



U.S. Economic Conditions

The U.S. economy expanded significantly faster than expected in the first quarter of 2019. Inflation-adjusted gross domestic product (real GDP) rose 3.2% in Q1, compared to an early January forecast of 2.1%. The composition of growth was weaker than in recent quarters, however, as a narrower trade deficit and faster inventory accumulation accounted for just over half of Q1 growth. Economists expect 1.8% real GDP in Q2 and 2.5% in 2019 overall, slowing to 1.8% in 2020. Those forecasts are on the low end of our expectation for 2.5–3.0% growth (Q4/Q4) in 2019 and 2.0–2.5% in 2020.

While each of those forecasts implies some slowdown from 3.0% real GDP growth in 2018, we remain more optimistic than most for a few reasons. First, we think there is still some “gas in the tank” from tax reform that will drive business investment higher. That should support rising labor productivity and help offset a slower pace of hiring and higher wages as the labor market tightens. Second, higher wages should support continued strength in personal income, even with slower job growth. Third, the immigration situation has become so untenable that we may actually see some policy reform that helps alleviate some labor shortages and benefits economic growth. Finally, financial conditions are substantially easier than they were at the end of 2018, which should support the U.S. economy over the next several years.

While the labor market has slowed from last year, job growth remains solid. New job growth is outpacing population growth and the labor market continues to tighten. The unemployment rate remains near historical lows and the employment-to-population ratio continues to trend upward. Similarly, wage gains continue to build slowly. We continue to expect wages will accelerate gradually and support personal income even when employment growth eventually slows.

The labor market remains robust overall and should continue to support personal consumption expenditures (which accounts for almost 70% of GDP). Even so, consumers have a cautious view on the current expansion's life expectancy. Consumers' caution was reflected in first-quarter GDP, but second-quarter consumer spending appears much stronger. Although plenty of risks to the U.S. economy are lurking, we think most of them will remain in the background and allow sustained growth in consumer spending over coming quarters.

Entering 2019, with financial conditions tighter and economic growth looking soft, the FOMC signaled a shift to significantly more accommodative monetary policy. At its January 2019 meeting, the FOMC introduced a new wait-and-see regime emphasizing “patience” on monetary policy during a period of economic uncertainty. It followed up in March with projections for the fed funds rate that eliminated rate hikes in 2019 (50 bp lower than prior expectations). The FOMC also announced plans to slow SOMA portfolio runoff beginning in May 2019 and end it in October 2019 – substantially earlier than prior expectations. At its June meeting, the FOMC shifted even further toward easing with 7 of 17 members projecting 50 bp of rate cuts by the end of 2019 and a lowering the long-run neutral rate of interest from 2.8% to 2.5%. As a result, the monetary base will remain higher than previously expected, and financial conditions eased considerably.

In Fed Chairman Powell's most recent testimony to Congress in July, he cited uncertainties that continue to weigh on the outlook and strengthen the case for more accommodative monetary policy. These uncertainties include escalating tariffs, slowing global growth and low inflation that could prove more persistent than previously anticipated. While markets now expect the FOMC to cut rates by a cumulative 50 bp at its July 31 and September 18 meetings, they have taken the FOMC's more-dovish policy stance several steps further. Markets now price in rate cuts that will bring the fed funds target (upper bound) down from 2.5% currently to about 1.4% by the year-end 2020, well below the Committee's 2.3% median “dot plot” expectation from June.

Our rate expectations are close to the FOMC's. The FOMC is likely to cut rates by 50 bps this year as "insurance" against risks to the current outlook. However, we expect relatively solid U.S. economic growth this year with gradually rising wages and inflation. If economic growth stabilizes and a trade deal happens, the Fed could hold rates steady for some time following those "insurance" cuts. However, we certainly see policy paths and economic outcomes that lead toward market forwards. In particular, in the absence of trade deals, escalating tariffs could weigh on business investment. In turn, that would reduce prospects for further gains in productivity, lowering potential economic growth, especially amidst stasis on immigration policy. Moreover, global economic growth – which space prevents us from exploring here – could slow more than we expect under those circumstances. For now, we view those as risks to our forecast, and we will continue to evaluate them as 2019 progresses.

Preferred Market Conditions

The fixed-income rally that began in early 2019 gained steam over the past few months as central banks around the world signaled that more accommodative monetary policy was a near certainty. Lower interest rates renewed a global hunt for yield and provided a steady tailwind for preferred securities.

The market's shift in outlook for monetary policy from future rate hikes to rate cuts was sudden and is largely responsible for the risk-asset rally in 2019. After a weak end to 2018, the market was poised to benefit from this change in sentiment. Preferred securities continue to offer more yield than most fixed-income alternatives, particularly on a risk-adjusted basis. Given limited supply and the desire for higher yields, investors scooped up almost every new issue brought to market this year. If Treasury rates remain low, demand should remain healthy.

Banks and financials continue to be our favorite sectors, largely driven by strong current and projected credit quality. Valuations in these sectors are rather mixed at this point, and, as always, it pays to be selective on issuers and structure.

Portfolio Results

Over the six months ending June 30, 2019, the Fund's portfolio trailed the ICE BofAML hybrid preferred securities index, which tracks the investment-grade US dollar-denominated taxable preferred securities market structured for retail investors. However, the Fund's portfolio outperformed the ICE BofAML capital securities index, which tracks the investment-grade U.S. dollar-denominated taxable preferred market structured for institutional investors.

During the first half of 2019, the Fund benefitted from its higher weighting toward securities with more call protection. Securities with more call protection (longer duration) outperformed securities with near-term calls, which is expected when Treasuries rally. Call protection is important as rates fall, since call options inherently favor issuers. Call protection allows the Fund to seek a more stable income profile over time as interest rates move up and down, and it is a feature we have always valued greatly.

The Fund also benefitted from its selection of bank issuers, most of which are CoCos (contingent capital securities issued by foreign banks) and not included in any of the indices mentioned above. Credit spreads narrowed on the Fund's selection of bank holdings more so than their counterparts in the benchmarks, providing a lift to fund performance.

A significant drag on performance over the first half of 2019 was the Fund's overweight to floating-rate preferreds. Slowing growth and a more dovish Fed stance led to declining short-term interest rates. Floating-rate preferreds underperformed since many have coupon formulas that are based on short-term interest rates. However a degree of perspective is warranted since floating-rate securities were among the best performers in 2018 as short-term interest rates increased.

Outlook for the Preferred Market

Despite the shifting macroeconomic landscape, credit conditions in 2019 have been stable to better. In particular, credit metrics at financial companies, which make up a majority of the Fund's investment universe, continued to improve. Leverage at financial companies continues to decline, and most of those companies have historically strong balance sheets and rising earnings.

Monetary policy has carried the day so far in 2019, and it is likely to remain an important driver looking forward. As the Fed evaluates how to proceed, economic data remains very important and could validate the market's move or muddy the picture further. Either way, Fed officials appear ready and willing to err on the side of stimulus – and that should be supportive of risk assets. In fairness, however, market expectations for central bank rate cuts are high and disappointment on this front could result in a pullback and increased market volatility. If the U.S. economy is stronger than markets predict, then somewhat higher Treasury rates over the next year or two would present a modest headwind for preferred securities, but credits spreads still have room to narrow.

| Annual Compound Returns ¹ | YTD | 1-Year | 3-Year | 5-Year | 10-Year | Since Inception |
|--|-------|--------|--------|--------|---------|-----------------|
| Flaherty & Crumrine Investment Grade Preferred Income Fund (NAV) | 16.2% | 9.9% | 8.4% | 6.9% | 15.2% | 5.7% |
| Hybrid Preferred Securities Index | 12.0% | 6.2% | 4.5% | 6.2% | 8.2% | 4.9% |
| Corporate US Capital Index | 11.0% | 7.9% | 6.8% | 4.7% | 9.8% | 5.3% |

¹Returns are for the periods ended June 30, 2019. Inception date December 15, 2004. The table shows the Fund's compound return for each period indicated, compared with the return for the ICE BofAML US Capital Securities US Issuers 8% Constrained Index ("Corporate US Capital Index") and the ICE BofAML Hybrid Preferred Securities 8% Constrained Index ("Hybrid Preferred Securities Index"). The Corporate US Capital Index includes investment-trade, fixed rate or fixed-to-floating rate \$1,000 par securities that are structured for institutional investors and that receive some degree of equity credit from the rating agencies or their regulators. The Hybrid Preferred Securities Index includes taxable, fixed rate, US dollar denominated, investment grade preferred securities listed in a US exchange and structured for retail investors. Since the Fund is actively managed, the sector weightings and credit ratings may differ from those of the indices. The indices are also not leveraged, whereas the Fund employs leverage. Further 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.

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