Funds in Focus: Brompton Flaherty & Crumrine Investment Grade Preferred ETF (BPRF)

Flaherty & Crumrine Investment Grade Preferred Income Fund (FFI)

U.S. Economy

The most recent data shows a sharp rebound in economic activity and employment, but the recovery has been uneven across sectors and regions. As a result, we begin with a summary on U.S. economic and market conditions, and end with commentary on the major credit sectors in the preferred market, including COVID-related impacts and responses to it. We will also touch upon some company- specific observations, although it should be noted that we believe none of the companies mentioned face outsized risks from the pandemic.

The COVID-19 pandemic and public and private responses to it dealt a severe blow to the U.S. economy in the second quarter of 2020. Safer-at-Home orders prompted many businesses to suspend or sharply reduce operations early in the quarter. While most businesses began to reopen in May, many remain closed or are operating at substantially reduced capacity. Leisure and hospitality businesses have been hit particularly hard. The National Bureau of Economic Research (NBER) declared March the beginning of a recession. Inflation-adjusted gross domestic product (real GDP) fell by 31.7% in Q2, led by a 34.1% plunge in personal consumption expenditures. This was by far the largest one-quarter decline in the economy since quarterly GDP statistics began in 1947.

The second quarter should mark the low for this contraction. In fact, monthly data suggests the U.S. economy hit bottom in April and began to recover in May, with growth accelerating in June. Economists expect real GDP to jump by 29.9% in Q3 and 4.0% in Q4. For the full year, economists forecast -4.0%, 3.7% and 2.7% growth in 2020, 2021 and 2022, respectively. That growth path would still leave the economy smaller and unemployment higher than expected to be prior to the pandemic, but it should not impose broad strain on issuers of preferred securities, most of which are investment grade companies. Companies we follow have highlighted efforts to reduce expenses and streamline operations in response to revenue pressures from COVID-19. Initiatives have ranged from closing underutilized retail bank branches to consolidating manufacturing plants. These actions should protect earnings currently and help them recover more quickly as the pandemic recedes.

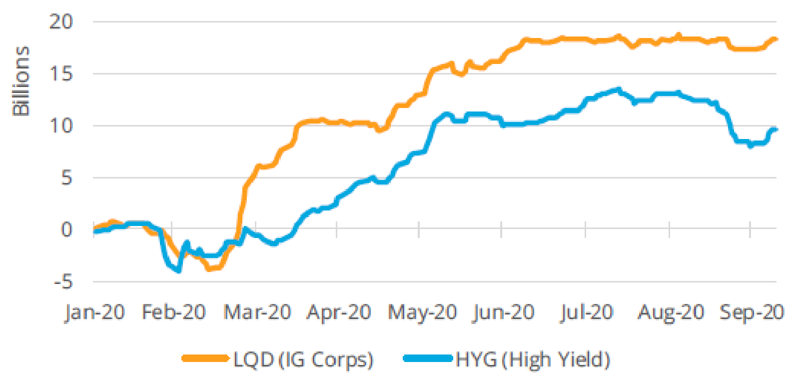
An elevated unemployment rate (7.9% in September compared to 3.5% as recently as February) is one of the ongoing burdens of the pandemic, with many businesses, especially in leisure and hospitality, either closed or operating at significantly reduced capacity. That poses risk to consumer spending, although a relatively rapid rebound in jobs and wages along with unemployment benefits have supported income and spending so far. Consumer leverage also remains low, and the personal savings rate is very high. Business investment is likely to remain subdued until existing capacity utilization increases, which will take time. Default rates among high yield issuers have increased substantially this year, primarily at nonfinancial companies. More positively, much stronger home sales and rising home prices (with an assist from record-low mortgage rates) suggest residential investment should be a bright spot for the economy.

Preferred Market Conditions

Actions taken by the Federal Reserve have greatly benefited fixed- income markets over recent months. Notably, the Fed began directly investing in both investment-grade (IG) corporate bonds and high yield (HY) bonds – with ETFs as their primary investment vehicle. While preferreds and contingent capital ("CoCo") securities are not directly included in the Fed's mandate, these markets have benefited from the overall positive sentiment and market technical. Not only did IG and HY markets rebound, but there was a pile-on trade in these markets as investors simply followed the Fed's lead. In this case, a chart likely tells the story better than words. The chart below includes daily fund flows (not necessarily price performance) for passive ETFs representing IG and HY.

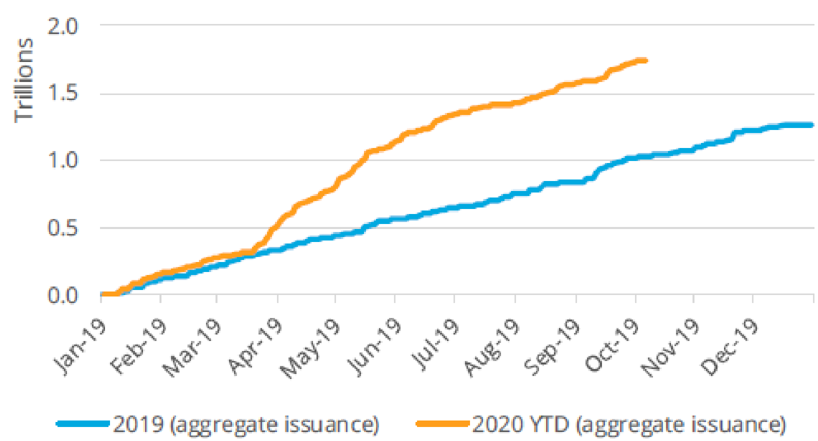
Fixed-Income ETF Growth

1/31/2020 - 10/9/2020



Supply has been another impressive story in fiscal-Q3, as companies rushed to issue both senior debt and, to a lesser extent, preferreds into a strong market. Many companies took advantage and termed out liabilities, often refunding short-term borrowings drawn at the height of the crisis in March/April – but also to further bolster cash positions as a defensive measure against an uncertain outlook ahead. Others sought to take advantage of historic low interest rates across the entire curve to either issue new debt or refinance higher cost securities. The chart below includes a 2019-2020 year-over-year comparison of investment-grade debt issuance.

IG Issuance (YoY Comparison)



Interest rates are not only at historically low levels, but they are also forecast to remain near these levels for several years. Low interest rates impact preferreds in many ways, both positive and negative. Income will likely trend lower over time, as issuers refinance higher- coupon preferreds – although call protection will keep the decline measured for some time. While fixed-rate and longer-duration investments have outperformed this year given the dramatic move lower in rates, much of the preferred market is a fixed-float structure, which results in intermediate interest rate duration. Earning attractive income, while exposed to only intermediate duration, is a combination we believe benefits long-term investors. However, certain fixed-float securities have extended beyond their first call date, and now reset at coupons below what many expected, which has depressed prices on many of these securities. The magnitude of interest rate changes has made for some interesting dislocations within fixed-float securities, especially with newer issuance coming with lower coupon rates but higher back-end spreads that reset off much lower benchmark rates.

We believe most preferred and CoCo issuers entered this latest crisis on solid footing and have taken steps necessary to weather this storm, but much uncertainty remains on the pace and extent of global recovery. We remain mindful that even as progress is made, there are likely to be setbacks on the road to recovery. Fortunately, the preferred market is dominated by issuers in the banking, insurance and other financial services industries, which we think are well-positioned to manage through current challenges. We close as we did last quarter: seeing good opportunity for long-term investors in preferred and CoCo markets to earn competitive returns over coming years, albeit with some bumps along the way.

Industry Survey

Banking
(53% of the preferred market)

Banks are closely tied to the economy because they lend to nearly all types of households and businesses. Despite a plunge in Q2 GDP, however, there are limited signs of deteriorating loan performance so far. Through the third quarter, overall delinquencies and charge- offs edged only slightly higher, even as the 3-month deferral period began expiring for borrowers that requested forbearance as the pandemic unfolded. It is now clear that most early forbearance requests were precautionary. In March and April, borrowers did not know how long safer-at-home orders would last or how bad the economy would get, and many requested loan deferrals. Initial deferrals were typically granted for three months, and most of those are rolling off in Q3. With a sizable majority of businesses now open, employment recovering and wages up, deferrals have dropped sharply – and many borrowers who requested deferral continued to make regular loan payments. For example, Regions Financial (RF) reported that deferrals dropped from 6% of loans in June to 2% by the end of July; Fifth Third Bank (FITB) saw deferrals fall by the same amounts between June and August; and Comerica's (CMA) deferrals declined by 90% over a similar period. While few banks have disclosed such specific statistics, many have noted similar trends. Nonetheless, not all borrowers will be able to meet their obligations, and we expect some loans that were in deferral will be classified as nonperforming.

At large broker dealers, market volatility supported trading operation results, though we expect some revenue moderation ahead. At Morgan Stanley (MS), a large majority of its loan book comes from its wealth management division, where charge-offs remain low at less than 1% of total loans. Goldman Sachs (GS) should benefit from its limited exposure to consumer lending and smaller commercial loan book as compared to other large banks. The company indicated that forbearance is low, at ~3% of the total portfolio. Capital ratios remain healthy and continue to improve despite large provisions for loan losses.

Looking ahead, we expect consumer delinquencies and charge-offs to increase. However, consumer balance sheets entered the pandemic in good shape and personal savings rates are exceptionally high. They should help cushion consumer spending and allow many households to continue servicing debt. Similarly, given strength in the housing market, we think residential mortgage loan problems will be manageable, despite a sharp increase in Q2 delinquencies. Commercial real estate loan performance is likely to be dependent on sector and region given varying business conditions and regional limits on occupancy and other health standards. We are monitoring bank exposures closely, but we do not see outsized risks.

Finally, and perhaps most importantly, U.S. banks dramatically boosted loan-loss provisions in 2020's first half and are prepared for a sizable increase in loan losses. U.S. banks now typically carry loan- loss reserves 2-4 times non-performing loans, which is nearly double its level at the end of 2019. Elevated provisions reduced earnings at most banks in Q1 and Q2, and led to losses at some, but they increased banks' ability to absorb losses without dipping into capital. Looking forward, we anticipate higher charge-offs in 2021 and think banks will book provisions to match them, but that will mean substantially lower provisions compared to Q1 and Q2. Among banks that have reported so far in Q3, loan loss provisions generally declined to pre-pandemic levels. At the same time, all large banks (and nearly all smaller ones too) eliminated common share repurchases starting in the first quarter, which has allowed most of them to boost common equity Tier 1 (CET1) capital, supporting preferred securities and other creditors. For Q3, Bank of America reported an impressive 130bps sequential improvement in CET1 (to 12.7%).

Insurance and Non-Bank Financial Services
(20% of the preferred market)

COVID-related loss exposures for property and casualty insurers (P&C) depend on the types of insurance coverage provided. The majority of these losses have tended to be from coverage related to event cancellation policies, worker compensation and possibly those business interruption policies where there were no specific physical property damage requirements or virus exclusions (typically, U.S. policies have such provisions). P&C insurers have benefited from reduced driving in their auto insurance books, but also report COVID- related losses on property policies that did not have virus exclusions along with higher claims under worker compensation and some financial lines. Despite COVID-related claims, P&C insurers generally reported good net income through Q2.

Life insurers have not been materially impacted by COVID mortality claims thus far and view COVID risk as manageable. These companies also have other business lines such as annuities (i.e., longevity risk) to offset life insurance (mortality) risk. Larger risks to these companies are more macro and long-term in nature, related to low interest rates and potential for declining credit quality of investments.

Brokerage and asset management firms have not identified any specific COVID-related loss exposures, and their businesses have performed well so far this year.

Utilities
(7% of the preferred market)

Utilities experienced less disruption from COVID-19 than other industries due to the regulated nature of earnings and cost-recovery mechanisms allowed. For example, utilities that operate under a regulator-approved decoupling mechanism (revenues not tied to customer usage volumes) have seen less revenue impact from reduced economic activity. Electricity demand, notably from industrial customers, decreases in an economic slowdown. However, even for utilities lacking a decoupling mechanism, industrial sales declines rarely translate into a big decline in earnings due to their lower margins.

In contrast, residential sales are higher margin, and sales generally increased with more people working from home. According to the Energy Information Administration, the YE19 average U.S. price of electricity for residential customers was around twice that for industrials. Utilities have seen 4-5% increases on average in residential usage. From an earnings perspective, this has offset much of the impact from commercial and industrial usage declines (down 10-15% on average), especially for a utility geared toward residential customers. Any remaining earnings drag from usage declines has largely been offset by operating cost cuts to date. Commentary from management on Q2 calls noted improving overall usage trends in July and August. For comparison purposes, overall customer demand growth was nearly flat (-0.5% to +0.5%) before the pandemic.

One negative impact from COVID-19 has been increased bad-debt expense. As a percent of operating cash flow, bad-debt expense is up to about 2.5% currently from 0.5-1.0% on average before COVID-19. Bad debt is typically recovered either via an increase in rate base or through various riders. Some regulators have allowed deferral of bad debt expense incurred since the beginning of the pandemic that is greater than levels already included in rates, with cash recovery in future rate cases. Overall, we think utilities have relatively low risk from COVID-19.

Energy
(6% of the preferred market)

Energy continues to be a sector under pressure, even though we don't see direct credit problems within most of this sector. The vast majority of energy issuers are pipeline companies, with limited direct commodity exposure – but rather exposure to volume changes on their systems. They have high-quality assets that continue to be utilized, often under take-or-pay arrangements with end-users. While pipeline credit metrics have remained largely unscathed by COVID- 19, there has been a sizable and negative shift in attitudes of both common stock investors and politicians toward fossil fuels. MLPs have evolved away from high-growth strategies, and corporate structures have been simplified to look more like a utility than growth company. Along with broad commodity price declines, this has radically shifted the investor base and depressed common stock valuations. Additionally, the political climate has shifted as green initiatives gain support as a replacement for traditional energy production and transport. Approvals for new pipeline projects have become extremely difficult to obtain (impacting growth outlooks), and we have seen a recent threat to a pipeline already in operation. Although energy is a sector in transition, we believe certain energy investments are good credits that will continue to be an important part of energy infrastructure.

Miscellaneous Segment
(5% of the preferred market)

Credits in the Miscellaneous segment include various companies in the agricultural sector. While food consumption has been resilient through the COVID-19 pandemic, it has created disruptions in distribution channels that have pressured earnings at most agricultural companies. We expect these companies to adapt to changed consumption patterns and manage through the pandemic, although leverage may increase modestly.

Flaherty & Crumrine Incorporated

BROMPTON FUNDS

VALUE
INTEGRITY
PERFORMANCE

THE FOUNDATION FOR EXCELLENCE

Investor Relations
PHONE 416.642.6000
TOLL FREE 1.866.642.6001
FAX 416.642.6001
EMAIL info@bromptongroup.com

Website
www.bromptongroup.com

Address
Bay Wellington Tower,
Brookfield Place
181 Bay Street
Suite 2930, Box 793
Toronto, Ontario M5J 2T3