U.S. Economic Conditions

The U.S. economy continues to recover from a sharp, pandemic-driven decline in the first half of 2020. Although the economy's rebound was considerably stronger than most economists expected when the pandemic surged in April 2020, real GDP was 2.4% smaller in the fourth quarter of 2020 than it was a year earlier and about 4% smaller than it probably would have been absent the pandemic. However, rapid growth in 2021 should push real GDP above its 4Q2019 level around mid- year, and it is expected to be back on its pre-pandemic growth trajectory around the end of 2021 – testimony to the U.S. economy's underlying resilience, strong fiscal and monetary policy support, and unprecedented speed in developing and deploying vaccines to fight the novel coronavirus.

After shedding more than 22 million jobs between February and April 2020, the labor market staged an impressive, albeit incomplete, rebound of almost 14 million jobs. That means total nonfarm payroll employment remains 8.4 million jobs below the February 2020 peak. Moreover, payrolls are more than 10 million jobs below what they would have been had employment continued to expand at the same pace as in 2019. Similarly, the unemployment rate started 2020 at 3.5%, jumped to 14.8% in April and fell to 6.0% in March 2021.

Despite this incomplete recovery, we are optimistic that most jobs lost during the pandemic will recover as COVID-19 recedes. For example, hotels and restaurants will reopen or expand services and rehire employees as consumer demand returns. After a year or more of COVID-related restrictions, there is likely substantial pent-up demand among consumers.

As that is unleashed, employment should jump not just at businesses that were closed or operated at reduced capacity but also at producers and distributors up and down the supply chain. We expect strong employment growth over the remainder of 2021 and into 2022.

Although employment fell, nominal personal income rose 4.3% over 12 months ending in February 2021. That was largely due to a jump in transfer payments – stimulus checks, supplemental unemployment benefits and other assistance – that largely replaced income lost during the pandemic.

Personal income excluding transfers fell 1% over the same period, or about -2.5% in inflation-adjusted terms. A $1.9 trillion stimulus plan passed in March should boost income again in 2Q2021, while growth in employment should keep income on an upward path beyond that.Personal consumption expenditure (PCE) fell sharply as the pandemic unfolded and recovered quickly as the economy reopened. Over 12 months ending in February 2021, nominal PCE growth was -0.6%, or -2.1% in inflation-adjusted terms.Income outpaced spending in 2020, and as a result, the savings rate was 13.6% as of February 2021, significantly above the 7%- 8% rate prior to the pandemic. Transfer payments already distributed or in the pipeline probably will boost the savings rate again in Q2. As the pandemic recedes, however, the savings rate is likely to fall and give an extra boost to consumer spending.

Government consumption performed its usual countercyclical role during a recession, rising sharply as the pandemic unfolded and slipping as spending programs either slowed or expired over subsequent quarters. Support came from the federal government with state and local spending falling in all but Q1. Looking ahead, federal government spending will rise in the wake of the $900 billion assistance bill passed by Congress in December 2020 and the $1.9 trillion Stimulus Package passed in March 2021. State and local spending, on the other hand, remains soft, but should gain strength as tax receipts respond to an advancing recovery.

Inflation fell sharply as economic activity slowed in the first half of 2020 and has remained well below the Federal Reserve's 2% target for the "core" PCE deflator excluding food and energy. For 12 months ending in March, the consumer price index (CPI) reading was up 2.6% overall but up just 1.6% excluding food and energy. The PCE deflator was up 1.6% overall and 1.4% excluding food and energy over 12 months ending in February. Inflation should accelerate over coming months, for several reasons. First, prices fell as the economy tumbled into recession a year ago. When year-over-year inflation rates are calculated from those lower base levels, they will rise even if monthly inflation does not accelerate. Second, energy prices increased sharply over recent months, with spot crude oil prices up by almost 50% (not annualized) since November. Admittedly, prices excluding food and energy have been tame over that period, but they should move up as higher energy prices filter into broader prices and as overall economic activity expands.

Nonetheless, a pickup in inflation is likely to be modest. Core inflation appears likely to accelerate to about 2% over coming months as strengthening growth and base effects take hold. However, excess capacity both here and abroad is available to meet rising demand. Unemployed workers can facilitate expansion in service-providing industries without spurring rapid wage and price inflation. In goods-producing industries, capacity utilization remains well below levels that have been associated with rising inflation in the past. And easy financial conditions (discussed below) mean companies can readily finance capital investments to boost productivity or add new capacity. Each of these should restrain inflation – not indefinitely, but at least for the next year or two.

The Federal Reserve kept monetary policy unchanged in the fourth quarter and so far in 2021. The Federal Open Market Committee (FOMC) left the fed funds rate target at 0-0.25% and the Fed will continue to buy at least $80 billion Treasuries and $40 billion agency mortgage-backed securities per month "until substantial further progress has been made toward the Committee's maximum employment and price stability goals." While that language is deliberately vague, it probably means large-scale balance sheet expansion through the end of this year, with a shift to slowing purchases beginning in 2022 – hopefully without a repeat of 2013's "taper tantrum." In addition, the FOMC's last "dot plot" from March 2021 shows Committee members expected the fed funds rate to remain near zero through year-end 2023. That contrasts with market forward rates showing a rate hike in early 2023, reflecting a strong economic outlook and risk that inflation could pick up sooner than the FOMC currently expects.

The Fed's balance sheet was $7.4 trillion at the end of 2020, compared to about $4.2 trillion at the end of 2019. A similar expansion took more than five years to accomplish following the global financial crisis. If the Fed buys $120 billion in Treasuries and mortgages each month in 2021, it will end the year over $8.8 trillion. The Fed appropriately flooded the market with liquidity as fear gripped markets and financial conditions tightened last spring.

Today, ample liquidity represents fuel to support a vigorous recovery as COVID recedes. The Fed will face a delicate task of how and when to pare back monetary accommodation, particularly since Congress has passed additional fiscal stimulus to bridge the economy through the next few months. If the Fed waits too long, inflation could build quickly as most Americans receive vaccinations and resume more normal activity. If the Fed acts too soon, economic recovery could stall. Given those risks, the Fed will probably wait too long. The Fed revised its longer-run inflation policy in August 2020 to target average inflation of 2%. It is unclear how much inflation above 2% the Fed would tolerate, or for how long, an uncertainty that adds risk. As we noted earlier, we do not see much inflation risk in 2021 and into 2022, when inflation should move up near the Fed's 2% target but not advance quickly beyond it. Risks mount thereafter, and we think it is why markets have priced in rates moving up faster and sooner than the Fed's projections.

Preferred Market Conditions

After three consecutive strong quarters to end 2020, the first quarter of 2021 was more muddled as the preferred market juggled a mix of news on the economy, interest rates, and COVID. However, the most consistent – and arguably most important – market force throughout this pandemic has been the Federal Reserve. We've written many times about specific actions they have taken, but as we are now passing the one- year mark of the pandemic, their impact on markets is even clearer. In addition to supporting markets as the pandemic unfolded in 2020, the Fed has now updated its policy approach to help ensure full recovery of the U.S. economy – keeping monetary policy highly accommodative through continued asset purchases and low rates and expressing a desire for higher near-term inflation in hopes of moving average inflation closer to the Fed's 2% target. Except for U.S. Treasuries, nearly all markets have reacted positively to these policies.

U.S. Treasury markets were less enthusiastic and began to reflect this sentiment over recent months. Expectations of higher inflation were inconsistent with 10yr and 30yr Treasury yields of 0.9% and 1.6%, respectively at the end of 2020, and long-term interest rates began moving higher. Over the first quarter of 2021, which also coincides with a dramatic improvement in vaccination rates, 10yr and 30yr Treasury yields have risen 83 bps and 77 bps, respectively.

The preferred market initially reacted negatively to higher interest rates, even though duration metrics are quite moderate overall. More recently however, the preferred market has been rather sanguine – even in the context of further interest rate increases. We sound like a broken record, but the global search for yield continues, and fear of missing out (not being invested) has taken precedence over higher Treasury rates, causing spreads to tighten and prices to rise. Cash continues to flow into fixed-income, and the preferred market offers higher yields than most alternatives – especially risk-adjusted. Supply of new preferreds has also been low, contributing to positive market technicals more recently.

There is no question the economic outlook has brightened as the pandemic has eased. Most markets have been out ahead of this improvement, however, so spread levels already reflect much of it. The low-rate environment (although higher than levels 6 months ago) cuts both ways in terms of outlook – with continued demand for yield supporting the preferred market near-term while also increasing the amount of refinancing available to issuers (call risk), resulting in potentially lower portfolio yields over time. The recent increase in longer-term interest rates has been a welcome change, in our opinion, as it may help keep preferred market yields from dropping further.

Spreads have tightened to offset much of that move, but if inflation expectations continue to rise as the economy recovers, it could lead to future opportunities in the market. In the meantime, the preferred market continues to compare favorably to most other fixed-income alternatives, especially on a risk-adjusted basis.

Annual Compound Returns[1]	1-YR	Since Inception[2]	Since Inception[3]
Brompton Flaherty & Crumrine Investment Grade Preferred ETF (CAD hedged)	28.0%	7.5%	-
Brompton Flaherty & Crumrine Investment Grade Preferred ETF (USD)	29.2%	-	8.3%
ICE BofAML 8% Constrained Core West Preferred & Jr Subordinated Securities Index	20.7%	8.7%	7.1%
S&P/TSX Preferred Share Index	49.7%	3.3%	12.5%

[1] Returns are for the periods ended March 31, 2021. 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") and the S&P/TSX Preferred Share Index ("Preferred Index") (together the "Indices"). The Preferred & Jr Subordinated 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 Preferred Index tracks the performance, on a market-weight basis, of preferred shares listed on the TSX that meet the criteria relating to size, liquidity and issuer rating. The Indices are 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.

[2] Inception Date October 15, 2018.

[3] Inception Date August 8, 2019.

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