

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

During the fourth quarter (4Q) of 2020, on net, U.S. equity prices increased while U.S. Treasuries sold-off as markets remained focused on the progress of the COVID-19 vaccine and the expectation of additional fiscal stimulus. Moreover, the United States Food and Drug Administration (FDA) approved Pfizer-BioNTech's and Moderna's COVID-19 vaccines which began to be administered in mid-December. Meanwhile, at the end of December, after much negotiation throughout the quarter, the U.S. Congress reached an agreement and passed the Consolidated Appropriations Act, 2021, a \$2.3 trillion fiscal spending bill which included a \$900 billion COVID-19 pandemic relief stimulus package. However, the overall optimism was partially offset by an increase in COVID-19 cases and deaths as flu season intensified and as the U.K. went into another shutdown after it reported a new strain of COVID-19, which was later discovered in the U.S. Moreover, on net, the 10-year U.S. Treasury yield increased by 23 bps from 0.69% to 0.92% as the market weighted the possibility of a Democratic party controlled government that would bring increased deficit spending and, as a consequence, the possibility of higher inflation. The Standard & Poor's 500 Index ("S&P 500 Index") increased 11.69% Quarter over Quarter ("QoQ") (price return) from 3,363, to 3,756, bringing its year-over-year total return (price return) for the year ending December 31, 2020, to 16.26%. Accordingly, credit spreads continued to tighten on the risk-on move, particularly high yield bonds. 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 40bps from 135 to 95. The Option Adjusted Spread ("OAS") for USD High Yield ("HY") bonds, as represented by the USD HY All Sectors OAS Index, decreased by 166bps from 546 to 380. Likewise, the 10YR BVAL Muni AAA Index Yield/UST ratio decreased from 1.22 to 0.75 as the 10YR BVAL Muni AAA Index yield decreased by 16 bps from 0.84% to 0.69% while the 10YR UST yield increased 23 bps, as mentioned above.

Furthermore, during the period, economic data was mixed and, as expected, the pace of economic improvement moderated. The U.S. unemployment rate decreased from 7.8% in September 2020 to 6.7% in December 2020, still below its pre COVID-19 level, while the underemployment rate decreased from 12.8% to 11.7%, respectively. Nonetheless, even though inflation expectations increased, actual headline consumer price inflation and core consumer price inflation readings decreased further below the Federal Open Market Committee ("FOMC") symmetric 2% objective. Moreover, on net, total consumer prices, as measured by Personal Consumption Expenditures ("PCE") price index, decreased from 1.4% over the twelve months ending in September 2020 to 1.1% on November (latest reported), while the Core PCE (which excludes changes in food and energy prices) decreased from 1.53% to 1.38%, respectively. Furthermore, GDP growth for the third quarter of 2020, reported during the fourth quarter, increased by 33.4% while the GDP growth forecast for the fourth quarter, as projected by the Bloomberg Contributor Composite, estimates an increase of 4.8% while the Atlanta Fed GDPNow™ Forecast 7.4% as of January 15, 2021.

During the quarter, the FOMC decided to maintain the target range for the federal funds rate at 0%-0.25% and it continues to expect it will be appropriate to maintain this target range until labor market conditions have reached levels consistent with the Committee's assessments of maximum employment and inflation has risen to 2 percent and is on track to moderately exceed 2 percent for some time. Furthermore, in its December meeting it reaffirmed its commitment to its current level of asset purchases by adding in the statement that it would continue to increase its holdings of Treasury securities by at least \$80 billion per month and of agency mortgage-backed securities by at least \$40 billion per month until substantial further progress had been made toward the Committee's maximum employment and price stability goals. In addition, it updated the economic projections of Federal Reserve Board members and Federal Reserve Bank presidents, under their individual assumptions of projected appropriate monetary policy. In the projections, most participants estimated that rates would be appropriate at the current level of 0%-0.25% through 2023. As of quarter-end, the expected path of the federal funds rate embedded in future prices, or the market implied probabilities, was in line with the FOMC Dot Plot at near zero for the rest of 2021.

Santander Asset Management ("SAM") expects the U.S. economy will continue to recover as the vaccine rolls out across America and the flu season ends while the U.S. Government continues supporting the economic recovery through its monetary and fiscal policy. 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, during the fourth quarter of 2020, in general, PR municipal bond prices increased by 5.30% as measured by the S&P Municipal Bond Puerto Rico Index due to positive risk sentiment. Consistently, prices of Puerto Rico Sales Tax Financing Corporation ("COFINA") bonds increased. Restructured COFINA Exempt Bond prices, as represented by COFINA 5% 07/01/58 (CUSIP 74529JPX7), increased by approximately \$5.74 from \$105.66 to \$111.40 as obtained from Bloomberg Valuation ("BVAL pricing").

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

At the beginning of October, the government Puerto Rico released a revised Proposed Plan of Adjustment that offered GO and PBA bondholders between 57.2% and 58.4% on the dollar, down from 73.6% offered in the February 2020 agreement. As it explained, the revised plan took into account the negative effects of the pandemic and economic shutdown reflected in the updated Fiscal Plan as of May 2020, certified by the Federal Oversight and Management Board ("FOMB"). Days later, the Supreme Court rejected an appeal and left intact the ruling that says the Puerto Rico governor's spending power was limited by Puerto Rico Oversight, Management, and Economic Stability Act ("PROMESA"). The rejection favored the FOMB, which said that the governor cannot make expenditures unless authorized through the board-certified budget, and rejected a government's appeal, which sought to spend unidentified funds that were left unused from previous budgetary cycles. The FOMB stated that the "effort by the Puerto Rico Government violated the FOMB's Certified Fiscal Plan and the requirements established by PROMESA". Also, that same month, the FOMB selected one of its current members, David A. Skeel, Jr. a corporate law professor, as the chairperson to replace José Carrión, III as he exited his post. At his designation, David A. Skeel, Jr. stressed it was imperative for the government to reach a settlement with its creditors and emerge from bankruptcy, saying that otherwise, "Puerto Rico will not truly begin to recover and begin to see the glimmer of economic prosperity." Furthermore, also in October, President Donald J. Trump appointed Justin Peterson to the FOMB. Peterson is a managing partner at DCI Group, a public relations and lobbying firm. Peterson's post was controversial as he previously worked as the spokesman for a group of general obligation bondholders, which included Aurelius Capital Management, LP and Autonomy Capital Monarch Alternative Capital, LP.

Additionally, at the end of October, Judge Swain established a February 10th deadline for the FOMB to submit "at a minimum an informative motion comprising of a term sheet disclosing the material economic and structural features of a Commonwealth and Public Building Administration (PBA) plan of adjustment (POA)." Judge Swain's decision to have a term sheet that would set an unofficial timeline to move along a POA and its plan support agreement (PSA) is a partial grant and a partial denial of a joint motion presented by a group denominated as the PSA creditors, which comprises the Ad Hoc Group of Constitutional Debtholders, the Ad Hoc Group of General Obligation Bondholders, the Lawful Constitutional Debt Coalition (LCDC) and the QTCB Noteholder Group, which requested a November 30th deadline for the board to refile a debt restructuring plan and a May 31st deadline for the court to approve it.

Then, in November 7th general elections in Puerto Rico, Pedro Pierluisi won the gubernatorial race while the nonbinding referendum favored U.S. statehood. Additionally, that same month, the Supreme Court rejected the request of the Puerto Rico's Employee Retirement System ("ERS") bondholders who said they were entitled to employer payments under federal bankruptcy law for the \$2.9 billion in bonds it issued in 2008. Moreover, the Court did not allow them to collect any employer contributions made after the system filed for bankruptcy in 2017. Furthermore, in November 23rd, Judge Richard Hertling of the U.S. Court of Federal Claims rejected the request of bondholders asking the U.S. government to compensate them for losses incurred in the restructuring of the Puerto Rico's debts. A group of bondholders claimed that they had the right to be compensated by the federal government since the FOMB was acting based on the sovereign authority of the U.S. The ruling also dismissed the lawsuit filed by Oaktree Capital Management LP and other bondholders accusing the U.S. government of taking their property illegally.

During the month of December, President Donald Trump appointed four members to the FOMB. The President reappointed Andrew Biggs, a resident scholar at the American Enterprise Institute, who previously held multiple positions in the Social Security Administration, who will remain on the board. Appointed Betty A. Rosa, the New York's interim Commissioner of Education and the President of the University of the State of New York. He also appointed John Nixon whom was Michigan's Director for the Department of Technology, Management, and Budget from 2011 through 2014 and also served as Utah's budget director. Nixon is senior vice president at CNSI, which provides health information technology to state and federal agencies. And, appointed Antonio Medina, former head of Puerto Rico's Industrial Development Company ("PRIDCO"). Medina served from 2012 to 2016 as executive director of PRIDCO and is currently president and founder of Convergent Strategies, a business consulting firm based in Puerto Rico.

Also, in December 10, 2020, Puerto Rico's Aqueduct and Sewer Authority ("PRASA") refunded approximately \$1.37 billion of debt. The deal is set to save PRASA \$350 million in debt service payments through 2047, the final maturity, according to the Puerto Rico Fiscal Agency and Financial Advisory Authority ("AAFAF"). Bonds maturing in 2047 with a 5% coupon priced at a yield of 4.15%, or 276 basis points more than top-rated municipal debt, according to data compiled by Bloomberg. Furthermore, in December 14th, the Ad Hoc Group of Constitutional Debtholders urged the FOMB to continue with the tentative debt restructuring plan that the parties agreed to in February 2020 rather than seek additional bondholder losses. Additionally, in December, the Puerto Rico Treasury Department released the collections of the Sales and Use Tax (SUT) up to November 2020. The report showed the collections derived from the 5.5% SUT were \$639.4 million by November, a lot higher than in the previous fiscal year where it collected \$476.6 million. The first funds of the 5.5% SUT collected each fiscal year, up to a specific amount each fiscal year, are owned by COFINA ("COFINA Revenues"). Since the amount of COFINA Revenues for the fiscal year 2020/2021 is approximately \$454.5 million, the amounts were already pledged by October 2020.

Cristina Cañellas, CFA - Senior Portfolio Manager

Santander Asset Management Investment Team

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Sources: Federal Reserve, Bloomberg, Wall Street Journal, Caribbean Business, El Nuevo Día and Departamento de Hacienda Gobierno de Puerto Rico: January 2021

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