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BRAMSHILL INSIGHTS

Active Income Strategies: Solutions in a Stagflationary Environment



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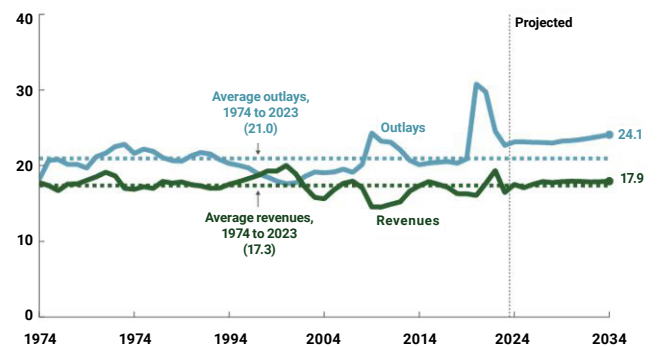
Active Income Strategies: Solutions in a Stagflationary Environment

Stagflation is a term loosely used in economics and journalism to describe a period of below trend real growth and above trend inflation. In popular parlance it originated in the 1970's during a period of high inflation related to commodity inflation and wage price increases. During this period reaccelerating growth caused even higher inflation which the US Federal Reserve could not extinguish with its customary monetary tools.

Currently, the Fed is roughly at the point of having completed a cycle of monetary tightening which attempts to control the inflation resulting from the highly stimulative fiscal and monetary policy adopted in response to the Covid pandemic, combined with associated supply shocks and degradation of many supply chains. To date, this process has failed to produce much slack in the labor market (much less a recession) while inflation remains uncomfortably above the Fed's 2 percent target. At the same time, recent GDP figures suggest that the economy is slowing below its long run potential based on population growth and productivity, which is also about 2 percent.

While economic forecasts are always uncertain, why might we be entering an extended period of stagflation? The economy's resistance to entering an actual recession—which was widely expected in the first half of 2023—is probably the result of fiscal dominance. This term characterizes an economic condition in which the magnitude of spending by the federal government is so large as to overwhelm the normal effects of monetary policy affecting the economy. At present, the federal budget deficit is running at about 6 percent of GDP, a figure unheard of in peacetime while at approximately full employment. This federal spending includes the enormous Covid relief American Rescue Plan, the Bipartisan Infrastructure Plan, the CHIPS act, and the Inflation Reduction Act, as well as ongoing major commitments to Social Security, Medicare, and the military. On top of these expenditures, increased policy rates from the Federal Reserve have resulted in much higher interest expenditures. The federal budget figures underlying this reality are summarized in the Congressional Budget Office's most recent projections shown in Figure 1.

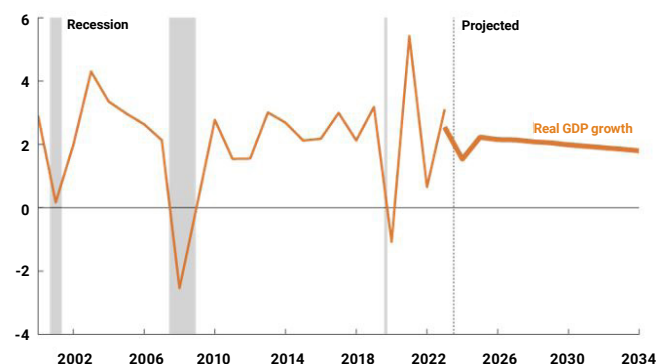
Figure 1: Federal Expenditures and Revenues as a Percentage of GDP



Sources: Congressional Budget Office

While increasing federal spending can have the effect of stimulating the economy and preventing to some degree the risk of recession—as happened in 2023- it is likely to have the long term effect of reducing growth, as projected by the CBO in Figure 2. Increased federal borrowing at this scale has the effect of withdrawing capital from private markets and reducing the funds available for productive private investment. Recent proposals by the administration to reduce the deficit by increasing capital gains taxes, if enacted, will have the further effect of reducing private investments.

Figure 2: Projected Real GDP Growth



Sources: Congressional Budget Office

A second major factor of the current environment is de-dollarization. As the incumbent reserve currency, the dollar is commonly used for both international transactions and by governments to hold currency reserves in the form of US Treasury bonds. In recent years the purchases by foreign holders have been declining, and central banks have increasingly purchased gold for reserves, as concerns have risen regarding US finances. An important turning point was reached in this trend in 2022, when the US and its allies seized Russian overseas reserves in response to the invasion of Ukraine. This “weaponization” of the dollar shook the confidence of many foreign holders of US Treasuries, as it implied that a significant political disagreement with the US could result in a confiscation of their reserve assets. This was widely seen as a major impetus for the BRICS nations to develop modalities for trade settlements apart from the dollar based on some combination of local currencies and gold. The long term effect of this trend is expected to produce increased pricing of commodities, especially oil, in relation to gold and a decline of the value of the dollar in terms of gold. This was discussed in detail in our June 2023 Monthly Insights. Along with the many geopolitical risks in the world, these trends seem likely to lead to above trend commodity inflation. Figure 3 shows the recent dramatic increase in the price of gold in dollar terms.

Figure 3: Gold Price in Dollars



Sources: Bloomberg

Although the use of the dollar in international transactions is unlikely to decline suddenly, the use of the dollar--particularly US Treasury bonds--as reserves has been declining for many years in favor of gold. In addition to increasing the value of gold relative to the dollar, this trend is likely to increase the use of gold as a pricing reference for commodity trading, particularly for oil, which will have the long run effect of raising these prices in dollar terms as well. If these trends are sustained, they create issues for many traditional investments.

Continued inflation—absent a recession—creates a difficult environment for long duration and passive fixed income styles. Slow growth creates a problem for many sectors of the equity market in the form of slower earnings growth. A nontraditional approach

to delivering income and total return in this environment is represented by various strategies at Bramshill Investments. Across different portfolios, several asset classes and/or security structures can produce better results than traditional passive fixed income. Some examples are Fixed-to-Float Preferreds, Short Duration Corporates, Various Structured Products, as well as select categories of pass throughs inclusive of Real Estate Investment Trusts, Master Limited Partnerships, and Business Development Companies.

As a group, these types of securities offer a number of advantages in a stagflationary environment:

1. Yields are higher than most generic index-linked fixed income options.
2. Yields are not fixed and can increase due to improved operations or pricing by the underlying businesses. Furthermore asset class and/or sector rotations can be used to capitalize on opportunities from stagflationary dislocations.
3. Target businesses and sectors which serve basic needs of their customers are stable even under slow economic growth.
4. Target securities with high current cash flows, makes them less sensitive to volatility in a stagflationary environment.

Bramshill has a long history in tailoring their portfolios to emerging macroeconomic conditions. To address current circumstances, we would highlight the following concentrations across various portfolios:

PERPETUAL FIXED-TO-FLOATING RATE PREFERREDS AND FIXED-TO-RESET PREFERREDS

Instruments that carry fixed coupons for a non-call period of typically 5 years, and then a floating rate coupon spread over a benchmark such as LIBOR or SOFR and instruments with a fixed coupon for 5 or 10 years, at which time they are either called or the coupon "resets" to a spread over matched duration Treasuries. Once resetting, these coupons are fixed for 5 years again until the next reset date in which the coupon would reset again. We find many of these structures very attractive as they provide attractive yields to short calls and mitigate interest rate risk by shortening in duration as rates rise. Some examples can be found in Financials such as SCHW and C, and Utilities such as EIX and SRE.

DOMESTIC ENERGY PRODUCTION

With global energy trade subject to geopolitical stress and likely to lead to higher energy prices we have exposure in various types of domestic energy producing enterprises across Fixed-to-Float Preferreds, Corporate Debt, and/or Equity. Select Examples: BP, SD, VNOM, ARLP, NEP

MIDSTREAM ENERGY

With US domestic oil and gas production near all-time highs at a time when siting and building new transmission and distribution

facilities are virtually impossible, existing pipelines, terminals, and gas stations are experiencing high throughput and profitability. Select Examples: ET, ENB, EPD, PAA, KNTK

BUSINESS DEVELOPMENT COMPANIES

With the recent turmoil in depository institutions banks have tightened lending standards, creating a potential void in middle market lending. BDCs have benefited, and with the appropriate due diligence regarding non-accruals, select investments to high quality, proven managements in this space can provide superior yield with upside potential across Senior Debt and Equity structures. Examples: ARCC, BXSL, OCSL, TSLX

OPPORTUNISTIC STABLE INCOME

Taking advantage of the bond market backup in late 2023, we took positions in high yielding senior loan and municipal bond closed end funds which had sold off significantly, were available at deep discounts to NAV, and which had successfully absorbed prior policy increases in short term interest rates. Furthermore, select ETFs provide short-term liquid exposure to less liquid, higher yielding fixed income asset classes providing low volatility investment opportunities at yields rarely seen in the past decade. Examples: SHYG, NAD, NEA, PAXS, JFR, AFT, FSCO

PRECIOUS METALS PRODUCERS

In an environment of higher inflation and muted growth, select precious metals producers can provide opportunities. Examples: AEM, GOLD.

BENEFICIARIES OF GLOBAL SUPPLY CHAIN DISRUPTIONS

International sanctions and conflicts have in recent months led to disruption of shipping routes, forcing international cargo to take many routes longer than those previously available. This in turn has led to longer voyages and higher day rates for shippers. Examples: SFL, GNK, FRO, FLNG

Perhaps the most important common denominator to many of these securities is that they have some form of pricing power which they are able to exercise in a stagflationary environment as well as offering basic products which have resilient demand even in a slow growth environment. We believe that many of these portfolio holdings are positively convex and have the potential to increase their yields. Therefore, while they represent income investments, they are not subject to the same pitfalls of a traditional, passive, fixed income portfolio. As such, we believe our portfolios will act well in various environments, including one with unwelcome inflation, and slower growth.

About Bramshill Investments

Bramshill Investments is an alternative fixed income asset manager with over \$5.46 billion in assets under management as of April 30, 2024.

Founded in 2012 and headquartered in Florida, with offices in California and New York, the firm offers alternatives to traditional fixed income investment management featuring a variety of strategies across various debt and fixed income markets and specializing in preferred securities.

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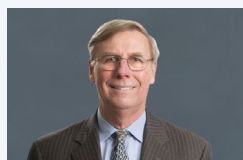
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Select investments are shown to demonstrate Bramshill's current focuses in the relevant sectors. There is no guarantee of future performance. For a list of full investments, please contact the firm