PORTFOLIO MANAGER COMMENTARY - SEPTEMBER 30, 2021

Global Markets Review

Following a stormy month in September, global equity markets narrowly extended positive gains during the quarter. For the three-month period ending September 30, 2021, the MSCI World Index edged up 0.1%, led by the Financials sector, which gained 2.2%; Energy was the second-best performing sector, rising 1.6% during the quarter and boosted by robust oil and gas prices. In North America, the S&P 500 was up 0.6%, also driven by Financials, while the S&P/TSX Composite was up 0.2%, with Consumer Staples and Industrials as the top performing sectors. In Europe, the STOXX 600 rose 1.0% during the quarter. Italy and the U.K. were the best-performing countries, where the FTSE MIB was up 3.0% and the FTSE 100 was up 1.9%. CAC 40 and IBEX 35 ticked up 0.4% and 0.3%, respectively. Switzerland and Germany finished the period in negative territory, down 2.4% and 1.7%, respectively.

Global economies continued the path to recovery through the third quarter, while sentiment on the growth deceleration has weighed on the market. U.S. manufacturing PMI came in at 61.1 for September, the strongest reading during the quarter, while the unemployment rate also saw sequential improvement. Nonetheless, inflationary pressures remained elevated, with August core CPI at 4%, despite dropping from the June high (4.5%). Global yields spiked after bottoming in August. The U.S. 10-year Treasury yield peaked above 1.5% after a mildly hawkish Federal Open Market Committee (FOMC) meeting. The U.K. 10-year Gilts also mirrored its U.S. peer, touching 1% for the first time since May 2019. These triggered market selloffs of high-growth names especially among Information Technology and Healthcare sectors in the back half of September, while value stocks in Financials and Energy sector were buoyed on the back of rising yields. Although growth still outperformed value during the quarter, the gap has narrowed since mid-September, which coincides with rising yields. At the same time, uncertainties around China's slowing economic momentum and contagion risks due to the property developer Evergrande's debt crisis also sent market volatility higher in September.

There were few major monetary policy changes among global central banks in developed economies during the quarter, with inflationary pressures becoming the key variable for the pace of policy shifts. The Federal Reserve left the policy rate unchanged at 0%-0.25% at the September FOMC meeting, while acknowledging that "a moderation in the pace of asset purchases may soon be warranted". The latest median dot plot projects the fed funds rate at 1% by the end of 2023 and 1.75% by the end of 2024. Moreover, the 2021 inflation outlook was substantially lifted again to 4.2%, 80 bps above the June estimate, reflecting stickier inflation than had previously been expected. Real GDP forecast for the year was also revised down to 5.9% from 7%, implying headwinds in the near-term economic growth outlook.

In Canada, the Bank of Canada (BoC) kept all policy variables unchanged in the September statement, including the overnight policy rate at 0.25% and government bond purchases at C$2 billion per week. On inflation, the central bank still saw the current spike as transitory, highlighting that wage increases have been moderate and medium-term inflation expectations are well anchored. BoC Governor Tiff Macklem also released a roadmap to exit monetary stimulus, outlining that once the new stimulus is removed the first step would be to move to the reinvestment phase of the QE program (most likely cutting bond purchases from C$2 billion per week to C$1 billion). He also reiterated that the reinvestment would be maintained well past the initial rate hikes.

The European Central Bank (ECB) kept the benchmark interest rate unchanged at -0.50%. President Christine Lagarde repeated in September that the upswing in inflation was temporary, and that base effect and rising energy prices would not result in lasting inflation. The Governing Council decided to moderately lower the pace of purchases under the pandemic emergency purchase program (PEPP) from that of the past two quarters, with an unchanged envelope of EUR1.85 trillion through the end of March 2022 at the least. Purchases under the asset purchase program (APP) will progress at a monthly pace of EUR20 billion. The ECB raised their projections on 2021 annual real GDP growth for the euro area to 5% from 4.6% in the June assessment and annual inflation rate to 2.2% from 1.9% in June. Despite the bullish tone on the economic rebound, it is still too early to call for an end of the PPEP, as the decision will still depend on upcoming economic data before the December meeting. The Bank of England (BoE) voted in September to keep the policy rate unchanged at 0.1% and maintain the asset purchase target of £875 billion, while revising down the Q3 GDP forecast to 2.1% from 2.9%. BoE also reiterated that it expected CPI inflation to rise slightly above 4% this year, double its target, largely on the back of upside risks posed by hefty energy and goods prices. On the political front, Olaf Scholz of the Social Democrats narrowly led Chancellor Angela Merkel's Conservatives in the German election. This narrow victory suggests that long negotiations lie ahead before a coalition government can emerge, which could raise extended period of market and policy uncertainties.

According to the statistics compiled by the World Health Organization, the number of confirmed infections worldwide exceeded 233 million by the end of September, while the weekly cases have continued to drop after peaking in August. On the other hand, global vaccination efforts are well underway, with 70% of the population fully vaccinated in Canada and 56% in the U.S. However, due to fears of vaccine effectiveness against the Delta variant and delay of the vaccine rollout for ages 5-11 in the U.S., the pace of reopening was slower than previously anticipated during the third quarter. Fiscal support in Q3 was a mixed bag. The American Rescue Plan, along with other assistances such as Child Tax Credit, continued enhancing household savings, which were channeled into consumer spending amid reopening. Furthermore, the U.S. Senate passed a $1.2 trillion infrastructure package in August, with the House vote delayed to the end of October. However, as many fiscal stimuli are fading, the fiscal impulse on growth could turn negative next year according to Goldman Sachs.

Looking ahead to the rest of 2021, sector rotations into value and cyclical could persist if the yield curve finds its support and ticks up. However, volatility would potentially linger into the fourth quarter given rising inflation expectations and contracting monetary gauges, as well as global supply chain issues and China's growth deceleration. Market leaderships would be rotating among value/growth and cyclical/defensive alternatively within short timeframes. In this regard, the barbell approach to our portfolios is still the preferred strategy, supplemented by opportunities in the covered call writing amid high volatility risk in the near term. We expect to have clearer visibility after upcoming waves of corporate earnings for Q3 and key economic releases. At the same time, widening vaccine coverage, resilient fiscal support, and abundant household savings should keep fueling economic growth.

Crude Oil Review

During the third quarter, WTI prices rose steadily from US$73.47 per barrel on June 30, 2021 to close at US$75.03 per barrel at quarter-end. Brent oil prices kept trading at a premium and closed at US$78.52 for the quarter, with intraday prices hitting US$80 for the first time in three years. We saw oil struggle in August due to demand concerns amid COVID-19 resurgence, and rally in September on the back of recovering demand and lagging supply. Looking into Q4, energy companies are expected to return to a more normalized oil price environment as prices recover to pre-pandemic levels. In Canada, heavy oil spreads are trading at a discount of US$11.62 per barrel at the end of the quarter, tighter than Q2. The start of Enbridge's Line 3 should lower transportation costs, which should narrow the spreads even further.

During this 3-month period, the business environment for energy producers has continued to improve amid further economic reopening, driving sector rotations into the Energy space. Despite lagging in July and August, energy stocks came back under the spotlight in September, which coincided with the upswing of global yield curves. Fund flows rotated into value cyclical names in the energy space at the expense of high-growth tech companies. Fundamentals in the sector are also promising. For the demand side of the equation, global oil demand was tepid during the quarter. Higher demand from improving industrial activities and vaccination rates were offset by the resurgence in regional COVID-19 cases in Asian countries. The International Energy Agency (IEA) forecasts that global oil demand will grow by 5.2 million barrels per day into the rest of 2021 with a major amelioration in October and 3.2 million barrels per day in 2022. The outlook for the oil market is predicated on the pace of the COVID-19 inoculation program and the strength of the subsequent recovery of economic activity. Furthermore, we believe that the recent natural gas shortages could lead to a switch from fuel to crude oil to some extent if the situation persists in the near term, translating into a demand surge into the winter.

OPEC+ has exercised tremendous discipline over the past year and the group had achieved their objective of balancing the oil market over the past months. Given the expectation of a steady recovery in 2021, in July, OPEC+ members have agreed to boost oil production by 400 thousand barrels per day until at least April 2022 to phase out 5.8 million barrels per day of existing production cuts. Saudi Arabia and UAE both agreed to increase baseline for oil production to 11.5 million barrels per day and 3.5 million barrels per day respectively. We also expect to see further supply growth from Canada, Norway, and Brazil. Higher oil prices could potentially lead to a higher level of production in the next 6 to 12 months, with the drilling and completion trend indicating possible future robust monthly growth. A combination of better capital discipline, lower cost structures and OPEC+'s optimism is why we are constructive on the sector heading into the coming months. Over the short to medium term, demand is expected to grind up further as nations make significant progress on rolling out vaccinations. However, supply levels still falls short of demand due to a steep fall in China's refinery activity in July, followed by Hurricane Ida's impact on the U.S. refining in August. We expect supply to remain subdued over the remainder of 2021, while demand-supply imbalance should be alleviated in 2022, on the expectation of a production ramp-up. Free cash flow and returning of capital is poised to rebound on strong commodity prices.

Portfolio Review

Brompton Oil Split Corp. (the "Fund") units were up 3.9% in the third quarter of 2021. This compares to the S&P/TSX Capped Energy Index, which was up 4.1%, and the S&P 500 Energy Index, which was down 1.7% over the same period. Top performers included Tourmaline Oil, Whitecap Resources, and ConocoPhillips, which returned +27.6%, +14.7% and +12.2% respectively in local currency terms. Upstream players involved in the exploration and production process outperformed midstream players during the quarter.

The portfolio was rebalanced and reconstituted in March and the number of holdings increased from 16 to 18 North American oil companies – 7 in Canada and 11 in the U.S. We currently favor upstream players since they are more sensitive to oil and gas price increases. Fracking spreads and rig counts have continued picking up since March. Low-cost structures and recovering North American oil demand should help drive meaningful accelerations in free cash flow over the next few years. WTI prices broke out above US$75 a barrel in the last trading week of September. We believe the portfolio is well positioned to benefit from a sustained rebound in global oil demand.

Looking out to the rest of 2021, we expect the further recovery of oil prices to support a pickup in production activities in the oil market. Over the years, the industry's cost structure has come down significantly; high quality oil producers were able to cope with the current crisis much better than in previous cycles. At current prices, oil producers are still exercising capital discipline, with some operators projecting low-to-mid single digit production growth. Energy producers are generating plenty of cash flow at current oil prices and starting to return capital to shareholders via share buybacks and dividends. In addition, valuations are attractive, with both U.S. and Canadian players trading at EV/EBITDA multiples reasonably below their 5-year averages. In the long term, demand is set to recover. The demand for transportation fuels has been solid, as leisure travel returns rapidly on a broader vaccine adoption. Moreover, on-road transportation fuels (gasoline and diesel fuel) should provide a solid baseline for oil prices with an upswing of business activities. Supply issues persist in the short term but should catch up once production climbs and manufacturing activities return to pre-COVID levels. We remain optimistic heading into the fourth quarter and see potential for further rotation into the sector over the coming months.

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Annual Compound Returns[1]	YTD	1-YR	3-YR	5-YR	Since Inception[2]
Brompton Oil Split Corp. - Unit	57.5%	93.7%	(8.2%)	(7.4%)	(6.6%)
S&P/TSX Capped Energy Index	62.4%	129.0%	(5.7%)	(3.2%)	(3.5%)

(1) Returns are for the periods ended September 30, 2021 and are unaudited. The table shows the Fund's compound return on a unit for each period indicated compared with the S&P/TSX Capped Energy Index ("Energy Index"). The Energy Index is derived from the Composite Index and tracks the performance of equity securities that are in the energy sector of the Toronto Stock Exchange (the "TSX"). The Fund invests, on an approximately equal-weight basis, in a portfolio comprised of at least 15 large-capitalization North American oil and gas companies. Since the Energy Index has more diversified portfolios that only include TSX-listed issuers, it is not expected that the Fund's performance will mirror that of the Energy Index. The Energy Index is 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. Further, the performance of the Fund's Class A shares is impacted by the leverage provided by the Fund's Preferred shares.

(2) Inception Date February 24, 2015.

BROMPTON FUNDS

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