During the fourth quarter (4Q) of 2019, on net, US equity prices increased while the U.S. Treasury curve steepened as longer-term yields increased after the Federal Open Market Committee ("FOMC") eased monetary policy while developments on trade and Brexit negotiations reduced downside risks. On the other hand, the markets have reacted fairly muted to the formal impeachment inquiry against President Trump following the Whistleblower allegations that he pressured Ukraine to meddle in the 2020 election. Moreover, in the trade side a preliminary phase-one trade agreement was reached between the U.S. and China while U.S. Congress and the White House agreed on the United States-Mexico-Canada Agreement ("USMCA") set to pass the Senate in first quarter of 2020. Likewise, the uncertainty regarding the Brexit decreased up to the point of almost certain when Boris Johnson won the majority of seats in the Prime Minister election. Furthermore, on net, the 10-year U.S. Treasury yield increased 25bps from 1.67% to 1.92% as investors risk appetite increased on optimism of a trade deal and lower interest rates. Accordingly, the U.S. Treasury yield curve steepened somewhat reflecting lower fed funds rates in the short-end of the curve and higher growth and inflation expectations in the long-end of the curve. The 3 month-10yr U.S. Treasury yield spread increased 52 bps, from -16bps to 36bps, becoming positive gain. The Standard & Poor's 500 Index ("S&P 500 Index") increased 8.53% Quarter over Quarter ("QoQ") (price return) closing the month at 3,231 after reaching a new all-time high of 3,240 in December 27th. On net, U.S. investment grade corporate bond spreads tightened 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 31bps from 128 to 97.

The U.S. economy continued rising at a moderate pace led by strong household spending while businesses fixed investments and exports remained lackluster. Manufacturing data was particularly underwhelming as the ISM Manufacturing Index fell further below 50 ending the year at 47. Furthermore, the U.S. labor market remained strong. The U.S. unemployment rate remained at 3.5% while nonfarm payrolls increased at an average rate of 184,000. However, wage pressures remained subdued. Average hourly earnings were mostly unchanged, merely declining from a revised 3.0% YoY in September 2019 to 2.9% YoY in December 2019. Likewise, headline consumer price inflation and core consumer price inflation remained below the FOMC symmetric 2% objective. Moreover, on net, during the fourth quarter of 2019, total consumer prices, as measured by Personal Consumption Expenditures ("PCE") price index, increased slightly from 1.4% to 1.5% over the twelve months ending in November 2019 (latest reported) when compared to August 2019, while the Core PCE (which changes in food and energy prices) decreased from 1.76% in August 2019 to 1.61% in November 2019.

In the period, the FOMC decreased the target range for the federal funds rate once, in October 2019, by 25 bps from 1.75%-2.00% to 1.50% to 1.75% citing it was lowering them in light of the implications of global developments and uncertainties for the economic outlook, as well as muted inflation pressures. Furthermore, the FOMC decided, at least into the second quarter of 2020, to purchase Treasury bills in order to maintain ample reserve balances at or above the level that prevailed in early September 2019. Also, they will continue, temporarily, conducting repurchase (repo) agreement operations to ensure that the supply of reserves remains ample even during periods of sharp increases in non-reserve liabilities, and to mitigate the risk of money market pressures that could adversely affect policy implementation. Looking forward, and as expressed in its December 2019 meeting and its updated economic projections, the Federal Reserve System ("Fed") is expected to be on hold as it continues to monitor the implications of incoming information for the economic outlook, including global developments and muted inflation pressures, and gauges the effect of the three rate cuts made in 2019 and recent trade and geopolitical developments. At year-end, the markets seemed complaisant with a stable interest rate environment at current levels in light of positive U.S.-China trade developments. As of quarter-end, the expected path of the federal funds rate embedded in future prices, or the market implied probabilities, reflected less than one rate cut by the end of 2020, in line with the Fed.

As Santander Asset Management ("SAM") expected, the FOMC decreased rates by 25bps during the fourth quarter of 2019 and with markets expectations now in line with the FOMC's projections the Committee will probably be able to keep rates on hold if the outlook remains mostly unchanged. Furthermore, SAM believes that with stable short term rates and less downside risks to the outlook the U.S. is well position for moderate economic growth in 2020. Moreover, SAM judges that there is a higher probability of lower rates than higher rates in the future as we do expect the FOMC would react by easing further if financial conditions deteriorate while it sees higher inflation as a precondition for the Fed to increase rates. And, considering that current low inflation and low inflation expectations have persisted even in light of temporary inflation pressures from trade tariffs, we think it would require further fiscal and/or monetary stimulus for inflation to increase above the symmetric 2% objective. Furthermore, currently the FOMC is undergoing a review of its monetary policy framework and the inflation subject is at the center of most of the discussions, as they continue undershooting the objective. From the conclusions of some of the discussions and research papers, the Fed could consider moving towards an inflation targeting approach which would lead them to ease monetary policy further to encourage higher inflation that, as a consequence, would warrant higher rates as to avoid the zero lower interest bound during the next downturn. Nonetheless, we think that any changes to the framework would be implemented after the elections to avoid questions regarding their political independence. Moreover, SAM remains alert to the Fed's deliberations regarding the repo facility and the longer-run composition of their domestic securities holdings, and its effect on the yield curve and also remains vigilant of economic, financial and geopolitical developments such as Donald Trump's impeachment proceedings and U.S.-Iran relations. 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 1.35% during the fourth 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 December 31, 2019. All prices mentioned were obtained from Bloomberg Valuation ("BVAL pricing").

Restructured COFINA Taxable Bond prices, as represented by PR Sales Tax Bond Series 2019 A-2 4.55% 07/01/40 (CUSIP 74529JPY5), were mostly unchanged increasing by 19 cents from $92.36 to $92.55. Furthermore, trading volumes on these securities have been muted after the option to exchange expired. Since the tender, there have only been two institutional size trades (i.e. trade size 1 million or higher) recorded. Restructured COFINA Exempt Bond prices, as represented by PR Sales Tax Bond Series 2019 B-1 4.55% 07/01/40 (CUSIP 74529JPV1), were also mostly unchanged decreasing by only 15 cents from $103.69 to $103.54.

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The following is a brief summary of the events that shaped Puerto Rico markets during the quarter ended December 31, 2019:

On October 15, the Justices of the U.S. Supreme Court heard the oral arguments regarding the dispute brought by Aurelius Investment, LLC vs. Commonwealth of Puerto Rico over the election process of the Financial Oversight and Management Board for Puerto Rico ("FOMB") Board Members – i.e. the Appointment Clause-, and therefore, the validity of decisions taken by those Members. As discussed on previous quarters, many legal experts consider 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 Government Development Bank for Puerto Rico ("GDB"), and disrupt the preliminary agreements with the Commonwealth of Puerto Rico General Obligation ("GO"), Puerto Rico Electric Power Authority ("PREPA"), Employee Retirement System of the Government of Puerto Rico ("ERS"), Puerto Rico Highways and Transportation Authority ("HTA") and Puerto Rico Public Building Authority ("PBA") bondholders. Meanwhile, on another legal dispute regarding Puerto Rico bonds, the U.S. Supreme Court rejected to review the case that challenges the legitimate claim of Pension Obligation Bonds ("POB") bondholders to the Retirement Systems Administration's assets, maintaining the lower court ruling that states that the public pension bondholders have a secured claim on the pension assets.

Meanwhile, in December, the U.S. Senate Finance Committee reached a bipartisan agreement to work on legislation that allocates over $11.869 billion in Medicaid funding to Puerto Rico over the next four fiscal years, amount that was subsequently cut to $5.7 billion by President Trump as part of a larger government spending deal. Nonetheless, after the corruption cases revealed last year, the Senate decided to include additional controls in the legislation such as the obligation to present annual audits performed by an independent third party, and the possibility of suffering cutbacks with the Medicaid funds if the program fails to comply with the mandated quality controls. In a related subject, after two years since Congress allocated approximately $44 billion in Hurricane María Disaster relief, only $15 billion has been distributed. Furthermore, of the approximately $20 billion Community Development Block Grant Program ("CDBG") funds allocated by the Department of Housing and Urban Development ("HUD"), only about $5 million has been disbursed. Reacting to the protracted, slow speed of the federal relief distributions and the possible effect on the economy, the FOMB warned the Commonwealth officials that Puerto Rico may be at risk of receiving less money than projected, and even experience significant delays in the disbursement of the disaster relief funding.

Regarding the U.S. Treasury Department intentions to end the federal tax credit that companies have received under the Act 154 during the past 10 years, Puerto Rico government officials are still uncertain when the Internal Revenue System ("IRS") will stop allowing the multinational companies operating in Puerto Rico under this treaty apply the local tax credit against their federal taxes. Specifically, 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 Puerto Rico General Fund budget, approximately $2 billion, for the fiscal year ended on June 30, 2019. A thoughtful, corroborated economic plan, as well as different viable alternatives to replace the Act 154 income stream, is of vital importance to the Commonwealth because -as reported on the previous newsletter- changes to this tax revenue could materially impact or put in jeopardy the economic recovery.

On a positive note, the Commonwealth coffers continued to post strong, positive revenue numbers. According to the Secretary of the Treasury Department of PR, Francisco Parés, the General Fund collected a total of $1,048.7 million, $773.6 million, $985.5 million and $881.6 million in July, August, September, and October, respectively. Remarkably, these numbers represent an increase of over $100 million per month when compared to the same four months of the previous year. The key driver of the revenue growth during this period can mostly be attributed to corporate income tax, which accounted for $657 million of the $706 million General Fund Net Revenue increase.

Finally, at the time of the publication of this writing, Puerto Rico has been experiencing a series of recurrent earthquakes, including a 6.4 magnitude on the Richter scale that struck the island on January 7, 2020. 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. Also, the Governor of Puerto Rico fired various government officials as a result of a controversy related to the misuse of emergency supplies discovered in a warehouse. SAM understands that recent developments could further delay ongoing debt restructurings, undermine the Commonwealth's economic recovery and deter tourism and investment on the island. Also, SAM continues to be vigilant on the deliberation of the Federal government regarding the excise tax of Act 154 as it represents approximately 20% of the yearly budget of Puerto Rico. 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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Source: Bloomberg January 2020

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