

**Portfolio Manager Commentary - September 30, 2022**

**Global Markets Review**

After a relief rally from mid-July to mid-August, global equity markets gave up all gains and finished the third quarter with negative returns. Both equity and bond markets continued to suffer from decade-high inflation and central banks' aggressive monetary tightening. Volatility remained high across all major asset classes, while the recessionary risk has been rising as well. For the three-month period ended September 30, 2022, the MSCI World Index fell by 6.1%. Consumer Discretionary was the only sector that registered positive returns (+0.3%), while Communication Services was the bottom-performing sector (-12.9%). In North America, the S&P 500 dropped by 4.9% with Consumer Discretionary also the best-performing sector. The S&P/TSX Composite lost 1.4%, boosted by Industrials. In Europe, the STOXX 600 was down 4.2% for the third quarter of this year. Major European indices also registered negative returns. Italy's FTSE MIB was the best-performing index (-2.5%). France CAC 40 and the U.K. FTSE 100 were down by 2.5% and 2.8%, respectively. Switzerland, Germany, and Spain lost 4.3%, 5.2%, and 8.3%, respectively.

Inflation has remained stubbornly high, which continues to challenge global economic growth. Energy prices have come down from the peak. Meanwhile, global supply chain disruptions continued easing. However, ripples from geopolitical tensions between Russia and Ukraine still linger. While a variety of key economic measures remained sound during the third quarter, deterioration in other data suggested an economic slowdown. August CPI pointed at 8.3%, a further deceleration from the peak in June, but this elevated inflation level would be unlikely to slow the pace of further aggressive monetary tightening. Rising inflation is eroding real wage growth, while unemployment rates continue to see sequential decline to pre-pandemic lows. Manufacturing PMI entered September at 50.9, which has largely trended down since its peak in March 2021. Bond market also sold off during the quarter. The U.S. Treasury market kept rising sharply in response to the inflation overshoot and monetary tightening, while the 2-year and 10-year Treasury spread remained in below-zero territory during the quarter. During the last few days of September, the newly formed U.K. government announced a fiscal package including a tax cut program that raised concerns of adding inflationary pressure to the economy. As a result, the budgetary announcement accelerated the market sell-off, sending GBP to an all-time low versus USD and the gilt yields surged accordingly. With most equity markets falling in Q3, Consumer Discretionary and Consumer Staples showed relative resilience thanks to strong consumer spending and still-low unemployment. Meanwhile, Energy stocks were boosted by solid Q2 results and strength in natural gas prices but were offset by weak oil prices during the quarter. Rate-sensitive sectors such as Real Estate generally underperformed amid the high interest rate environment.

Central banks in developed economies continued to deliver more hawkish stances of their monetary policy to combat inflationary risks. This quarter witnessed two consecutive 75-basis-point interest rate hikes—at the July and September Federal Open Market Committee (“FOMC”) meetings—to the 3.00%-3.25% range. As the Fed reaffirmed its commitment to fighting inflation, the Fed funds futures market is pricing in another 140 basis points of tightening by year-end. This includes another two possible 0.75% hikes at both November and December meetings. Along with rate increases, the Committee also confirmed the full speed of balance sheet reduction at a pace of \$95 billion a month starting from September.

The Bank of Canada (BoC) delivered even more aggressive policy stances to tame inflation by raising its policy rate by 100 at the July meeting and 75 basis points at the September meeting. This sent Canada's overnight policy rate to 3.25%, bringing the cumulative hikes so far this year to 300 basis points, the fastest tightening pace since the mid-1990s. The statement communicated that “the policy rate will need to rise further”. Higher interest rates will test Canadian households' ability to service their debts, as the housing market extended its cooldown during the third quarter.

The European Central Bank (ECB) started raising its benchmark interest rate during the quarter: 50 basis points in July, followed by 75 basis points in September. With the current benchmark interest rate at 1.25%, the ECB President Lagarde signaled that policy rates remain far below levels that ensure the return of 2% inflation. Given a deteriorating inflation picture in Europe, including rising wage growth and hefty energy prices, further rate hikes over the next several meetings should be expected to slow demand and curtail persistent inflationary pressure. Meanwhile, the Bank of England (BoE) voted to lift the policy rate by two consecutive 50 basis points hikes in August and September to 2.25%. However, the newly announced fiscal measure including a large amount of tax cuts drew global criticism, leading to a historic U.K. gilt and British pound sell-off. The BoE was forced to postpone the planned commencement of its gilt selling and begin temporary purchases of long-dated bonds in order to calm the market turbulence. Rating agencies Fitch and Standard & Poor's downgraded the outlook for the country's credit rating to reflect their lower confidence in the U.K. financial market and the policy framework.

Visibility on inflation outlook is low. Some evidence suggests that components of CPI have shown signs of decline in the U.S. at the end of Q3. Food, housing, and transportation account for the largest portion of the recent CPI spike. Lower oil prices during the three-month period have pulled transportation costs lower. Falling grain prices from the peak should also bode well for a cooldown in food CPI component. However, Shelter inflation could remain higher and longer, as rent increases have been accelerating, especially on existing leases. In Europe, energy costs

continued to be the top contributor to inflation. Nord Stream 1, whose gas supply capacity accounts for over 10% of European demand and over 50% of Germany's demand, was shut down for maintenance in July. It came onstream temporarily before Russia closed it again after several leaks were found. This put further pressure on the power generator. Countries such as Spain and Portugal were forced to cut VAT rate on electricity bills to tackle soaring energy prices. In short, inflationary pressure and associated geopolitical tensions are more problematic in Europe than North America.

Looking forward to the rest of 2022, the global economic slowdown should persist, and broad markets should continue to experience high volatility until a less-aggressive Fed pivot occurs. There are early signs of peak inflation, but this is not sufficient to stop global monetary tightening. Rising inflation has weighed on corporate margins and earnings growth. With still-high inflation, aggressive monetary tightening, and unresolved geopolitical tensions, we expect a further multiple compression across all sectors after the Q3 earnings season, but valuations of some companies are at levels that are historically attractive. Therefore, in response to the ongoing market turbulence, we are positioning our portfolios tilted towards more defensive names. We continue to favor high quality companies that demonstrate low sensitivity to rate hike cycle, sustainable earnings growth, and reasonable valuations. Regarding country exposure, we still favor U.S. and Canada over Europe, with mounting risks for European households and business tied to more severe inflationary pressure and geopolitical tensions. To take advantage of market volatility and cushion against further market decline, we have also increased our call options overwrite levels.

## **Financial Sector Review & Outlook**

The macro economic risks continue to be a headwind to the financial sector. The market is factoring increased probability of a recession and the level of impact on banks stocks as reduced earnings power exacerbates capital pressure particularly across the large cap banks. There remains significant uncertainty around what a recession would look like, given the strength of consumer balance sheets and currently strong labor market. At this juncture investors who believe the economy will not enter a deep recession, should find banks stocks attractive as large banks are trading at 8.3x forward P/E (55% discount to the S&P 500) below its historic average of 11x. In a recessionary scenario the current P/TBV (1.3x) suggest there is additional room to fall given prior recessionary troughs.

Rising interest rates is a tailwind for net interest income as liquidity is reinvested into higher yielding securities and as a result banks are expected to see significant net interest margin expansion. While a steeper yield curve is generally more positive for the banking sector, the boost to the net interest margin is from the front-end of the yield curve rising rather than the yield curve steepening. As a result, we believe the longer-term trajectory for net interest income could reach a crescendo earlier than expected as the Fed continues to hike rates aggressively.

The pace of rising yields negatively impacts banks' accumulated other comprehensive income (the US 10 year yield increased 100 bps in Q3). As yields rise, banks experience higher mark-to-market losses on available for sale bond holdings. These negative levels of accumulated other comprehensive income impacts banks equity value which reduces tangible book value per share. To mitigate this bank have moved more of their bond securities into the held to maturity and available for sale portfolio categories. Conversely as interest rates fall over time, these unrealized losses in accumulated other comprehensive income will decline.

Overall, banks are attractively valued and remain well capitalized. We believe strong net interest income growth more than offset higher levels of loan loss provisions. The impact of rising yields on book value is transitory in our view and should normalize as interest rates normalize over the long term.

## **Portfolio Review**

Brompton North American Financials Dividend ETF (the "Fund") was down 1.5% during the quarter versus the S&P/TSX Capped Financials Index, which was down 1.2% and the S&P 500 Financials Index, down 3.1%.

The Fund benefitted from an overweight position in Asset Managers with performance ahead of the benchmark. On average our holdings were down 3.5% versus benchmark holdings down 6%.

The Fund's overweight exposure in Data Processing contributed to performance which was ahead of the benchmark. Our holding in Automatic Data Processing was up 8.2% which was partially offset by Paychex (down 0.9%).

An underweight position in Diversified Banks detracted slightly from performance relative to the benchmark. Our top holdings include JP Morgan (up 6.2%) and Bank of Nova Scotia (down 0.9%).

The Fund was market weight Financial Exchanges, with performance ahead of benchmark holdings. Our top performer was Factset which was up 4.3%.

An overweight position in Investment Banks contributed to performance which was ahead of benchmark holdings. Top performing holdings include Schwab (up 14%), Raymond James (up 11%) and Morgan Stanley (up 4.9%).

The Fund was overweight Property & Casualty Insurance which detracted from performance and lagged the benchmark. Our top performer was Chubb (up 0.5%).

The Fund was market weight Regional Banks with performance ahead of the benchmark. Top performers include SVB Financial (up 11%) and Fifth Third Bank (up 7.9%).

| Annual Compound Returns <sup>1</sup>                         | YTD     | 1-YR    | 3-YR | Since Inception <sup>2</sup> | Since Inception <sup>3</sup> |
|--|---------|---------|------|------------------------------|------------------------------|
| Brompton North American Financials Dividend ETF (CAD Hedged) | (23.4%) | (19.8%) | 2.8% | 3.0%                         | -                            |
| Brompton North American Financials Dividend ETF (USD)        | (24.2%) | (20.6%) | 3.7% | -                            | 4.5%                         |

<sup>(1)</sup> Returns are for the periods ended September 30, 2022 and are unaudited. The table shows the ETF's compound returns for each period indicated. Past performance does not necessarily indicate how the ETF will perform in the future. The information shown is based on Net Asset Value per unit and assumes that distributions made by the ETF on its units in the period shown were reinvested at Net Asset Value per unit in additional units of the ETF.

<sup>(2)</sup> Inception Date October 17, 2018

<sup>(3)</sup> Inception Date August 8, 2019.

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