



PORTFOLIO MANAGER COMMENTARY - JUNE 30, 2020

## U.S. Economic Conditions

The U.S. economy slowed sharply in the first quarter of 2020 as “Safer at Home” orders proliferated in the second half of March and many businesses – especially in travel and hospitality – suspended or curtailed operations. Economic activity promptly slumped, making February the last month of a 128-month expansion and March the start of a severe, but likely short, recession. Inflation-adjusted gross domestic product (real GDP) fell by 5.0% in Q1, led by a 6.8% drop in personal consumption. Economists expect the second quarter of 2020 to post by far the largest decline on record: (35%).

We expect the second quarter to mark the low for this contraction. With many businesses at least partially reopened, growth expectations for Q3 and Q4 are 19.8% and 8.8%, respectively. For the full year 2020, economists forecast a decline in GDP of 5.7%, rebounding to +4.0% in 2021. These forecasts compare to expectations for growth of about 2% in 2020 and 2021 prior to the COVID-19 pandemic. Beyond 2021, we expect the economy to expand a bit faster than the prior 2% trend for several years as businesses that closed are replaced by new ones and absorb workers whose jobs disappeared during the recession. It’s likely to take a number of years to recover economic growth lost to the pandemic, however.

Developments in the labor market over the past few months vividly illustrate the sudden and devastating economic impact of coronavirus and public and private responses to it. Job growth remained solid early in the first quarter. Nonfarm payroll jobs rose by an average of 233,000 jobs per month in January and February before falling by 1.4 million jobs in March and a staggering 20.8 million in April, pushing the unemployment rate to 14.7%. Many job losses were temporary, however, and May and June saw increases of 2.7 million and 4.8 million jobs, respectively, as businesses reopened and rehired workers. The unemployment rate dropped back to 11.1% in June, although that is still far above February’s 3.5% rate.

Renewed growth in employment and consumer spending has been substantially better than expected and reflects both the economy’s inherent resilience and fiscal and monetary policy responses to the crisis. Personal income and consumption slumped as “Safer at Home” orders were imposed but rebounded strongly in April (income) and May (consumption) as stimulus checks arrived, businesses began to reopen and consumer confidence rose. Savings jumped and should help sustain consumer spending as fiscal support tapers over coming quarters.

Home sales slumped as the pandemic unfolded, but they have started to pick up as restrictions have eased. We expect residential investment to turn upward again in the third quarter, although the strength of any housing rebound beyond that will depend on job recovery, which remains uncertain. Business investment, which slipped 6.4% in the first quarter and probably even more in Q2, is likely to remain subdued given sizable excess capacity currently. Stronger consumer spending and a revival of exports should pull it up eventually, but that may take a couple of quarters.

After passing nearly \$3 trillion in fiscal stimulus as the pandemic unfolded in the second quarter, Federal government spending should increase considerably this year. However, because much of the incremental spending is on loans and transfer payments, some of the money will be saved by consumers or returned by borrowers, making its impact on economic growth uncertain.

Inflation was already slowing in the first quarter and plunged after “Safer at Home” orders prompted layoffs and much weaker consumer spending. For 12 months ending in May, the consumer price index (CPI) was up just 0.1% overall and 1.2% excluding food and energy. Through May, the PCE deflator (a measure of inflation based on changes in personal consumption) was up 0.5% overall and 1.0% excluding food and energy. A dramatic decline in energy prices was primarily responsible for slower inflation. However, slack demand and sizable excess capacity should keep a lid on inflation for an extended period, which should leave the Federal Reserve firmly focused on its “maximum employment” objective.

In response to rapidly-emerging risks, the Federal Open Market Committee (“FOMC”) in March cut the federal funds rate target by 1.5% to its current level of 0–0.25%. FOMC members expect rates to remain near zero at least through 2022. The Fed also reinstated quantitative easing for the fourth time (QE4) since it was first used during the financial crisis, this time broadening its scope and making its size effectively unlimited. The Fed also reinstated or introduced new lending programs, including new facilities to purchase corporate and high-yield securities. Markets recovered substantially and financial conditions eased. Treasury yields fell sharply, with rates on 10- and 30-year Treasury bonds currently yielding about 0.7% and 1.4%, respectively.

## Preferred Market Conditions

The first half of 2020 has been a tale of two very different periods. The first two months of 2020 were largely a continuation of 2019's familiar themes. Financial conditions eased materially in 2019; credit quality remained healthy, especially for "financial" issuers; preferreds and contingent capital securities ("CoCos") continued to offer a yield advantage compared to senior debt, presenting an attractive option for income investors in a low-yield environment. Many of the pressing issues from 2019 were also showing improvement, such as Brexit and US-China trade negotiations – leaving many investors looking to the November election as the next catalyst for market disruption.

All of that was upended in March by a novel coronavirus. It is clear the world was blindsided by COVID-19 and thoroughly unprepared for a pandemic of this speed and magnitude. Government response in the U.S. has been a patchwork of federal, state and local orders. The response was uneven, with some states imposing strict social distancing rules in mid-March and others waiting weeks after the first states acted. Removal of those restrictions has been equally uneven, with some areas moving slowly and others rapidly to reopen businesses and public activities. Scientific knowledge of this novel coronavirus is advancing but not as quickly as we would all prefer.

In response to COVID-19, and a sudden halt in economic activity brought on by measures to flatten its spread, prices of stocks and fixed-income securities in the first three weeks of March moved lower rapidly and relentlessly. While wider credit spreads were to be expected, markets were thin and investors in need of liquidity were forced to accept lower and lower prices.

As prices declined, leverage ratios at some funds rushed higher and resulted in even more selling as leveraged investors raised cash to pay down borrowings. All told, over the course of a few weeks in March, it appears closed-end preferred funds alone repaid over \$1 billion in leverage; open-end preferred funds saw outflows of almost \$2 billion; and preferred ETFs saw outflows of more than \$1.5 billion. Moreover, it appears similar trades were occurring in most segments of fixed-income markets (loans, municipals, high yield, investment-grade corporate credit). Overall, we estimate at least \$5 billion left the preferred market in March. In light of the preferred market's modest size, this was a significant amount of activity.

Selling of such magnitude over a short period of time resulted in drastic price changes and dislocations in every market segment – exceeding moves attributable to fundamental credit concerns. However, the extent of outflows and the amount of deleveraging so early in the process helped markets make a dramatic recovery since the lows of March 23, in many cases cutting losses by more than half. This impact of COVID-19 is far from over, and much economic loss is yet to be quantified – but at least we feel that markets have returned to evaluating "credit" more than chasing "liquidity".

## Portfolio Results

Over the six months ending June 30, 2020, the Flaherty & Crumrine Investment Grade Preferred Income Fund's (the "Fund") US dollar-denominated investment portfolio (before the impact of expenses and hedging currency risk between U.S. and Canadian dollars) trailed the ICE BofAML Hybrid Preferred Securities Index, which tracks the investment-grade US-dollar-denominated taxable preferred securities market structured for retail investors. The Fund's portfolio also trailed the ICE BofAML US Capital Securities Index, which tracks the investment-grade US-dollar-denominated taxable preferred market structured for institutional investors.

COVID-19 and related social-distancing orders resulted in a material decline in global demand for oil as economic activity suddenly slowed in many countries. A second, and seemingly unnecessary, oil crisis developed as OPEC+ participants argued over much-needed production cuts – with Saudi Arabia actually increasing oil production and driving prices even lower. Given these developments it's no surprise that energy companies were by far the worst performing sector in the benchmarks over the first half of the year. As a result, even the portfolio's moderate overweight exposure to energy companies (12% of the Fund as of June 30, 2020) was a significant drag on performance since the drop in the price of oil began. However, unlike exploration and production companies, the portfolio's energy holdings are pipeline and midstream companies that have significantly less commodity price exposure and have the ability, we believe, to tolerate a period of slack demand and lower energy prices.

Entering this crisis, European banks as a group had weaker credit quality than their U.S. bank counterparts. That being said, we believe certain European banks remain very solid credits. However, dividend payout ratios were much higher for European banks, and, as a precaution, their common stock dividends have been eliminated until further notice. This spooked investors in CoCos, even though subsequent communications from regulators indicated support for CoCo coupons to continue. Consequently, CoCos underperformed and the Fund's exposure to CoCos (17% of the Fund as of June 30, 2020) was a significant drag over the first half of 2020.

In response to the crisis, the Federal Reserve lowered its overnight lending rate to near 0% and Treasury rates declined substantially across all maturities. In this environment, floating-rate securities underperformed since most have coupon formulas based on short-term interest rates. As a result, the Fund's overweight exposure to floating-rate preferreds (14% of the Fund as of June 30, 2020) was a drag on performance. Keep in mind though that the Fund portfolio has exposure to a variety of coupon types in order to maintain flexibility under different economic and interest rate environments.

### **Outlook for the Preferred Market**

The magnitude of recent fiscal and monetary policy responses will help limit the economic impact from the COVID-19 pandemic. However, it's inevitable that some households and businesses will be unable to meet their financial obligations, and we expect some credit strains to emerge over coming quarters. Nonetheless, we expect economic recovery will begin in the third quarter after a devastating second quarter.

Moreover, financial companies, which comprise the bulk of the Fund's investments, are in a good position to ride out the storm and benefit from recovery. Most financial companies in the U.S. have dramatically reduced their own leverage over the past decade and are better prepared for a downturn compared to the financial crisis in 2008. They possess both strong capital levels to support lending and healthy loan-loss reserves for potential defaults. Banks took large provisions for loan losses in the first quarter to get ahead of potential problems, and we expect another round of elevated provisions in the second quarter, albeit smaller than in the first quarter. Earnings at financial companies are likely to be muted as a result, but these actions strengthen their balance sheets and benefit debt and preferred investors.

COVID-19 already has proven to be a terrible event in both human and economic terms, and it is still very much with us. Although markets have calmed considerably from their drastic initial moves, no one yet knows the full magnitude of this calamity. Mandated "Safer at Home" orders have slowly been supplemented with continued social-distancing and mask requirements, along with a cautious, staggered approach to re-opening our economy. There remains too much uncertainty to predict timing on any of this with any specificity.

In the meantime, we continue to monitor credits and security valuations closely and work to position our portfolios to meet their objectives – and for the best chance of recovery in asset values as the pandemic recedes. We remain cautiously optimistic on the preferred and CoCo markets, especially from the viewpoint of long-term income investors. Flow data indicates investors are returning to fixed-income, absorbing record levels of new issue debt over the last few months. However, we acknowledge that there is limited modern historical precedent for this pandemic and its global economic impact, making our "crystal ball" unusually cloudy.

Annual Compound Returns <sup>1</sup>	1-Year	3-Year	5-Year	10-Year	Since Inception <sup>2</sup>
Flaherty & Crumrine Investment Grade Preferred Income Fund	(6.1%)	0.6%	4.5%	9.8%	4.9%
Hybrid Preferred Securities Index	2.5%	3.7%	5.6%	6.5%	4.8%
Corporate US Capital Index	6.3%	5.3%	5.5%	7.3%	5.3%

<sup>1</sup> Returns are for the periods ended June 30, 2020. 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") (together the "Indices"). 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.

<sup>2</sup> Inception date December 15, 2004.

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