Global X Active Preferred Share ETF (HPR)

Market Overview

North American bond yields were generally higher and the yield curve steepened over the second quarter. The quarter began with the theme that the U.S. economy was resilient, inflation was persistent, and the U.S. Federal Reserve (Fed) would have to keep rates higher for longer. Economic data started showing signs that the Fed's restrictive monetary policy was working to cool the economy. Later in the quarter, the probability of a soft landing increased, requiring interest rate cuts before the end of the year. The Fed still needs to see further evidence that inflation is moving lower before it starts loosening policy. At the end of March, investors were looking for the Fed to reduce rates by 70 basis points (bps) to 4.63% with the first 25 bps ease built in by July. At the end of the second quarter, forecasted rate cuts had been reduced to just 40 bps for the year with the first cut in U.S. rates now expected in November.

The Bank of Canada (BoC) reduced its overnight rate to 4.75% from 5.00% in June. The Canadian economy has been operating in excess supply and inflation continued to move lower, giving the BoC more confidence it would be able to achieve its 2% inflation target over time. As a result, the BoC's Governing Council said monetary policy no longer needed to be as restrictive and cut 25 basis points. Inflation has come down from the highs in 2022 and the breadth of price increases has narrowed. Since the start of the year, headline inflation declined from 3.5% to 2.9% and core inflation on average fell by 70 bps to 2.9%. However, investors were disappointed in June with the latest inflation print as it bounced slightly higher after falling for four consecutive months. The market is now only expecting the Bank to cut rates twice in 2024 to 4.25%, with the next move anticipated in September. At one-point investors were looking for an additional 75 bps in cuts before year-end.

In this environment, mid-term provincial spreads declined by 4 bps to 55 bps and corporate spreads narrowed by 4 bps to 149 bps.

The Canadian preferred share market performed strongly in the second quarter but was volatile. The S&P/TSX Preferred Share Index returned 4.17% while the Solactive Laddered Canadian Preferred Share Index (100% rate reset) returned 4.54%. The asset class was mostly supported by bank redemptions of fixed reset issues with a low reset level and by continuous strong credit tone on Hybrids and Limited Recourse Capital Notes (LRCNs). Fund flows were negative in the quarter and explained most of the volatility, particularly in June. The Financial sector, including Financial Services and Banks, outperformed in the quarter while Telecommunications and the Utility sectors underperformed. Fixed reset issues continued to outperform while floating rate issues (mostly) and fixed-rate perpetual issues underperformed in the quarter.

Quarter in Review

HPR's overweight position in the Utilities and Energy sectors and Hybrids and LRCNs were the main drivers of the performance in the quarter. Also, HPR's underweight position in perpetuals was a positive contributor to performance. Our underweight and security selection in Banks and Financial Services reduced our performance.

Over the quarter, HPR reduced its position in Banks and in 2024 reset issues mostly with redemptions and redeployed it into multiple sectors including Banks that will reset in 2025, Insurance, Energy and the Utility sector. HPR increased its allocation in issues that will reset later in 2024, 2025, and 2026. HPR increased its overweight position in LRCNs and in institutional preferred shares issues with a particular focus on low- and mid-reset issues. HPR also bought the most recent Capital Power hybrid.

Outlook and Positioning

The BoC has begun the process of loosening monetary policy and the Sub-Advisor expects this to continue in 2024 and into 2025. It will not be a straightforward exercise where the BoC cuts at every meeting until it gets to a neutral level. The Sub-Advisor expects stops and starts as the economy is not falling off a cliff and there are still risks to the inflation outlook. The U.S. economy has been more resilient than Canada, but it is also starting to show signs of weakening which will eventually lead to an interest rate cut from the Fed. Restrictive policy is working in both countries, but there are long and variable lags. We expect a heightened level of interest rate volatility as the market transitions to lower rates, which will provide HPR with trading opportunities. Elevated bond supply and geopolitical events will also contribute to this environment.

Investment grade credit spreads are close to long-term historical averages. The Sub-Advisor's base case is for an economic soft landing, where Canadian growth operates below potential, but does not fall into a recession, inflation

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trends towards target in 2024 and 2025, and the BoC cuts rates to neutral over this period. The Sub-Advisor's focus today is on the high-quality sectors or on names where spreads are attractive.

The average current yield of Canadian preferred shares remains attractive historically and should increase substantially over the next few quarters/years as fixed reset issues reset at a much higher 5-year Canada rate. Banks and issuers in other sectors should continue to redeem some expensive preferred share issues versus hybrid and LRCNs new issue levels which should be supportive of the Canadian preferred share market. Volatility should remain elevated in the following quarters of 2024 subject to the timing and amplitude of further central bank interest rate cuts in the current low Canadian Gross Domestic Product growth environment. HPR flows will continue to add some volatility as investors could continue to take some profits. The Sub-Advisor would be ready to add risk to the portfolio if opportunities arise and would be ready to take profit if needed. In this environment, the Sub-Advisor thinks the fixed reset issues that reset later in 2024 and in 2025 represent the best risk/reward opportunities as the 5-year Canada rate could be sticky above 3% over the next few quarters.

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