Santander Asset Management LLC - Quarterly Market Commentary June 30, 2020

During the second quarter (2Q) of 2020, U.S. equity prices rebounded together with other risk assets while U.S. Treasury yields remained range bound as investor optimism regarding a quick recovery was uplifted after the U.S. government employed aggressive economic stimulus through its fiscal and monetary policy to backstop the economy from the damage caused by the Covid-19 pandemic. Also, in general, market volatility decreased while liquidity and market depth improved. Nonetheless, the overall optimism was partially offset by increased tensions between the US and China and uncertainty regarding the pace of the recovery as signs of a resurgence of cases became apparent once the economy started reopening after several states reported significant increases in Covid-19 infections and hospitalizations. Moreover, on net, the 10-year U.S. Treasury yield remained mostly unchanged decreasing by 1bp from 0.67% to 0.66%. The Standard & Poor's 500 Index ("S&P 500 Index") increased 19.95% Quarter over Quarter ("QoQ") (price return) from 2,585 to 3,100, bringing its year-to-date total return (price return) to -4.04%. Accordingly, spreads tightened across credit bond sectors on the risk-on move. The Option Adjusted Spread ("OAS") for Investment Grade ("IG") U.S. corporate bonds, as represented by the USD IG All Sector OAS Index, decreased by 122bps from 271 to 150. The Option Adjusted Spread ("OAS") for USD High Yield ("HY") bonds, as represented by the USD HY All Sectors OAS Index, decreased by 236bps from 882 to 646. And, the 10YR BVAL Muni AAA Index Yield/UST ratio decreased from 2.15 to 1.30 as the 10YR BVAL Muni AAA Index yield decreased by 59 bps from 1.44% to 0.86% while the 10YR UST yield decreased 1bp, as mentioned above. Additionally, crude oil future prices rebounded somewhat increasing by $18.79 from $20.48 to $39.27, after decreasing to -$37.63 on April 20, 2020, as low demand and oversupply led to inventory buildups which caused storage space to become limited.

Furthermore, the global pandemic weighed down economic activity, employment, and inflation during the period. The U.S. unemployment rate increased from 4.4% in March 2020 to 11.1% in June 2020 while the underemployment rate increased from 8.7% to 18%, respectively. Numbers that are expected to underestimate the level of unemployment as the Bureau of Labor Statistics misclassified millions of COVID layoffs and furloughs. Headline consumer price inflation and core consumer price inflation decreased further below the Federal Open Market Committee ("FOMC") symmetric 2% objective. Moreover, on net, during the second quarter of 2020, total consumer prices, as measured by Personal Consumption Expenditures ("PCE") price index, decreased from 1.3% in March 2020 to 0.5% over the twelve months ending in May 2020 (latest reported), while the Core PCE (which excludes changes in food and energy prices) decreased from 1.69% to 1.02%, respectively. Furthermore, GDP growth plunged 5.0% in the first quarter of 2020 and is expected to fall 20-40% in the second quarter.

The U.S. Government continued adding economic stimulus through its fiscal and monetary policy to try to offset some of the economic damage caused by the pandemic. During the quarter, in its April and June meeting, the FOMC decided to maintain the target range for the federal funds rate at 0%-0.25%. Moreover, the Committee expects to maintain this target range and is committed to using its full range of tools to support the U.S. economy in this challenging time until it is confident that the economy has weathered recent events and is on track to achieve its maximum employment and price stability goals. It increased its balance sheet through its quantitative easing (QE) program from approximately $5.8 trillion to $7 trillion. Furthermore, in the minutes of the June meeting released on July 1st, it is noted that the FOMC discussed tools for stimulating the economy given that the federal funds rate is at its effective lower bound (ELB). The discussion addressed forward guidance and large-scale asset purchase programs in supporting of the attainment of the Committee's goals and cap or target interest rates along the yield curve. Participants noted that the results from model simulations suggested that outcome-based forward guidance and asset purchases can help support the labor market recovery and the return of inflation to the Committee's symmetric 2 percent inflation goal. Nonetheless, the models showed that the Committee would have to maintain highly accommodative financial conditions for many years to quicken meaningfully the recovery from the current severe downturn. In addition, in June 2020, the FOMC updated the economic projections of Federal Reserve Board members and Federal Reserve Bank presidents, under their individual assumptions of projected appropriate monetary policy, downgrading the median projection for the unemployment rate and inflation for 2020, 2021, and 2022 and the GDP median projection for 2020. In the projections, most participants estimated that rates would be appropriate at the current level of 0%-0.25% through 2022. As of June 30, 2020, market expectations were in line with the FOMC Dot Plot as the expected path of federal funds rates implied by future prices was at near zero for the rest of 2020.

Santander Asset Management ("SAM") understands that the economic recovery will be a function of how fast a vaccine and/or cure will be available so people can carry on with their lives and return to work and normal life activities safely. Moreover, 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 notes that the FOMC's actions have stabilized market liquidity and reinstated market confidence and expects that it will continue to act to support the recovery through forward guidance and communications with the public, large-scale asset purchases and its lending facilities. Furthermore, as the Committee completes its monetary policy framework review, including revising the Statement on Longer-Run Goals and Monetary Policy Strategy, it will provide additional context to the Committee's policy actions. As SAM has mentioned in the past, it understands that the Committee will include an inflation target as it has been undershooting its inflation mandate since before the pandemic which could then lead them to ease monetary policy further to encourage higher inflation. 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, PR municipal bond prices, on average, increased by 7.47% during the second quarter of 2020, as measured by the S&P Municipal Bond Puerto Rico Index, as PR municipal bonds rebounded together with other risk assets. Furthermore, in general, the prices of Puerto Rico Sales Tax Financing Corporation ("COFINA") bonds increased for the quarter ending June 30, 2020, as obtained from Bloomberg Valuation ("BVAL pricing"). Moreover, restructured COFINA Exempt Bond prices, as represented by COFINA 5% 07/01/58 (CUSIP 74529JPX7), increased by approximately $7 from $97.27 to $104.54.

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The following is a brief summary of the events that shaped Puerto Rico markets during the quarter ended on June 30, 2020:

In May 2020, the government of Puerto Rico released a revised fiscal plan, stating that it reflected the best information the Government currently possesses in light of substantial economic uncertainties caused by COVID-19. And, that, in light of those uncertainties, many of the assumptions incorporated into the Fiscal Plan would be subject to reconsideration and substantial revisions 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 Financial Oversight and Management Board ("FOMB" or "Board") 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. On May 27, 2020, the FOMB approved a revised fiscal plan that cuts $15 billion from the amount the government is expected to have to repay bondholders through 2032 due to the coronavirus pandemic. It anticipates that the island will have some $8 billion available for debt payments through 2032.

Then, in June, in a unanimous decision, the Supreme Court said the FOMB was appointed constitutionally and dismissed arguments that members needed to be nominated by the president and confirmed by the Senate saying that the FOMB was not subject to the appointments clause because the panel handles primarily local affairs. It also mentioned that the Board possesses considerable power regarding local matters, including the authority to substitute its own judgment for the considered judgment of the governor and other elected officials. Furthermore, during June, LUMA Energy LLC, a consortium made of Canadian firm ATCO and U.S.-based companies Quanta Services Inc. and IEM, was awarded a multimillion-dollar contract for 15 years to take over the transmission and distribution system of the island's public power company. Aside from transmission and distribution, LUMA also will be responsible for areas including billing and collection, capital improvements and human resources. In addition, Puerto Rico's FOMB filed a lawsuit with the U.S. District Court for the District of Puerto Rico to force the Puerto Rico government to turn over documents relating to more than $40m worth of emergency contracts to purchase COVID-19 tests and other medical supplies saying it was compelled to go to the court after the administration repeatedly failed to provide information about contracts with Apex General Contractors and 313 LLC.

In July, José Carrión, Chairman of FOMB announced he will not be available for re-nomination for a second term, according to a release from the Board. The Chairman's last day will be October 5 or when the President and Congress appoint a successor, whichever happens first. Also, Board member Carlos García expressed he will not be available to serve a second term either, and will remain on the Board until August 31. Finally, the FOMB certified a $10.05 billion general fund budget plan for fiscal year 2021 after the Puerto Rico House of Representatives and the Senate failed to approve a "compliant budget" before deadline pursuant to PROMESA. The FOMB said that it was the fourth consecutive year that Puerto Rico's government has submitted a budget inconsistent with a fiscal plan. Furthermore, during the meeting, several Board members reprimanded Puerto Rico officials for not presenting audited financial statements since 2017.

SAM understands that recent developments, particularly the effect of the pandemic on the local economy and, as a consequence, the revised fiscal plan, could further delay ongoing debt restructurings and undermine the Commonwealth's economic recovery as it deters tourism and investment on the island. Nonetheless, SAM understands that there are ways that the government could work to improve people's trust and market confidence, including having up-to-date audited financial statements, tackling corruption more forcefully, and cutting unnecessary expenses.

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Santander Asset Management Investment Team

Source: Bloomberg July 2020, Federal Reserve

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