TSX DIVS

Q4 COMMENTARY

Evolve Active Canadian Preferred Share ETF

DIVS seeks to provide holders of Units with stable income and long-term capital appreciation by investing primarily in a diversified mix of preferred shares of primarily Canadian issuers, in addition to U.S. and international issuers.

For the quarter ending December 31, 2018

TICKER: DIVS

SUB-ADVISOR: Foyston, Gordon & Payne, Inc.

Foyston, Gordon & Payne Inc.
INVESTMENT COUNSEL

Active management in Canadian Preferred Shares continue to be an attractive investment opportunity. Foyston, Gordon & Payne Inc. has managed Canadian Preferred Shares since 2012 and the FGP Preferred Share Fund since November 22, 2015.

ECONOMIC REVIEW:

The fourth quarter saw the return of volatility in financial markets around the world. The combined weight of central bank interest rate increases, quantitative tightening, global trade tensions, a wave of geopolitical concerns (Brexit, Italy currently) as well as a collapse in oil prices all worked to alter the perception of the global economy as we head into 2019. This despite the relative economic strength currently seen in the U.S. and in Canada to a lesser extent. Both the U.S. Federal Reserve Bank as well as the Bank of Canada increased policy rates by 25 basis points in the final quarter of the year but, seemingly in reaction to the downturn in financial markets, have each downgraded their outlooks for the coming year as well as lowering expectations for the continuation of their respective tightening cycles.

Given the openness of our economy, Canada has been negatively impacted by the trade tensions and weak oil prices. Heading into the new year, growth should be weighed down by the impacts of a further slowing in the number of housing transactions, the overhang of consumer debt, oil production cuts in Alberta as well as slower U.S. spending. The latest reading on inflation, from November, came in at an 18-month low of 1.7% although the core measures remain around the Bank's target of 2%. Continued restraint in wage growth also implies that there remains some slack in the economy. That being said, growth in 2018 was about 2% and shouldn't be much lower than that in 2019. Indeed, with more certainty on the North American trade front and an expectation of some stimulative fiscal policy measures leading up to the October federal election growth may not be quite as gloomy as the market is now forecasting.

In response to weakness in equity markets and the heightened uncertainty and volatility, yields across the curve fell in in both Canada and the U.S. throughout the quarter. Short-end yields fell at roughly the same pace as long-end yields, thus there was little change in the shape of the full yield curve. The curve remains positively sloped, but only marginally so with about 25 basis points of yield separating two-year and thirty-year maturities.

PORTFOLIO STRATEGY:

At the end of October, preferred shares yielded to the widening risk-off sentiment in the Canadian and Global markets, resulting in persistent losses throughout the quarter. This weakness was significant and has been driven by contagion from equities with added impacts from increased selling activity by the retail segment of the pref market as well as an eventual decline in interest rates (and rate expectations) mentioned above.

The activity from retail investors was skewed towards holdings that were materially down on the year implying much of it was related to tax-loss selling. This translated into dramatically divergent performance from prefs with similar characteristics, which has created opportunities that should add value in the future.

Over the short-term we expect the preferred share market will continue to be influenced by the sentiment in the equity markets, however, the preferred share market became exceptionally attractive by the end of December. Additionally, there has been an increasing dislocation between bonds and prefs which has been exacerbated over the last few weeks and preferred shares are now a great relative value trade. Going forward we are positive on the economic outlook for North America which, combined with the improving trade picture and strong North American employment data from December (and Q4), should move markets higher in the coming months. This should allow for rates to begin to move higher again and bolster the preferred share market in Canada. Eventually, the move to higher rates (current rates are much higher than recent years) will be reflected in higher preferred share dividends that should provide the opportunity for capital appreciation in addition to the currently outsized dividends being paid.