# Brompton Flaherty & Crumrine Investment Grade Preferred ETF — BPRF

# Brompton Flaherty & Crumrine *Enhanced* Investment Grade Preferred ETF — BEPR

**Portfolio Manager Commentary - December 31, 2022**

## Preferred Market Conditions

Markets in 2022 were defined by uncertainty, with a constant push and pull between rate hikes by the Federal Reserve and investor expectations about when the tide would turn and once again usher in lower interest rates (i.e., the Fed's "pivot"). 2022's pace of Fed rate increases was the fastest since 1980-81, including four consecutive 0.75% hikes and a cumulative total of 4.25% since the first tightening in March 2022. Many investors have never known higher interest rates or inflation much over 2% and have been conditioned by years of easy policy to "buy the dip" when markets weaken. Uncertainty is a market's kryptonite, and markets faced plenty of it. The result this year was a high-correlation selloff in nearly all risk assets (equities, fixed income, loans, real estate) and more than one false-start recovery rally during the year.

In 2021, investors accepted that inflation would be "transitory" and lower interest rates were here to stay. In 2022, surprisingly high and persistent actual inflation caused a flat-footed Fed (and investment community) to play catch-up and repeatedly shift their rate expectations upward. Markets were priced for near perfection, and surprise inflation upended assumptions supporting risk assets.

Preferred market performance in 2022 was driven by higher interest rates and wider credit spreads, along with broad-market macro factors that accompany most market selloffs, including fund outflows (de-risking), thinner trading markets, and investor de-leveraging. With macro conditions driving performance, it is no surprise that other fixed income markets faced similar challenges.

The benchmark preferred index[1] total return in 2022 was -14.4%. For comparison, over the same period the Bloomberg U.S. Corporate Bond Index[2] total return was -15.8%, the Bloomberg U.S. High Yield Index[3] total return was -11.2% and Bloomberg U.S. Aggregate Index[4] total return was -13.0%.

## Outlook

Credit quality remains a highlight of the preferred and contingent capital securities (CoCo) market, and investors are now earning much higher yields on these credits. Banks remain very well capitalized, highly regulated, and most are asset-sensitive—which means earnings should increase with higher interest rates. Insurance companies have been longing for higher interest rates to boost portfolio yields, and they finally have arrived. Higher interest rates should also reduce pressure on insurance liability calculations. Energy issuers, most pipeline companies in the preferred market, have been buoyed by higher commodity prices and potential increases in usage because of a shifting energy landscape. This stands in contrast to securities of high-yield (junk) issuers, where higher interest rates are likely to be more concerning due to their weaker balance sheets and greater exposure to rising interest costs and slower economic growth.

Looking ahead, we expect tighter monetary policy to push the U.S. economy into a mild recession in the second half of 2023, which should accelerate inflation's decline toward the Fed's 2% target. Core PCE inflation should fall below 3% in early 2024 and allow the Fed to begin easing monetary policy. Forward interest rates are more optimistic and suggest the Fed will start easing in the second half of 2023. We expect the fed funds rate to remain at a "terminal" rate of about 5% through year-end 2023 before falling in 2024. As a result, we think 10- and 30-year Treasury rates could move modestly higher as markets adjust to a later "pivot" by the FOMC. As interest rates fall and an economic recovery begins in 2024, credit fears should recede. Markets probably would start to anticipate both lower rates and an improving credit outlook sometime in 2023.

Nevertheless, with inflation currently elevated, the Fed tightening monetary policy, the global economy slowing, and the war between Ukraine and Russia still raging, it may be too soon to expect a near-term rebound in credit markets. However, yields are up significantly from a year ago, and we think most of the adjustments to higher rates and wider credit spreads are behind us. We believe long-term investors will find attractive yields and solid credit quality in preferred and contingent capital securities today as they wait for better days ahead.

| Annual Compound Returns[5] | 1-YR | 3-YR | 5-YR | 10-YR | S.I. BPRF[6] | S.I. BPRF.U[7] |
|---|---|---|---|---|---|---|
| BPRF - Brompton Flaherty & Crumrine Investment Grade Preferred ETF (CAD-H) | (13.4%) | (1.8%) | - | - | 1.8% | - |
| BPRF.U - Brompton Flaherty & Crumrine Investment Grade Preferred ETF (USD) | (13.8%) | (1.0%) | - | - | - | 0.7% |
| BEPR - Brompton Flaherty & Crumrine *Enhanced* Investment Grade Preferred ETF (CAD-H) | (19.5%) | (4.7%) | 0.0% | 4.8% | - | - |
| ICE BofAML 8% Constrained Core West Preferred & Jr Subordinated Securities Index | (14.4%) | (1.4%) | - | - | 2.2% | 0.0% |

*(1) The benchmark preferred index is the ICE BofA 8% Constrained Core West Preferred & Jr Subordinated Securities Index (P8JC).*

*(2) The Bloomberg US Corporate Bond Index measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD denominated securities publicly issued by US and non-US industrial, utility and financial issuers.*

*(3) The Bloomberg US 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.*

*(4) The Bloomberg US Aggregate Bond Index is a broad-based index that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate pass-throughs), ABS and CMBS (agency and non-agency).*

*(5) Returns are for the periods ended December 31, 2022 and are unaudited. The table shows the Fund's compound returns for each period indicated compared with the ICE BofAML 8% Constrained Core West Preferred & Jr Subordinated Securities Index ("Preferred & Jr Subordinated Securities Index"), (the "Index"). The Preferred & Jr Subordinated Securities Index tracks the performance of US dollar denominated high grade and high yield preferred securities and deeply subordinated corporate debt issued in the US domestic market. Qualifying securities must be rated at least B3, based on an average of Moody's, Standard & Poor's and Fitch and have a country of risk of either the U.S. or a Western European country. The Index is calculated without the deduction of management fees, fund expenses and trading commissions, whereas the performance of the Fund is calculated after deducting such fees and expenses. Past performance does not necessarily indicate how the Fund will perform in the future. The information shown is based on Net Asset Value per unit and assumes that distributions made by the ETF on its units in the period shown were reinvested at Net Asset Value per unit in additional units of the Fund.*

*(6) BPRF inception date October 15, 2018.*

*(7) BPRF.U inception date August 8, 2019.*

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