

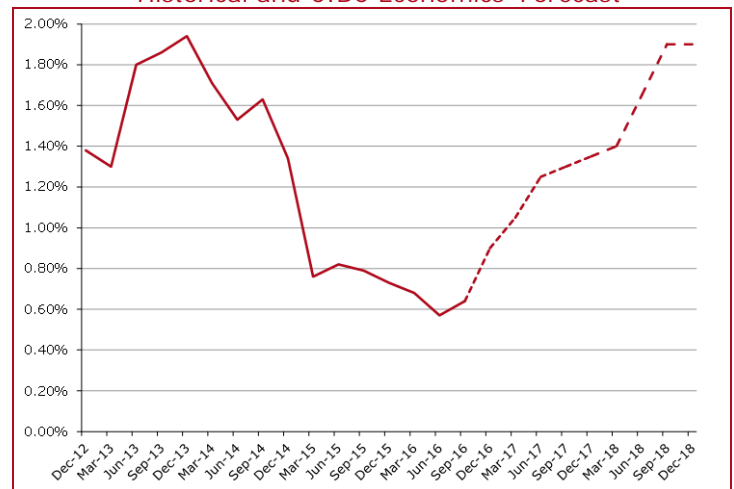
Preferred Shares: Hit Them While They're Down

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The consensus view among economists is that the next few years will be characterized as a period with *low to modestly higher interest rates*. That being said, many expect that beyond this lull in the rate environment we will eventually enter a period of rising interest rates. We believe that one such way to take advantage of a potential slow but rising rate environment is with the use of fixed-reset preferred shares. While many investors traditionally look towards preferred shares as securities that are inversely correlated with rates, much like bonds, fixed-reset preferred shares are a different beast in themselves. They are perpetual in nature, however every five years their dividend rate is reset at a predetermined spread over the 5-Year Government of Canada Bond yield (5Y GoC yield). Therefore, given that the level of income fixed-reset preferred shares offer is linked to interest rates, they also enjoy positive correlation with the short-end of the yield curve when rates move higher.

Given the impact that low rates have had on fixed-reset preferred shares ([click here](#) for a detailed recap on the Canadian preferred share market), we believe there is an opportunity brewing in the fixed-reset preferred share market. We are particularly constructive on "beaten up" fixed-resets (i.e. those trading at significant discount to par), since they offer higher leverage to rising rates. Regardless of the features of a particular preferred share, we believe that credit quality is of the utmost importance when investing in any type of preferred share (explained further in the "Risks" section below). With rates forecasted to begin rising steadily in 2018/2019, it is best to look towards fixed-resets that reset after this period of an expected uptick in interest rates since they would be the best positioned to see their dividend rate increased when they reset. Below we discuss the risks of investing in fixed-reset preferred shares and provide a list of names that we believe are attractive in a rising rate environment.

Quarterly 5-Year Government of Canada Bond Yield: Historical and CIBC Economics' Forecast



Source: Bloomberg, CIBC Economics

Note: Solid line = historical figures and dashed line = CIBC Economics' forecast

Risks

As is the case with any type of investment, we believe that investors should always consider risk factors before taking any action. Below we've outlined some of the potential risks related to investing in fixed-reset preferred shares:

- i. **Credit Risk:** Since preferred shares are income generating assets, it is of vital importance that an issuer of a preferred share has the ability to make regular reoccurring dividend payments and has the ability to pay off the principal at maturity. Therefore, it is likely that a preferred share for an issuer facing financial hardship would see its price eroded faster and steeper than a comparable preferred with a solid financial profile.
- ii. **Interest Rate Risk:** While the U.S. Federal Reserve is setting the stage for a potential rate hike later this year, the Bank of Canada (BoC) has on the contrary signaled that it is in no rush to follow suit. CIBC's Economics team is not projecting a rate increase by the BoC until mid-2018 at the earliest. One of the major risks that could further prolong a rate hike by the BoC beyond 2018 is a slower than expected improvement in economic conditions or worse, a deterioration in economic condition, which would force the BoC to keep interest rate levels lower for longer. A lower for longer interest rate outlook means yields on outstanding preferred shares would remain subdued beyond their reset dates. Given that the dividend rate on fixed-resets are reset at a spread over the 5YR GoC yield, low rates at the time of reset have a direct impact of reducing dividend income until the next reset date.
- iii. **Liquidity Risk:** Compared to common equity, the market for preferred shares is much smaller and less liquid. As a result of this, investors should be weary of the size of the bid/ask spread on shares they are considering purchasing along with the daily liquidity since both of these factors can have a substantial impact on the share price and the implicit cost of a fixed-rate preferred share investment.

Attractive "Beaten Up" Fixed-Reset Preferreds

We used the following criteria to identify the fixed-reset preferred shares with the greatest upside to current price in a rising rate environment.

- **DBRS Credit Rating:** ≥ Pfd-3H (conservative investors recommended to select ≥ Pfd-2L)
- **Next Reset Date:** No earlier than January 1, 2019
- **Reset Spread:** ≥ 2.50% (market average is ~2.80%)
- **Current Yield:** ≥ 4.50%
- **Discount to Par:** ≥ 15.00%

Preferred Share Issue	Series	Symbol	DBRS Rating	Price 22-Sep-16	Current Yield	Yield assuming 5YR GoC yield at reset =			Reset Terms		
						0.50%	1.50%	2.50%	Next Date	Yield to	Spread ¹
Bank of Montreal 3.80%	33	BMO.PR.Y	Pfd-2	\$20.53	4.63%	3.91%	5.13%	6.34%	Aug 2020	9.43%	+2.71%
Brookfield Asset Mgmt. Inc. 4.20%	34	BAM.PF.B	Pfd-2L	\$17.67	5.94%	4.43%	5.84%	7.26%	Mar 2019	19.19%	+2.63%
Brookfield Asset Mgmt. Inc. 4.40%	38	BAM.PF.E	Pfd-2L	\$18.80	5.85%	4.06%	5.39%	6.72%	Mar 2020	13.36%	+2.55%
Brookfield Asset Mgmt. Inc. 4.50%	40	BAM.PF.F	Pfd-2L	\$19.90	5.65%	4.22%	5.48%	6.73%	Sep 2019	12.76%	+2.86%
Brookfield Asset Mgmt. Inc. 4.50%	42	BAM.PF.G	Pfd-2L	\$20.27	5.55%	4.12%	5.35%	6.59%	Jun 2020	10.67%	+2.84%
Brookfield Renewable Power 3.355%	1	BRF.PR.A	Pfd-3H	\$15.49	5.41%	5.04%	6.65%	8.26%	Apr 2020	18.22%	+2.62%
Brookfield Renewable Power 4.40%	3	BRF.PR.C	Pfd-3H	\$17.69	6.22%	4.86%	6.27%	7.69%	Jul 2019	18.11%	+2.94%
CIBC 3.60%	43	CM.PR.Q	Pfd-2	\$20.16	4.46%	4.08%	5.32%	6.56%	Jul 2020	9.91%	+2.79%
Enbridge Inc. 4.00%	P	ENB.PR.P	Pfd-3H	\$15.80	6.33%	4.75%	6.33%	7.91%	Mar 2019	24.77%	+2.50%
Enbridge Inc. 4.00%	R	ENB.PR.T	Pfd-3H	\$15.71	6.37%	4.77%	6.37%	7.96%	Jun 2019	23.14%	+2.50%
Enbridge Inc. 4.40%	7	ENB.PR.J	Pfd-3H	\$16.76	6.56%	4.58%	6.07%	7.56%	Mar 2019	22.79%	+2.57%
Enbridge Inc. 4.40%	9	ENB.PF.A	Pfd-3H	\$17.12	6.43%	4.61%	6.07%	7.54%	Dec 2019	17.71%	+2.66%
Enbridge Inc. 4.40%	11	ENB.PF.C	Pfd-3H	\$17.18	6.40%	4.57%	6.02%	7.48%	Mar 2020	16.68%	+2.64%
Enbridge Inc. 4.40%	13	ENB.PF.E	Pfd-3H	\$17.31	6.35%	4.56%	6.01%	7.45%	Jun 2020	15.67%	+2.66%
Enbridge Inc. 4.40%	15	ENB.PF.G	Pfd-3H	\$17.72	6.21%	4.49%	5.90%	7.31%	Sep 2020	14.33%	+2.68%
Husky Energy Inc. 4.50%	3	HSE.PR.C	Pfd-2L	\$19.25	5.84%	4.71%	6.01%	7.31%	Dec 2019	13.30%	+3.13%
Husky Energy Inc. 4.60%	7	HSE.PR.G	Pfd-2L	\$21.14	5.44%	4.75%	5.94%	7.12%	Jun 2020	9.53%	+3.52%
Royal Bank of Canada 3.60%	BD	RY.PR.J	Pfd-2	\$20.07	4.48%	4.04%	5.28%	6.53%	May 2020	10.24%	+2.74%
Royal Bank of Canada 3.60%	BF	RY.PR.M	Pfd-2	\$19.69	4.57%	3.96%	5.23%	6.50%	Nov 2020	10.01%	+2.62%
Toronto-Dominion Bank 3.60%	7	TD.PF.D	Pfd-2	\$20.30	4.43%	4.05%	5.28%	6.51%	Jul 2020	9.70%	+2.79%
Toronto-Dominion Bank 3.70%	9	TD.PF.E	Pfd-2	\$21.03	4.40%	4.01%	5.19%	6.38%	Oct 2020	8.51%	+2.87%
TransCanada Corporation 3.80%	11	TRP.PR.G	Pfd-2L	\$20.52	4.63%	4.22%	5.43%	6.65%	Nov 2020	9.09%	+2.96%

1 - Represents that spread over the prevailing 5YR GoC yield at the time of set

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Bank of Montreal (2a, 2c, 2e, 2g, 3a, 3c, 7) (BMO-TSX, C\$85.97)
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Brookfield Renewable Partners LP (2a, 2c, 2e, 2g, 13) (BEP.UN-TSX, C\$41.89)
Canadian Imperial Bank of Commerce (2a, 2c, 2e, 2g, 3a, 3c, 6a, 7, 9, CD37) (CM-TSX, C\$100.88)
Enbridge Inc. (2a, 2c, 2e, 2g, 7) (ENB-TSX, C\$56.97)
Husky Energy Inc. (2a, 2e, 2g) (HSE-TSX, C\$15.29)
Royal Bank of Canada (2a, 2c, 2e, 2g, 3a, 3c, 7) (RY-TSX, C\$81.01)
Toronto-Dominion Bank (2a, 2c, 2d, 2e, 2g, 3a, 3c, 7) (TD-TSX, C\$58.03)
TransCanada Corp. (2a, 2c, 2e, 2g, 7) (TRP-TSX, C\$62.32)

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SP	Sector Performer	Stock is expected to perform in line with the sector during the next 12-18 months.
SU	Sector Underperformer	Stock is expected to underperform the sector during the next 12-18 months.
NR	Not Rated	CIBC World Markets does not maintain an investment recommendation on the stock.
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O	Overweight	Sector is expected to outperform the broader market averages.
M	Market Weight	Sector is expected to equal the performance of the broader market averages.
U	Underweight	Sector is expected to underperform the broader market averages.
NA	None	Sector rating is not applicable.

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