National
Investment Services

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NIS Update March 17, 2020:

It seems very hard to believe, but in less than three weeks the U.S. stock market has gone from setting a record high to falling more than 25%. This is the fastest time between a new high and a bear market in history, even eclipsing the 1929 disaster which took 42 days! Remarkably it has been the lack of initial panic from too many people/governments, etc. that has most likely contributed to the market's current demise. The "it's just the flu" mentality has now been replaced by "cancel everything and stay at home." It is too early to estimate the economic damage. In the meantime, uncertainty prevails but the Federal Reserve has now acted in what we feel is a very meaningful way and the market awaits a strong fiscal package from Washington. The timing of the "right" fiscal stimulus package is a huge wildcard right now and it appears that equities and credit spreads will remain volatile until we are able collectively look forward.

National Investment Services' entire staff is now working remotely as a cohesive unit. Our portfolio managers are in constant contact with each other via instant messaging in Bloomberg chat rooms. This is also our standard way of communicating with the entities we trade with, so very little has changed regarding our day-to-day trading and portfolio management operations.

With regard to client liquidity and portfolio management positioning, we are starting to see a bit more two-way trading here on Tuesday, as there is finally a small dose of calmness within our markets. We started the month with relatively high levels of cash and U.S. Treasury exposure (for us) and have been maintaining these levels as we are cognizant of the potential liquidity needs of our clients as they are faced with countless uncertainties and business disruptions. Current spread levels are very tempting, but we are balancing new buys with sells in an effort to maintain liquidity and overall portfolio risk exposures.

Liquidity and color on select NIS sectors:

- Treasuries: Markets in off-the-run issues have been spotty and have been as wide as .75 bps to 1.5 bps. This is as wide as we can ever remember. On-the-run issues are better; we executed a $30mm buy of the current 10-yr. with minimal market impact yesterday.

- Energy and Industrials: We are underweight energy and industrials within corporate bonds. The energy sector has been under a lot of pressure as spreads are out about 200 bps for a higher quality name like XOM AAA, AA-rated since the virus and OPEC situations escalated. Spread widening overall is significant and back to the wides of 2016, which seems appropriate given all the uncertainty. XOM is actually in the market today with a new deal across the curve, which we think offers some value and should help overall liquidity across the industrial complex. Generically speaking, a lot of large issuers are maintaining decent overall liquidity. Large size tranche, on the run BBB or better names have decent liquidity overall, CVS, CI, ABBV to name a few.

- Banks: Bank liquidity and capital are fine for now. The new regulations enacted following the 2008 financial crisis force all G-SIBs (globally systemic important banks) to hold sufficient high quality liquid assets, suitable enough to meet their estimated total net cash flows over a 30 calendar day period of significant stress, similar to what we are seeing right now. The Liquidity Capital Ratio or LCR must be at a minimum of 100%. The denominator of this ratio includes off balance sheet items such as lending commitments that can be drawn down in 30 days or less. All G-SIBs have ratios well above the 100%, with Citigroup being the lowest at 115%, followed by JPM and BAC at 116% , WFC at 120% and GS 127% MS 134%. Spreads on banks have widened as much as 120 bps for JPM to more than +220 bps for some credit card issuers. Financials tend to have the most liquidity and get leaned on during times of poor liquidity. On-the-run financials are doing better than off-the-run maturities. The credit curves have been flat and remain flat from the 7 yr. part of the curve out to the 30 yr. part of the curve. The front of the curve is actually now inverted due to all of the selling pressure on the front of the curve. The bid/ask has certainly widened and what used to be just 3-4 bps back in early February is now more like 10 bps on highly liquid bonds to 20+ bps for more illiquid names.

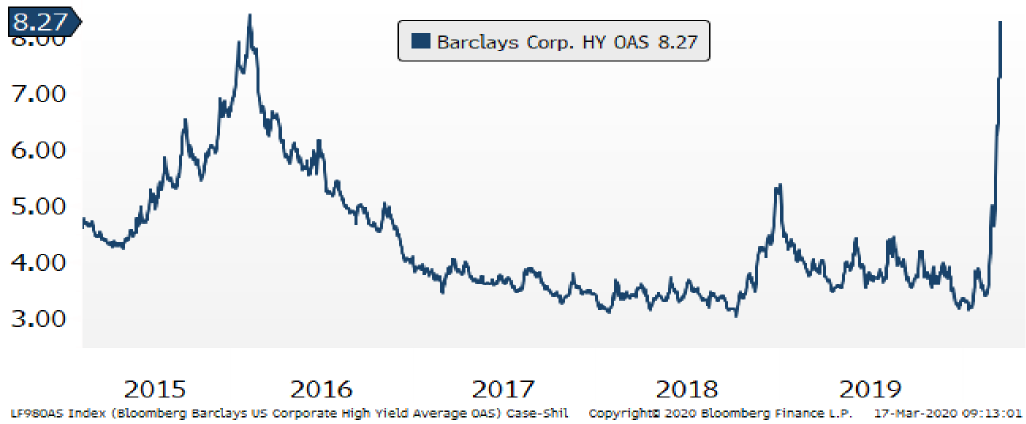
- <u>Structured</u>: AAA CMBS 75 wider, single A 15 0, BBB- 250. ABS: 2yr credit card, 2yr prime auto and 5yr rental car about 150 wider, FFELP 100, 3yr timeshare and 5yr container 200 wider. 5yr aircraft 400 bps wider and is being directly impacted by the epidemic. Our exposure to this subsector is relatively limited.

- <u>Agency MBS</u>: With news from Fed that they will be purchasing these assets, spreads are expected to gradually improve. Spreads had widened 50-75 basis points until the Fed made their announcement yesterday. By this morning they had tightened back in by 30 basis points.

- <u>Non-Agency</u>: Liquidity is less clear because less is trading. Front-pay AAA Non-QM (high quality but not jumbo) 2-yr A/L that priced in January at +78 and you can buy that bond today 150 basis points wider. Prices have declined some, but really they just haven't increased with Tsys. Obviously the market is fearful, and rightfully so, of prepays increasing, so prices are compressing once they get above par. Liquidity is not the best, but we traded some Agy MBS yesterday in a terrible day for overall risk.

- <u>Taxable Muni</u>: Generically speaking, we are seeing spreads 75-150 bps wider in university/hospital and municipal names and it hasn't really mattered whether it is AA+ or A- type credits. Let's call the midpoint being 100-110 wider.

- <u>High Yield</u>: This remains a tough market to invest in right now due investor uncertainty and the unpredictable fund flows. We are being cautious with almost 4% cash. Our Fund is down about 9.5%* for the month vs. -10.3% for the general high yield market. The selloff continues in HY with spreads out over 325 bps since the start of the month and almost out to 2016 wides.



Preferred Stock

The preferred market has also traded off in dramatic fashion. This market move has pushed spreads to panic-wide levels not seen since the 2008 financial crisis: Our Fund is down a bit over 12%* on the month vs. -10% for the ML Fixed rate benchmark in a very fast moving market.

- Liquidity is challenged, but preferred securities are trading, albeit with extraordinarily wide bid /offer spreads - with many bids at what we consider distressed levels in both the listed $25 market as well as the over the counter, 1k/par institutional market.
- For example, trace activity for today, which filters public/$ denominated 1k issue that we track, posted 635 trades, with 779,527M par in volume.
- 5 major Pfd ETFs, PFF, PGF, PGX, FPE & VRP traded a total of 26,348M shares today.
- We currently have just over 5% in cash in our preferred stock fund.

Please feel free to contact us with any follow-on questions.

Sincerely,

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*Performance is preliminary as of 3/16/20 and gross of fees.

Source: Bloomberg