

During the third quarter (3Q) of 2019, on net, US equity prices increased modestly while US Treasury yields decreased across the curve, with longer-term yields falling the most, after central banks around the world eased monetary policy as a response to slowing global growth, geopolitical tensions and muted inflation pressures. Moreover, volatility increased as markets reacted to negative news about risks to the global economic outlook including US-China trade and currency tensions, political unrest in Hong Kong, ongoing Brexit negotiations, and an impeachment inquiry against US President Donald Trump. Abroad, in other advanced foreign economies, sovereign yields declined notably and negative yielding debt reached a record high of \$16.838 trillion on August 30th represented by the Bloomberg Barclays Global Agg Neg Yielding Debt Market Value USD Index. Accordingly, during the quarter, in the US the expected path of the federal funds rate embedded in future prices shifted down while the curve flattened and remained partially inverted suggesting further easing might be necessary. The spread between the 30 year and the 2 year US Treasury yield decreased 29bps to 49bps as the 2-year US Treasury yield ended the quarter at 1.63% and the 30-year US Treasury bond ended the quarter at 2.11%, after it reached its all-time low of 1.95% in August 27th, while the spread between the 10 year and the 3 month US Treasury yield became negative. The 10-year US Treasury note decreased 34bps from 2.01% to 1.67% as growth and inflation expectations declined. Furthermore, the Standard & Poor's 500 Index ("S&P 500 Index") increased by 1.19% Quarter over Quarter ("QoQ") (price return) to 2,977 while the Dow Jones Industrial Average also increased 1.19% QoQ to 26,917. On net, US investment grade corporate bond spreads widened modestly in light of heavy corporate bond issuance. The Option Adjusted Spread ("OAS") for Investment Grade ("IG") U.S. corporate bonds, as represented by the USD IG All Sector OAS Index, increased 8bps from 120 to 128.

The US economy rose at a moderate pace as household spending strengthen while business fixed investment and exports weakened. Furthermore, the US labor market remained strong while headline consumer price inflation and core consumer price inflation stayed low below the Federal Open Market Committee's ("FOMC") symmetric 2% objective. Moreover, during the second quarter of 2019, the US unemployment rate declined from 3.7% to 3.5% while average hourly earnings declined from 3.2% YoY in June 2019 to 2.9% YoY in September. Total consumer prices, as measured by Personal Consumption Expenditures ("PCE") price index, remained stable at 1.4% over the twelve months ending in August (latest reported) when compared to May 2019, while the Core PCE (which changes in food and energy prices) rose at a pace of 1.8% on August.

In the period, the FOMC decreased the target range for the federal funds rate twice by 25 bps citing it was lowering rates in lights of implications of global developments for the economic outlook as well as muted inflations pressures. Moreover, it lowered the rates in July by 25bps from 2.25%-2.50% to 2.00%-2.25% and it lowered rates again in September by an additional 25bps from 2.00%-2.25% to 1.75%-2.00%. Furthermore, the FOMC concluded the reduction of its aggregate securities holdings in the System Open Market Account in August, two months earlier than previously indicated, and in mid-September it started conducting open market operations to add liquidity to system after a liquidity crunch caused overnight lending rates to spike. Also, it released its updated economic projections in September were it decreased the projected federal funds rate to reflect the two 25bps decreases of July and September but did not project further cuts for 2019 and 2020. Nonetheless, as of quarter-end, the market implied probabilities reflected approximately two to three rate cuts by the end of 2020, one before the end of the year and another one or two cuts by the end of 2020.

Santander Asset Management ("SAM") believes that monetary easing should support the current moderate rate of growth. As SAM expected, the FOMC decreased rates by 50bps during the third quarter. Nonetheless, SAM believes the FOMC should have been more aggressive in order to lift growth and inflation expectations. Therefore, given that concerns of downside risks, low inflation expectations and uncertainties surrounding the economic outlook are still present after two 25bps cuts, and a partially inverted yield curve and muted inflation readings have persisted, it is foreseeable that the FOMC will cut rates at least 25 bps during the fourth quarter. However, we do expect the FOMC will react by easing further by cutting rates and/or through QE operations if conditions deteriorate. SAM notes that temporary price increases caused by tariffs via temporary higher inflation readings could fog the outlook during the fourth quarter. Moreover, SAM remains alert to the Fed's deliberations regarding the longer-run composition of their domestic securities holdings, and its effect on the yield curve and it also remains vigilant of economic, financial and geopolitical developments.

Turning to Puerto Rico capital markets, PR municipal bond prices, on average, increased 5.16% during the third quarter, as measured by the S&P Municipal Bond Puerto Rico Index. Below we summarize the price movements of certain Puerto Rico Sales Tax Financing Corporation ("COFINA") bonds for the quarter ending September 30, 2019. Overall, COFINA tax-exempt bond prices increased as US Treasury bonds rallied and investors sought for yield on lower credit quality bonds, while COFINA taxable bond prices decreased after an option to exchange taxable bonds to tax-exempt expired and the tender occurred. All prices mentioned were obtained from Bloomberg Valuation ("BVAL pricing").

Restructured COFINA Taxable Bonds, as represented by PR Sales Tax Bond Series 2019 A-2 4.55% 07/01/40 (CUSIP 74529JPY5), decreased more than 4 points from \$96.46 to \$92.36, after, as mentioned above, the option to exchange the newly issued taxable sales-tax bonds for tax-exempt bonds expired. Furthermore, trading volumes on these decreased significantly right after the option to exchange expired. Since the tender, there has not been any institutional size trades (i.e. trade size 1 million or higher) recorded. Restructured COFINA Exempt Bonds, as represented by PR Sales Tax Bond Series 2019 B-1 4.55% 07/01/40 (CUSIP 74529JPV1), increased nearly 4 points from \$99.97 to \$103.69.

The following is a brief summary of the events that shaped Puerto Rico markets during the quarter ended September 30, 2019:

During the third quarter, the Government of the Commonwealth of Puerto Rico and the Financial Oversight and Management Board ("FOMB") continued restructuring Puerto Rico' debt, including General Obligations ("GO") and Public Building Authority ("PBA") bonds, the Employee Retirement System ("ERS"), Puerto Rico Highways and Transportation Authority ("HTA"), Puerto Rico Aqueduct and Sewer Authority ("PRASA"), and Puerto Rico Electric Power Authority ("PREPA"), among others. In addition to news related to the restructuring process, bond market participants reacted to other non-bond related news including government corruption allegations and the state of the economy.

To begin the quarter, on the first day of July, the FOMB announced that the panel had unanimously decided to certify its own version of Central Government Budget and General Fund budget for the fiscal year 2020. This decision was made after the Commonwealth allegedly failed to submit a budget that satisfied the FOMB's conditions as required by Section 202(c)(2) of Puerto Rico Oversight, Management, and Economic Stability Act ("PROMESA"). The \$9.1 billion certified General Fund budget, as adopted by the FOMB, represents approximately \$600 million less than the budget approved by former Governor Ricardo Roselló and includes, among other things, an allocation of \$2.6 billion (about 30% of the budget) to employee pension payments, a 30% cut in professional services expenses, and a 13% reduction in the Legislature's spending. A day later, on July 2, the U.S. Court of Appeals for the First Circuit ordered to the FOMB's board members to continue to operate until the US Supreme Court rules on the case related to the FOMB's Appointment Clause.

Furthermore, in July, the FBI arrested on charges of directing federal funding to politically connected contractors two former senior officials who served in the Roselló's administration. After several weeks of public manifestations, Roselló resigned to his position as the Governor of Puerto Rico along with several other high-ranked cabinet members in view of the discontent of various sectors of the island due to recent FBI arrests and the public release of a chat that contained derogatory comments. Pedro Pierluisi was named Secretary of State and thereof Roselló's successor. Subsequently, the PR Supreme Court overturned Pierluisi and Justice Secretary Wanda Vázquez took the post after weeks of turmoil. Moreover, after the "alleged corruption, fiscal irregularities and mismanagement of the Puerto Rico government" the U.S. Department of Housing and Urban Development (HUD) opted to appoint a federal monitor to oversee the disbursement and use of nearly \$20 billion. This decision adds an extra layer of scrutiny to the already bureaucratic process, and will most likely cause delays in the federal aid distributions to the reconstruction projects.

Thereafter, on August 1, COFINA completed the bond exchange of the investors who tendered their federally taxable COFINA bonds for tax-exempt bonds. Moreover, COFINA had extended an exchange offer to eligible bondholders offering them the opportunity to exchange their taxable bonds for tax-exempt bonds with yields no more than 0.25 percentage points lower than the current (restructured) bonds. Later, on August 9, the Puerto Rico Fiscal Agency and Financial Advisory Authority ("AAFAF") announced that the PR Government had reached a consensual agreement with the Federal Government on behalf of PRASA to restructure approximately \$1 billion loans with several federal agencies, including EPA and USDA, under different government programs. The deal, among other things, would reduce PRASA's debt service by \$380 million over the next ten years as well as renew access to potential sources of funds under federal programs for infrastructure projects.

Then, in September, during his visit to the island, Raúl Grijalva, chairman of the U.S. House Committee on Natural Resources announced he will propose new changes to the PROMESA law, including a creation of a reconstruction coordinator to oversee the island's recovery; a public audit of the island's debt; and federal funding for the oversight board. Meanwhile, a few days later, the FOMB submitted to the Court the latest debt-adjustment proposal for the GO debt and PBA bonds; and for the pension system liabilities. The proposed reductions in the GO debt vary depending on the issue date of the securities, going from 64% recovery value for pre-2012 GO securities to as little as 35% for those 2014 GO bondholders who decide to settle their claim rather than litigate in court. The proposal also includes a provision for a "Litigation Trust", GO and PBA bondholders who are subject to the Recovery Litigation and who choose to litigate, and lose, may be subject to a demand that they return prior payments of principal and interest to their respective bond issuers, but holders of GO and PBA bonds who opt to settle their claims would be immune to any collateral effects of the Recovery Litigation on their claims and distributions. Moreover, the plan also includes alterations to the monthly pension payments for those retirees who earn over \$1,200 a month. The applicable haircut would be the smaller "of (a) the lesser of 8.5% of the Total Monthly Benefit or the reduction of the Total Monthly Benefit to \$1,200 per month, or (b) 25% of the difference of the Total Monthly Benefit plus the Monthly Medical Insurance benefit, if any, minus either (i) \$1,000 for those Participants without Social Security benefits or (ii) \$600 per month for those Participants with Social Security benefits."

On a positive note, the Commonwealth coffers- and the economy- appears to be in a better position than previous years. According to the Secretary of the Treasury Department of PR, Francisco Parés, Puerto Rico's General Fund collected a total of \$11,376 million during the fiscal year 2018-2019, experiencing a new record in tax collections. The reported net revenue exceeded the previous fiscal year tax collections by \$2,063 million, an increase of 22% YoY. In addition, the Sales and Use Tax ("SUT") collections for the fiscal year was \$2,299 million, \$653 million more than the previous fiscal year. Furthermore, in a measure that seeks to pressure businesses to comply with the SUT payments to Treasury Department, the Treasury Secretary announced that the Agency is in the process of reducing the SUT from 11.5% to 7% on certain goods such as the sale of prepared foods to eligible and certified merchants. Eligible merchants must apply and obtain a certification to charge the reduced rate of 7% IVU, beginning on the 1st of October. Likewise, the local banking sector continues to show healthy results. The five commercial banks reported a combined net income of \$505.32 million in the second quarter, which is \$9.8 million (+2.0%) more than the second quarter of 2018. The increase in earnings was mostly attributed to higher net interest income (grew 16.3% YoY) and lower provisions for loan losses (declined 35% YoY).

Similarly, the bank delinquency rates reached the lowest level since 2008, decreasing to 5.94% in the second quarter. However, despite the positive news from the economy, on September, local newspapers reported that the U.S. Treasury has asked Puerto Rico to develop a plan to end the federal tax credit the companies have received on Act 154 payments. Changes to the Act 154 tax revenue could materially impact the economic recovery and delay the debt-restructuring negotiations between GO and PBA bondholders and the Commonwealth government. The Act 154 imposes a 4% levy on the revenues of the multinational manufacturers not based on the island. This revenue stream accounted for 18% of the budget, approximately \$2 billion, for the fiscal year ended in June 30, 2019.

Finally, at the time of the publication of this writing, the justices of the U.S. Supreme Court began to hear the oral arguments regarding the dispute brought by Aurelius Investment over the election process of the FOMB's board members – i.e. the Appointment Clause-, and therefore, the validity of decisions taken by those members. For many legal experts, this case could represent one of the most important cases of the Commonwealth in recent years, as a decision of Supreme Court in favor of the Claimant could invalidate all of the Board prior actions, including reverting the already materialized debt restructurings of COFINA and GDB, and disrupt the preliminary agreements with GO, PREPA, ERS and PBA bondholders.

SAM understands that the uncertainty and lack of leadership in the Government of Puerto Rico could undermine the island's debt restructuring and the economic recovery. Furthermore, ending the excise tax of Act 154, which represents approximately 20% or \$2 billion of the yearly budget of Puerto Rico, on top of the austerity measures already in place would bring additional distress to the Island's economy. SAM expects that PR bond price volatility will continue, especially in those credits under restricting negotiations and those exposed to court rulings. Furthermore, 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.

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