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First Quarter 2021 Market Commentary

Equities

Economic rebound continues with burgeoning signs of inflation

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

April 9, 2021

It's Been a Hard Year's Night

It's been a hard year's night, and we've been working like a dog,
It's been a hard year's night, the pandemic's created such a fog,
But when we get back to do, the things we love so to do,
Will make us feel alright!

Apologies to John Lennon and Paul McCartney
"A Hard Day's Night"

A massive new government stimulus package, expansion and extension of unemployment benefits, and strong economic data led to a surge in longer-term bond yields, but did little to dampen investor enthusiasm for equities during the first three months of the year. Indeed, most stock market benchmarks rose to record levels, though this latest bull market advance was led by smaller-capitalization and value-oriented equities. Our new President and Democratically-controlled Congress embarked upon a series of bigger and bolder stimulus measures to enhance consumer liquidity. These efforts, coupled with promises for more stimulus centered around infrastructure in the next few months, contributed to a doubling of the yield on the 10-year U.S. Treasury, albeit off a small base. With vaccination rates increasing, Covid case counts dropping and the economy showing continued signs of rebound, it is not surprising stocks staged a broad advance to start the year. I am pleased to report that our client accounts performed admirably as our value tilt enabled our equity accounts to generally outperform the S&P 500 market benchmark's 6.05% gain.

Even though the equity market advance was broad-based, investors whose portfolios were full of last year's winners lagged. For example, in 2020 growth and tech issues led the market higher, but in the first quarter of 2021, the Dow Jones Industrials gain of 7.41% outperformed the tech-heavy S&P 500, and the Nasdaq Composite's modest 2.78%

rise. That does not mean investing in any of the Dow 30 assured gains. In fact, nine of the Dow Index's members fell for the quarter, as investors took a 7.9% bite out of Apple, Nike slipped 6.1%, Walmart dropped 5.8% and Merck experienced a painful 5.8% fall. Losses in the blue chips mentioned above, as well as in new Dow members Salesforce.com, Coca-Cola, Visa, Proctor & Gamble and Verizon, exemplify how even great companies can experience downside volatility in the short-term and why it pays to be a long-term investor. We have been espousing the need to look to the future in recent quarterly letters and are pleased our client portfolios benefited from the rotation to early cycle value equities.

The first Coronavirus Aid (or CARES Act) passed in March 2020 was a $2.2 trillion program that sent checks worth $412 billion into consumers' bank accounts. Following CARES, additional government stimulus plans sent consumers another $164 billion in December 2020 and $281 billion in March 2021. According to the Wall Street Journal, money held in savings, checking and other cash equivalents rose by $2.8 trillion in the fourth quarter, a whopping 21% rise from levels a year earlier. When the economy reopens in earnest and consumers feel comfortable venturing out again to spend money on dining, travel, entertainment and other previously restricted activities, there will be a boom in spending that could cause GDP to jump by as much as 8%! Furthermore, the Federal Reserve estimates that higher equity and real estate values have increased the wealth of consumers by about $8 trillion! Many companies will see a huge uptick in demand for their goods or services. We expect the best managed and more cyclically-oriented companies will be able to capitalize on the rebound and generate significant earnings growth.

As mentioned above and in previous letters, the housing market has been one of the strongest industries underpinning the rebounding economy. Sales of existing homes hit their highest level in 14 years in 2020 and S&P CoreLogic Case-Shiller estimates the national home price index rose 11.29% on a year-over-year basis in January 2021. Redfin estimates that the median existing home sales price jumped in February 2021 by a mouth-watering 14% over year-ago levels. With soaring housing values and consumers' bank accounts flush from stimulus programs, it is not surprising that the Conference Board's Consumer Confidence Index skyrocketed in March to its highest level in a year.

Investors seeking beneficiaries of the stimulus checks and pent-up demand for travel and entertainment have flocked to retailers, airlines and media and entertainment companies. We have long had an exposure to media franchises and continue to be well positioned in discount and home improvement retailers. We recently added drug store retailers to client portfolios, as we believe resurgent customer traffic in a post-Covid world will benefit sales and the industry's renewed focus on streamlining their businesses will aid margins.

The prospect of additional stimulus aimed at rebuilding our nation's infrastructure has renewed interest in companies that sell parts and equipment needed for industrial manufacturing, as well as companies that participate in helping

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strengthen the transportation grid and telecommunications network. We have significant exposure to leading manufacturing and industrial companies in client accounts and own companies providing consulting and operating services related to building and maintaining our nation's telecommunications infrastructure and transmission grid. The latest multi-trillion-dollar infrastructure stimulus plan will, if enacted, provide an additional tailwind to those companies responsible for strengthening these vital utility and telecom services.

Manufacturing activity around the world rebounded dramatically in recent months. In the eurozone, IHS Markit estimates that March factory activity grew at its strongest rate in over two decades, while in the U.S. the forward-looking ISM manufacturing index rose to a 37-year high. With more states relaxing social distancing measures and the world ratcheting its way back to normalcy, we can expect greater demand for goods and services and accelerating demand for manufactured goods. The increase of business re-openings combined with the broad-based economic recovery caused the jobless rate to drop to 6.0% in March, and companies are now having a harder time finding workers. Interestingly, temporary worker employment was flat in March, so the gains were all longer-term full-time jobs. This is a positive sign that businesses are increasingly confident in the sustainability of the rebound.

Pent-up demand for goods has reduced inventories and begun to affect the availability of parts and finished products. Already, chip shortages have forced auto makers to restrict production of certain models, but thankfully they have been able to satisfy the production needs of higher margin vehicles and SUVs. Thus, while production might be restrained and below optimal levels, the lack of product will enable auto manufacturers to achieve better pricing and margins. J.D. Power estimates that the price of the average car sold in the first quarter was $37,314, up $3,000 from the year earlier level.

The housing industry is facing similar crosscurrents. Interest from city dwellers and those able to work from home has caused demand for existing and new homes to skyrocket, wiping out available supply. As noted earlier, housing prices have soared by double-digit percentages in the past year and builders cannot make new houses fast enough to satisfy current demand. Unfortunately, the news is not all good for homebuilders or potential buyers as lumber prices have soared (doubling in the last three months alone) and higher longer-term interest rates have increased borrowing costs. As such, housing affordability has deteriorated, and some investors are rightly wondering how long the housing boom can last. Clearly, there is plenty of pent-up demand in the short-to-intermediate term, but margins could get squeezed as lumber, labor and other costs continue to rise. In addition, according to the Mortgage Banking Association, mortgage credit availability is already at its lowest level since 2014. Given these increasing headwinds, we have reduced our exposure to homebuilders in recent months.

The success of multiple vaccines and the rise in vaccinations have enabled the world to gradually recover a sense of normalcy. It hasn't been a straight line and many parts of the economy are still being restrained by social distancing measures, but there is hope and expectation that happier days are coming soon. The stock market has anticipated the recovery and now the key will be to invest in those companies that will outperform in the quarters and years ahead as the economy rebounds. A steeper yield curve (with higher intermediate- and long-term rates) is clearly positive for bank and financial institutions, yet the group sells at modest P/E multiples and offers generous yields. We have been increasing our exposure to this under-owned, unloved sector in recent months.

As the paragraphs above indicate, inflationary trends are increasing, and we believe they will intensify in the year ahead, as a shortage of available workers forces wages higher and depleted inventories of raw materials and parts causes product prices to rise. Kimberly-Clark, General Mills, Hormel and J.M. Smucker all announced price increases in the past month. While the Federal Reserve has promised to keep short-term interest rates near zero for at least the next two years, investors are beginning to question if they can keep that promise and have begun to require higher interest rates to compensate for the purchase of longer-dated fixed income instruments. Furthermore, all the recent and planned fiscal spending is going to have to be funded somehow and higher tax rates on businesses and consumers seem inevitable.

The recent rotation out of the pandemic winners is healthy and we are well positioned to benefit from better breadth in the stock market. The latest economic data (including last month's whopping 916k jump in non-farm payrolls) points to an improving economy and provides a supportive backdrop for earnings growth in the near-intermediate term. Moreover, stock picking is making a comeback and we are confident our eclectic style of investing will continue to provide clients with competitive long-term returns. At some point, investors will question what the appropriate earnings multiple is in an era of higher inflation and higher taxes. Our job is to ensure that as the bull market ages and overall valuations expand, we are appropriately positioned for potential periods of higher volatility. Remember, the stock market takes the stairs on the way up, but it's often an express elevator on the way down!

It is an honor to manage a portion of your investment portfolio 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 four pooled investment funds.

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Intermediate Municipal Bonds

Municipal Bonds Navigate A Challenging Start To 2021

Tom Dalpiaz – Portfolio Manager, Intermediate Municipal Bond Strategy

April 5, 2021

Resilient is a word often used to describe municipal bonds. The ability of muni bond issuers to use the tools they have to work through budgetary challenges is one way muni bonds display their resilience. Another kind of resilience munis often display is their relatively moderate market behavior in a rising interest rate environment. The first quarter of 2021 was the kind of quarter where the resilience of muni bonds was on full display.

While 10-year Treasury bond yields rose significantly from 0.92% at the start of 2021 to 1.74% by the end of the quarter, 10-year high grade muni bond yields rose more moderately from 0.68% to 1.07%. This more moderate muni bond market behavior was evident in the different first quarter total returns of Treasury, Corporate, and Municipal bonds. The ICE BofA 1-10 Year Treasury Bond Index had a first quarter total return of --1.73% while the ICE BofA 1-10 Year Corporate Bond Index returned -2.06%. The corresponding ICE BofA 1-10 Year Municipal Index had a first quarter return of just -0.25%. The Seelaus Asset Management Intermediate Municipal Strategy finished the first quarter with a slightly positive return in a very challenging interest rate environment.

The first quarter outperformance of munis stemmed from strong fundamentals that barely wavered. Though the demand for munis lessened a bit in late February and early March, by the end of the quarter the demand for munis recovered to levels of strength seen earlier in the year. New issue supply so far this year has been slightly ahead of last year's level but 25% of it has been taxable municipal bonds. A feeling of relative scarcity for traditional tax-exempt munis remains a persistent fact of life for muni investors.

These good supply/demand fundamentals were strengthened by the passage of another Covid-19 relief bill, this one with sizable direct aid to states and localities. The outlook for stabilizing or even improving credit quality for many muni bond issuers was acknowledged by the market, giving additional strength to the positive tone for muni bonds generally.

The positive forces mentioned above could be tempered somewhat in the near term given the seasonal impact of muni bond selling to cover tax payments. The other factor influencing muni bond yields higher of course would be rising Treasury bond yields. While munis have shown this year (and generally in past years as well) that they tend not to rise as much as Treasury bond yields, munis are unlikely to be able to resist completely the pull of higher Treasury bond

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yields should they occur. If Treasury bond yields settle in a range, the strong fundamentals of the muni bond market are likely to re-assert themselves as the major force moving muni bond yields.

It is easy when the consensus is for higher interest rates for investors to dismiss the bond market generally as "not a good idea." We are tempted at those kinds of times to remind investors to ask the question, "Which bond market are you talking about?" The first quarter was a good example of how different sectors within the bond market can behave in comparatively different ways depending on the specific factors unique to each sector.

Municipal bonds have weathered a challenging first quarter comparatively well. We mentioned in our January commentary that 2021 could be the kind of year where muni bond investors appreciate the variety of investment tasks munis perform: providing safety, modest volatility, capital preservation, and returns uncorrelated to other asset classes. Regarding yields captured, with the first quarter interest rate rise, the entry point in the muni bond market is more attractive than in the recent past. Yield levels are back to where they were in mid-May of last year. The bond math on munis continues to make sense for top income tax bracket investors given the conservative taxable fixed income alternatives currently available.

We continue to believe effective, value-laden bond picking can be done in any interest rate environment and will continue our quest to uncover value in short/intermediate maturity munis. We believe strong muni specific factors are likely to continue to moderate the impact of rising rates going forward. A rising rate environment also means that the "yields captured" part of the muni bond proposition should provide attractive opportunities throughout 2021 if expectations materialize.

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

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Tactical Mortgage-Backed Securities

Opportunities in the Long End

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

April 9, 2021

Interest rates took a sharp turn higher over the last quarter, with the 10-year U.S. treasury bond down 7% and mortgage rates moving higher. As of March 31, 2021, Bankrate.com had the 30-year fixed rate mortgage at 3.27%, almost 50 basis points (0.50%) higher than it was in December. This put downward pressure on most of the bond market, but it has also created some opportunities.

A unique feature to the mortgage-backed securities (MBS) market is the concept of extension risk. When interest rates rise, homeowners are less likely to refinance their mortgage if current rates are higher than they had been. This can extend the duration (longer time till maturity) of MBS securities beyond what valuation and risk models initially predicted. Another way to describe this risk is that MBS bonds get hit with a double whammy: MBS bonds move down in price when longer term interest rates rise and also when a bond's duration extends.

Interestingly, in some instances, the majority of the extension happens during an initial selloff in longer term interest rates. That risk is then primarily off the table while the opposite side of the coin is now in play. If interest rates go lower (bond prices up) due to a flight to quality or repricing of inflation risk, these MBS bonds may outperform the market and can provide meaningful upside. Another term to describe this attractive bond profile would be to say these securities have positive convexity. While this idea goes against the current market view that rates will continue to rise, it can offer an attractive return profile in a high-quality government guaranteed asset class.

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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