has led investors to seek out “safer” banking alternatives, resulting in a divergence in performance between large US banks and their regional counterparts. While elevated rates and deposit outflows may potentially disadvantage regional bank investors, the market-capitalization weighted structure of the index tracked by the Global X U.S. Preferred ETF (PFFD) has resulted in a gradual reduction in exposure to regional banks and an increase in allocation towards diversified banks. With a weight of 32% in diversified banks and only 5% in regional banks, PFFD has the potential to largely mitigate the overall impact of potential bank runs from small and mid-cap regional banks.

## PFFD ALLOCATION SHIFT AWAY FROM REGIONAL BANKS

Source: Bloomberg, data from 4/30/2020 to 5/3/2023.



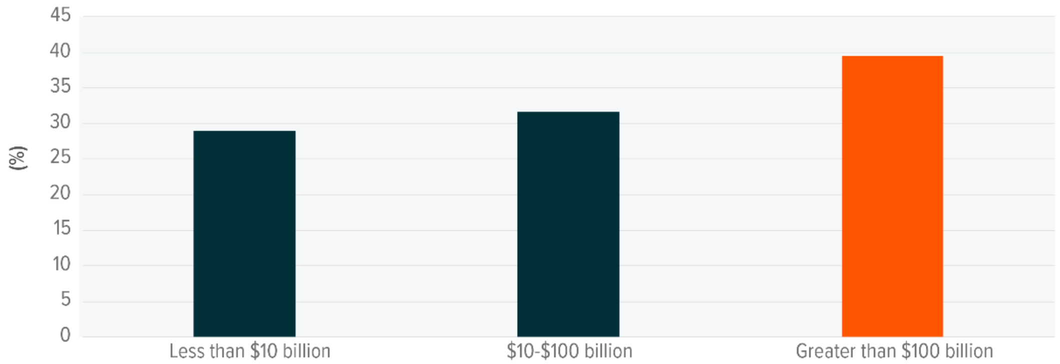
### Weighted Average Market Cap by Size Buckets

The Global X U.S. Preferred ETF provides investors with a diversified opportunity to invest in preferred securities issued by institutions across the market capitalization range. When analyzing the portfolio weights, the fund holds 39.45% of its assets in preferred securities issued by institutions with a market cap greater than $100 billion, 31.61% in preferred securities issued by institutions with a market cap ranging from $10 billion to $100 billion, and the remaining 28.9% in preferred securities issued by comparatively smaller institutions with a market cap of less than $10 billion. The overall allocation towards preferred issued by larger institutions is reinforced by the weighted average market cap of issuers found in PFFD, which stands at $110 billion.[13]

As discussed above, the significant presence of big banks within PFFD, forming a sizable proportion of its assets, has resulted in better-than-expected performance. This may continue to contribute positively to the fund's returns, particularly if we see a continuation of regional bank contagion and investors migrate towards larger banks that are perceived to be less risky. On the other hand, the fund may also offer diversification benefits by investing a decent proportion of its assets in preferred securities issued by comparatively smaller institutions. Overall, PFFD offers a balanced investment approach with a goal to generate regular income from preferred stocks.

**PFFD WEIGHTED AVERAGE MARKET CAP BY BUCKET**

Source: Bloomberg, data as of 04/30/2023.



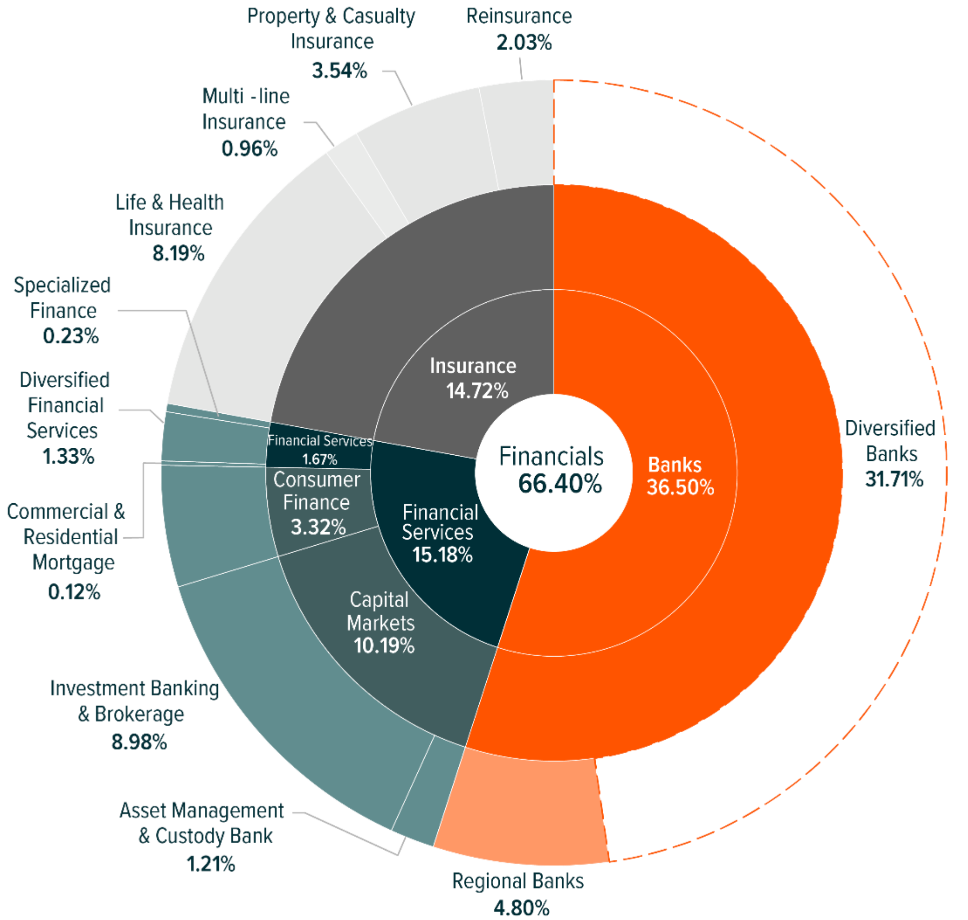

### PFFD Overweight G-SIBs and Large Cap Issuers

PFFD's exposure towards large banks is evident not only in its allocation towards diversified and large-cap issuers but also in its exposure to G-SIBs, which are widely perceived as "too big to fail." PFFD holds preferreds issued by the four largest U.S. banks, by deposits, and whom are also classified as G-SIBs. PFFD has currently allocated 30% of its portfolio weight to their preferred shares as of 04/30/2023. These banks have demonstrated resilience in the face of market volatility and we believe possess the resources to hedge interest rate risks, which could benefit PFFD if rates remain elevated for an extended period.

The pie chart below demonstrates the current allocation of PFFD, highlighting its substantial weighting towards diversified banks, along with a well-diversified distribution across various industries and sub-industries within the broader financial ecosystem.

## PFFD FINANCIAL SECTOR BREAKDOWN

Source: Bloomberg, data as of 04/30/2023. Holdings are subject to change.




In addition to its allocation towards the major US G-SIBs, PFFD also holds well-capitalized banks, such as Morgan Stanley and Goldman Sachs. The strategy's allocation towards large-cap issuers extends beyond the banking sector, with PFFD holding a diverse range of preferred issuers, including AT&T for exposure to the telecommunications sector and Public Storage in the self-storage space.

## Conclusion

Amidst an uncertain landscape for regional banks, large and diversified banks have been able to capitalize on the “flight to safety” mentality within the banking sector. These same banks, which are often the largest issuers of preferred securities, have maintained a higher weighting in PFFD, relative to regional banks, due to the underlying index’s market-cap weighted approach. We believe the fund’s exposure to these more diversified banks is rapidly transitioning from a headwind to a tailwind as the focus shifts from interest risk to credit risk. The passive nature of the strategy has also mitigated unsystematic risk by placing significant emphasis on the overall portfolio rather than the portfolio managers taking on overweight exposure towards individual issuer. In this uncertain future, we believe that preferred securities offer an alternative for income-seeking investors while potentially benefiting from a potential decrease in interest rates.

## Footnotes

1. Pew Research Center. (2023, June 15). In the U.S. and around the world inflation is high and getting higher.
2. Global X analysis with information derived from: Bloomberg L.P. (n.d.) {Data set}. Data from 12/31/2008 to 12/31/2010. Broad Bank Index is represented by the KBW Nasdaq Bank Index; Regional Banks are represented by the KBW Nasdaq Regional Banking Index.
3. Global X analysis with information derived from: Bloomberg L.P. (n.d.) {Data set}. Data from 12/31/2008 to 12/31/2010. Broad U.S. Preferreds are represented by the S&P U.S. Preferred Stock Index; Broad Bank Index is represented by the KBW Nasdaq Bank Index.
4. Reuters. (2023, May 11). SVB is largest bank faulure since 2008 financial crisis.
5. Ibid.
6. FDIC. (2023, May 18). Remarks by Chairman Martin J. Gruenberg on “Oversight of Financial Regulators: Financial Stability, Supervision, and Consumer Protection in the Wake of Recent Bank Failures” before the Committee on Banking, Housing, and Urban Affairs, United States Senate. Speeches, Statements & Testimonies.
7. Global X analysis with information derived from: Bloomberg L.P. (n.d.) (Data set).Data compiled from the S&P 500 Diversified Banks Sub-Industry using the earning analysis function.
8. Global X analysis with information derived from: Bloomberg L.P. (n.d.) (Data set). US FDIC National Rates Saving.
9. Global X analysis with information derived from: Bloomberrg L.P. (n.d.) (Data set). Index used is the US CPI Urban Consumers YoY NSA Index.
10. Global X analysis with information derived from: Bloomberg L.P. (n.d.) {Data set}. Effective duration is measured as of 04/30/2023.
11. PacWest Bancorp (2023, May 4). Pacific Western Bank Issues Update. Press Release.
12. Sourced from Bloomberg and measured from 12/31/2022 to 04/30/2023. Diversified Banks are represented by the S&P 500 Diversified Banks Sub Industry Index.
13. Analysis derived from Bloomberg L.P. Using the holdings and issuer weight average market cap as of 04/30/2023.

## Glossary

**Consumer Price Index (CPI):** CPI measures the average change in prices that consumers pay for a defined basket of goods and services.

**Duration:** A measure of a bond’s price sensitivity to changes in interest rates. In general, the higher the duration, the more a bond’s price will drop as interest rates rise (and the greater the interest rate risk).

**G-SIBs (Global Systemically Important Banks):** are financial institutions that have a significant impact on the global financial system due to their size, complexity, and interconnectedness. They are subject to stricter regulation and supervision to mitigate the risks they pose to the overall stability of the financial system.

**KBW Nasdaq Bank Index:** is a benchmark index that tracks the performance of large U.S. banking companies. It includes commercial banks and regional banks that are listed on major U.S. stock exchanges. The index provides a snapshot of the overall performance of the banking sector and is often used by investors and analysts to assess the health and trends within the banking industry.

**KBW Regional Bank Index:** is a financial index that measures the performance of regional banks in the United States. It includes publicly traded regional banks that are listed on major U.S. stock exchanges.

**Diversified Banks:** Financial institutions that offer a wide range of banking services and products to both retail and commercial customers. They have diversified operations and business lines, providing services such as savings and checking accounts, loans, mortgages, credit cards, investment banking, wealth management, and insurance products.

**Regional Banks:** Financial institutions that operate in a specific geographic region or a limited number of states. They provide banking services to local communities and businesses, offering products such as deposits, loans, and mortgages. Regional banks serve as important sources of credit and financial support for small and medium-sized enterprises (MSEs) and individuals in their respective regions.

**Bloomberg US Corporate High Yield Bond Total Return Index:** The Bloomberg U.S. Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below. Bonds from issuers with an emerging markets country of risk, based on Bloomberg EM country definition, are excluded.

**ICE BofA Diversified Core US Preferred Securities Index:** tracks the performance of exchange-listed U.S. dollar denominated preferred stock and convertible preferred stock publicly issued by corporations in the U.S. domestic market.

**Bloomberg US Aggregate Bond Index:** The Bloomberg U.S. Aggregate Bond Index is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-through), ABS and SMBS (agency and non-agency).

**S&P 500:** S&P 500 Index tracks the performance of 500 leading U.S. stocks and captures approximately 80% coverage of available U.S. market capitalization. It is widely regarded as the best single gauge of large-cap U.S. equities.

**Uninsured deposits:** refer to the portion of a depositor's funds held in a bank that exceeds the maximum limit covered by deposit insurance. In the United States, the Federal Deposit Insurance Corporation (FDIC) provides deposit insurance coverage for eligible deposits up to $250,000 per depositor, per insured bank.

**Federal Funds Futures**: derivatives contracts based in which the underlying asset is the Federal Funds Rate

**Swap**: a derivative contract through which two parties exchange cash flows or liabilities from two different financial instruments.

**1 Year Forward Inflation Swap 10-year Zero Coupon Index**: an index measuring a swap to transfer inflation risk from one party to another through an exchange of cash flows. This specific index measures a zero coupon inflation swap in which one party pays a fixed rate on a notional principal amount, while the other party pays a floating rate linked to an inflation index.

**Option-Adjusted Duration**: the duration for a bond with an embedded option when the value is calculated to include the expected change in cash flow caused by changes in interest rates.

**S&P 500 Regional Banks Sub Industry Index**: Measures a capitalization-weighted basket of Regional Bank equities within the S&P 500 Index.

**S&P 500 Diversified Banks Sub Industry Index**: Measures a capitalization-weighted basket of Diversified Bank equities within the S&P 500 Index.

**S&P U.S. Preferred Stock Index**: designed to be a representation of the U.S. preferred stock market and includes all preferred stock issued by US corporations & those trading in major exchanges.

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