Santander Asset Management LLC - Quarterly Market Commentary March 31, 2020

During the first quarter (1Q) of 2020, a global pandemic, the COVID-19 virus (a.k.a. coronavirus), shook the world economy to its core as, for the moment, the best way to fight the virus is to prevent it by social/physical distancing which is economically detrimental. Financial markets reacted accordingly, U.S. equity prices decreased while U.S. Treasury prices increased on a flight-to-quality move as investors' weighted the effect of lockdowns all over the world on economic activity. Moreover, volatility increased, market depth decreased, and market dislocations arose. Initially, in general, liquidity dried (i.e. bonds were not trading) causing prices to drop precipitously across bond sectors as big bond funds were forced to sell bonds at depressed prices to meet a high level of outflows. Likewise, and to a much higher extent, the lack of liquidity coupled with the risk-off move greatly affected high yield bond markets. Moreover, on net, the 10-year U.S. Treasury yield decreased 125bps from 1.92% to 0.67% and the U.S. Treasury yield curve shifted down reflecting lower fed funds rates in the short-end of the curve and lower growth and inflation expectations across the curve. The Standard & Poor's 500 Index ("S&P 500 Index") decreased 20% Quarter over Quarter ("QoQ") (price return) closing the month at 2,585, the worst QoQ price return since the fourth quarter of 2008 during the financial crisis. Furthermore, market turmoil spilled into municipal bonds and US investment grade corporates as spreads widened substantially. The Option Adjusted Spread ("OAS") for Investment Grade ("IG") U.S. corporate bonds, as represented by the USD IG All Sector OAS Index, increased by 174bps from 97 to 271. And, the 10YR BVAL Muni AAA Index Yield/UST ratio increased from 0.77 to 2.15 as the 10YR BVAL Muni AAA Index yield decreased only by 4bps from 1.48% to 1.44% while the 10YR UST yield decreased 125bps, as mentioned above.

The U.S. economy came into this challenging period on a solid footing. Through February, the labor market remained strong and economic activity rose at a moderate rate led by household spending. But since then, global financial conditions and economic activity has been significantly damaged by the coronavirus. Furthermore, during the quarter, the U.S. unemployment rate rose from 3.5% in December 2019 to 4.4% in March 2020 while nonfarm payrolls decreased at an average rate of 71,000, as it increased at an average pace of 245,000 in in the first two months of the year but then decreased 701,000 in March. Headline consumer price inflation and core consumer price inflation remained below the Federal Open Market Committee ("FOMC") symmetric 2% objective. Moreover, on net, during the first quarter of 2020, total consumer prices, as measured by Personal Consumption Expenditures ("PCE") price index, increased from 1.6% in December 2019 to 1.8% over the twelve months ending in February 2020 (latest reported), while the Core PCE (which changes in food and energy prices) increased from 1.57% to 1.82%, respectively. Furthermore, recent data that covered the period since the escalation of concerns about the effects of the coronavirus points to significant weakness in the labor market and inflation. For example, initial claims for unemployment insurance benefits increased significantly from 282,000 on the week ending March 13 to 3,307,000 on the week ending March 20 to 6,867,000 on the week ending March 27. Also, during the quarter, crude oil future prices decreased by $40.58 from $61.06 to $20.48 highlighting the magnitude of the demand-side shock.

Nonetheless, as expected, in response to the crisis, the U.S. Government is adding economic stimulus through its fiscal and monetary policy which should somewhat offset the economic downturn and ease strains in the financial markets. Moreover, Congress passed the Coronavirus Aid, Relief, and Economic Security ("CARES") Act on March 27, 2020, a $2.2 Trillion (around 10% of GDP) stimulus package which aims to stabilize the economy by providing relief to individuals and businesses that have been negatively impacted by the Covid-19 epidemic and also increases health care spending to fight the outbreak. Additionally, FOMC decreased the target range for the federal funds rate by 150bps in March during two unscheduled emergency meetings from 1.50%-1.75% to 0%-0.25% and reinstated the quantitative easing program (i.e. QE4) together with several emergency lending programs to ease financial conditions by supporting the flow of credit in the economy and to smooth the functioning of markets.

Santander Asset Management ("SAM") notes that the FOMC's and U.S. Government actions have already started normalizing market liquidity, especially the investment grade markets such as U.S. Treasuries, Agency MBS and CMBS, and investment-grade corporate bonds, among other, which have or will be directly benefit by the programs. Nonetheless, SAM understands that the unemployment rate could rise to 15-20% and that economic stimulus will probably only partially offset the loss in GDP and will not prevent a recession. Furthermore, SAM thinks the economic recovery will be a function of how quickly people can go on with their lives and return to work safely. However, to go back to "normal" a vaccine and/or a cure would have to be available. Furthermore, the longer it takes for a vaccine to develop, the longer the lockdowns will last and the higher the probability we will get an L-shape recovery, hence a steep decline in economic growth followed by a slow recovery. SAM will continue to monitor the investment portfolios on a daily basis in order to seize opportunities that may arise due to market inefficiencies in order and make the appropriate adjustments that are consistent with long-term objectives.

Turning to Puerto Rico's capital markets, P.R. municipal bond prices, on average, decreased by 5.52% during the first quarter of 2020, as measured by the S&P Municipal Bond Puerto Rico Index, as high-yield municipal bond prices fell after investors shunned riskier assets on concerns the Covid-19 outbreak would cause a global recession. Furthermore, in general, the prices of Puerto Rico Sales Tax Financing Corporation ("COFINA") bonds decreased for the quarter ending March 31, 2020, as obtained from Bloomberg Valuation ("BVAL pricing"). Moreover, restructured COFINA Exempt Bond prices, as represented by COFINA 2019 B-1 4.55% 07/01/40 (CUSIP 74529JPV1), decreased by approximately $9 from $103.54 to $94.38.

http://puertorico.santandersecurities.com/SecuritiesFamFunds/sec_family_funds.aspx

The following is a brief summary of the events that shaped Puerto Rico markets during the quarter ended on March 31, 2020:

Started in December 2019, Puerto Rico continued experiencing a series of earthquakes, the highest being a 6.4 magnitude on the Richter scale that struck the island on January 7, 2020 and left the Island without power for almost a week. The effects of the quakes have dramatically affected properties in several towns of the southwest region of the island, including major towns such as Ponce. Actual damages amounts and the total repercussion of the natural disasters to the economy are yet to be determined as seismic activity continues. Also, in January 13, 2020, the U.S. Supreme Court declined to review the appeal cases brought by Ambac Assurance and Assured Guaranty against the Financial Oversight and Management Board ("FOMB") concerning the Puerto Rico Highway and Transportation Authority ("HWY") bonds. Therefore, leaving in place the First U.S. Circuit Court of Appeals decision, which states that the payments on certain Puerto Rico bonds secured by special revenues are not required – and are rather optional - while the issuer's bankruptcy is ongoing. Similarly, the Employee Retirement System ("ERS") bondholders will not receive the employer contributions made after the system filed its bankruptcy-like reorganization in 2017. In January 30, 2020, the U.S. Court of Appeals for the First Circuit deemed that employer contributions are not "special revenues" exempt from bankruptcy law, saying property acquired by a debtor after the case filing is not subject to a pre-filing security interest. Furthermore, bankruptcy Judge Laura Taylor Swain approved a request by the FOMB to postpone a hearing on the Puerto Rico Electric Power Authority's ("PREPA") restructuring plan as lawmakers said they would not support the utility's current debt-restructuring plan which involved raising electricity rates.

Then, in February, 2020, the FOMB announced it had reached a Plan Support Agreement ("PSA") with some Puerto Rico General Obligation ("GO") and Puerto Rico Public Building Authority ("PBA") bondholders. Under the terms of the PSA, recoveries of holders of GO and commonwealth guaranteed claims and PBA bonds would approximately average between 70%-80% and bondholders would receive a combination of cash and new bonds secured by a 50% GO revenues and 50% junior lien COFINA revenues. Nonetheless, the PSA currently lacks sufficient bondholder support to be validated by the District Court, and Wanda Vazquez, the Governor of Puerto Rico, has already said her administration will not join the agreement unless pensioners receive better treatment. In addition, in February, the Center for Municipal Revenue Collection ("CRIM") filed an *amicus curiae*, or "friend of the court", disputing the reversal of P.R. Law 29, which was signed into law by former Governor Rosselló and, in summary, attempts to relieve the municipalities from their financial responsibilities of disbursing payments for the health insurance and pension benefits of their public employees. According to the court filing, the municipal agency alleges that some of the actions taken by the FOMB have placed the CRIM in jeopardy of insolvency. The filing reveals that if Judge Swain decides to override PR Law 29, over 35 municipalities would be in grave danger of bankruptcy. Additionally, the *amicus curiae* also states that the financial den would endanger the loan payments to Government Development Bank ("GDB"), which are part of the Restructuring Property included in from which the debt service to bondholders is paid.

Later, on March 15, 2020, as news surfaced all over the world of the spread of the Covid-19 virus into a global pandemic, Puerto Rico's governor, Wanda Vázquez, signed an executive order instituting a closure of all nonessential businesses and government offices and an overnight curfew, among other measures to prevent the spread of the Covid-19 virus. Furthermore, days later, she announced several economic incentives to mitigate the effects of the coronavirus pandemic on workers and companies on the island including suspending the collection of the sales-and-use tax at the docks and the resale chain for three months, extending the period of income tax payments until July 15, and a 90-day moratorium on loans which could be requested directly to the banks. It was also announced that the FOMB had authorized the Government of Puerto Rico to use $787 million to fight the COVID-19 emergency. Additionally, in March, the FOMB and the government of Puerto Rico presented a motion in court to adjourn consideration of the proposed Plan of Adjustment's disclosure hearing until further notice as island officials' focus on working to slow the spread of Covid-19 virus. Judge Laura Taylor Swain ordered the postponement of the deadlines in the central government bankruptcy and ordered a status report no later than May 1, 2020, summarizing the impact of the virus on the government and a propose schedule for disclosure hearing and related deadlines.

Finally, at the time of the publication of this writing, the government of Puerto Rico released a revised fiscal plan, mentioning that it reflects the best information the Government currently possesses in light of substantial ongoing social and economic uncertainties caused by COVID-19. And, that, in light of ongoing uncertainties, many of the assumptions incorporated into the Fiscal Plan would be subject to reconsideration and that substantial revisions may be required to more accurately reflect Puerto Rico's new economic reality. Furthermore, it mentions that Puerto Rico may lose in excess of $1.5 billion in tax revenue due to a combination of reduced economic activity and delays or postponements of tax payments during the remaining four months of the current fiscal year ending June 30, 2020. And, concludes, by saying that it strongly believes that the FOMB will have to reconsider its proposed plan of adjustment for the Commonwealth which is founded upon the pre-COVID-19 economic assumptions as it is likely not feasible in Puerto Rico's post-COVID-19 reality and should, therefore, be subject to re-evaluation and a potentially substantial revision.

Cristina Cañellas, CFA - Senior Portfolio Manager

Santander Asset Management Investment Team

Source: Bloomberg and Federal Reserve- April 2020

http://puertorico.santandersecurities.com/SecuritiesFamFunds/sec_family_funds.aspx