National Investment Services

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APRIL 16, 2020

TOPIC: FED & FISCAL PROGRAMS' IMPACT ON FIXED INCOME

To Our Clients and Consultants:

The rise of the COVID-19 Pandemic has wreaked tremendous havoc on the world's economies and most financial markets. Investors have found few places to hide as many remain uncertain and operating primarily from their homes with shelter in place mandates being the norm. One of the few bright spots has been the quick and we think strong response from the U.S. Federal Reserve. The CARES act along with some smaller fiscal measures have helped to calm some investor angst, but it seems to be the Fed that has taken charge and given the market something to hang on to. They were quick to not only cut interest rates back in March, but to also announce a host of programs to help the economy, markets and businesses regain their collective footing. The following paragraphs highlight some of these measures and how they impact our investments:

Monetary & Federal Policy Actions Timeline

MARCH 2020

- 3/3/2020 **FOMC**: Cut the Federal Funds rate by 50bp to 1.0-1.25%
- 3/6/2020 **Congress**: $8.3bn emergency healthcare spending bill
- 3/13/2020 **Executive**: National emergency declared
- 3/15/2020 **FOMC**: Cut the Federal Funds rate by 100bp to 0-25%
  FOMC: Announced $700bn of purchases, including $500bn of treasuries and $200bn of agency MBS
  FOMC: Encourages banks to use the discount window, cuts the primary rate by 150bp to 0.25%
  FOMC: Fed encourages banks to utilize intracredit on a collateralized and uncollateralized basis
  FOMC: Fed encourages banks to use their capital and liquidity buffers
  FOMC: Reserve requirements will be reduced to 0%
  FOMC: Fed announces coordinated action to enhance dollar liquidity w/ global central banks
- 3/17/2020 **FOMC/Treasury**: Fed announces the Commercial Paper Funding Facility
  FOMC/Treasury: Fed announces the Primary Dealer Credit Facility (PDCF)
- 3/18/2020 **FOMC/Treasury**: Fed announces the Market Mutual Fund Liquidity Facility (MMLF)
  Congress: Families First Coronavirus Response Act
- 3/19/2020 **FOMC**: Fed announces additional dollar swap lines with global central banks
  Congress: Senate proposes draft of Coronavirus Aid, Relief, and Economic Security Act
- 3/20/2020 **FOMC/Treasury**: Fed expands the MMLF to include US municipal short term debt as eligible collateral
- 3/22/2020 **FOMC**: Fed encourages financial institutions to work with borrowers affected by COVID-19
- 3/23/2020 **FOMC:** Fed expands the purchases of treasuries and MBS to an open-ended basis and include commercial MBS
  FOMC/Treasury: Fed announces the Primary Market Corporate Credit Facility (PMCCF)
  FOMC/Treasury: Fed announces the Secondary Market Corporate Credit Facility (SMCCF)
  FOMC/Treasury: Fed announces the Term Asset-Backed Lending Facility (TALF)
  FOMC/Treasury: MMLL expanded to include a wider range of securities
  FOMC/Treasury: CPFF expanded to include high-quality, tax-exempt commercial paper
  FOMC/Treasury: Fed expects to soon announce a Main Street Business Lending Program
  FOMC: Fed issues an interim final TLAC rule
- 3/25/2020 **Congress**: Passes Coronavirus Aid, Relief, and Economic Security Act
- 3/31/2020 **FOMC**: Fed announces a temporary FIMA Repo Facility

APRIL 2020

- 4/1/2020 **FOMC:** Fed announces a temporary change to the supplementary leverage rule
- 4/9/2020 **FOMC/Treasury:** Details given on CARES Act backed Federal Reserve programs
  Fallen Angels included in PMCCF and SMCCF

Source: Federal Reserve, CreditSights.

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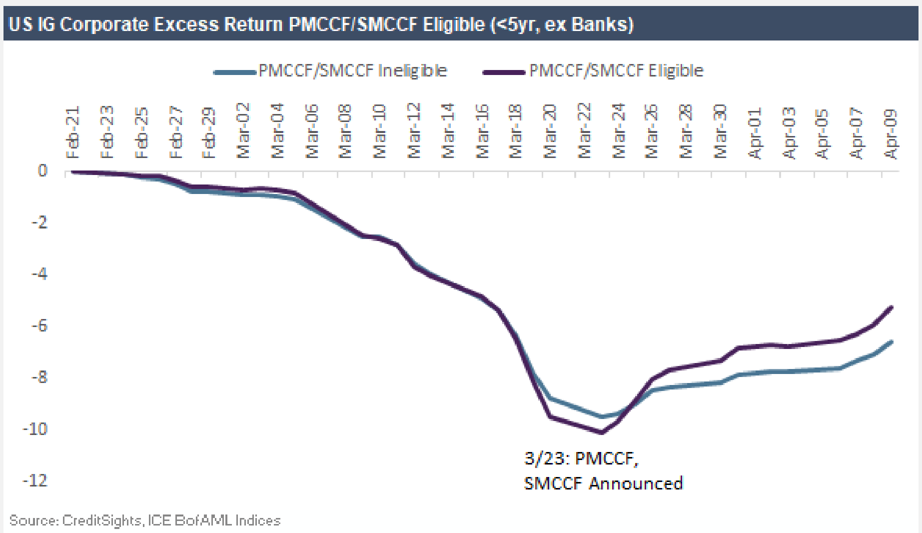
On April 9, 2020 the Fed provided a bit more clarity regarding a few of its facilities relating to supporting the corporate bond markets. Most notably they will include fallen-angel credits (formerly investment grade that have been recently downgraded to high-yield or junk). The ratings cutoff date is March 22, 2020 and is rated BB-/Ba3 at time of purchase to be eligible for the facility. If a company meets this criteria, they are eligible for financing from the Fed or that the Fed/Treasury can buy some of their debt. This hopefully alleviates some forced selling pressure typically seen when angels fall. It is important to keep in mind that the Fed is doing this with loans from the Treasury with leverage limitations that range from basically 10-1 for investment grade and 7-1 for high yield.

PMCC – Primary Market Corporate Credit Facility – A loan or bond purchase from the Federal Reserve lending to an SPV which will purchase qualifying bonds in a single bond issuance (4 years or less) or the SPV will purchase portions of syndicated loans or bonds at issuance. $50 billion in capital to start and must meet the criteria listed above.

SMCCF – Secondary Market Corporate Credit Facility – Basically the buying of corporate bonds and ETFs. The main focus was to be on investment grade credit but the big news on Thursday was the detail around helping the aforementioned fallen angels the ability to purchase high yield ETF's. HYG ETF was up 4.4% while the investment grade was up 2.3%. This is what got jumpstarted the high yield market last Thursday and it was more the promise to buy the debt, not whether they actually do or not, that brought back some much welcomed liquidity. The chart below graphs the performance of both qualifying and non-qualifying securities:



TALF – Term Asset-Backed Securities Loan Facility Dusting off the playbook from the financial crisis of 2007-2008, the Fed wants to keep the funding spigot open for a number of important industries within the U.S. The Fed will lend on a non-recourse basis to holders of certain AAA-rated ABS. Here are the eligible asset backed collateral:

1. Auto loans and leases;
2. Student Loans
3. Credit card receivables (both consumer and corporate);
4. Equipment loans and leases
5. Floorplan loans;
6. Insurance premium finance loans;
7. Some small business loans (SBA)
8. Leveraged loans
9. Commercial mortgages

ABS Recent market color: Buyers are back and clamoring for anything short and top tier in ABS. A welcomed change from the previous three weeks, where brokers were in some cases giving awful throw away bids. **TALF seems to be having a positive effect on sentiment and spreads of the higher-rated tranches:**

- 2yr/AAA Credit Cards @ +73
- 2yr/AAA Prime Auto @ +90

These areas were trading +100 around Apr. 2 and as wide as +350 on 3/23

CMBS: Support by the Fed of Agency CMBS (through its MBS purchase plan) and AAA Non-Agency conduit CMBS (through inclusion in TALF 2.0) have allowed these bonds to recover most of their March widening, and should result in a grind tighter over the next 6 months. Recovery of AA and A rated CMBS will be more deal-by-deal and more gradual, hindering the return of new issuance. BBB- and below bonds will be even more highly-levered to the underlying collateral; some of these bonds are likely to continue to decline in price as their credit story plays out.

WHAT WE ARE HEARING ON THE FORBEARANCE FRONT REGARDING CMBS

As expected, we are hearing that a large number of CMBS borrowers have contacted their servicers seeking relief. According to one servicer, these requests are generally temporary in nature; most borrowers appear to believe that when the world "returns to normal", they will once again be able to cover their debt service.

Borrowers seeking relief on Agency CMBS loans issued by Fannie Mae and Freddie Mac are being granted 90-day forbearance, with the provision that they do no evict any tenants during this period.

Unlike Fannie and Freddie, servicers of Non-Agency CMBS loans do not have 'fiat' powers to enact such a blanket forbearance program. Instead, they are governed by the Pooling and Servicing Agreement, which varies from deal to deal. Certain technical aspects of the PSAs prevent them from granting blanket forbearance. Non-Agency CMBS borrowers seeking relief will be handled the traditional way, case-by-case. Master servicers are triaging these loans, with those identified as 'imminent defaults' being transferred to the special servicer for initiation of a workout. All other loans will remain with the master servicer unless they become 60 days delinquent.

Regardless of whether it is an Agency CMBS loan that has been granted 90-day forbearance, or a Non-Agency CMBS loan that has become delinquent, the servicers are obligated to advance on the loans (P&I, property protection advances, etc.) until any such advances are deemed non-recoverable. CMBS is a little different from non-agency RMBS in that servicer advances are not binary (all or nothing); an appraisal is ordered, and depending on the appraised value relative to the loan exposure (UPB plus outstanding advances, etc.), they will only advance on a portion of the loan. Any resulting interest shortfalls are applied from the bottom tranches on up, depending on magnitude.

While the health of retail properties is obviously gravely impacted by the COVID-19 crisis, the more immediate concern is hospitality loans. One hotel industry exec stated that this crisis is like "9/11 and 2008 combined", and in terms of the speed and depth of the decline in cash flows, he's probably right. We are hearing that many MSAs have 10-20% occupancy or even worse (e.g. – the Las Vegas Strip is closed). Some hotels have been trying to do what they can to remain open – reducing services, closing entire floors, etc.) – but more are scheduled to close. This will make the eventual recovery more difficult.

Hotel loans comprise 16% of the non-agency CMBS universe by balance. Barclays estimates that 15% of conduit hotel loans will be "at risk", with "limited impact" on SASB (single asset, single borrower) hotel loans.

What will the rating agencies do in all this? Commercial Mortgage Alert interviewed several of them, and they all made it sound like they would take a measured approach and not just push through mass downgrades without more clarity (as they did during the GFC). Fitch has acted the most aggressively so far, placing classes from the single-borrower hotel deals they rate on watch for downgrade and publishing a list of fairly punitive stresses that they plan to apply to hotel, retail and multifamily loans as a specific result of the COVID-19 outbreak.

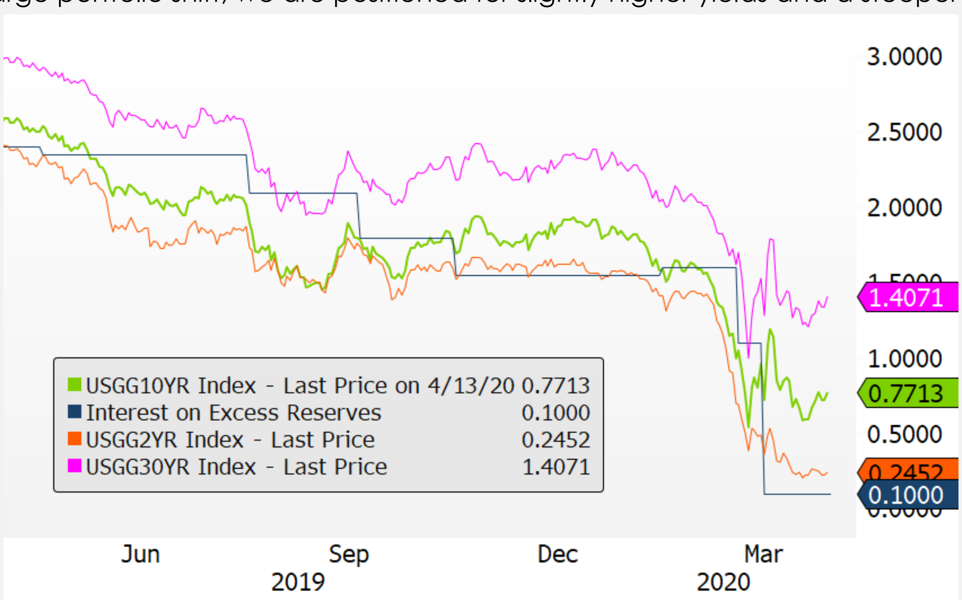
MBS Review: Although TALF does not include residential MBS but AAA has been the first to come back with the broader credit rally but curves still steep by rating. **The Fed is buying Agency MBS however as outlined in their 3/23/20 announcement** and that has helped the Agy MBS basis (spreads). As before, the Fed is buying the worst convexity/worst to deliver pools, so much so that many dealers are changing their definition of TBA.

Non-Agency MBS: In the least transparent of all the markets, spreads and performance in Non-Agency have been weak to say the least. March performance reported by dealer's ranges from -5%-15%, depending on the sector, type of bond, etc. Since month-end, spreads have improved. The most transparent sectors are the 2.0 ones. As examples, Non-Qualifying Mortgages AAAs got to +400 and are now +250. Re-performing loans (formerly delinquent) AAAs had gotten to +450 and now trade +200. The least transparent sector within Non-Agency is Legacy. Some yields allegedly reached 10% and have come back in to 4-6%. **Legacy also includes many subprime loss-taking bonds which we don't own.**

Municipal Liquidity Facility – The Fed can directly buy up to $500 billion in municipal bonds from states, cities with more than one million people, and counties with more than two million people. According to Barron's, only 10 cities and 16 counties meet this criteria. Additionally, these government entities will only be able to sell bonds maturing in two years or less to the Fed with current credit ratings playing a role into the cost "with details to be provided later." The Fed and Congress will likely have to do a lot more to bridge the gap in the lost revenues from a host of state, local and other municipally funded entities and projects. Look for a lot more to come from Washington regarding this sector, as we believe this just scratches the surface with regard to helping local governments and the muni market. **Thus far we are seeing a limited impact on spreads in the sector but we note, spreads did not widen as much as other sectors.**

CPFF – Commercial Paper Funding Facility – NY Fed purchases eligible 90-Day CP restricted to A-1/P-1
PDCF – Primary Dealers Credit Facility – includes expanded collateral pool CP (no ratings restrictions), international agency bonds, even equities; the 2008 facility was an overnight one.

Interest Rate Cuts and effect on yields: we note that after some intimal flattening, we are seeing 10+ year yields creep higher which is perhaps telling of risk taking as well as some concerns of potential inflation. While it is too early to make a large portfolio shift, we are positioned for slightly higher yields and a steeper curve.



Sources: Bloomberg, CreditSights – Erin Lyons, ICE BofAML Indices