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Second Quarter 2020 Market Commentary

Financial markets rebounded in the second quarter as monetary and fiscal responses helped calm investors' angst. The gradual reopening of the economy and the "flattening of the curve" in COVID-19-inflicted states also brought a sense of normalcy to the markets. In the following commentaries we look back at the stunning performance of financial assets in the second quarter and look forward into a crystal ball made hazy by the reemergence of the COVID-19 threat and the upcoming elections.

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Equities

The Waiting is the Hardest Part

James P. O'Mealia – Head of Equity Portfolio Management

July 6, 2020

The waiting is the hardest part
Every day we get closer to a restart
You take it on faith, you take it to the heart
The waiting is the hardest part

-Apologies to Tom Petty, The Waiting

Equity markets registered their strongest quarterly gains in over two decades as investors cheered signs of a reduction in the spread of the coronavirus and reopening of worldwide economies. Government initiatives to support businesses and consumers and Federal Reserve programs to backstop the financial markets enabled the economy to survive record unemployment and an unprecedented drop in business activity. A slowing of coronavirus activity and a better understanding of how to combat the virus improved treatment outcomes which improved consumer and investor sentiment. While the stock market as a whole remains in the red for the year, the second quarter rebound left the major averages down by a modest amount and the much-loved Nasdaq in positive territory. I am pleased to report that our accounts participated in the market recovery and generally outperformed the relevant stock market indices.

While the second quarter equity market gains were broad based, the performance of sectors and industries was uneven. Technology stocks led the markets higher once again, with the Nasdaq Composite (+30.63%) trouncing the S&P 500 (+19.95%). However, the Russell 2000 index of small cap issues (+25.00%) and S&P MidCap 400 (+23.54%) also rebounded smartly as the breadth of the market recovery improved. Apple (+43.5%) remains the Oracle's and seemingly everyone's favorite pet, but the strong performance of Dow Chemical (+39.4%) and Home Depot (+34.2%) underscored the willingness of investors to buy companies with cyclical exposure. However, not every Dow stock participated in the market rally. In fact, of the 30 Industrials, ten rose by less than 10% and one, Walgreens, actually lost 7.3%. Other laggards included Pfizer (+0.2%), Merck (+0.5%), Coca-Cola (+1.0%) and Verizon (+2.6%).

There were plenty of reasons for investors to be wary and uncertain of the future during the quarter as none of us have ever had to live and work in a partially shut-down economy with shelter-in-place restrictions. The World Bank estimates that the global economy will shrink by 5.2% for the year, consumer spending in the U.S. fell a record 13.6% in April and the U-3 unemployment rate soared to 14.7%! However, Government programs like the Paycheck Protection Plan helped to stabilize businesses and paid many displaced workers more money than they earned before. With no place to go other than supermarkets, home improvement retailers and drug stores, consumer savings increased at the fastest rate in decades. As a result, record drops of consumer and business activity in April were followed by record rebounds of consumer spending. U.S. retail sales rose a record 18% in May, auto sales revved higher and demand for RVs soared. In similar fashion, the plunge in unemployment to depression levels in April, began to recover in May and has shown further improvement in June as businesses begin to reopen.

That doesn't mean all is well and the world has completely recovered. Indeed, the economy is not firing on all cylinders and Federal Reserve Chairman Powell suggests that a full economic recovery might not be in place for more than another year. As such, he has counseled that the Federal Reserve plans to keep short-term interest rates at current levels of near zero for all of 2021. That policy has profound implications for companies and consumers alike, as it promises to keep interest and finance costs low for borrowers. With historically low mortgage costs, a massive wave of refinancing activity is underway which will create additional free cash flow for homeowners. Housing affordability will increase dramatically for new and existing home buyers and, not surprisingly, housing values in the suburbs are moving higher once again as renters decide to own and city dwellers decide to move to more open spaces. We have been fans of the homebuilders and believe they have long-term appeal at current prices.

The speed with which the economy collapsed was unprecedented and we are clearly in a recession. The good news, from an investor's perspective, is that stocks generally do well coming out of a recession. Obviously, some of that good news is priced into the stock market and there are signs that certain sectors of the equity market are overheated. However, the collapse in equities and uneven recovery has left some opportunities for disciplined investors. For example, temporary help companies remain 20-30% below where they started this year and are selling at significant discounts to the broad market on most valuation metrics. Certain leading companies in the industry are debt free or have more cash than debt and offer a solid yield, which means you get paid to wait for a recovery in their fortunes. While the economic recovery will be uneven, the current unique environment of workplace safety protocols and uncertainty as to the long-term structural changes facing businesses could cause more newly-formed businesses to rely on temporary workers. In addition, those companies struggling to manage a returning workforce might find a need for temps to manage the office while higher paid workers continue to work remotely. History has shown that the temporary help industry gets hurt in recessions, but its leading companies are among the best performing in an economic recovery.

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The economic impact of the slowdown has hurt manufacturing as plants have had to close that produce durable goods. Thus, it's not surprising that one of the best real-time indicators of economic activity reported that June-originated carloads were 22.4% below year earlier levels. (source: Association of American Railroads) Increased demand for autos and fulfillment of orders for other capital goods will help increase monthly activity for railroads and other economically sensitive industries, but as Fed Chairman Powell suggested, it will take time before we get back to where we were. Why then has the stock market recovered as far as it has and why is the Nasdaq in record territory? As we've said before, the stock market is a forecasting mechanism and investors value equities in relation to their long-term earnings potential. The stock market is putting a high relative valuation on equities because of the Federal Reserve's promise to keep short term rates near zero for 2021. With low inflation, low interest costs and a new more efficient way of conducting business, profit margins look as if they could be expanding in the years ahead as rent costs decrease and service companies reduce their need for physical office space. Technological advances are increasing productivity of businesses and the pandemic has redefined how businesses can and will operate. Modern technological advances like Zoom and Google hangouts for teleconferencing and Docusign for approving legal documents have enabled work to be conducted and completed remotely and limited the severity of the downturn.

While stocks appear much more attractive than the low returns offered by bonds, they still have risks. Indeed, on a short-term basis stocks are volatile and can drop in value (as we were reminded in March!). Furthermore, until there is a proven vaccine, we will have to suffer through the ebbs and flows of distancing requirements for the overall safety of the general population. Indeed, flare ups of COVID-19 cases in Florida, Texas and California have already caused many states to enact enhanced restrictions on their residents or visitors. Bloomberg noted in early July that real-time economic indicators of job listings, credit card spending and retail foot traffic have begun weakening as the virus flare ups have intensified. Manpower reported in June that only 60% of businesses surveyed anticipated hiring levels to return to pre-pandemic levels by the end of 2020! Nevertheless, there has been progress on the virus front, we have better treatment procedures and outcomes, and enthusiasm over a cure is building. Just last week, Pfizer noted extremely positive antibody responses from one of its preliminary vaccines, increasing the odds that a vaccine will be available by or near year end. Furthermore Becton Dickinson has just won approval of a portable hand held test that gives COVID-19 test results in 15 minutes. As we stated in last quarter's letter, never count out American ingenuity and resolve to tackle problems. As confidence increases that we are near a solution to the virus, certain cyclical sectors of the market left behind in the equity market rally should start to recover and outperform the recent market winners. Auto suppliers and manufacturers of components and systems for industrial goods should experience stronger demand and offer long-term appeal. We continue to favor IT consulting services companies, as their workers' ability to work remotely was already baked into how they performed jobs. Now, without having to travel to many of those assignments, costs have decreased and profit margins expanded.

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We invest for the long term, but are cognizant of the short term risks that these economic data points cause for the equity markets. Plenty of other folks are focusing on the risks at present, as investment strategists warn about valuation levels, economists raise concerns about the implications of a second wave, money market assets soar to a new record and shorting of stocks has increased to its highest level in years. With short-term interest rates near zero and the ten-year U.S. Treasury offering a scant 0.65% yield, it's no surprise that valuation models prefer the 1.73% yield offered by the broad equity market! We will continue to capitalize on the short-term volatility of sectors and individual stocks to create long-term oriented portfolios for our clients. The most important message we have for our clients is to make sure they understand the short-term risk of stocks and to have the appropriate asset allocation for their risk level. Fidelity reported that nearly one third of its clients 65 and older sold all of their stock positions between February and May. If they had understood the risk and inherent volatility of stocks and had the appropriate asset allocation, they would not have felt compelled to sell in fear as the COVID-19 virus reports inundated the news. That's a reminder why it's a smart idea to leave the investing to someone you trust and who has been through these market panics before. It's an especially useful reminder as we face an uncertain future and the Congressional and Presidential elections in November.

We are honored to manage a portion of your investment portfolio and, as always, welcome your comments and questions.

James P. O'Mealia manages separately managed equity and balanced accounts for institutions, foundations, and high-net-worth individuals, as well as five pooled investment funds.

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High Yield Bonds

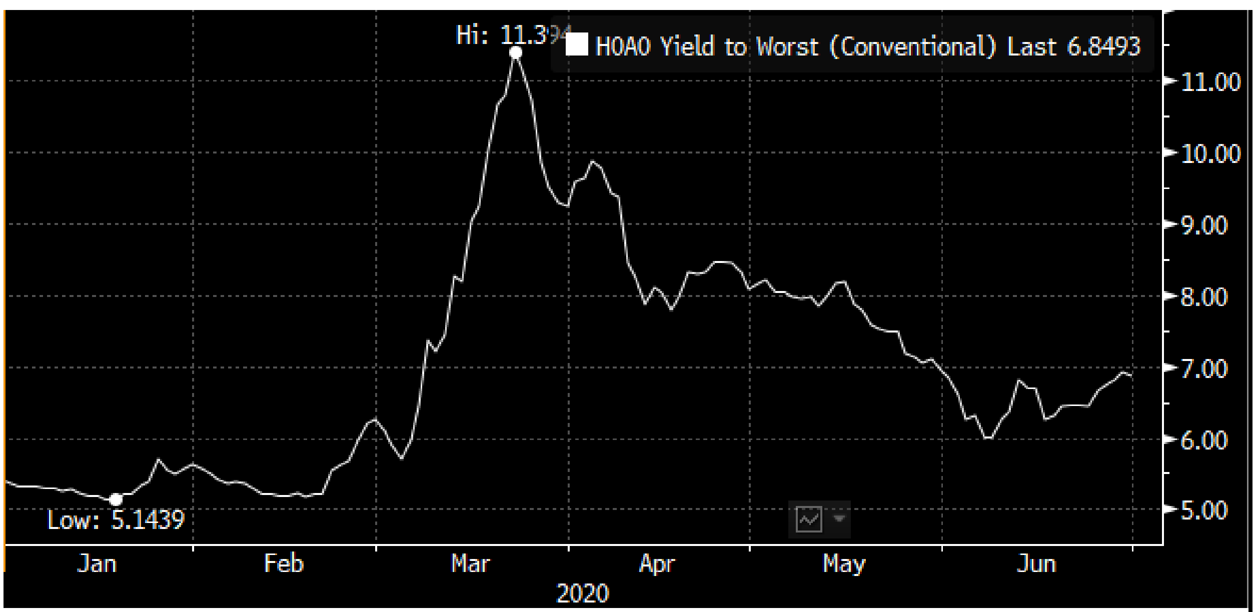
High Yield Does a U-Turn

Randy Masel – Portfolio Manager, Corporate High Yield Bond Strategy

July 8, 2020

Amidst all the talk of a V-shaped economic recovery, the high yield market executed a U-turn in the second quarter of 2020. After plummeting 13.1% in the first quarter as a result of the COVID-19-related economic shutdown and the collapse in oil prices, the ICE Bank of America U.S. High Yield Index (ICE HY Index) rebounded 9.6% in the second quarter. The gradual reopening of the economy, the "flattening of the curve" in the states most impacted by COVID-19, and a host of fiscal stimulus programs all helped reduce investor anxiety and boost risk assets. But what really got the markets going was the Federal Reserve's "all-in" approach to easing financial conditions and underpinning the economy. The Fed's response was so strong in fact that asset prices bounced sharply before the Fed bought a single bond under its newly announced asset purchase programs.

The Fed's influence on financial markets in general, and on high yield in particular, can be seen in the following graph, which tracks the ICE HY Index's yield to worst over the first six months of 2020. The yield to worst peaked at 11.39% on March 23, the day that the Fed announced its asset purchase programs.



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The yield to worst for the index stood at 6.85% on June 30th, compared to an average over the last ten years of 6.59%. On the surface, the small incremental bump that high yield is currently providing relative to historical averages does not seem very significant given the remaining uncertainty over the impact of COVID-19 on people's lives and the economy as well as an upcoming election that will be highly contentious. However, high yield's risk premium, or spread over corresponding Treasuries, tells a slightly different story. The ICE HY Index's spread to worst was 6.47% as of June 30th, compared to a ten-year average spread of 5.07%. Put differently, the sub-investment grade market's 6.85% all in yield to worst was comprised of .38% coming from underlying Treasuries and 6.47% in risk premium.

And that, in short, is the conundrum facing high yield investors. Overall yields do not seem particularly attractive in historical terms given all the current uncertainty. However, Treasury yields are at historic lows and the Fed has pledged to keep rates suppressed for the next few years. Relative to the minimal rates in Treasuries or high-quality investment grade bonds, high yield looks attractive by comparison (at least in theory). Averages can be misleading and breaking down the ICE HY Index by rating category is instructive. The BB-B rated component of the index, more or less the heart of high yield, was yielding 5.83% on June 30th. By comparison, the "junkier" CCC and lower rated component of the index was yielding 14.53% on the same date. The good news implied by this data is that investors have become more discerning when looking at credits. The bad news is that much of the high yield market is pretty picked over- decent credits have pre-tax yields that start with a 5 or even a 4. That may be exciting versus sub 1% Treasuries, but that certainly is not saying very much in the big scheme of things.

COVID-19 has accelerated the problems of companies that entered 2020 with poorly positioned business models - high cost energy producers, retailers that were competitively challenged, etc. Bankruptcies of household names - Hertz, J.C. Penney, Chesapeake Energy - have ensued. Stronger high yield companies have been able to roll over bank debt and issue new bonds, thereby preserving liquidity. However, for the most part we have not yet seen the real financial impact of the economic downturn on corporate America. It was business as usual for most of the first quarter, and first quarter earnings did not reflect the brunt of COVID-19 shutdowns. Second quarter earnings, as well as guidance, will be more instructive. Still, the longer lasting impact of COVID-19 on the U.S. economy and businesses is far from clear. The American economy has proven its dynamism time after time, and I have little doubt that at some point U.S. companies will prosper once again. The twists and turns on this path back to prosperity, and the length of the path, remain largely a function of limiting the spread of COVID-19 and the development of COVID-19-related therapies and vaccines.

Randy Masel manages a high yield corporate bond strategy that he created and launched upon joining Seelaus Asset Management in January 2014 He is also a Senior Portfolio Manager on the firm's long-only and long-short private credit funds.

Intermediate Municipal Bonds

A Host Of Factors Calm The Municipal Bond Market

Tom Dalpiaz – Portfolio Manager, Intermediate Municipal Bond Strategy

July 8, 2020

The municipal bond market of the past seven weeks has been remarkably calm. In that time, yields on high grade ten-year municipal bonds have fluctuated in a tiny two basis point range (can two basis points even be considered a range?). The stable, nearly catatonic state of municipal bond yields in recent weeks has been quite a contrast to the unprecedented convulsions of just four months ago. The movement of municipal bond yields in March occurred so quickly and was of such a magnitude that a snapback of some sort was to be expected. Still, it is impressive just how fast the tone of the municipal bond market improved in the second quarter. High grade ten-year municipal bond yields fell from 1.74% in early April to 0.83% by the third week of May, essentially back to the level before the muni market's own version of March Madness began.

The total return of the Bank of America 3-7 Year Muni Index for the second quarter was up 2.96%, a striking comeback from the first quarter's modestly negative return. The index was up 2.13% for all of 2020 through June 30. Given the heightened concern for credit quality in a time of sharply reduced economic activity, municipal bonds rated AA and higher were the prime beneficiaries of falling rates and tightening spreads throughout April and May. Single A and BBB rated munis generally lagged their more pristine brethren during those months. Starting in late May and continuing through June, however, spreads on single A and BBB rated munis began to tighten. By that time, demand for munis had bounced back significantly, supply was tight, and yields on high grade munis were close to their lows for the year. As long as these forces persist, which seems likely for the near future, further spread tightening will likely continue for single A and BBB rated munis.

While the speedy second quarter recovery of munis has been welcomed by market participants, some element of discomfort and disbelief has accompanied that recovery each step of the way. Can everything really be back to normal so quickly? Analysts and portfolio managers continue to assess the impact of substantially reduced economic activity on muni bond issuer revenues, expenses, and credit quality generally. The amount and timing of additional direct Federal aid to states and localities has not been settled. How will muni bond issuers deal with the current economic and financial challenges?

These concerns are real but a host of other factors have contributed to the benign muni bond market we currently face. The Federal Reserve has announced its intention to keep the Fed Funds rate low for the next year and a half or so.

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The Fed's new borrowing program available to municipal bond issuers to help them meet short-term financing needs has reassured the muni bond market. The Treasury bond market has stabilized with ten-year Treasury yields essentially range-bound between 0.60% and 0.80% for the past three months. The drastic economic decline of March and April has slowed and small indications of economic growth have appeared. Seasoned muni bond investors have harkened back to the previous recession of 2008/2009 and reminded themselves of just how resilient municipal bond issuers can be through difficult times. They know of issuers' self-correcting tools (unpleasant as they may be) of expense control, staff recalibration, revenue enhancement, and debt management. In addition, strong muni market fundamentals continue. The recent tight supply of traditional tax-exempt bonds and the re-emergence of muni bond demand have lent an air of relative scarcity to the muni bond market.

A quick look at the numbers in the muni market can also explain its generally positive tone. The attractiveness of municipal bonds to Treasuries remains even as yields have declined dramatically since March. Ten-year, high grade, tax-exempt muni bond yields have provided 120% to 135% of Treasury bond yields for the past month, well above the 72% to 89% range for the year prior to the market dislocations of this past March. Carefully researched 7- to 12-year muni bonds rated single A currently offer yields of 150 to 200 basis points above similar maturity AAA rated munis.

The litany of forces and factors mentioned above, taken together, has overwhelmed the ongoing, sometimes back-of-the-room concern about municipal bond credit quality. Spreads have indeed widened meaningfully since January and February so one could argue that the muni market is taking note of potential credit quality issues. How these spreads will adjust going forward will depend on how the muni market assesses the speed and magnitude of economic recovery and its effect on municipal bond credit quality. As I have said before in these commentaries (half joking and half serious), you tell me what the economy is going to do and I can pretty well fill in what bonds are likely to do. In the current environment, it is not surprising that crystal balls everywhere are cloudy. Regardless, we continue to believe tapping into available muni expertise and experience will be particularly helpful in navigating the calmer but still highly uncertain muni market waters.

Tom Dalpiaz has managed the Intermediate Municipal Bond Strategy since January 2014.

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Tactical Mortgage-Backed Securities

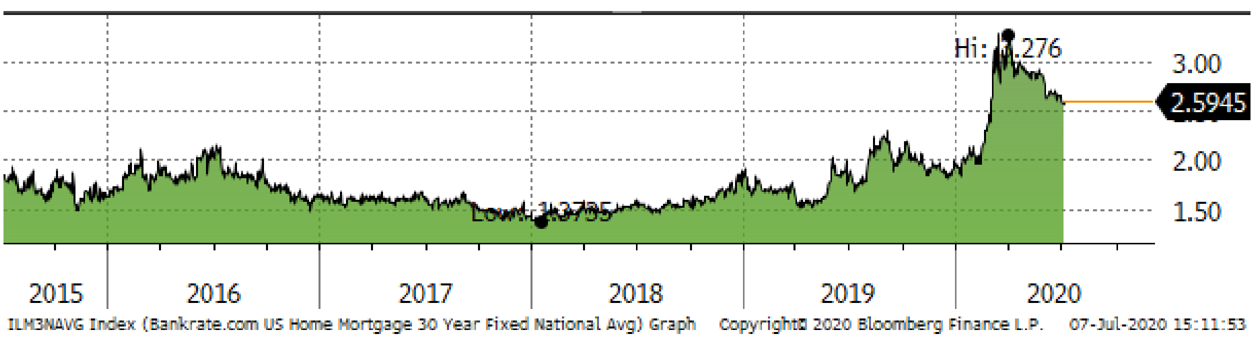
It's Time to Refi!

David Mangone, Lee Sterling, and Cliff Sterling – Portfolio Managers, Agency Mortgage-Backed Securities Strategy

July 8, 2020

Mortgage rates continue to fall and are sitting at all time lows. The average 30-year fixed rate conventional mortgage is 3.25% according to Bankrate.com, though select borrowers have access to rates below 3%. The spread between government bonds and mortgage rates is also historically wide, which provides room for the mortgage rate to drop even further – the spread peaked in March around 327 basis points (bps), but has since decreased to 260 bps. The spread can continue to drop as competition and capacity increase, as the average spread over the last 5 years was 170 bps. This, combined with the forced adoption of fintech solutions for mortgage lenders due to the COVID-19 work from home environment, should be expected to lead to elevated levels of mortgage activity even with the current status of most company employees working remote. While mortgage rates are at historic lows, the availability of mortgage credit has also hit a 5 year low. Mortgage lenders have tightened their lending standards in light of the economic impact of COVID-19 which has resulted in a 30% drop in available mortgage credit.

Spread Between 30-year Fixed Mortgage Rate and 10-year U.S. Treasury:



Another factor that is driving mortgages rates lower is the demand from investors for Mortgage Backed Securities (MBS). With more than $250 billion per month being originated and absorbed by investors and the Fed (compared to $160 billion per month during the first quarter of 2020), it should be no surprise that refinancing activity has increased so dramatically. This has taken most market participants by surprise as the assumption was the disruption in mortgage lenders' work flow would act as a counter force against lower rates, which would hamper refinance actively. Demand for structured agency MBS is also very strong, most likely caused by the increase in the demand deposit banks have taken in (measure of the M1 supply). As banks need to invest these deposits in high quality assets, structured Agency MBS is a logical choice, and banks have been the marginal buyer of CMO product in the last few months.

While the MBS market is dealing with prepayment uncertainty and surprises, the mREIT sector has had a few tailwinds. As equity markets have enjoyed a rally in the risk on environment, mREITs have followed suit and are also benefiting from a lower cost of financing. As mREITs borrow money short term at lower rates and buy longer term securities at higher rates, they benefit if the spread between their borrowing cost and what their assets yield gets wider. This has played out over the last three months as well. Most mREITs are still trading below historic price-to-book metrics which is the market's way of saying there should still be volatility in the sector, both to the upside and/or downside.

There is a lot of uncertainty and opportunity in the securities side of the mortgage market, both MBS and mREITs, but one thing is very clear at this point: mortgage rates are at historic lows and if you haven't thought about refinancing, maybe it's a good time to start.

David Mangone, Cliff Sterling and Lee Sterling joined Seelaus Asset Management in June 2019, bringing with them a collective expertise in the Mortgage market backed by a combined 60 years of experience. The addition of this strategy provides Seelaus Asset clients with access to experts in a unique section of the market and is a strong compliment to our existing strategies.

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