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2020 may finally be behind us but it certainly will not be forgotten any time soon. While we should look forward to a more benign 2021, some of the issues of 2020 still linger: a resurgence in COVID infections, continued high levels of unemployment and underemployment, a highly partisan political environment, and low (but rising) interest rates. In the following commentaries we review a most unique year that just passed and assess the prospects for the financial markets in 2021.

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Fourth Quarter 2020 Market Commentary

Equities

Stock Rally Continues as Investors Look Forward to Economic Recovery and Stimulus

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

January 7, 2021

Turn the Page

On a long and lonesome highway, to almost any working town
You listen for the engines, that used to drown out sounds
You think about the traffic, the buzz that went before,
But your thoughts will soon be wanderin', the way they always do,
When you're suffering in isolation, and there's nothin' much to do,
And you don't feel much like buyin', and you wish COVID was through.
Yet here we are, record highs again!
Here we are, up every day.
Here we go, watching Nasdaq stars again,
It's value's time you know, turn the page.

Apologies to Bob Seger, *Turn the Page*

In 2020, domestic stocks didn't just survive a pandemic, killer hornets, government funding worries, a contentious Presidential election and Brexit, but rallied mightily as investors cheered record fiscal and monetary stimulus and a sharp rebound in economic activity from the depths of the pandemic related shutdown. For the year, most major indices posted solid gains, while the shares of dominant technology and new-economy companies soared. The S&P 500 rose by over 11% for the fourth quarter and more than 16% for the year, creating the strongest two-year performance since 1999. With speculative excesses evident in burgeoning industries with little revenue and investor fervor for initial public offerings, so-called market gurus and pundits wondered if value stocks would ever be relevant again. Not surprisingly, value stocks led the stock market higher in the fourth quarter, outperforming the S&P 500 and other growth indices. I am pleased to report that our equity portfolios participated in the fourth quarter stock market rally and achieved one of our strongest years of performance relative to the appropriate benchmarks.

With the major equity averages at or near records as the tumultuous year came to a close, one would think it was easy to make money in stocks in 2020. That conclusion would be wrong. Even with a strong fourth quarter (+15.69%), the Russell 1000 value index was only able to eke out a nominal gain (+0.13%) for the year, the New York Stock Exchange Composite rose a modest 4.4% and the Value Line (geometric) equal weight index gained only 3.0%. The Dow Jones Industrial Average rose a respectable 6.0% for the year, but 13 of the mighty Dow 30 fell for the twelve-month period and three lost nearly a third of their value! Chevron (-29.9%), Walgreens (-32.4%) and Boeing (-34.3%) were shunned for various reasons during the spring and summer months, yet all three rose sharply in the fourth quarter.

The improved performance by laggard value issues during the fourth quarter is a shift we have been expecting, and the start of a trend which we think will continue in the year ahead. There is no doubt that many of the technology companies leading the stock market higher over the past few years enabled employers and employees to survive the near-total shutdown of office life by enabling employees to seamlessly transition to working from remote locations. Yet, valuations of these companies now more than reflect arguably ambitious growth expectations.

A lasting consequence of the work-from-home phenomenon is that companies are learning that employees can be productive working remotely. Jefferies' CEO recently noted that he envisioned a new hybrid work environment that has significant implications for the size and layout of offices, eliminating the "misguided notion that people raising families or caring for loved ones can't be completely effective when they spend time at home." The reduced need for physical office space will lead to more efficient business models, better employee recruitment and retention, and higher margins for most industries, providing a nice tailwind for corporate earnings. We believe part of the stock market's strength in the fourth quarter is due to investors' recognition of lower costs and stronger margins in the year ahead.

While the pandemic is not over and a new strain of the virus is exploding in the UK and spreading to other parts of the world, the recent approval and rollout of multiple vaccines should pave the way to a return to some normalcy by the second half of the year. As people around the world begin to resume their old ways and routines, the tenor of business and consumer activity will change. Consumers itching to get out and about have been buying cars (mostly SUVs), bicycles and motor homes, all of which have seen heady gains in recent months. Looking further out, consumers will be primed to spend in other areas after being cooped up and socking away cash that would have normally been spent on travel and leisure activities along with proceeds from government stimulus checks.

Many of those who lost their jobs due to COVID-related shutdowns have been paid more in unemployment benefits than they were being paid to work. While that unemployment program ended December 26th, Congress approved, and

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the President signed a new $900 billion aid package providing a fresh round of stimulus checks and guaranteeing six months of expanded unemployment benefits. We noted in previous letters that the personal savings rate exploded to 33.7% in April of 2020. While the personal savings rate fell in November to 12.9%, that is still sharply above normal levels. Now with unemployment benefits extended and a new stimulus check on the way, unemployed consumers will feel comfortable spending again. For many still employed workers, commuting and other discretionary costs have been slashed since March and their excess disposable income continues to build.

As the vaccination counts grow and the economy reopens in earnest, the spending surge that will be unleashed for entertainment, travel and leisure, and bars and restaurants will dramatically improve the fortunes of companies most negatively affected by the virus. Goldman Sachs estimates that U.S. GDP will grow 5.8% in 2021, more than recovering the 3.5% drop it estimates for 2020. The Federal Reserve has stated that it is not likely to raise short term interest rates until 2023, further noting that a resurgence in inflation above 2% will not cause them to adjust policy. With a backdrop of an accommodative Federal Reserve, historically low interest rates and an economy primed to expand dramatically in the year ahead, it is not surprising that the stock market averages are at record highs. What might surprise you is how portfolios ought to be structured to capitalize on the opportunities ahead.

The minimum wage was raised in 20 states this month will be raised in 32 cities and counties around the U.S. this year. Furthermore, the economic rebound we foresee will likely cause inflation to rise. Already we are seeing a surge in materials prices like lumber, crop prices are on the rise and renewed discipline by the Saudi’s have driven oil prices to over $50 per barrel again.

We have been underweight bank stocks and financials for many years but are now beginning to actively increase our exposure to the sector. While the Fed might be committed to keeping short term interest rates low, longer term rates could move higher. We would therefore avoid longer-dated bonds and Treasuries. The 10-year U.S. Treasury currently yields about 1.0%. If the 10-year yields rise 100 basis points from 1% to 2%, an investor would suffer an 8% drop in value. That’s one of the reasons the stocks of bank and financial companies are appealing; many offer dividend yields of 3-4% that will grow on an annual basis, are actively buying back stock and whose business fortunes will benefit from a steeper yield curve. Furthermore, an improving economy will limit or reduce credit losses for banks with disciplined lending practices. Lastly, it doesn’t hurt that valuations remain subdued with the group selling at a significant discount to the market, improving the potential risk/reward.

When the pandemic hit, businesses focused much of their spending on upgrading their networks and ability to manage their business in the digital age. In recent months, companies that managed the transition well began to spend on capital investment. In November, demand for durable goods rose by 0.4%, but Capital Economics estimates that shipments of non-defense capital goods rose by 17% in the fourth quarter, after leaping 33% in the third quarter. In December, the Institute of Supply Management manufacturing index jumped to its highest level in 30 months, led higher by a surge in new orders and production. The prices paid sub index also jumped, reinforcing our comments above about the incipient return of inflation. Moreover, inventories generally remain lean. We have added to materials, manufacturing and industrial companies in recent months. We feel we are well positioned to capitalize on the prospect for improved performance by these economically sensitive sectors, which could see an added boost if a much-needed infrastructure bill is passed under the new administration—a higher probability event with Democrats taking control of the Senate post the Georgia runoff elections.

All is not wine and roses, however, as the new virus strain and higher COVID infection case counts have caused renewed lockdowns and calls for increased social distancing. These restrictions led to a 1.1% drop in retail sales in November and a 0.4% drop in consumer spending (the first drop since April). Many retailers dependent on physical stores have shuttered locations or gone bankrupt. While the unemployment rate has fallen dramatically, employment gains have become more subdued in the past two months and unemployment remains at troublesome levels. The next few months may continue to be challenging until vaccination rates improve.

While housing has been a bright spot for the economy as low interest rates have helped spur sales of new and existing homes, sharply higher prices for housing (+8.4% in October versus year ago levels) have caused affordability to fall to a twelve-year low. November pending home sales fell slightly from October's level, but were at a record high for the month.

Sentiment indicators are also elevated. Margin debt hit a record high in December, Bank of America reported that December money manager cash levels were at their lowest level since May 2013, the major stock market averages are at record price levels and valuations for certain sectors and companies are stretched. Speculative activity is elevated judging from the record number of initial public offerings last year. Across the pond, Brexit might have been settled, but the implementation of new rules and tariffs could strain ports and the transport of goods. Lastly, now that Democrats will have control of the Senate for the next four years there is a higher probability of tax hikes in coming years.

While the long-term return for stocks is about 10%, we have had two years of above average gains and it will be harder for equities to three-peat. To achieve higher returns in 2021, investors will need to venture away from the crowds chasing fads and highly valued growth stocks. That plays right into our wheelhouse and we'd be glad to show you just how we can help you achieve your investment goals.

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

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Intermediate Municipal Bonds

Now Is Always The Hardest Time To Invest

Tom Dalpiaz – Portfolio Manager, Intermediate Municipal Bond Strategy

January 8, 2021

Reflecting on the year 2020 and the present investing moment is probably as good a time as any to trot out the old saying, "Now is always the hardest time to invest." That quote -- stated over 80 years ago by Bernard Baruch, financier and presidential advisor -- still resonates today. Its timeless wisdom reminds us how common it is for investors to hesitate when investing because of the perception that each environment is uniquely fraught with uncertainties. The quote very nicely captures the idea that it is always easy to compile a list of uncertain and puzzling factors that could convince investors to sit on the sidelines.

Bringing up "the hardest time to invest" quote does not dismiss the fact that investors in the past have had truly difficult times in which to invest, nor should it diminish the present uncertainties. A once-in-a-century global virus, including recently a new stronger strain, continues to impact economic activity. While vaccines have just started to appear, the speed of their distribution and the vaccine's ultimate usage by the public remain uncertain. Just how soon and to what degree the current cautiousness regarding economic activity will dissipate is unclear. The political uncertainty of a new administration, a deeply divided nation, and a one-vote Democratic Senate majority add additional cloudiness to financial market crystal balls.

Of course, investment environments always contain uncertainties of various degrees. Investors waiting on the sidelines for uncertainties to clear may result in waiting for a market clarity that never arrives. Extended waiting carries a cost and turns investors into timers and thus players in a game unlikely to be won consistently.

So where does the municipal bond market stand right now? Municipal bond yields are undoubtedly low though somewhat higher than their historic August 2020 lows. From a total return perspective, intermediate muni bonds (measured by the ICE BofA 3-7 Year Muni Bond Index) had a respectable 2020, finishing the year at +4.15%. Single A and BBB rated munis lagged that performance somewhat as investors favored the more pristine areas of the muni market given the challenging budgetary conditions of many issuers. Still, the end of last year saw some spread tightening in lower investment grade munis as higher quality muni bond yields seemingly exhausted their strong run. That exhaustion plus overall steady demand and still modest supply in 2021 are likely to bode well for further spread tightening in single A and BBB rated muni credits.

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An assessment of muni bond market total returns is a useful way to tell the story of the markets' journey and to gauge the interim volatility bondholders have experienced, but it should not necessarily elevate total return as the only objective of muni bond investors. It is my experience that muni bond investors tend to ask their muni bond assets to perform a number of investment roles. Because of this, they often measure their satisfaction by a host of factors. These signposts include original yields captured, modest volatility, capital preservation, safety, and behavior uncorrelated to other asset classes. I believe these are useful perspectives to remember, particularly in low rate and potentially challenging total return environments.

If interest rates continue their rise of early January, it will be important to keep in mind that intermediate municipal bonds have tended to handle rising rate environments comparatively well. There have been eight periods in the past dozen years where ten-year Treasury yields have risen at least 60 basis points before dropping. Ten-year municipal bond yields in each of these scenarios, with one exception, rose proportionately less than Treasuries (on average one-third less). That one exception was this past March when historic dislocation in the muni bond market was quite sharp but also quite brief, lasting just two weeks or so. For the remainder of 2020, municipal bond yields were remarkably stable.

While current municipal bond yields remain persistently (and annoyingly) low, there are still positive factors affecting the muni bond market that require mentioning. The feeling of scarcity – a main characteristic of the muni market for the past few years -- seems likely to continue as demand remains steady and new supply is expected to be short of those needs. The draconian declines in revenue collection for many muni bond issuers first projected in March and April of last year have not materialized. While shortfalls exist and budgets are strained, many issuers (California, for example) have been pleasantly surprised by revenue collection numbers that have exceeded expectations. Regardless of these happy revenue surprises, additional direct stimulus to states and localities appears more likely given the new Congress and new administration. This should help improve muni bond credit quality generally. Higher Federal income tax rates have been proposed by the new administration and, if implemented, should heighten the demand for tax-exempt municipal bonds to some extent. All these forces could be supportive factors for municipal bond prices in 2021.

At the present time, the Federal Reserve has made it clear they intend to hold the overnight Fed Funds rate target at its current level of 0% to 0.25% for all of 2021 and beyond. I will not be surprised to see the bond market continue to push Treasury bond yields upward if signs of economic recovery become increasingly evident. The Fed's stated intentions though could act as a ceiling of sorts on just how far that movement may go. The first change in Fed messaging -- if and when it occurs (and it may not occur for some time) -- will likely reset that ceiling. Muni bond yields will likely follow although historically they have done so to a smaller extent than Treasuries.

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None of these observations stated above are likely to cause investors to get overly excited and jump in with both feet to scoop up the low yields currently available. While today's investor reluctance and caution are understandable, we suggest remembering all that investors ask their bond allocations to do. Effective, value-laden bond picking can be done in any interest rate environment. Including all muni bond purchases executed last year, we garnered an average yield to call of 163 basis points above a standard triple A muni bond scale and an average yield to maturity of +175 basis points. For all of 2020, our average maturity for bonds purchased was ten years, average call six years, and average rating single A. We use this comparison to a triple A scale because the pristine high-grade space is a real-world safety spot for many retail muni bond buyers and their advisors.

We continue to focus on uncovering value in the short/intermediate maturity part of the muni bond market. That modest maturity focus combined with the use of spread product and defensive bond structures should work together to produce the low volatility and capital preservation objectives which could be critical in the uncertain and puzzling markets likely to be in store for us this year.

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

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Tactical Mortgage-Backed Securities

We Still Say Refi!

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

January 8, 2021

We ended the Second Quarter 2020 Market Commentary with: "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."

Well, six months later let's take a look at how Mortgage REITs have performed and where mortgage and interest rates are now.

iShares Mortgage Real Estate ETF (REM) produced a total return of 31.7% in price appreciation and 36% when including dividends. Meanwhile the S&P 500 returned 19%, 30-year mortgage rates fell approximately 40 basis points (0.4%) and the 10-year U.S. Treasury Bond would have produced a negative return.

With mortgage rates well below 3%, this may be your last chance to refinance at these historic levels. We pound the table here because though mortgage rates have come down over the last six months, interest rates have risen and that inverse relationship will not go on forever.

Longer-term interest rates have begun to move higher as the market is anticipating more stimulus out of Washington, which may actually push mortgage rates up as well. Though the market is not forecasting runaway inflation, we do have a setup where interest rates may move meaningfully higher, which, as Jim pointed out in his Equity commentary above, could lead to some short-term pain in fixed income portfolios. Generally, bond investors have few options to combat rising interest rates in a bond portfolio, but in the case of the Seelaus mortgage team, we have one tool that can be very effective in managing rising rates: Interest Only MBS securities.

Interest Only Agency MBS securities, also known as IOs, are bonds which receive only the interest portion of a mortgage payment. These IO securities, in general, go UP in price as interest rates rise, which is the opposite of most other fixed income securities. IOs can be used in a portfolio to help reduce a portfolio's sensitivity to rising interest rates or can be used as a directional bet that interest rates will go higher. Either way, this is a lesser-known corner of the fixed income market but an area in which we specialize.

Happy New Year to all and wishing everyone success in 2021.

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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