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Third Quarter 2020 Market Commentary

Equity markets rallied further in the third quarter as the U.S. economy continued to regain its footing. At the same tme, the Federal Reserve's decision to keep interest rates pinned at historically low levels suppressed volatility in fixed income markets while pushing mortgage rates down to previously unseen levels. In the following commentaries we review the third quarter and take a peek into the fourth quarter, where the elections, COVID, and a stll uncertain economic outlook all loom over the financial markets.

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Equities

Stocks Continue to Advance as Economy Recovers Slowly

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

October 6, 2020

Changes in Platitudes, Changes in Attitudes

It's these changes in platitudes, changes in attitudes
Nothing remains quite the same
With all of their running and all of their cunning
If we couldn't laugh we would all go insane

-Apologies to Jimmy Buffet,
Changes in Latitudes, Changes in Attitudes

Political uncertainty and concerns about a second phase of Coronavirus outbreaks rattled U.S. equity investors in September, but that didn't stop stocks from posting solid gains for the third quarter of 2020. Strength in the housing markets and robust job gains from businesses returning to work helped fuel the economic recovery, while encouraging news about the prospects for a Covid vaccine by year end gave investors hope that the V-shaped economic rebound would continue. Federal Reserve Chairman Powell's promise to keep short-term rates near-zero through 2023 and continued efforts to inject liquidity into the financial markets instilled confidence, but spawned a wave of speculative activity in initial public offerings (IPOs) reminiscent of the tech bubble of 1999. I am pleased to report that amongst all the volatility, our client portfolios fully participated in the equity market recovery and generally outperformed most major indices.

The Nasdaq and S&P 500 notched record highs in early September and are both now positive for the year, but not all stocks or sectors joined in the broad market advance. Indeed, four of the mighty Dow Industrials fell by more than 10% for the period. Concerns about the long-term viability of Chevron's dividend fueled a 15.8% drop, weakness in spending for on-premises office networks caused Cisco Systems to fall 15.5%, and a lack of foot traffic and lower spending on beauty and discretionary goods led to a 15.3% slide in Walgreens' shares. Intel's struggles to regain dominance in the chip market caused its shares to dip 13.5% and Boeing's troubles getting its 737 Max re-certified caused a 9.8% descent. The list of laggards would have been longer, but the folks at Dow Jones kicked out ExxonMobil (along with Raytheon and Pfizer) to maintain the technology weighting of the index subsequent to Apple's four-for-one stock split. Boosting the Dow Jones Industrials Index was new addition Salesforce.com (+34.2%), Nike (+28.0%), Apple (+27.0%), McDonalds (+19.0%) and Caterpillar (+17.9%). Twelve of the 30 Dow Industrials rose by double-digit percentages, but as you can see from the above, calling the average an index of industrials is a misnomer as the components now include consumer, health care, technology, financial, retail and communications issues. The folks at Dow Jones are trying to keep the index relevant as a barometer of economic, not industrial activity.

Smaller capitalization issues woefully underperformed their large capitalization brethren, with the Russell 2000 Index rising a modest 5.03%, and its Value component eking out a skimpy 2.56% gain. This lackluster performance makes sense, as larger companies have greater opportunities to consolidate plants, cut costs and generate efficiencies during downturns. Furthermore, larger more established companies have stronger credit ratings and greater access to the public debt markets. In fact, a record amount of new debt was issued in the third quarter, as many of the larger investment grade companies tapped the debt markets for liquidity this summer. Without the support of the Federal Reserve, which quickly promised to buy the debt of companies that were rated investment grade before the crisis, the cruise ship, airline and hospitality industries would likely have collapsed as revenues dried up. Many smaller companies, especially retailers, restaurants and movie theatres, didn't have access to the credit or equity markets as their fortunes deteriorated and thus felt the full brunt of the shutdown.

While the Federal Reserve backstopped American corporations, Congress and the Administration took care of individuals through the CARES Act, providing individuals with needed liquidity and income as jobs disappeared. Extremely generous Federal unemployment payments enabled many individuals to make more money sitting at home doing nothing than when they were employed. Unable or unwilling to travel by air or go out to eat, consumers found other ways to spend both their free time and excess liquidity. Many consumers decided to spend money on home improvements and new recreational vehicles, while others socked money away, pushing the personal savings rate in July to 17.7%. Unfortunately, the CARES Act unemployment benefits have expired and Congress is having trouble creating a new bi-partisan stimulus program. They better come together soon, for August consumer income fell 2.7% from July and the personal savings rate has fallen to 14.1%. The financial cushion created by the CARES Act is dissipating and the economy is still operating at a severely reduced rate as many companies and businesses are just now returning to work. Despite solid gains in manufacturing in recent months, according to Federal Reserve data, September's output remained 7% below February's pre-Covid level. The harsh reality of a slow recovery has forced many companies to make difficult choices, causing companies like Allstate, Disney, Goldman Sachs and Marathon Petroleum to announce job cuts in recent days. While the unemployment rate has made drastic improvement from 15%

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to 7.9%, in light of the increased amount of layoff announcements, it is likely that further job growth will be modest until we have a vaccine or a new stimulus bill.

Somewhat surprisingly, Consumer Confidence has rebounded dramatically in recent months and in September, surged by the most since 2003. Granted, confidence numbers are still 20% below pre-Covid levels, but the rebound in the stock market off the March lows and a strong housing market have obviously made people feel better about their finances. Furthermore, historically low interest rates have enabled companies and individuals alike to refinance their debt and generate more cash flow and disposable income. Low rates are a clear positive for new home buyers as well, and in September, applications for new mortgages rose to their highest level since 2009. (source: Mortgage Bankers Association) Would-be homebuyers were obviously enticed by plunging mortgage rates which fell in September to 2.89% for a conventional 30-year loan, the lowest on record. (source: Freddie Mac)

In previous letters we have mentioned that a secular move from the cities to the suburbs was occurring and that we felt the homebuilders were attractive on a long-term basis. Sales of previously owned homes surged 24.7% in July, the steepest monthly gain since they began tracking the data in 1968! We continue to maintain our positions in the group, but after 30-plus percent rallies in the third quarter, would not be buying more at current levels. In similar fashion, while we continue to hold some of the mega-cap tech companies, recent strong performance has many of them priced for perfection. The mania surrounding new IPO's of companies with leading-edge technologies is another cause for concern about the froth in the sector. Snowflake, a software solutions company with $575 million of revenues came public at 55 times revenue, then proceeded to double! We're not talking earnings or a multiple of cash flow. Nope, the Snowflake shares are selling for over 110 times revenue. This is just one example of speculative excess, but there are too many stories like this to not ignore the warning sign. The lesson from history is that these fads and manias always end badly.

So where should you be investing your hard-earned assets? We won't get into individual company names, but will give you a hint that we're not chasing technology IPOs! Rather, we believe the more traditional cyclical stocks have become too cheap to ignore and offer exceptional long-term risk/reward potential. Discount clothing retailers are selling well below their all-time highs and should benefit as more states and stores relax social distancing requirements. Energy stocks are so out of favor that even companies with limited exposure to energy prices, such as mid-stream and utility businesses, are trading at bargain basement prices. This is a niche that Warren Buffett understands well and has bought when the companies get dirt cheap like they are now. Another industry where we have been accumulating intriguing investments is the automotive sector. No, we aren't buying Tesla, but we find great value in the industry, especially companies that will be supplying Tesla and others with leading edge original equipment and parts for decades to come. Automobile sales and production fell dramatically in the spring, but this summer due to stronger consumer confidence and record high savings from the CARES Act, people have started buying cars again and depleted inventories at dealerships. As such, prices are improving for new cars, incentives are decreasing, margins are improving and there is less pressure on the suppliers to cut prices. With incredibly lean cost structures already, the rebound in auto manufacturing will lead to a healthy uptick in margins and earnings for the leading suppliers. No one seems to care about any other company than Tesla, but we believe there is a lot of opportunity in this undervalued group, which would get an added boost from additional stimulus.

Similar to the underperformance in small caps discussed earlier, many mid-caps have also lagged the broader market this year. We have decades of experience covering many of the leading companies in the mid-cap arena and feel that they offer some of the best opportunities in the stock market today. Long-term clients will recognize many of these companies, and we think midcaps and the more cyclical issues noted above will provide us with an ample number of attractive investment opportunities in the months and quarters ahead. It's worth noting that new orders for non-defense capital goods (excluding aircraft) rose by 1.4% in August as demand for computers, communications equipment and machinery all registered solid gains. More importantly, a strong gain of 1.8% in new orders for capital goods suggests the strength in manufacturing will continue in coming months and supports our positive view toward more cyclical stocks.

Stocks will likely be buffeted in coming weeks by volatility ahead of the November Election. It is times like these that investors need to remain calm and not react emotionally to the daily news, opinion polls and even the Election results. There will be winners and losers under either administration. If Trump were to lose the Presidency, taxes will likely go up for individuals and businesses, but the odds of increased stimulus packages for individuals will also improve. If Trump wins, a better business climate is likely, but social unrest could cause investor unease. In the end, owning the best run companies who have proven time and again how to embrace and adapt to change have been the best ways to create long term capital gains and wealth. That's what we do every day for our clients, search for the best companies with the best management teams, invest in them at reasonable prices, and let the rest take care of itself. Accordingly we would use any volatility as an opportunity to build positions at attractive prices for the long-term.

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 five pooled investment funds.

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Intermediate Municipal Bonds

Tax-Free Income and Steadiness In An Uncommon Time

Tom Dalpiaz – Portfolio Manager, Intermediate Municipal Bond Strategy

October 7, 2020

The municipal bond market throughout the third quarter demonstrated remarkable stability and low volatility. Including the uneventful period from late May through June, municipal bonds are now approaching nearly five months of an unusually tight trading range. For all of September, yields on high grade ten-year municipal bonds barely moved at all. The total return of the Bank of America 3-7 Year Muni Index was essentially flat for September, up 1.10% for the third quarter, and up 3.25% for all of 2020 through September 30.

Why have municipal bond yields generally been so steady? Given the unprecedented public health and economic uncertainty of recent months, the generally low volatility of municipal bond yields could simply reflect a kind of stuck-in-place confusion as to what comes next. The anticipation of additional stimulus including more direct aid to states and localities has also contributed to a wait-and-see attitude among market participants. While these practical considerations have played a part, larger forces have contributed to recently tight trading ranges as well. Strong muni market fundamentals have been as consistent as a skip in a scratchy vinyl record (but not as annoying). For buyers of traditional tax-exempt bonds, steady demand and a feeling of scarcity continue to be main characteristics of the market this year. Rating agencies may be contributing to the stability of municipal bonds by playing somewhat of a wait-and-see game these days as well. While negative trends have been placed on muni sectors and particular issuers most directly affected by declining economic activity, widespread downgrades have not occurred. The Federal Reserve has also had a quiet but broad calming effect on the muni market with its new short-term borrowing program for municipal bond issuers. Though not widely used so far, the program's mere existence has reassured the muni bond market to some degree by providing a helpful backstop for challenged issuers.

Having outlined some reasons for the stability of muni bond yields, which one of these might give? In the category of "not likely to change much (or at all)" is the Fed's short-term borrowing program for municipal bond issuers and its clearly stated intention of keeping interest rates low for an extended period. The Fed's programs and stated interest rate intentions may act as something of a ceiling, limiting broad muni credit problems and sizable upward interest rate moves.

In the category of "good luck predicting things happening in the political arena" is the passage of additional stimulus that provides funds for states and localities. The news on that prospect seems to change every other week. A new stimulus package would of course be a positive for municipal bonds and likely hold off the rating agencies from instituting widespread downgrades. A lack of additional aid to states and localities could test the rating agencies' patience and result in more downgrades than we have seen so far. With that event, muni credit spreads could widen and shake muni bond yields out of their slumber.

In the category of "not expecting a major impact" is a possible sizable change in municipal bond supply or demand. Heavier muni bond supply tends to come to market every October and November but this year a meaningful amount of muni new supply has come in the form of taxable municipal bonds. If that trend continues, the feeling of scarcity in the muni bond market will likely continue. The demand for municipal bonds seems unlikely to decline sharply as long as attractive Muni to Treasury bond yield ratios persist at current levels. Ten-year, high grade, tax-exempt muni bond yields have provided 105% to 125% of Treasury bond yields for the past two months, well above the 72% to 89% range for the year prior to the market dislocations of this past March.

Of course, the elephant in the room in terms of possible influencers on interest rates generally is the upcoming election. This puts us back in the previously mentioned category of "good luck predicting things happening in the political arena." We make no predictions here but only observe that equity markets tend to react more broadly to presidential elections than bond markets. Treasury bond yields may react to sizable equity market moves and municipal bond yields could be dragged along with Treasuries, although historically municipals have tended to move to a smaller degree. Regardless, the Fed's clear policy statements outlining an extended period of low interest rates should ultimately temper any sizable upward interest rate move. One possible election result that could benefit municipal bonds -- other things being equal – is a Democratic sweep of the Presidency and the Senate which could increase the likelihood of higher tax rates and additional stimulus for states and localities.

Writing economic and market commentary in the year 2020 should come with a certain amount of extra hazard pay. That sentiment is an exaggeration of course but it does illustrate the challenge of offering an opinion on future market direction in an environment of ever-changing news flow. It is difficult to write forward looking commentary (to say nothing of investing) when the world seems to shift around you every other week. We continue to monitor the municipal bond market and judiciously pick our spots in carefully researched, value-laden intermediate munis. Perhaps these are times when it is wise to take note of and be grateful for ordinary things. In the investment world that might include the careful shepherding of assets through uncertain times while securing attractive tax-free income along the way.

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

Tactical Mortgage-Backed Securities

Tsunami Alert!

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

October 8, 2020

Unless you have been living the good life on a beach with no internet connection, you have been bombarded with advertisements to refinance your mortgage at "rock bottom" interest rates. Maybe you have heard an ad-man tell you about "The biggest no-brainer in the history of all mankind"? With the 30-year fixed mortgage rate currently sitting slightly below 3%, they are correct! But away from the headlines and ad-man, there are a few interesting dynamics going on under the surface and in the background.

The actual mortgage rate is a function of where overall interest rates are, which is driven by federal reserve policies and free market forces. While both interest rates and mortgage rates are at all-time lows, the primary-secondary spread is at an all-time wide. The primary-secondary spread is the difference between what the borrowing public pays for a mortgage (primary rate) and the yields on newly issued Agency MBS securities (secondary rate). This metric is a good guide to how profitable mortgage originators can be and how much room mortgage rates can move both up and down in a constant interest rate environment. The average primary-secondary spread from 2014-2019 was 1.129%, with the 30-day average low spread being 0.992% (Oct. 2018) and a 30-day average high of 1.345% (Jan 2015). Today's spread stands at 1.689%, with the last 6-month average of 1.737%. The difference between today's rate and the 2014-2019 average is 0.59%, and in a market where both the consumer and investors of mortgage-backed securities make a big deal over a few basis points, there is a lot to be said about a spread of 0.59%.

Two implications of this historic spread are that mortgage rates have room to go even lower from here, and that if we do see interest rates rise modestly, mortgage originators can hold the mortgage rate around 3% and allow the primary-secondary spread to compress. This would help keep the housing market hot and could trigger an even larger refinance wave as consumers worry that they may miss out on low mortgage rates and rush to refinance. Either way, with interest rates at all-time lows, there is room for rates to go lower. So, who is benefiting from these conditions? Mortgage originators and the consumer.

Mortgage originators have been booming for the past year and enjoying rocket ship revenue growth since the pandemic drove interest rates to current levels. For example, Rocket Company (Quicken), which is the nation's largest non-bank originator, estimated that its revenues were between $6.3 billion and $6.5 billion in the first half of 2020, up from $1.6 billion over the same period in 2019. With most market participants and analysts expecting interest rates to stay low for years, Rocket company used this unique period in time to go to the public markets and raise capital through an IPO. On the heels of the Rocket IPO, four other non-bank mortgage originators are looking to or have begun the process to go public: LoanDepot, United Mortgage Wholesale (UMW), Amerihome, and Caliber. The rush to IPO can be viewed as an opportunistic time for the company's owners to cash-out, or as a way for companies to build up cash to continue to compete for a larger share of the origination market. Non-bank mortgage companies originated 51% of all mortgages in 2019, up from only 10% at the peak of the housing boom in the 2000's. These companies are all taking market share from bank originators like JP Morgan, Wells Fargo, etc.

The funds raised from the companies going public will most likely be reinvested into technology and marketing. Ultimately, this is all great news for consumers for the foreseeable future. With rates at all times lows, the primary-secondary spread at all time wide levels and fresh capital in the hands of non-bank originators, the increased competition should drive mortgage rates lower and expanded mortgage credit for hopefully years to come. Something to cheer about in today's world.

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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