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INVESTMENT MANAGERS

Natixis Canadian Preferred Share Funds

FUND COMMENTARY

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CANADIAN PREFERRED SHARES FEEL THE NEGATIVE IMPACT OF TRADE WAR IN MAY

Global financial markets were roiled by the collapse of the U.S.-China trade talks in early May. Investors worried that increased trade restrictions between the world's two largest economies were going to have a substantial negative impact on global economic activity. Equity prices declined and global government bond markets rallied as investors sought safe havens. Late in the month, the U.S. announced plans to use tariffs against Mexico in response to migrant immigration which caused further uncertainty and pushed stock prices and bond yields even lower. Preferred shares did not perform well in the economic uncertainty. With 5-year Canada bond yields dropping 18 basis points in the month, investors in rate reset preferred shares worried that their dividend rates would be sharply cut whenever they next reset. As a result, rate reset prices fell roughly 4.0%. Perpetual issues fared better, but still declined 1.0% in May. The S&P/TSX Preferred Share Total Return Index returned -3.00% in the month.

There were three new rate reset issues in May. Capital Power came early in the month and attracted limited institutional interest, with only 8 institutional buyers. The TD Bank and CIBC issues came to market on the same day, following the releases of their respective quarterly results a few days earlier. The TD deal was the only one of the three in May to be upsized (from $250,000,000) due to strong demand from institutional managers. A total of 30 institutional buyers participated in the issue, and we suspect several of them were bond managers attracted to the combination of relatively good yield and a high reset spread. The CIBC deal was launched minutes after the TD issue, but the marginally higher yield was insufficient to generate the same amount of interest because of the perceived slightly lower creditworthiness of CIBC versus TD. Only 16 institutions bought the CIBC issue.

We didn't participate in any of the new issues because we identified better value in secondary offerings. For example, at the time of the new TD issue, TD.PF.K was yielding 5.54% and not scheduled to reset its dividend for four and a half years. While the new issue had a higher reset spread than TD.PF.K, that did not seem to compensate for giving up so much yield for such a long time period.

Details of the new issues were as follows:

Issue	Size	Type	Dividend Rate	Dividend Floor	Reset Spread	Institutional/ Retail
CPX.PR.K	$150,000,000	Rate Reset	5.75%	Yes	+415 bp.	12%/88%
TD.PF.M	$450,000,000	Rate Reset	5.10%	No	+356 bp.	57%/43%
CM.PR.Y	$250,000,000	Rate Reset	5.15%	No	+362 bp.	27%/73%

Five issuers reset their dividend rates for additional 5-year terms in May. The holders of these issues generally had a couple of weeks to decide on whether to stay with a fixed dividend rate or change to the floating dividend rate issue.

Details of the resetting issues were as follows:

Issue	Existing Fixed Dividend Pricing Date	Existing Fixed Dividend Rate	New Fixed Dividend Rate	New Floating Dividend Rate
PPL.PR.E	Jan. 7, 2014	5.00%	4.573%	4.666%
ENB.PR.T	Dec. 5, 2012	4.00%	4.073%	4.204%
LB.PR.H	Mar. 25, 2014	4.30%	4.123%	4.226%
MFC.PR.L	Feb. 28, 2014	3.90%	3.786%	3.836%
EFN.PR.C	Feb. 26, 2014	6.50%	6.210%	6.476%

As in recent months, most of the issues resetting in May will experience a slight lowering of their respective fixed dividend rates. However, the declines are much less than the approximately 105 basis points decline in the 5-year Canada bond yields since last October. As we have pointed out previously, the key to the magnitude of change in dividend rates is not the recent change in bond yields, but the change since the existing fixed dividend pricing date of the preferred share.

Continuing the trend of the last two years, resetting issues of National Bank (NA.PR.S), Bank of Montreal (BMO.PR.S), Royal Bank (RY.PR.Z), and Enbridge (ENB.PR.T) received insufficient interest in the floating rate option and all shareholders of each issue will continue to receive fixed dividends for the next five years.

ETF flows in in the month were mixed, with the six largest preferred share ETFs having net inflows of only $26 million in April. Four of the ETFs experienced net withdrawals. While ZPR added $67 million, we believe ZPR benefitted from an increase in issuance of structured notes based on its value.

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The fund marginally underperformed the index in May. While the rate reset holdings that will be resetting in the next few months were understandably weak, five of the ten largest negatives in the portfolio during May were issues that will not reset until 2022 or 2023 when the 5-year Canada bond yield might be substantially higher than current levels. In the absence of any negative credit news, that suggested the underperformance was attributable to random volatility that may reverse in June.

Noteworthy transactions included sales of two small perpetual holding, ELF.PR.F and GWO.PR.S. The ZPR holding was also sold. We switched out of EMA.PR.E and into EMA.PR.C, which we believe offered better value. Purchases included additions to existing holdings of undervalued rate reset issues including CPX.PR.E and MFC.PR.Q.

Outlook and Strategy

The Bank of Canada believes that Canada will not fall into a recession this year, barring further unanticipated shocks to the global economy. We concur. Indeed, the Canadian economy is expected to experience a growth rate in excess 2% in the second quarter, following two quarters of disappointingly slow growth. As a result, we believe the Bank of Canada will not be changing its trend-setting interest rates, either up or down, this year. The Bank will be in good company, as the U.S. Federal Reserve (Fed) seems unlikely to change its rates either. With economic growth still strong and unemployment at the lowest level in decades, we believe the Fed will not try to anticipate the impact of threatened trade restrictions. In addition, while the policies of U.S. President Trump are wholly unpredictable, we believe that as the 2020 election nears, the resultant need for the U.S. administration to maintain good economic growth will lead to fewer shocks and reduced impediments to growth, including tariffs.

The preferred share market in 2019 has been disappointing because it did not recover from fourth quarter weakness the way that equities or corporate bonds did. We believe the preferred market has remained weak because investors are anticipating a repeat of 2015 when preferred share dividends were being cut by 40% to 50% and share prices plunged. However, the yield of 5-year Canada bonds is roughly where it was five years ago, implying that dividend rates will not be greatly changed. We believe that as the Canadian economy continues to exhibit positive economic growth, the pessimism that pushed Canada bond yields below the Bank of Canada's 1.75% overnight target will dissipate and yields will rise.

If we are correct in our analysis, there are some very attractive opportunities to add rate reset issues that have been significantly oversold. At the same time, the yields of perpetual preferred issues have in some cases fallen below the yields of rate reset issues for the first time since rate reset issues were invented. That suggests that perpetuals are overvalued and we have been reducing the sector accordingly. We also believe that Canada will not go into a recession this year, and the Bank of Canada will hold interest rates steady for the next few quarters. If we are correct, bond yields should rise from current levels and that may lead to dividend rate increases in coming months.

For more information about Natixis Canadian Preferred Share Funds, please contact your financial advisor.

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