PORTFOLIO MANAGER COMMENTARY - DECEMBER 31, 2019

U.S. Economic Conditions

The U.S. economy grew at a moderate pace in 2019. While fourth quarter numbers are not yet available, inflation-adjusted gross domestic product (real GDP) should be up about 2.3% in 2019. That would be modestly below economists' consensus forecast of 2.7% growth entering 2019 and our expectation for a 2.5–3.0% expansion. Looking ahead, economists expect another slowdown in growth to 1.8% in 2020 and 2021. We are more optimistic for 2020, when we look for real GDP to expand by 2.0–2.5% on continued strength in consumer spending, a gradual recovery in housing and a modest rebound in business investment – all of which support a favorable credit outlook for the coming year.

The labor market was a source of strength once again for consumers. Payrolls were up by 2.1 million jobs (1.4%) and average hourly earnings rose by 2.9% over 12 months ending in December 2019. That contributed to a 4.9% jump in personal income over 12 months ending in November (latest data available). In turn, personal consumption expenditures (PCE) rose 3.9% year-over-year (YoY) in November, or 2.4% after inflation, and the savings rate moved up to 7.9%, well above its 20-year average of about 6%. With savings elevated, jobs plentiful and income growth strong, we think personal spending in 2020 should equal or exceed 2019's pace.

The housing market began to recover in 2019's second half, with combined new and existing home sales consistently over 6 million units (at an annual rate) in each month since June. Residential investment turned positive in the third quarter after declining for six consecutive quarters, and we expect further gains in 2020. In contrast, business investment slowed to just 0.3% through the first nine months of 2019 after rising 5.9% in 2018. We are hopeful that a trade agreement between the U.S. and China signed in mid-January 2020 will help unleash investment that was deferred in 2019, although we expect only a modest rebound given lower capacity utilization rates in recent quarters. Finally, government spending rose a bit faster than overall GDP in 2019, and we expect a similar result in 2020.

Despite moderate economic growth, rising wages and higher import tariffs, inflation remained subdued. For 12 months ending in December, the consumer price index (CPI) was up 2.3% both overall and excluding food and energy prices. The Federal Reserve's preferred inflation gauge, the PCE deflator, was up 1.5% overall and 1.6% excluding food and energy over 12 months ending in November – 0.4% below year-ago levels and well below the Fed's 2% target for PCE excluding food and energy. We think inflation will edge up in 2020, but global excess capacity and some tariff rollbacks should prevent inflation from rising rapidly.

Monetary policy was active last year as the Fed shifted from rate hikes and a shrinking balance sheet in 2018 to rate cuts and a growing balance sheet in 2019. Financial conditions progressively loosened as the Federal Open Market Committee (FOMC) signaled a shift to significantly more accommodative monetary policy in January 2019; eliminated projections of additional rate hikes in March; delivered 25 bp rate cuts in July, September and October, bringing the fed funds rate target to 1.50–1.75%; ended balance sheet runoff in August; introduced stepped-up purchases of Treasury bills to address strains in money markets in September; and in December projected no rate hikes through the end of 2020. For now, the FOMC believes it has completed a "mid-cycle adjustment" to monetary policy that should help support economic growth and move inflation up toward its 2% target. These actions added up to considerably easier financial conditions, which propelled the preferred market but also reduced reinvestment yields as the year progressed.

Preferred Market Conditions

What a difference a year can make! The preferred market delivered a fantastic year of performance in 2019, a remarkable turn-around considering that just one year ago during the fourth quarter of 2018, markets produced dismal performance as investors worried about rate hikes and a possible recession. The Federal Reserve's unexpected pivot toward looser monetary policy, however, prompted a sudden and dramatic mood change in early 2019. As the year progressed and the Fed's shift from tighter to more accommodative monetary policy became clear, markets gradually became desensitized to macro headlines. While trade and political uncertainty was abundant, the U.S. economy continued to progress despite these uncertainties, and interest rates settled into a relatively narrow range in the second half of 2019.

The Fed's pivot was a strong signal to markets that it would be cautious on monetary policy, erring on the side of protecting a U.S. economy whose growth stood out among struggling global economies. With the Fed signaling that higher interest rates were unlikely near-term, markets began to price in lower rates as a dovish stance was in place for the foreseeable future. Indeed, interest rates moved substantially lower across the curve, and risk assets generally benefited from monetary policy easing. A global hunt for yield was once again in full effect.

Preferreds and contingent capital securities ("CoCos") offer a yield advantage compared to senior debt (and most other fixed-income alternatives), primarily because they are subordinated in an issuer's capital structure. Issuer credit quality in these markets has remained sound, partly due to a strong regulatory oversight regime for most financial issuers. Preferreds and CoCos have been a natural fit for investors searching for yield. While once very specialized, the preferred market has benefited from a substantial broadening of the investor base. Even traditional bond funds now regularly add a layer of preferreds and CoCos to their portfolios to enhance yield and total return.

While investor demand has been strong, net new issuance this year has been measured. Issuers have largely entered a maintenance phase, where they issue at the margin to facilitate modest balance sheet growth, but where most issuance reflects refinancing of older securities to take advantage of lower rates. We believe this trend likely continues near-term, although CoCo issuance could pick up in 2020. Broad-based demand combined with limited supply kept the preferred market well bid throughout this past year.

Portfolio Results

Over the six months ending December 31, 2019, the Fund's US dollar-denominated investment portfolio (before the impact of expenses and hedging currency risk between U.S. and Canadian dollars) outperformed the ICE BofAML 8% Constrained Core West Preferred & Jr Subordinated Securities Index, which tracks the US dollar-denominated preferred securities market.

Over the full calendar year, the Fund's portfolio also outperformed the Index. Over both the trailing six months and full calendar year, the Fund portfolio benefitted significantly from its overweight to securities with greater call protection. When rates are low, issuers have an incentive to call their outstanding securities and refinance them at lower coupons. This refinancing activity accelerated in the second half of 2019 as the outlook for lower rates became entrenched. Under this environment securities with greater call protection have generally outperformed. Securities with greater call protection can sustain higher prices since they have more time to amortize any price premium before eventually being called at par value. On the other hand, securities nearer to their call date haven't seen as much price appreciation since most are expected to be called at par.

Greater call protection allows the Fund's portfolio to have a more stable income profile over time as interest rates move up and down, and it is a feature we have always valued greatly. Of course, call protection is only one aspect that we consider in a preferred investment. Evaluation of spreads, trading patterns and ongoing credit monitoring are equally important to our investment process. So while nearly all market sectors ended the year in positive territory, the Fund's portfolio benefitted from its careful selection of securities that had greater room for their credit spreads to narrow.

Outlook for the Preferred Market

A number of recent developments helped close 2019 on a positive note and should improve the outlook for 2020. U.K. elections provided a path to proceed finally with Brexit, and although much work remains over coming years, moving Brexit to resolution is positive for markets. China trade issues are much the same – a lot of work remains, but progress is being made and both sides appear to be seeking common ground. As 2020 is a presidential election year in the U.S., we would caution that a long-term investment view is always prudent regarding political events.

More specifically for the preferred market, credit conditions and economic growth should remain broadly favorable in 2020 and benefit preferred and contingent capital securities. Leverage at U.S. financial companies has continued to decline since the financial crisis, and most of those companies have historically strong balance sheets and rising earnings. U.S. banks continue to be better positioned than their foreign counterparts on both earnings and capital, but European bank CoCos have been some of the best performers recently as Brexit finally appears to be on-track. While not a near-term concern, rising leverage at nonfinancial companies is a longer-term risk we are monitoring.

Looking ahead, financial conditions are supportive, and U.S. fiscal policy is mildly expansionary. Risk is mostly for lower rates if growth falters, as we think the Fed is unlikely to raise rates if the economy does better than expected. Markets have to incorporate that risk, and forward rates look about right to us today. But if the Fed leaves rates steady as we expect, that means intermediate- and long-term rates should move modestly higher over the course of 2020. However, credit spreads have room to narrow further in this environment, which should help offset a rise in intermediate- and long-term interest rates if economic growth outpaces economists' subdued expectations for 2020.

We believe the preferred market continues to offer long-term investors an attractive combination of good credit quality, high income and moderate interest-rate risk. We have no doubt 2020 will be another interesting year – and we hope a good one for investors in preferred securities.

Annual Compound Returns[1]	1-YR	Since Inception[2]
Brompton Flaherty & Crumrine Investment Grade Preferred ETF (CAD hedged)	17.4%	10.8%
ICE BofAML 8% Constrained Core West Preferred & Jr Subordinated Securities Index	18.2%	14.4%
S&P/TSX Preferred Share Index	3.5%	(5.4%)

[1] Returns are for the periods ended December 31, 2019. The table shows the Fund's compound returns for each period indicated compared with the ICE BofAML 8% Constrained Core West Preferred & Jr Subordinated Securities Index ("Preferred & Jr Subordinated Securities Index") and the S&P/TSX Preferred Share Index ("Preferred Index") (together the "Indices"). The Preferred & Jr Subordinated Index tracks the performance of US dollar denominated high grade and high yield preferred securities and deeply subordinated corporate debt issued in the US domestic market. Qualifying securities must be rated at least B3, based on an average of Moody's, Standard & Poor's and Fitch and have a country of risk of either the U.S. or a Western European country. The Preferred Index tracks the performance, on a market-weight basis, of preferred shares listed on the TSX that meet the criteria relating to size, liquidity and issuer rating. 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.

[2] Inception Date October 15, 2018.

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