

## PORTFOLIO MANAGER COMMENTARY - JUNE 30, 2021

### U.S. Economic Conditions

The U.S. economy continues its recovery from a sharp, pandemic-driven decline in the first half of 2020. Although the economy's rebound was considerably stronger than most economists expected when the pandemic unfolded, real GDP was still 2.4% smaller in the fourth quarter of 2020 than it was a year earlier and about 4% smaller than it might have been absent the pandemic. However, rapid growth in 2021, including a 6.4% jump in the first quarter, probably pushed real GDP above its 4Q2019 level in the second quarter, and it is expected to be back on its pre-pandemic growth path around the end of 2021. This is testimony to the U.S. economy's underlying resilience, strong fiscal and monetary policy support, and unprecedented speed in developing and deploying vaccines to fight the novel coronavirus.

After shedding more than 22 million jobs between February and April 2020, the labor market staged an impressive, albeit incomplete, rebound of 15.6 million jobs through June 2021. That means total nonfarm payroll employment remains 6.8 million jobs below the February 2020 peak. Moreover, payrolls are more than 9 million jobs below what they would have been had employment continued to expand at the same pace as in 2019. Similarly, the unemployment rate started 2020 at 3.5%, jumped to 14.8% in April and fell to 5.9% in June 2021.

Despite this incomplete recovery, we are optimistic that most jobs lost during the pandemic will recover as COVID-19 recedes. For example, as consumer demand returns, hotels and restaurants have reopened or expanded services and are hiring employees. As pent-up demand is unleashed, employment should jump not just at businesses that were closed or operated at reduced capacity but also at producers and distributors up and down the supply chain. We expect strong employment growth over the remainder of 2021 and into 2022, although GDP is likely to recover ground lost to COVID more rapidly than employment.

Personal income is well above pre-pandemic levels. Transfer payments – stimulus checks, supplemental unemployment benefits and other assistance – largely replaced income lost during the pandemic, and wage and salary income has rebounded strongly over the past year, up 13.8% over 12 months ending in May. Continued employment growth and rising wages should keep income on an upward path as transfer payments diminish.

Personal consumption expenditure (PCE) continues to recover, with demand shifting from goods toward services spending as restaurants, travel and other leisure activities expand. PCE is also above its pre-pandemic peak, up about 4% in May 2021 compared to February 2020. However, spending lagged income, which rose 8.8% over the same period, and consumers have accumulated a large amount of savings as a result. High consumer confidence combined with rising employment and wages, high savings, and simply more things to do as the public health situation improves should drive rapid growth in PCE over coming quarters.

Fueled by fiscal stimulus, highly accommodative monetary policy and a global economic recovery, inflation accelerated substantially. The core PCE deflator excluding food and energy was up 3.4% over 12 months ending in May, and the consumer price index (CPI) excluding food and energy was up 3.8% over the same period. From February 2020 to May 2021, those inflation gauges are up 2.4% and 2.6%, respectively, at an annual rate. Inflation has probably peaked on a year-on-year basis for now, but it is likely to remain elevated at least through year-end. It is important to recognize that higher inflation resulting from aggressive fiscal and monetary stimulus is a policy choice, not a policy mistake – at least not yet – but it does raise the risk that inflation becomes stickier than desired.

Monetary policy was unchanged in the first half of 2021. The Federal Open Market Committee (FOMC) left the fed funds rate target at 0-0.25%, and the Fed will continue to buy at least \$80 billion of Treasuries and \$40 billion of agency mortgage-backed securities per month "until substantial further progress has been made toward the Committee's maximum employment and price stability goals." With the economy likely to regain growth lost to the pandemic by the end of 2021 and inflation up, the Fed is likely to begin dialing back monetary support for the economy sometime over the next few quarters. We expect that by August or September, the Fed will signal a shift to tapering securities purchases beginning in early 2022. That could set the stage for rate hikes in late 2022 or early 2023. Already, the FOMC's last "dot plot" from June 2021 showed Committee members expect the fed funds rate to increase by 50 basis points (bp) by year-end 2023, up from no change in prior projections and bringing them roughly in-line with market forward rates.

Credit conditions broadly improved along with the economy over the first half of 2021. Business bankruptcy filings have continued to decline and in May were at the lowest level since 2006. Bank loan quality remained good and improved in most categories in the first calendar quarter of 2021 (latest data available). Total bank loan delinquencies and charge-offs in 1Q2021 were flat or down slightly compared to 4Q2019, before the pandemic struck. This is much better loan performance than expected given the severity of last year's economic slowdown, and problem loans should remain subdued as economic growth continues over coming quarters. Away from banks, other industries that are major issuers of preferred and contingent capital securities remain broadly healthy. Higher interest rates have brightened outlooks for insurance and other financial services, while utilities and communications businesses benefit from faster economic growth. Even energy companies, which seemed most at risk when economic activity plummeted in 2Q2020, revived in recent quarters as a rising economy drove up energy demand and prices.

## **Preferred Market Conditions**

Throughout this pandemic, the most consistent – and arguably most important – market force has been the Federal Reserve. In addition to supporting markets as the pandemic unfolded in 2020, the Fed updated its policy approach to help ensure full recovery of the U.S. economy – keeping monetary policy highly accommodative through continued asset purchases and low rates, and expressing a desire for higher near-term inflation in hopes of moving average inflation closer to the Fed's 2% target. Except for U.S. Treasuries, nearly all markets have reacted positively to these policies.

U.S. Treasury markets were less enthusiastic and began to reflect this sentiment starting in February. Expectations for higher inflation, and probably materially higher over the short run, were inconsistent with 10- and 30-year Treasury yields of 0.9% and 1.6%, respectively, and intermediate and long-term interest rates began moving higher. In February alone, 10- and 30-year interest rates rose by 36 bps and 33 bps, respectively. Ten- and 30-year Treasury yields peaked in late March around 1.75% and 2.48%, respectively, and have since trended lower again as markets settled into a new range that is reflective of Fed policy and current economic data. While there is a risk of policy error, with inflation moving higher than expected, markets continue to have faith in both an economic recovery and the Fed's ability to manage inflation around that recovery.

Preferred and contingent capital securities (CoCos) initially reacted negatively in February to higher interest rates, even though duration metrics are quite moderate overall. Developments in the second quarter, however, have caused markets to improve dramatically from first quarter levels. Progress on vaccination rollout and re-opening of the economy have been impressive and very positive for corporate credit metrics. A global search for yield continues, and fear of missing out (not being invested) has taken precedence over higher Treasury rates, causing credit spreads to tighten and prices to rise. Cash continues to flow into fixed-income, and preferreds/CoCos continue to offer higher yields than most alternatives – especially risk-adjusted.

Broadly speaking, the Fund's portfolio didn't change much during the first half of the year, as current holdings continue to be preferable to most new-issue alternatives – especially in terms of current income. Banks remain our favorite credits, as reflected in our high allocation to the sector. Bank balance sheets strengthened through the pandemic, and earnings are rebounding from already respectable levels in the second half of 2020. Spreads have tightened in the sector, causing certain new-issue coupons to be lower than we might hope – but that properly reflects banks' strong credit profile. Insurance has also done well, although insurers' earnings continue to be a step behind banks due to lower investment yields and higher catastrophe losses in recent years.

## **Portfolio Results**

Over the six months ending June 30, 2021, 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 BofA 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 outperformed the ICE BofA capital securities index, which tracks the investment-grade U.S. dollar-denominated taxable preferred market structured for institutional investors.

Over the first half of 2021, the portfolio benefitted from its overweight to fixed-float preferreds (63.0% of the portfolio compared to 47.9% of the benchmark) and corresponding underweight to fixed-rate preferreds (19.3% of the portfolio compared to 48.9% of the benchmark). Since underperforming through the lows of last year, fixed-float and fixed-reset preferreds have made a complete turnaround, outperforming their fixed-rate counterparts in total return since the end of 2019 and we think conditions remain favorable for their continued outperformance. Today's low yield environment means the typically longer call protection offered by fixed-float preferreds is critical for shielding against call risk and sustaining portfolio income. Additionally, as we saw in the first few months of this year when fixed-rate preferreds underperformed, a floating- or reset-rate component can provide some insulation against rising interest rates. While we always have to be selective about coupon rate and structure, we tend to find greater value among fixed-float and fixed-reset preferreds.

Despite the recent decline in longer-term U.S. Treasury yields, the yield curve remains much steeper than it was at beginning the year, reflecting impressive progress on vaccinations and re-opening of the U.S. economy. As one would expect, securities with longer duration generally underperformed with the 10 Year U.S. Treasury yield rising 55 bps since the start of the year and ending at 1.47% on June 30. Longer duration preferreds include those with lower coupons, which were among the worst performers since their durations extend more dramatically as interest rates rise. Extension risk has heightened for preferreds with lower coupons (and generally tighter spreads), which are at greater risk of remaining outstanding as interest rates rise.

In contrast, preferreds with higher coupons are more insulated from rising interest rates at these levels, given that they typically carry greater spread and can withstand some rise in interest rates without extending duration much. The portfolio's greater exposure to higher coupon securities was a significant benefit over the first half of 2021. In particular, many of the portfolio's higher coupon preferreds are contingent capital securities (CoCos), 17.8% of the portfolio compared to 0.8% of the benchmark. Many CoCos performed well as credit spreads on CoCos narrowed with the steepening yield curve portending higher bank profits. Additionally, in their continual hunt for yield, investors found higher yields on CoCos difficult to resist, especially after this past year when central banks showed clear support for CoCos by not suspending CoCo dividends, even as they suspended common stock dividends.

## **Outlook for the Preferred Market**

There is no question the economic outlook has brightened as the COVID-19 pandemic has eased. Most markets have been out ahead of this improvement, and spread levels already reflect much of it. The low-rate environment (although higher than levels six months ago) cuts both ways in terms of outlook – with continued demand for yield supporting preferreds and CoCos near-term while also increasing the amount of refinancing available to issuers (call risk), resulting in potentially lower portfolio yields over time. The recent increase in longer-term interest rates has been a welcome change, in our opinion, as it may help keep yields from dropping further. Spreads have tightened to offset much of that move, but if inflation expectations continue to rise as the economy recovers, it could lead to future opportunities in the market.

In preferred and CoCo markets, call protection allows investors to tolerate lower interest rates for a period of time without reinvestment risk – and we place a high value on call protection in the Fund's portfolio. Low interest rates and tighter credit spreads arrived as non-call periods ended for a wide swath of the broader preferred market, resulting in advantageous refinancing opportunities for issuers over the past few months. Many securities have been refinanced into lower coupons, but part of the market has been redeemed without replacement. Recent redemptions resulted in a large reinvestment exercise across the preferred market, adding demand to an already technically strong market. Having more call protection in the portfolio than the broader market (especially compared to passive ETF products) and prioritizing it in our management process has resulted in a moderate level of reinvestment within the portfolio, which has helped sustain the Fund's distributable income. However, persistently low interest rates could outlast call protection and put pressure on income. None of this is new or unusual. The Fund has been through numerous interest rate cycles in the past, and our focus remains on generating attractive long-term income to shareholders.

Looking ahead, strong economic growth and ongoing fiscal and monetary stimulus translate to a favorable credit environment and, over time, a moderately higher interest rate environment, albeit with more inflation risk than we have needed to contemplate for many years. We believe this should favor fixed income sectors with higher credit spreads and moderate interest rate risk — precisely what preferreds offer today.

After a sustained rally since market lows in March 2020, corporate credit spreads reached lows not seen since before the global financial crisis. Additionally, near-zero short-term rates, intermediate Treasury yields below 1.5%, record household savings, and ample liquidity leave investors searching for yield. In this environment, we think preferred and contingent capital securities continue to offer high income and attractive risk-adjusted returns to investors.

Annual Compound Returns <sup>1</sup>	YTD	1-YR	3-YR	5-YR	10-YR	Since Inception <sup>2</sup>
Flaherty & Crumrine Investment Grade Preferred Income Fund	5.3%	22.6%	8.2%	8.0%	9.5%	5.9%
Hybrid Preferred Securities Index	0.5%	9.8%	6.1%	5.1%	6.1%	5.1%
Corporate US Capital Index	2.8%	13.4%	9.2%	8.0%	7.2%	5.8%

<sup>1</sup> Returns are for the periods ended June 30, 2021 and are unaudited. 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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