

PORTFOLIO MANAGER COMMENTARY - DECEMBER 31, 2018

U.S. Economic Conditions

The U.S. economy in 2018 likely turned in its best annual performance since 2015, matching that year's inflation adjusted gross domestic product (real GDP) growth rate of 2.9%. That would be about 0.5% better than economists expected at the beginning of the year. On a Q4 over Q4 basis, real GDP should be up about 3.1% in 2018, which would be the fastest pace since 2005. Economists expect continued expansion of 2.5% in 2019 and 1.9% in 2020. Assuming the U.S. government's partial shutdown is resolved relatively soon, we remain broadly in agreement with the 2019 forecast, but we think 2020 will be a little better.

Real GDP was paced by personal consumption expenditures (+2.6% average growth over the first three quarters of 2018), which benefitted from a strong labor market and lower personal income tax rates. Job growth averaged 220,000 jobs per month in 2018, average hourly earnings were up 3.2% and the unemployment rate touched 3.7%, its lowest level since 1969. Rising consumer demand and corporate tax reform drove a sizable jump in business investment (+7.5% three-quarter average), especially in the first half of the year. Federal government spending (+3.3%) also accelerated in 2018, though state and local government spending (+1.6%) was subdued. Residential investment (-2.8%) fell despite strong employment growth, however, as rising home prices, higher mortgage rates and new limits on deductibility of state and local taxes (including property taxes) combined to dampen demand for housing.

A growing economy and tighter labor market pushed inflation up modestly in 2018. Excluding volatile food and energy prices, the consumer price index (CPI) was up 2.2% over 12 months ending in December 2018. The Federal Reserve's preferred inflation measure, the personal consumption expenditures deflator excluding food and energy was up 1.9% over 12 months ending in November. Those are 0.3–0.5% higher than a year ago and are near the Fed's 2% target. Looking ahead, higher wages should put upward pressure on inflation, but lower commodity prices and somewhat slower economic growth push against that; we expect inflation will rise only modestly in 2019.

In response to strong growth and faster inflation, the Federal Open Market Committee (FOMC) raised the federal funds rate by 100 bp in 2018. Benchmark short-term rates rose even faster, with three-month LIBOR rising from 1.7% to 2.8% at the end of December 2017 and 2018, respectively. Ten-year Treasury rates also moved up during most of the year, rising from 2.41% on December 31, 2017 to a high of 3.24% on November 8, 2018. Higher rates were a headwind to credit market performance for much of that period.

The Fed also trimmed reinvestment of maturing Treasury and mortgage-backed securities in its System Open Market Account (SOMA) to a maximum of \$50 billion runoff per month beginning in October. SOMA is currently around \$4.0 trillion, down about \$500 billion since portfolio runoff began in October 2017. While the SOMA reduction is small relative to the size of the Treasury and agency mortgage markets – and more importantly has had no discernable impact on bank lending volume – it coincides with rising Treasury issuance needed to finance a wider budget deficit. Investors have to make room for more low-risk assets, dampening demand for riskier assets. This shift came as signs of slower global economic growth began to proliferate, trade tensions widened, and political uncertainty increased. A selloff in equities that began in October spread to credit markets and pushed the ten-year Treasury yield down to 2.69% as of December 31, 2018. Volatility and risk aversion returned with a vengeance, and lower Treasury rates did little to buoy demand for preferreds or other credit instruments.

Preferred Market Conditions

Preferred securities held up reasonably well for the first three quarters of 2018. Investors continued to find attractive levels of income in preferreds and seemed to remain hopeful a strong U.S. economy would carry the day – which, by most measures, proved resilient. Returns in the first half of 2018 were slightly negative due to concerns about higher interest rates. On a relative basis, preferreds performed well during this period, outperforming most corporate-credit benchmarks due to modest spread tightening for preferreds.

While higher interest rates were a headwind to returns in the first two quarters, preferreds rebounded in the third quarter as interest rates moved sideways or lower, and preferred yields continued to look attractive. By the fourth quarter, however, worries about future global and domestic economic growth were added to a growing list of market concerns, and almost all markets moved materially lower, including preferreds.

U.S. bank preferreds were the most stable sector for the year, consistent with limited supply and continued good credit quality. Tax reform was a positive for bank earnings, and a healthy economy combined with modestly higher interest rates further supported the outlook. Foreign banks were more mixed, with weakness targeted at those with country-specific issues, including Brexit in the U.K., weak balance sheets for many German banks and ongoing political and economic concerns in Italy. While the economy, interest rates and consumer health will impact profitability, U.S. banks are expected to report record earnings heading into 2019.

The energy sector faced the strongest headwinds during the year, especially late-2018 as commodity prices moved sharply lower. Recall that rating agencies allow preferreds some equity credit when calculating financial ratios, so many non-financial issuers have an incentive to include preferreds in their capital structures. With energy common stock prices depressed, issuers avoided issuing common stock whenever possible. Instead, many companies issued preferred securities to fund capital expenditures, pushing down prices on outstanding securities. On a positive note, many energy issuers moved to simplify their corporate structures in 2018 – consolidating subsidiaries and eliminating rather high incentive distribution rights that were so common in older Master Limited Partnership (MLP) structures. Simplification is almost always good for preferred investors, and these changes also improve earnings outlooks moving forward.

The fourth quarter stood out during the year as nearly all markets (equity, credit, commodities) were lower in price. Intermediate- and longer-term interest rates were volatile, with rates rising sharply at the beginning of the quarter and reaching 4 year highs and then moving materially lower by the end of the quarter in a flight-to-quality trade versus other markets. Even though interest rates ultimately moved lower, prices of credit instruments traded down and spreads widened significantly. Fund flows (mutual funds, ETFs, etc.) were modestly negative for much of the year, but outflows accelerated in the last months of 2018.

This selloff seems to reflect an accumulation of factors that have been bubbling under the surface for much of the year. Top concerns include a global economic slowdown, widening tariffs and potential for escalating trade wars, the Federal Reserve tightening credit conditions, the impact of Brexit beyond the U.K. and Europe and most recently a federal government shutdown to end the year. Many of these concerns involve politics, which often are not aligned with investor goals and tend to heighten volatility. Investors are climbing a wall of worry and, more recently, choosing to wait it out by holding more cash.

While a full discussion is beyond the scope of this letter, it is worth mentioning that changes in market structure are also likely responsible for the magnitude of the selloff. Statistics abound showing the rising influence of robo-trading and index-based passive investment products that buy and sell based solely on flows – regardless of value. Liquidity is scarce in market selloffs, and we all pay a price as momentum trading requires lower and lower prices for trade execution. This trend is not new, but it is probably fair to say it has not been fully tested by a bear market or under tightening financial conditions.

Market corrections can be a difficult experience, but we remain optimistic about prospects for preferred securities. As you know, we take a long-term view of investing and our process is rooted in fundamental credit research – and there is much to like about preferred issuers' credit quality. At the same time, preferreds offer very competitive yields (higher by 1-2% in most cases compared to December 2017). Volatility likely will persist into 2019, but we believe long-term investors will be rewarded with attractive income and, from current levels, potential for price appreciation.

Portfolio Results

Since the Fund's inception on October 15, 2018 through December 31, 2018, the Fund's US dollar-denominated investment portfolio (before the impact of expenses and hedging currency risk between U.S. and Canadian dollars) underperformed the ICE BofAML 8% Constrained Core West Preferred & Jr Subordinated Securities Index, which tracks the US dollar-denominated preferred securities market. In general, preferreds had outperformed most other fixed-income asset classes for much of 2018 as benchmark interest rates trended upward throughout the first three quarters. During the fourth quarter though, preferreds were unable to sidestep market volatility and experienced one of their worst performing quarters since the financial crisis. Investors sought shelter in safer assets, pushing the 10-year Treasury rate down to February 2018 levels and erasing much of the rise in rates for the year. The correlation between preferreds and Treasuries broke down in the fourth quarter and credit spreads on preferred securities widened significantly to levels last seen in 2013.

In this environment, the Fund's portfolio underperformed the benchmark due in large part to the Fund's mix of securities as it continues to deploy cash and build portfolio positions. Since inception, the Fund quickly established positions in exchange-traded preferreds, facilitating smaller transactions given the Fund's initial size. These initial positions were in preferreds with longer call protection and wider reset spreads, limiting extension risk (the potential that a preferred may remain outstanding past its non-call period on unattractive terms). However, these securities underperformed as benchmark interest rates declined toward the end of 2018. Over time the Fund portfolio will establish larger positions in preferreds that trade "over-the-counter" (similar to senior bonds). These preferreds will help to provide diversification among credits and security types in the Fund portfolio.

Outlook for the Preferred Market

While 2018 probably represents a high point for U.S. economic growth over the next several years, that's not a bad thing. Given underlying labor force growth, 3% real GDP growth is not sustainable without higher productivity growth that the economy has been unable to muster so far. We still hope business investment will boost productivity and sustainable growth, but a somewhat slower pace of growth in the meantime reduces inflation risk. In turn, that reduces risk that the Federal Reserve might tighten monetary policy too aggressively and bring forward a recession.

Although we still expect another Fed tightening or two in 2019, risk of an even more rapid pace of tightening than in 2018 – which was very much on investors' minds just a couple of months ago – has transformed into expectations of steady monetary policy, and maybe even a rate cut. And while U.S. growth is likely to slow, it still should be better than most years of this recovery. That should support household and corporate income and balance sheets while limiting prospects for sharply higher long-term interest rates.

Leverage at financial companies has continued to decline, and most of those companies have historically strong balance sheets and rising earnings. U.S. bank loan delinquencies and charge-offs are stable or falling from already-low levels, and loan-loss reserves are strong. We do not anticipate a recession over the next two years, but major U.S. banks appear to be well prepared if one arrives. Of course, individual companies will face challenges – especially among nonfinancial companies, where leverage has increased since the financial crisis – but we think credit fundamentals among preferred issuers remains solid. Although volatility is likely to remain elevated for a time, we think the macroeconomic and credit environments are favorable for preferred securities.

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