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ASSET MANAGEMENT

First Quarter 2020 Market Commentary

2020 was off to a great start till the spread of the coronavirus disrupted our lives and the financial markets. In the attached commentaries we review the unprecedented events of the first quarter of 2020 and discuss the impact of the coronavirus on the equity, high yield, municipal bond and mortgage markets as we move forward.

Seelaus Asset Management, LLC
26 Main Street, Suite #304
Chatham, NJ 07928
(855) 212-0955
www.rseelaus.com
contact@seelausam.com

Equities

The Curse of Corona

James P. O'Mealia – Head of Equity Portfolio Management

April 6, 2020

Well we're on our way
I sure know where we're going
We're on our way
I'm taking my time,
'Cause it's rough out there
Goodbye bear market,
The curse of Corona
Seein' me and insiders
Down by the junk yard
Seeing me and Insiders
Picking up the discards.

-Apologies to Paul Simon,
"Me and Julio Down by the Schoolyard"

Equity markets plunged as investors faced the prospect of and then the reality of the world economy being put on hold as the nightmare of Coronavirus forced consumers to stay at home and businesses to temporarily close to ensure the safety of their workers. The longest bull market in history crashed in historic fashion as the virus spread from China to other countries. Adding fuel to the fire, Saudi Arabia got tired of waiting for Russia to agree to limit production and decided it was time to remind everyone just who was in charge of the energy markets, promising to glut the world markets with oil and caused Nymex's crude oil prices to plummet 66.46%. The Federal Reserve lowered short-term interest rates to near zero, supported the financial system through massive purchases of securities, Congress passed and the President signed a $2 trillion Coronavirus Aid, Relief and Economic Security Act (CARES), yet these moves weren't able to prevent the equity markets from collapsing at their fastest pace in history and stocks registering their worst quarter since the financial crisis twelve years ago. While no equity strategy performed well, our managed equity accounts significantly outperformed the relevant value indices.

The S&P 500 fell a heady 20% for the period, but that paled in comparison with other sectors and styles. Indeed, the Dow Jones Industrials sagged 23.2%, the Dow Transports slumped 29.1%, the S&P Mid Cap Index dropped 30.9% and the Russell 2000 index of small capitalization value issues plunged 35.7%! Based upon the above, one might guess that being in larger issues would have protected investors from the worst of the onslaught, but there was plenty of opportunity for massive loss of capital in some of the biggest and previously bluest of blue chips. In just the Dow Industrials, Boeing's stock crashed (-54.2%) as passenger airline activity nosedived, Dow's shares crumpled (-46.6%) as demand for chemicals and plastics melted, while energy companies Exxon Mobil (-45.6%) and Chevron (-39.9%) evaporated as the Saudis promised to glut the oil market. Even best-in-class manufacturers like United Technologies (-37%), world-class banks like JP Morgan Chase (-35.4%) and media powerhouses like Disney (-33.2%) were pummeled as investors sold indiscriminantly, at times without regard to price. These examples barely scratch the surface of the devastating wealth destruction from the February highs, which Wilshire Associates estimates totaled $10 trillion for equities alone.

The economic news for the quarter was generally strong through February and didn't start to show the impact of the coronavirus-related slowdown until the very end of March. Equity investors look to the future and realized in early March that economic activity was going to fall dramatically in the months ahead. What they did not know and could not predict with certainty was how deep the slowdown would be and how long it would last. We still don't know the answers to those questions, which is why market volatility was so intense in March. In fact, according to Dow Jones' market data team, March's average daily market volatility of more than 5% exceeded the previous record of 3.9%, set way back in November 1929! What we do know is many leading companies have irreplaceable businesses and franchises, as well as the financial strength to withstand the most-dire forecasts of softer economic activity. We have counseled in previous letters that market valuations were stretched and higher-than-average cash balances were called for. We are confident that our portfolios are full of companies that will thrive in the years and decades ahead and we have used the recent periods of heightened volatility to purchase more of these industry leaders.

We know that the news coming out of Main Street is going to be terrible for the next few months and since Wall Street is not focused on the past, we are not going to rehash how strong the economy was going into this downturn. In simple terms, the drop in second quarter GDP is going to be one for the record books with estimates of a drop of as much as 10-15%. The unemployment rate will surge from its decades-low reading of 3.5% in February to a level that according to St. Louis Fed President Bullard could approach 30%. The Organization for Economic Cooperation and Development estimated that the activities most directly affected by the virus-related shutdowns from auto production to restaurants were responsible for 30% to 40% of the total output of developed countries. In the immortal words of Chris Farley in the movie Tommy Boy, "that'll leave a mark!"

There is little doubt that we are now in a recession, as the third quarter economic activity will suffer from after effects of the virus and companies getting back to work. But ingenuity and creativity are part of the American culture and we are already making massive strides in improved and faster testing, better methods of worker protection, and scores of companies have expanded efforts to create vaccines and shorter-term remedies to manage the virus. Car makers and industrial companies are making ventilators, manufacturing and fabric companies are making masks and the business community is focused on doing whatever is needed to help save lives. All of these efforts will improve the odds of limiting loss of life and will increase near-term business activity.

It is worth remembering that the economy was structurally fine before the virus hit and that the Federal Reserve, Congress and the Administration all have a vested interest in doing whatever it takes to get us through this horrific period. None of them want to make the mistakes that created the financial crisis of 2008, so we can expect to see more support from governmental agencies to help us weather the economic storm. Federal Reserve Chairman Powell went so far as to say, “When it comes to lending, we are not going to run out of ammunition.” We are not alone in this economic battle and other nations are doing their part as well, as this truly is a global pandemic affecting all the world’s economies. The international banking system has become incredibly accommodative and here in the U.S., we have authorized unparalleled assistance for consumers and businesses to help get them through the near total shutdown of many industries and companies. There are still some rough spots that need to be dealt with, especially in the mortgage industry where deferrals of rent payments will cause financial stress for landlords and those who package mortgage products. However, we are confident that issues like these can and will be resolved.

We were wary of the slowing demand for industrial activity before the coronavirus hit and the anticipated further drop in demand for machinery caused us to further lower our exposure to the group in the first quarter. We increased our weighting in the media industry, bought additional medical and pharmaceutical firms and added exposure to companies that provide technological solutions and consulting services to a variety of industries. The homebuilding industry has been among the hardest hit in the one-month-old bear market as investors worry about slowing sales in the months ahead. Investors seem to be forgetting that one of the best industries to invest in (once you are in a recession) is the homebuilders, as they will benefit from a strong uptick in demand once the virus clears and the world begins to return to work. In fact, it is entirely plausible that the coronavirus shut down will cause city dwellers tired of being cooped up and trapped in their apartments for extended periods to rush out to the suburbs as soon as they can and buy a home. With longer-term interest rates at record lows, mortgage rates should make housing purchases an affordable option and the industry could stage an impressive stock market rebound.

Investors hate uncertainty and the timing of a return to normalcy is uncertain. No one trusts the timeline or data coming out of China, so our first guidelines will be based upon data from Italy and Spain. Thankfully, it appears that the rate of infections is slowing in both countries and the death rate has stopped accelerating in Italy, Spain, Germany and France. Here in the U.S., while many states and counties are early in the process of virus spread, New York City should see its peak of deaths in the next week or two and many areas seem to be not as hard hit as the crowded cities. Social distancing and naturally less densely populated areas could limit the extent of the outbreak, but it could also perversely extend the period with which the virus spreads. One thing is for certain, a return to office work for most by Easter is not happening and for many some time in May or early June is more likely. We will continue to manage our lives in a changed world for the next few months and the impact on how we live and work will be long lasting.

Most importantly, once investors get a grasp on when the infection rate and death rate will peak and have a better sense as to when things will get less worse, equity prices will likely rebound. As we reminded you earlier, Wall Street looks ahead and the price investors are willing to pay for a company's shares are a function of the long-term earnings potential of that business. For many companies, that longer-term earnings potential has not changed nearly as dramatically as the recent stock market valuation of its shares. For many leading companies, the current business environment has hurt their competitors more than them, so these leaders will come out of this economic downturn in a stronger relative financial condition. We will continue to strategically focus our investments in those companies with the financial strength and business models to thrive well into the next decade.

The selling pressure in March extended to other asset classes and at times was so intense that some investor decisions made no sense. At times, high quality municipal bonds were yielding significantly more than U.S. Treasuries and high grade corporate bonds (even though they are taxed less or not at all and should therefore have lesser yields), many preferred shares fell more than their companies' common stock and the bonds of many investment grade companies with significant cash and liquidity were offered at levels that suggested they could be bankrupt within months. In addition, some exchange traded funds were offered at a discount to their intrinsic value, as investors were too preoccupied with protecting principal or raising capital to care about price inefficiencies. The IPO market effectively shut down, investment grade corporate new issue spreads expanded to junk market levels and corporate insiders significantly increased their purchases of shares in their own companies. The good news is these are exactly the conditions often associated with or occurring at stock market bottoms. We have repeatedly stressed that asset allocation is the most critical variable to managing bouts of extreme market volatility. With short term U.S. Treasuries now offering negative yields, depending on one's risk level, the odds favor maintaining or adding to equity holdings at current valuations. Yes, the near-term risks to the economy have increased, but the potential long-term reward and capital gains opportunities from owning stocks has also increased.

It is an honor to manage a portion of your investment assets and, as always, we welcome your comments and questions.

James P. O'Mealia manages separately managed equity and balanced accounts for institutions, foundations, and high-net-worth individuals, as well as five pooled investment funds.

High Yield Bonds

Coronavirus and Getting to the Other Side

Randy Masel – Portfolio Manager, Corporate High Yield Bond Strategy

April 7, 2020

The first quarter of 2020 will be remembered by most everyone for a very long time, so I am not going to use much space here rehashing what people will not quickly forget. Suffice it to say that the spread of the coronavirus outside of China created an unprecedented level of fear and uncertainty on both a humanitarian and economic level. Almost simultaneously, Saudi Arabia and Russia decided to engage in an oil price war that sent energy prices plummeting. This of course all started to happen while most financial assets were priced to perfection, which more or less made sense given low unemployment, a steadily growing U.S. economy, and a very accommodating Federal Reserve Bank.

Uncertainty is the bane of investors. When investors are uncertain, their first response is often to sell. When they collectively decide to sell at the same time, prices plunge, volatility increases, and markets become dislocated. This is, of course, what happened in March. Volatility was particularly acute in the corporate bond market because the vast majority of corporate bonds trade over the counter and rely on dealers to provide liquidity. Few dealers were willing to step in and make markets. Those corporate bond investors that needed to sell sold what they could and prices often gapped down in dramatic fashion. As a result, the ICE Bank of America U.S. High Yield Index (ICE HY Index) was down 13.1% in the first quarter of this year. The index's yield-to-worst call, which started the year at 5.41%, more than doubled at one point before finishing the quarter at 9.24%. The investment grade bond market performed better, as one would expect: the ICE Bank of America U.S. Corporate Index was down 4.1% in the first quarter of 2020. The preferred stock market, which is dominated by retail investors and can be illiquid, was jolted by a fund liquidation that caused some preferreds to drop 20% to 50% in just a few days.

The financial markets started to settle down during the last week in March as the Federal Reserve Bank cut its target funds rate to effectively zero and announced a series of programs designed to increase bond market liquidity and support pricing in a wide swath of bond asset classes. Shortly thereafter, the $2 trillion CARES act was signed into law to provide fiscal stimulus to the U.S. economy. More recently, financial markets have been boosted by indications that corona-related infection rates and mortalities may be peaking in "hot spots" such as Italy, Spain, and New York. It does appear that the combination of the Fed's response, fiscal stimulus, and indications that social distancing can "flatten the curve" have helped alleviate concerns of a true disaster scenario, the dreaded far "left tail". But outside of that, not much else is clear, at least to me. Upcoming economic numbers will paint a picture not seen since the Great Depression. Of

26 Main Street | Suite #304 | Chatham, NJ 07928 | T: (212) 935-0755 | F: (888) 901-4201 | www.rseelaus.com

course, the economic and social disruption caused by the corona virus should dissipate over time. We will get to the "other side" of this crisis. How and when we get there and what the "other side" will look like is uncertain. Social distancing and working from home may reduce corona risk, but a vaccine is the real solution to getting Americans fully back to work and feeling comfortable.

My crystal ball is less hazy about a few things. U.S. interest rates are at historically low levels and are likely to stay that way for a while. The Federal Reserve will be loath to let rates rise until it is abundantly clear that the U.S. economy is back on track. The Fed's program to buy investment grade corporate bonds has already provided a boost to that part of the market. While the Fed does not have a similar program in place to support high yield bonds, the combination of low interest rates, a stronger investment grade market, and the elimination of the "left tail" will help support demand for high yield and preferred stocks. We also know that the current spread, or risk premium, of high yield over corresponding Treasuries sits at 9.23% (according to the ICE HY index), compared to a 20 year average of 5.81% and a five-year Treasury yield of just .47%. Clearly, a fair amount of bad news is already priced into high yield.

Companies that issue high yield are "junk" as the result of any combination of three factors: they are smaller in size than their investment grade brethren, they have more leverage, and their business models may be more vulnerable than investment grade companies. Of course, these factors are not static: high yield companies often cut leverage, get bigger, fix their business and improve their credit quality. This causes their bond prices to go up, and sometimes the rating agencies promote them to investment grade. These are the kinds of bonds we like to buy.

While the future is indeed unclear, as fundamental investors we have been scrubbing our portfolios and looking at opportunities using the three factors above as a guide:

- Size -- does the company have the scale to withstand the economic shock caused by the corona virus? Will its customers notice or care if it goes out of business?
- Leverage -- is the company's leverage unsustainable given the uncertain economic outlook? What will its cash flow look like as business slows? Does it have ample sources of liquidity to bridge it to the "other side"?
- Business model -- What is the intrinsic value of the company's business? What is unique about its product lines and assets? In a worst case scenario, will a competitor want to buy the company or could the business model survive a liquidity-induced bankruptcy?

Over the course of 2020, we have pared our holdings in the energy space. Even if the coronavirus threat recedes, energy markets are in disarray. Although a truce in the Saudi-Russian oil war is likely at some point, the energy sector has been deeply damaged. We have also sold bonds that had substantial downside but limited upside because of their

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call structure. As a result, we have built up cash and have been developing a shopping list of bonds to buy that have the right set of attributes mentioned above to make it to the "other side". The high yield market remains fairly illiquid so it has not been easy to scratch things off our shopping list.

Please stay safe and stay well.

Randy Masel manages a high yield corporate bond strategy that he created and launched upon joining Seelaus Asset Management in January 2014 He is also a Senior Portfolio Manager on the firm's long-only private credit fund.

Intermediate Municipal Bonds

Markets Convulse in Unprecedented Fashion

Tom Dalpiaz – Portfolio Manager, Intermediate Municipal Bond Strategy

April 6, 2020

The words *convulse* and *unprecedented* probably win the dubious honor of the most accurate way of describing March 2020 financial market behavior. The dictionary definition of the word *convulse* includes images of "shaking or agitating violently," or having "irregular spasmodic contractions." The definition of *unprecedented* includes the phrases "without previous instance, never before known or experienced," and "unexampled or unparalleled." Those images and phrases are as good as any for describing the dislocated and broken market behavior experienced in a variety of asset classes in March 2020. Municipal bonds were no exception to the recent market tumult.

Given the severe market turmoil of the past three weeks, it might be difficult to remember that the early part of this year was quite benevolent for municipal bonds. The combined forces of falling Treasury bond yields, strong muni bond demand, and still modest supply produced a continuation of last year's happy muni bond environment. From the beginning of the year through the first week of March, yields on the highest grade 10-year municipal bonds fell from 1.48% to 0.80%. The year-to-date total return of the Bank of America/Merrill 3-7 Year Muni Index up to the first week in March was an impressive +2.21%.

Then the market dislocations began. By the third week in March, flows out of muni ETFs and bonds funds were overwhelmingly large and muni bond yields rose dramatically (up 209 basis points to 2.89% for the highest grade 10-year muni bonds). Year-to-date muni bond total returns at that point were not pretty to say the least. The muni bond market then recovered dramatically and normalized somewhat in the last week of March. As the yield on the highest grade 10-year muni bonds fell to 1.44% by quarter's end, muni market total returns also recovered. The Bank of America/Merrill 3-7 Year Muni Index finally limped to the March 31 first quarter finish line with a more palatable total return of -0.81%. A number of forces combined to calm muni bond markets in late March: statements by the Federal Reserve that muni bonds would be part of their bond purchasing program, a stimulus bill passed by Congress that included direct aid to states and localities, and the return of relatively normal day-to-day Treasury bond trading activity.

The muni bond market's focus has now turned to assessing the impact of the virus and of dramatically reduced economic activity on muni bond issuer revenues, expenses, and credit quality. Here the word unprecedented comes up again. Major portions of the economy have shut down for a duration that is unknown at the present time. We simply don't know the depth and length of the curve for the virus as well as the depth and length of reduced economic activity.

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Market participants as a matter of course engage in the day-to-day exercise of sorting out short-term market and economic effects from possible long-term implications. This sorting out process -- challenging even in normal times -- is currently weighed down with additional unprecedented uncertainty. Occasionally stepping away from the present maelstrom of sometimes breathless, negative news flow and prognostications is recommended to gain perspective.

Here are some perspectives I suggest keeping in mind as investors sort through the current muni market and economic turmoil. The vast majority of muni bond issuers come to this challenging moment from a position of strength. The lengthy ten year economic expansion has steadily increased tax collections; rainy day fund balances are at an all time high. The municipal bond market is remarkably large and diverse with over 55,000 separate issuers, the overwhelming majority of which have lengthy experience in honoring their obligations and providing ongoing, necessary public services through difficult times. The default rate of Moody's investment grade rated municipal bonds in the Great Recession of 2008 and the years that followed remained at a very low 0.18%. Not to sound too trite, but people will, at some point, return to work, again eat at restaurants, engage in air travel, use airports and hotels, and attend sporting events, concerts, and conventions. It seems unlikely that they have irretrievably given up on such activities.

This is not to dismiss the seriousness of what many muni bond issuers are currently facing. Issuers who were at the lower end of the rating spectrum before the virus have much more vulnerable cushions of safety in the current environment. These issuers have the greatest challenges to their budgets and are most in need of additional direct stimulus from the federal government. Muni strategists at B of A/Merrill have estimated that another $150 to $300 billion is needed for the most challenged issuers. Some Congressional leaders have recognized this additional need and have begun talking about including additional direct aid to state and local governments in the next stimulus bill. The muni bond market will be watching and reacting to the progress (or not) regarding that stimulus.

In whatever way the muni bond market moves forward from here, tapping into available muni expertise and experience could be particularly helpful in navigating the currently choppy muni market waters. All asset classes, to varying degrees, can get painted with a broadly negative brush in difficult times. There is likely to be a lot of throwing the baby out with the bath water in the current environment. The muni bond market, with its size and fragmentation, may be more susceptible to this than others. Even with the current uncertainties and difficulties, we believe there is attractive value to be found in the short/intermediate maturity, investment grade muni bond market for the careful, astute investor.

Tom Dalpiaz has managed the Intermediate Municipal Bond Strategy since January 2014.

Tactical Mortgage-Backed Securities

Turmoil in the Mortgage Market

David Mangone, Lee Sterling, and Cliff Sterling – Portfolio Managers, Agency Mortgage-Backed Securities Strategy

April 8, 2020

It was a busy start of the year in the mortgage market but looking back at the first quarter, everything else was a sideshow when compared to the meltdown in the mortgage REIT (mREIT) sector. We focus on what happened in that corner of the market, and where the market stands now that some of the dust has settled.

The mREITs took an assault from every angle during the month of March. The iShares Mortgage Real Estate ETF (ticker: REM) dropped from a 12 month high of 48.35 on Feb 20 to a low of 18.70 on March 31. That is a 61% drop, compared to a 23% for the S&P 500 over the same period. This large and forceful decline was the result of a number of problems all surfacing at once which we discuss below.

Overall risk-off: Like every sector, the mREIT sector can blame some of the declines on the market going into a pronounced risk-off pattern.

Bank Balance Sheets: Once it became apparent that COVID-19 was going to be a major event, most companies drew down their credit facilities all at once. This drained banks' balance sheets and left them with smaller amounts of capital to deploy in the markets. As primary dealers bought assets during the first leg down in the market, the banks began to hit capital leverage ratios imposed on them by regulators. This created serious issues as sellers of MBS and other assets were looking for the exit all at once and the banks were not able to act in their normal capacity as risk takers.

Fed steps in: The Fed responded quickly, by opening their repo facility in mid-March and injecting over $200 billion into the repo market (pledging up to $1 trillion/day if needed). Shortly after, the Fed announced two facilities for purchasing corporate debt, and began buying upwards of $50 billion per day in MBS from banks and dealers, freeing up their balance sheets. The Fed also bought several billion of Agency Commercial MBS to support that market. The effect was immediate and asset prices rebounded quickly.

MBS Basis widening: Mortgage REITs hedge their MBS assets with some form of rates product, generally interest rate swaps. When the flight to safe haven assets began with COVID-19 fears in early to mid-March, treasuries rallied much faster than Agency MBS. Because mREITs short treasuries or pay on swaps as a hedge for their Agency MBS portfolios, they lose money when their assets greatly underperform their hedges. Furthermore, margin calls on their hedges forced the REITs to sell assets to raise cash, further driving MBS prices down. This combined with investor selling and levered REIT ETN selling (see below) put the REITS into freefall with some of them plunging 80% by mid-March.

Levered mREIT ETN liquidation: Three levered ETNs (MRRL, MORL, and LRET) all were forced to liquidate as the REIT market collapsed on 3/18/20 and 3/19. Forced sellers and no liquidity added to the already enormous pressure on the mREIT market.

Concerns around housing valuations: With an unemployment surge on the horizon, an obvious concern is how will the public stay current on debt obligations (auto, credit card, mortgage, etc.) The mREITs that invest primarily in non-government guaranteed mortgage credit are the first to feel the pain if there is a default wave along with lower home values. Some of these REITS (and some funds as well) were forced to sell a significant portion of their non-government guaranteed portfolios at the wides in March to cover redemptions/margin calls. Two Harbors for example, sold their entire non-government guaranteed MBS portfolio at this time and saw their book value cut roughly in half. Alpha-centric Income opportunities fund (IOFOX), an open ended fund that invests primarily in these assets, was forced to sell at the wides to meet redemption requests, and saw its value cut in half in a few short days.

REPO (leverage): most REITs rely on the repo market for leverage. As all assets classes were in free fall, the banks REPO counterparties began to issue margin calls. And with no buyers in the market during the panic (VIX – a great proxy for investor fear, hit an all-time high during mid-March), margin calls forced mREITs to sell assets, which created a vortex of lower and lower prices.

After the Federal Reserve has stepped in to buy investment grade assets from the large banks, many of the above issues went away. Most mREITs have provided positive market updates as to book value, leverage, and liquidity. Their common and preferreds have recovered some to most of their losses, down anywhere from 15% to 75% from the highs in Feb, depending on what assets they held. Most mREITs are trading well below last reported book value and the preferreds are trading well below their $25 par price. We believe the worst is behind us for the sector.

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Two mortgage market professionals who have been in the mortgage market for over 30 years each accurately summarized what happened over the last month:

“This makes 2008 look like a picnic” – securities expert
“Even Stephen King could not have scripted something as scary as this” – mortgage banking expert

David Mangone, Cliff Sterling and Lee Sterling joined Seelaus Asset Management in June 2019, bringing with them a collective expertise in the Mortgage market backed by a combined 60 years of experience. The addition of this strategy provides Seelaus Asset clients with access to experts in a unique section of the market and is a strong compliment to our existing strategies.

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