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U.S. equities and fixed income performed well for the most part in the third quarter. However, volatility ticked higher and headline results understate the intra-quarter moves. Given an uncertain economic and political backdrop, volatility is likely to stay elevated in the fourth quarter.

In the attached commentaries, we discuss how investors should navigate the last few months of 2019.

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Third Quarter 2019 Market Commentary

Equities

The Waiting is the Hardest Part

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

October 7, 2019

Impeachment is the hardest part
Every day you see one more card
You take it on faith, you take it to the heart
The waiting is the hardest part

-Apologies to Tom Petty

Stocks achieved mixed results and the S&P 500 eked out a modest gain in the third quarter of 2019. However, it was strong enough to generate the best nine-month start to a year since 1997. Stocks were buffeted by Trump trade tweets, Brexit uncertainty, increased signs of industrial weakness and the beginning of an impeachment inquiry. As expected, the Federal Reserve lowered short-term rates for the second time this year as global economic conditions deteriorated and vowed to continue to act appropriately. Investors worried that weak industrial activity would cause rates around the world to fall further and make U.S. fixed income securities relatively more attractive. These factors benefited bonds more than stocks in the third quarter and long dated Treasury bonds were among the best performing asset classes. I am pleased to report that amidst all the volatility and uncertainty, our equity accounts generally outperformed the broad market averages and value benchmarks for the period.

While the broad market indices posted modest gains for the third quarter, the S&P Small Cap and Mid Cap indices suffered negative returns for the period. Interestingly, while the Nasdaq Composite suffered a narrow loss (-0.09%), information technology issues gained 2.97%. The biggest winners, however, were beneficiaries of lower interest rates like Utilities (+8.40%) and Real Estate (+6.88%). Among the mighty Dow Industrials, Proctor & Gamble, Apple, Nike and Home Depot chalked up double digit percentage gains, while health care companies Pfizer (-17.1%) and Unitedhealth Group (-10.9%) fell ill due to concerns about looming price controls or increased regulation. Finally, the IPO market faltered as many hyped new issues failed to excite the investment community, with Uber, Lyft, SmileDirectClub, Peloton and others suffering significant declines from their initial public offering price. We have warned about the speculative fervor in the market for “disruptors” and “new era” companies, and in the third quarter, investors paid a premium for companies earning money.

We have also suggested that many of the leaders of the bull market were extended and that certain sectors were vulnerable for fundamental reasons. The rotation into some less traveled industries and sectors in the third quarter was healthy and proved once again that valuation matters. With technology stocks under increasing scrutiny by legislators around the world, we think it will be hard for them to lead the market higher in upcoming quarters. Disgust over the lack of oversight of drug companies and distributors, who contributed to or profited from the opioid epidemic, has caused lawsuits and massive fines against the industry. That crisis has turned the industry into a whipping boy for politicians and has increased pressure from the Administration and political candidates to limit or increase oversight of drug prices. Already, House Speaker Pelosi has teed up legislation which would allow Medicare to negotiate hundreds of drug prices. Finally, proposals by candidates to privatize health care and restructure our health care system could keep the industry under a cloud for much of the campaign season. We do, however, believe certain biotech companies offer novel new drug opportunities and thus capital gains potential.

The drop in interest rates has had a positive effect on businesses and the multitude of homeowners who have been able to refinance their debt at historically low interest rates. Strong employment levels and healthy wage gains for consumers have helped strengthen demand for new homes and caused an uptick in homebuilder activity. Indeed, in August, housing starts for new residential homes rose a snappy 12.3% and building permits jumped a solid 7.7% to the highest level since 2007. According to Freddie Mac, mortgage rates for 30-year loans have fallen from 4.72% a year ago to 3.64% the last week of September. Last week Lennar Corp., one of the nation’s largest homebuilders announced strong earnings and its Chairman Stuart Miller stated, “We continue to believe the basic underlying fundamentals of low unemployment, higher wages and low inventory levels remain favorable.” We have invested in the homebuilding industry and believe the group continues to be attractive at current levels.

While a softening global economic outlook and weaker industrial activity are contributing to the fall in interest rates, another significant factor is the low or negative yields in other foreign markets. Bloomberg estimates that $17 trillion or 30% of all investment grade debt obligations in their global aggregate bond index on August 31, 2019 offered sub-zero yields. Think about that for a second -- almost a third of the world’s investment grade debt offers you the opportunity to lose money when you purchase it! While negative yields might not be here soon, the possibility and its implication need to be considered. We believe that the attractiveness of U.S. investment grade bonds on a global scale will keep a lid on our interest rates and will continue to benefit corporate borrowers and consumers.

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While the housing market might be on a solid footing, unfortunately the rest of the economy is not firing on all cylinders. Auto sales have stalled at a 17.2 million annualized rate (September data), presaging production cuts in the months to come as sales are slated to drop about 2% versus year-ago levels. Concerns over the prospects of tariffs with China and other trading partners has caused worldwide industrial activity to falter, but U.S. manufacturing has been resilient with positive Institute of Supply Manufacturing (ISM) reports. However, the September ISM manufacturing level of 47.8% marked its worst reading since June 2009 (anything below 50 indicates contraction) and the 47.3% new orders component indicates the weakness will likely continue in the near term. We have suggested the industrial side of the economy and its companies' shares were vulnerable and have limited exposure to this problematic sector.

Thankfully, the consumer and services sides of the economy represent more than 70% of the economy and have not, thus far, been negatively affected by the weak industrial sector. While September's ISM non-manufacturing (or services) reading of 52.6% represents solid growth, the level fell from 56.4% in August and represented the slowest growth level in three years. Similarly, employment growth continues in the broad economy, but at less robust levels than before. ADP estimated that private payrolls increased by 135,000 in September, but that represents the slowest growth in three months. Clearly, trade issues with China and other countries are causing businesses to become more cautious in their hiring and capital spending decisions. That uncertainty is trickling down through the economy and we are experiencing more subdued economic growth. With tight labor markets, and rising wage and other costs, it will be especially difficult for companies to increase margins or experience accelerating earnings growth. Thus, while we believe there are still opportunities in the services sector of the economy, stock selection will be critical.

The Administration has been battling China and others to garner improved trade deals, which has caused consternation and confusion amongst investors. Random tweets representing the musings of the President have destabilized markets as participants are left to wonder if he really means it. At times he has proposed massive tariffs, suggested U.S. companies leave China and that they stop doing business with China. In response to the World Trade Organization supporting the U.S. and finding that Airbus was unfairly subsidized in the manufacture and pricing of its planes, the Administration has proposed $7.5 billion of tariffs against European countries. In addition to 10% tariffs on planes, the Office of the U.S. Trade Representative has announced 25% duties will be imposed on October 18th for Scotch and Irish whiskies, French wines, sweaters made in the U.K., coffee and tools and machinery from Germany and a host of agricultural products from the region. As with all things proposed by the Trump Administration, this is the opening salvo and expect much banter and histrionics before the final outcome. Unfortunately, it just increases the level of caution and uncertainty businesses will face in coming months.

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The Federal Reserve meets October 29 and 30 and could lower rates once again. After all, Fed Chairman Powell said in September that if the economy worsens, "we would have to cut them (rates) more aggressively." Anecdotal evidence of deteriorating conditions will force the Fed's hand and likely cause further rate cuts in the months ahead. You might not have seen it, but the Architectural Building Index slumped in September to a seven-year low, RV shipments were reduced 15% in August due to bloated inventory levels, orders for heavy trucks fell for the tenth straight month, American Express credit card delinquency rates have deteriorated and Rockwell Automation and Emerson Electric both noted customers were delaying or pushing out demand for equipment. It seems investors everywhere are concerned that weak global demand and soft manufacturing could spill over to the consumer and services side of the economy, sparking a recession in 2020. We are not convinced that we will have a recession, but have adjusted our client portfolios for a slowdown in industrial activity.

Should you run out and sell all your stocks? No. After all, the equity market sells at only 16 times next year's estimated earnings and with interest rates at historic lows, valuations are not excessive. The economy continues to grow and create jobs, the unemployment rate of 3.5% is at a 50-year low, the index of Leading Economic Indicators suggests modest growth and commodities inflation is subdued. The recent troubles facing the IPO market is a positive, as it indicates a reduction of speculative activity and the rotation out of the market leaders is a welcome change. The attack on Saudi Arabia's oil facilities restrained production and caused a short-term spike in prices, but weaker global demand has restrained inflationary pressures. Stimulative measures are underway around the world as countries react to weakening conditions: The Indian government cut domestic tax rates from 30% to 22% and cut manufacturing companies rate to 15% to stimulate demand; the French government plans to gradually reduce taxes on business and individuals through 2022: China reduced the reserves it required banks to hold in September for the third time this year; and the European Central Bank recently lowered its key interest rate further below zero and launched a bond buying program to jump start its economy. All of these moves should help stabilize the worldwide economy, but it will take increased business confidence to get things improving significantly.

Of course, we will need to suffer through the volatility associated with tweets, trade issues and tariff negotiations for the foreseeable future, as well as impeachment pressure from Democrats and the burgeoning progressive platform of the Democratic candidates. But that just keeps it lively. The Biden controversy and Bernie Sanders' recent health issue could push Elizabeth Warren to become a front-runner to be the Democratic Presidential candidate, which could cast a pall over stocks in general, and banks in particular. Nevertheless, the election is more than a year away and one thing is certain, there will be lots of ebbs and flows over who might become the nominee. In the meantime, we have a Federal Reserve rate meeting, a Brexit deadline and a host of earnings reports from companies ahead of us. It's worth noting that the fourth quarter historically has been the best performing period for stocks over the long run with an average 4.11% gain (source: Argus Research). It's not a sure thing, as last year's fourth quarter swoon proved, but at least the odds are in our favor. Speaking of odds, the New York Federal Reserve's economic model puts the chance of a recession in the next twelve months at 38%, but that means there is a 62% chance that there won't be a recession. The key for investors will be to make sure their asset allocation is sufficiently conservative to withstand potential equity market shocks in the quarters ahead, just in case a recession or equity market correction rears its ugly head!

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.

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High Yield Bonds

Fourth Quarter Jitters

Randy Masel – Portfolio Manager, Corporate High Yield Bond Strategy

October 7, 2019

All in all, the high yield market put in a respectable performance in the third quarter. After racking up a total return of 10.16% in the first half of 2019, the ICE Bank of America High Yield Master II index (BAML HY II index) returned another 1.22% in the three months ended September 30th. The further drop in interest rates was the primary driver of third quarter performance, as high yield spreads (the risk premium to Treasuries) stayed relatively constant at +420 basis points. The yield to worst call for the BAML HY II index fell further, ending the third quarter at 5.87%.

In last quarter's write-up I joked that the high yield market should be renamed the "mediocre yield market". A better name may be the "relatively high yield market". With 30-year Treasuries carrying interest rates of around 2% of this writing, the relative yield of "high" yield looks compelling to investors starved for a fixed income return. This dynamic is unlikely to change anytime soon, as the recent weakness in economic data may prompt another Federal Reserve rate cut, and at the very least, will keep a lid on rates. Moreover, five-year government bond yields are now negative in 18 different European countries, making the current interest rate of 1.45% on five-year U.S. Treasuries look like an absolute bargain.

Of course, interest rates around the world are low because global economic growth is anemic and slowing. This presents a double-edged sword for the high yield market. If the economy sputters too much, the high yield market will surely suffer. Concerns about the vibrancy of the economy are already evident in certain corners of the high yield market. The most vulnerable high yield companies, those rated CCC or lower in the BAML HY II index, returned just 6.13% through the nine months ended September 30th, a little more than half of the overall index's return. High yield energy companies, weighed down by soft oil and gas prices, are doing even worse. The energy component of the BAML HY II index posted a return of just 2.58% through the first three quarters of this year. Auto-related companies have faced a similar fate.

The dispersion in how certain pockets of high yield are trading is starting to create some opportunities to put money to work. Every once in a while, a baby gets thrown out with the bath water and we are able to buy a bond that is overlooked and undervalued. But for the most part, the pickings are still slim. The fourth quarter is shaping up as a tricky period for the financial markets: economic growth is slowing, the Federal Reserve is divided on the future path

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of interest rates, the trade war with China appears to have no solution anytime soon, and the political backdrop around the world feels divisive and unsettled. These uncertainties are likely to create more volatility and trading opportunities. We maintained a cautious stance regarding high yield over the last few months and built up our dry powder. For better or worse we may get a chance to use it in the next few months.

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.

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Intermediate Municipal Bonds

Still Finding Value Though Rates Have Fallen

Tom Dalpiaz – Portfolio Manager, Intermediate Municipal Bond Strategy

October 7, 2019

Municipal bond yields generally fell in the third quarter but to a smaller degree than Treasuries. The intermediate maturity municipal bond market produced positive yet modest total returns in the third quarter (Merrill Lynch 3-7 Year Muni Index up 0.66%) while Treasury bond performance was stronger (Barclays 3-7 Year Treasury Bond Index up 1.30%). For all of 2019 through the end of September, the Merrill Lynch 3-7 Year Muni Index was up 4.42%.

Many municipal bond issuers took advantage of lower rates in the third quarter by coming to market with an increasing amount of new issue supply. This additional supply contributed to muni bonds underperforming Treasuries. While there was plenty of understandable grumbling about the low yields available in the muni bond market, this dissatisfaction did not substantially affect the demand for munis. Fund flows into muni ETFs and bonds funds remained quite strong throughout the third quarter.

The ratio of 10-year high grade muni bond yields to 10-year Treasury bond yields rose to 88% at the end of September, the highest level seen since March of 2018. This is what happens when Treasury bond yields fall rapidly and muni yields (due to increased supply) remain a bit sticky. From the perspective of this particular measure, entry into the muni market is reasonably attractive compared to recent history.

What does the muni bond math look like currently? Seven-year municipal bond yields in the single A and Baa rating categories can be garnered right now in the 1.90% to 2.20% range – hardly exciting at first glance. And yet -- for top Federal tax bracket investors, those yields equate to a range of 3.15% to 3.64% on taxable basis. For investors in the 24% bracket, those taxable equivalent yields would be 2.50% and 2.89%. With the 7-year Treasury bond yield currently at 1.47%, carefully selected intermediate maturity municipal bonds still provide helpful after-tax yields and generally less volatile interim price behavior. Muni bonds in the 10- and 12-year part of the curve offer higher yields and of course potential higher volatility.

Throughout the third quarter, we have selectively found value in the muni bond market primarily in 7- to 13-year maturities, 3.25% to 4.50% coupons, and single A and BBB ratings. Including all muni bond purchases executed this year, we have garnered an average yield to call of 107 basis points above a standard triple A muni bond scale and an average yield-to-maturity of +132 basis points. So far in 2019, our average maturity has been nine years, average call six years, and average rating single A. We use this comparison of a triple A scale because the pristine high grade space is a real world safety spot for many retail muni bond buyers and their advisors.

In managing portfolios, we have always used our judgment to speed up or slow down, to some extent, the pace at which we invest cash based on market conditions. Since the spring of this year, we have generally felt inclined not to wait too long to deploy cash. While we will continue to be deliberate and thoughtful about the pace at which we invest cash, we still agree with our previous inclination not to get too cute about waiting to invest cash. Demand for munis remains quite strong and the big picture forecast for the munis in the next year or so remains one of a slightly shrinking market (supply is expected to be less than bond maturities and reinvestment of interest).

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

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Tactical Mortgage-Backed Securities

Mortgage Market Volatility Picked Up Steam in 3Q

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

October 7, 2019

The big news in the mortgage market this past quarter was certainly the speed and magnitude of the rally from a 2.01% 10-year Treasury rate to 1.45%, which exposed some (and widened some other) cracks within mortgages. Most notable was the breakdown in the mortgage/Treasury basis (which traditionally has a high correlation). There were several distinct periods during the rally, and the violent selloff which followed, where the relationship between mortgages and Treasuries broke down completely, rendering model-generated hedge ratios and the liquidity providers that rely on them, useless. Those who were waiting patiently were rewarded with opportunities to add at attractive levels.

Although 10-year Treasury yields dropped 57 basis points from the start of the quarter to the low in rates in September, mortgage rates only dropped 20 basis points or so (30-year Fixed Mortgage: 3.72%, Source: Bloomberg). It should be noted, however, that 30-year mortgage rates have dropped 85 basis points so far in 2019 and we are within striking distance (40 basis points) of the historic lows in mortgage rates of 2016. The Mortgage Refi Index, a nationwide survey of refinance activity (Source: Bloomberg) shows the early signs of a pending, significant refinance wave.

Our discussions with originators confirm what we already knew – originators are and have been running at full capacity, which explains why they didn't need to lower their rates as Treasury yields dropped. Additionally, and possibly more importantly, they are hiring and building their infrastructure to increase their capacity which will help bring rates down further if the market holds at these rate levels, and which will also allow originators to hold rates as Treasury rates begin to rise.

Mortgage model errors tend to amplify anytime the market moves in large or unusual ways– which it did repeatedly this quarter. The method by which prepayment models calculate refinance incentives available to homeowners can be flawed, and the model outputs (prepayment projections and hedge ratios) can differ significantly from reality. Overstated hedge ratios, when combined with the precipitous drop in Treasury rates, and a lack of supply in certain types of securities (principal inverses, for example) drove pricing for certain mortgage securities to historic highs this quarter. We viewed this as a selling opportunity for the most highly appreciated assets and an attractive entry point for negative duration assets such as Interest Only Securities, which traded down significantly this quarter and offered substantial value to those waiting for opportunities.

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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