Brompton Flaherty & Crumrine Investment Grade Preferred ETF

BROMPTON FUNDS

PORTFOLIO MANAGER COMMENTARY - MARCH 31, 2019

U.S. Economic Conditions

U.S. real GDP growth in 2018 posted its best annual performance since 2015. However, economists forecast real GDP growth to slow to 2.4% in 2019 and 1.9% in 2020. With Federal Reserve policy likely to be less restrictive than previously expected, we think the economy will modestly outpace both of those forecasts.

Although 2018's 3.0% expansion probably represents a peak, 2019 growth should be faster than the 2.3% average annual growth rate during this recovery and 2020 should be close. Recent economic data confirm a slower economy, but importantly there are no signs of recession in the data. Over the first three months of 2019, job growth averaged 180,000 jobs per month while hourly earnings continue to grow at a monthly average of 3.3%. While the labor market has cooled somewhat, it remains a key strength of the U.S. economy.

A strong, but not too strong, labor market is helping keep inflation near the Fed's target. Excluding volatile food and energy prices, the consumer price index (CPI) has held between 2.0% and 2.4% over the 12 months ending March. The Fed's preferred inflation measure, the personal consumption expenditures deflator excluding food and energy has held between 1.8% and 2.0% since March 2018. While there has been some recent weakness in the inflation numbers, higher wages and energy prices may put some upward pressure on inflation, although slower economic growth push against that. Overall, given the counterbalancing forces, we expect inflation will rise only modestly in 2019.

Although we still believe the Fed could tighten once or twice more over the next two years, risk of an even more rapid pace of tightening than in 2018 – which was very much on investors' minds just a few months ago – has transformed into expectations of steady monetary policy, and maybe even a rate cut. And while U.S. growth is likely to slow from its 2018 pace, it still should be better than most years of this recovery. That should support household and corporate income and balance sheets while limiting prospects for sharply higher long-term interest rates.

Among U.S. bank preferreds, we continue to expect limited supply and good credit quality. Leverage at financial companies has continued to decline, and most of those companies have historically strong balance sheets and rising earnings. U.S. bank loan delinquencies and charge-offs are stable or falling from already-low levels, and loan-loss reserves are strong. Tax reform was a positive for bank earnings, and a healthy economy combined with modestly higher interest rates further support the outlook. While the economy, interest rates and consumer health will impact profitability, U.S. banks generally reported record earnings in 2018 and should see further gains (albeit at a slower pace) in 2019. We do not anticipate a recession over the next two years, but major U.S. banks appear to be well prepared if one arrives.

Preferred Market Conditions

While 2018 ended on a very weak note, with fixed-income markets (including preferreds) down sharply in December, markets did a 180-degree turn as the Fed changed its tune on monetary policy to start 2019. Rebounding prices were broad-based and more than made up for weakness in December, and investors are once again on a hunt for yield.

As discussed in our previous report, there were many factors contributing to weakness in 2018. A few of them remain in play today, including a global economic slowdown, ongoing trade wars, and continuous political headlines from both sides of the aisle. However, the Federal Reserve's unexpected pivot on its outlook for future rate hikes and size of its balance sheet (SOMA– System Open Market Account – portfolio) deserve most of the credit for the market's sudden mood change. As of its March 20 meeting, the Federal Open Market Committee estimates no rate increases in 2019 and one 0.25% hike in 2020, which would leave the year-end 2021 fed funds rate 0.5% below earlier projections. It also plans to halt SOMA reductions in October 2019, an earlier end point than previously expected.

The Fed's revised positions on rates and SOMA have been followed by similar policy statements from the European Central Bank (ECB). Investors globally have shifted expectations and now expect government officials to keep close watch over economies and markets with continued dovish monetary policies. The result has been lower, and remarkably stable, Treasury rates and a dramatic re-tightening of credit spreads.

Flow data on money going into and out of markets and investment products from late-2018 indicate many may have underestimated the degree of concern among investors. Outflows, particularly from corporate credit fixed-income funds, were substantial and help explain the magnitude of market weakness. Flows back into markets in 2019 have been impressive as well, slightly eclipsing late-2018's outflows.

While macro factors have been driving markets, our strategy continues to focus on credit quality and structure – both of which remain healthy – and portfolio turnover remains low. Still, the economic outlook and related macro factors – such as global monetary policy and trade – should continue to have an outsized impact on our market's direction over the near-term.

Credit fundamentals for most issuers of preferreds are strong, and we expect them to remain resilient even if the pace of economic growth slows over the next several years. Supply of newly-issued preferreds should remain very manageable, providing technical support to the market. Combined with competitive yields, tax advantages, and benign credit conditions, we believe the case for preferreds as an income investment remains intact.

Portfolio Results

Over the first quarter of 2019, Brompton Flaherty & Crumrine Investment Grade Preferred ETF (the "Fund") US dollar-denominated investment portfolio underperformed the ICE BofAML 8% Constrained Core West Preferred & Jr Subordinated Securities Index (the "Index"), which tracks the US dollar-denominated preferred securities market. The Index includes preferreds whose income is subject to withholding taxes (DRD eligible), as well as preferreds not subject to withholding.

On an absolute basis, preferreds (and the Fund's portfolio) had a very good first quarter. While last year's decline seemed to gather momentum rather quickly, the recovery was even swifter. By the beginning of February preferred prices had regained most of the ground they lost and continued to climb higher through the end of the first quarter. Prices remain a bit lower than prior to last year's swoon, but preferreds have more than made up for losses on a total return basis.

While the Funds portfolio performed well in absolute terms, it lagged the Index primarily due to its cash balance. The Fund's number of shares outstanding increased by 40% during the first quarter, a good development to be sure, but that made it difficult for the portfolio to keep pace with the rapidly climbing benchmark. Recognizing the pace of market gains we put cash to work as quickly as possible, but remained deliberate in our investment process, taking a long-term view and focusing on credit quality. Excluding the impact of the cash balance, the Funds portfolio of securities outperformed the Index.

The Federal Reserve turned dovish during the first quarter, forecasting no rate increases and an end to its balance sheet reduction in 2019. Investors quickly grew comfortable with the new rate outlook, moving further out on the yield curve as interest rates declined. In the preferred market, issues with shorter call protection (and shorter duration) underperformed. The portfolio benefitted from this shift since it is weighted toward preferreds with longer call protection and wider reset spreads. Having greater call protection limits the portfolio's call risk and allow us to control the timing of reinvestment. The portfolio's longer call protection means that its duration is slightly longer than the benchmark, but we think the modest increase in duration is well worth the tradeoff to limit the portfolio's call risk and allow us to control the timing of reinvestment.

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