



PORTFOLIO MANAGER COMMENTARY - SEPTEMBER 30, 2019

U.S. Economic Conditions

While the U.S. economy slowed in the second quarter of 2019, for the most part the economy looks fundamentally healthy. Inflation-adjusted gross domestic product (real GDP) averaged a solid 2.6% rate in 2019's first half, supported by consumer spending and wage growth. Economists expect 1.8% real GDP in Q3 and 2.3% in 2019 overall, slowing to 1.7% in 2020. Our 2019 GDP forecast is near consensus, but we think 2.0–2.5% growth in 2020 remains achievable if a broad trade agreement with China is reached later this year or early in 2020. Prospects for such a deal prior to the November 2020 presidential election appear to have dimmed, however, which could prolong weakness in manufacturing and business investment and pull GDP growth down below 2% next year.

As this economic cycle matures, job growth has predictably slowed, averaging 161,000 jobs per month this year through September as the pool of available workers diminished. However, employment continues to expand more rapidly than the working-age population. As a result, the unemployment rate dipped to 3.5% in September from 3.9% at the end of 2018, while the employment-to-population ratio rose to a 10-year high of 61.0%. Average hourly earnings were up 2.9% YoY in September, down from a peak of 3.4% YoY in February but still up considerably from a couple of years ago. Wages should continue to accelerate gradually and support personal income even as employment growth slows.

Personal spending so far in 2019 was up 4.7% (annualized) through August. Consumption is well-supported by personal income, which rose 4.2% YTD, and by a robust savings rate of 8.1% in August. Solid employment growth and strong consumer balance sheets support our outlook for continued strength in consumer spending. However, business investment has slowed, and residential investment – while perhaps beginning to bottom out – remains a drag on growth.

Inflation remains below the Federal Reserve's 2% target. For 12 months ending in September, the consumer price index (CPI) was up 1.7% overall and 2.4% excluding food and energy. For 12 months ending in August (latest data available), the PCE deflator, was up 1.4% overall and 1.8% excluding food and energy over the same period. Inflation has yet to move meaningfully higher despite impressive economic growth, tariffs that boosted import prices, and rising wages.

At its January 2019 meeting, the FOMC turned away from continued rate hikes toward “patience” on monetary policy during a period of higher economic uncertainty. In March, it eliminated projections of additional rate hikes in 2019 and announced that System Open Market Account (SOMA) portfolio runoff would slow in May 2019 and end in October 2019. In early May, trade negotiations between the U.S. and China broke down, rattling financial markets and denting business investment. In June, the FOMC opened the door to future rate cuts but left the fed funds rate target unchanged at 2.25-2.50%. It walked through that door on July 31, cutting the fed funds rate by 25 bp and accelerating the end of SOMA runoff to August 1, two months ahead of its prior schedule. The FOMC followed with another 25 bp rate cut at its September 18 meeting as global growth slowed and trade tariffs continued to drag on economic activity. As a result of this series of increasingly accommodative policy changes, financial conditions mostly eased so far in 2019.

Economic projections from the FOMC's September 18 meeting suggest that further rate cuts will face a higher bar with 10 out of 17 FOMC members projecting no additional rate cuts in 2019 and 9 out of 17 FOMC members projecting no additional rate cuts in 2020. The FOMC continues to emphasize both data dependence and a risk-management approach. On one hand, the U.S. economy has remained on solid footing thus far. On the other hand, risks have increased due to slower global growth and ongoing trade uncertainty. Meanwhile, markets are bracing for a weaker economy and now price in one more 25 bp rate cut by year-end 2019 and an additional 50 bp of rate cuts next year, bringing the fed funds rate target to 1.00-1.25% by late 2020.

We currently expect an additional 25 bp rate cut in before year-end but a stable fed funds rate through 2020. However, risks lie mostly to the downside, and if consumer spending turns soft, the Fed almost certainly would respond forcefully to it. For now, we see strength in consumer spending continuing, which should prompt somewhat higher intermediate- and long-term Treasury rates from current levels. But we also see downside risks that not only justify current Treasury yields but could push them even lower.

Credit metrics at financial companies have generally been steady. Overall bank loan delinquencies are unchanged compared to a year earlier, while overall loan charge-off rates rose slightly. Delinquency rates fell on real-estate loans, rose on commercial/industrial loans and were unchanged on consumer loans. Bank earnings are strong, loan growth remains modest and capital ratios are steady at very healthy levels. U.S. banks remain highly resilient and are well prepared for the next downturn.

Our reasons for optimism on the U.S. economy have not changed materially. We think business investment should pick up again (especially following a trade deal), which would boost labor productivity and help offset a slower pace of hiring and rising wages from a tighter labor market. Second, higher wages should support continued strength in personal income, even with slower job growth. Third, immigration reform could help alleviate some labor shortages and benefit economic growth, although the politics around it make progress difficult. Finally, financial conditions have eased considerably and are likely to ease further, which should support the economy over the next several years.

On the other hand, downside risks have increased. Global economic growth has been weaker than expected so far in 2019. The International Monetary Fund now forecasts 3.0% global growth in 2019 and 3.4% in 2020, down 0.2% and 0.1%, respectively, from a quarter ago. Although we expect a deal eventually, trade negotiators between the U.S. and China have only been able to agree on a relatively narrow set of issues, and achieving a broader agreement remains highly uncertain. Trade tariffs and policy uncertainty have chilled global trade, contributed to slower global growth, and prompted businesses to postpone or reduce investment. While we are optimistic on immigration reform at some point, a path to compromise remains elusive and may not be achieved before 2021.

So far in 2019 credit markets have posted strong returns, buoyed by declining Treasury rates and narrowing credit spreads as investors sought yield in a lower-rate environment. If U.S. economic growth remains above 2% – not a high bar – higher Treasury rates may present a modest headwind to performance over the next year or two. However, credit conditions mostly remain supportive, especially for financial companies, and credit spreads have room to narrow further.

Preferred Market Conditions

By almost any measure, 2019 has been a banner year for fixed-income (including preferreds) – fueled primarily by significantly lower interest rates but also tightening credit spreads. Preferred and other capital securities have continued to benefit from investors' appetite for yield, along with limited new issue supply and favorable market technicals.

In this environment, long-duration assets have outperformed materially. The preferred and capital securities market, on average, is more intermediate duration given the predominance of fixed-to-float structures. Even though prices have increased, these securities continue to offer extra yield over comparable senior-debt of similar issuers. In other words, they have largely kept pace with the move but still offer healthy subordination premium relative to senior debt. Embedded call options result in negative convexity as prices move higher, so the portfolios' bias toward longer call protection has proven valuable.

Credit quality continues to be a bright spot, particularly in the U.S. A weakening economy could eventually result in earnings pressure, but for financials this should be isolated to earnings and not be a threat to capital. Loan losses could tick higher from recent historical lows, but the banking system is in very good shape to weather a storm. Similarly, insurers face headwinds from low investment yields, but underwriting generally remains sound (and data to better assess risk is expanding rapidly) and liabilities have adjusted over the past decade to accommodate low rates. As has been the case for some time, the global picture is not quite as good – but even so, financials stand above most non-financial companies given continued regulatory oversight and increased levels of common-equity capital.

Risks to our otherwise positive outlook for the preferred market center primarily on a reversal of this year's decline in interest rates, but that likely results from better-than-expected economic data – which should be good news for credit. Alternatively, a weaker economy could put pressure on spreads (which have narrowed across fixed income this year) that would likely affect preferred and capital securities as well. Longer-term, however, we believe the preferred market continues to be well positioned to provide attractive levels of income.

Annual Compound Returns ¹	YTD	1-Year	3-Year	5-Year	10-Year	Since Inception
Flaherty & Crumrine Investment Grade Preferred Income Fund	22.5%	14.5%	8.2%	7.7%	13.3%	6.0%
Hybrid Preferred Securities Index	16.5%	12.1%	5.6%	6.9%	7.6%	5.1%
Corporate US Capital Index	15.8%	11.3%	6.8%	5.5%	8.5%	5.5%

¹Returns are for the periods ended September 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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