



Global X Active Preferred Share ETF (HPR)

Market Overview

North American bond yields declined significantly over the third quarter (Q3), and yield curves adjusted from being inverted to positively sloped, an environment which has not been seen in over two years. The U.S. Federal Reserve (Fed) started its interest rate-cutting cycle in September by lowering rates by 50 basis points (bps) which surprised some investors looking for a smaller 25-bps reduction. The Fed forecasted it will lower yields from the current restrictive level to a neutral rate over the next two years, ending at 2.875%. However, the market is well on its way to pricing in this yield level over the next year. The unemployment rate continued to nudge higher and inflation made further progress towards the Fed's 2% inflation target. Core inflation, although still elevated, has declined from 4% at the beginning of the year to 3.2% at the end of September. The Fed's rate-setting Federal Open Market Committee (FOMC) has a dual mandate to support maximum employment and return inflation to its target. Over the last several years, the Fed has been more concerned about inflation, but today it judges that the risks to achieving these two goals as now roughly balanced.

The Bank of Canada (BoC) continued to reduce its target for the overnight rate during the quarter to 4.25%. It has now cut rates by 75 bps since early June. The economy continued to operate in excess supply, allowing inflation to move lower which gave the BoC more confidence it would be able to achieve its 2% inflation target over time. Since the start of 2024, headline inflation declined from 3.4% to 2%, and core inflation on average fell 110 bps to 2.4%. The market is now expecting the BoC to cut rates another 170 bps over the next year to end at 2.6%.

Although the quarter saw some turmoil related to fears of a recession, the risk-off tone was brief due to the dovish pivot from the BoC and Fed. In this environment, mid-term Provincial spreads declined four bps to 52 bps and corporate spreads on average narrowed nine bps to 139 bps.

The Canadian preferred share market outperformed in Q3. The S&P/TSX Preferred Share Index returned 5.52% while the Solactive Laddered Canadian Preferred Share Index (100% rate reset) returned 4.89%. The asset class was supported by strong credit tone on Hybrids and Limited Recourse Capital Notes (LRCNs) and by important preferred share redemptions, particularly in July and August. Fixed-rate perpetual issues and fixed reset issues that will reset in 2028 and 2029 have outperformed in this lower interest rate environment while floating rate issues and fixed reset issues that will reset in 2024 or in 2025 underperformed. Real estate, energy and utility sectors outperformed in Q3 while banks underperformed following the surprise decision by TD Bank to extend a fixed reset issue late in the quarter.

Quarter in Review

HPR's underweight position in the Energy and Financial sectors, both Banks and Financial Services, and in fixed reset issues explained most of the underperformance in the quarter. HPR's overweight position in hybrid and LRCN reduced the underperformance.

Over the last quarter, HPR redeployed the cash from banks' fixed reset redemptions into multiple sectors including Banks that will reset in 2025, Insurance, Energy and Utility sectors. HPR increased its allocation in issues that will reset in 2025, and 2026, and in perpetuals. The Sub-Advisor increased its overweight position in LRCNs and institutional preferred shares issues with a particular focus on low and mid-reset issues.

Outlook and Positioning

The BoC began the process of loosening monetary policy in June, and the Sub-Advisor expects this to continue in 2024 and 2025. The Sub-Advisor believes the BoC will reduce rates over this period to a neutral level of approximately 2.75%. This does not mean a cut of 25 bps every meeting – the BoC could skip a meeting or even cut by 50 bps. The economy is soft, and inflation has moved lower, but we are not falling off a cliff. The Sub-Advisor's base case is for the BoC to achieve a soft landing next year, but the Sub-Advisor is anticipating volatility and opportunities through this easing cycle. Currently, investors have priced in an overly aggressive BoC making the market vulnerable to a sell-off. The U.S. economy has been more resilient than Canada, but they have also started cutting rates with a goal to get to a neutral level in two years. Restrictive policy is working in both countries but there are long and variable lags. Elevated bond supply and geopolitical events will also contribute to this environment.

The average current yield of Canadian preferred shares remains attractive historically and has upside over the next two years. However, this upside could be limited if the 5-year Canada yield continues to decrease. Despite TD Bank decision to extend one preferred share issue, we believe that Banks (mostly) and other issuers will continue to redeem expense preferred share issues and replace them with LRCNs and hybrids which should be supportive for the Canadian preferred share market.



Volatility should remain elevated in the following quarters subject to the timing and amplitude of further central bank interest rate cuts in this low Canadian GDP growth environment. Fund flows will continue to add some volatility as investors could continue to take some profit. The Sub-Advisor would be ready to add risk in the portfolio if opportunities arise and will be ready to take profit if needed. In this environment, the Sub-Advisor thinks the fixed reset issues that reset in 2025 and in 2026 represent the best risk/reward opportunities as it thinks the 5-year Canada rate could be sticky around 2.75% over the next few quarters.

Source: Fiera Capital Corporation as at September 30, 2024.

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