During the first quarter (1Q) of 2019, on net, US equity prices increased while US Treasury yields decreased across the curve as investor sentiment improved after the Federal Open Market Committee’s (“FOMC”) communications turned dovish in reaction to the violent decline of US equity markets at the end of 2018; a risk-off move upon market concerns of an economic recession over fears that the Fed would keep increasing interest rates despite of imminent economic headwinds. Moreover, optimism over a trade deal between the US and China also improved overall sentiment. The Standard & Poor’s 500 Index (“S&P 500 Index”) rebounded increasing by 13.07% Quarter over Quarter (“QoQ”) (price return) to 2,834 while the Dow Jones Industrial Average increased 11.15% QoQ to 25,929. Stock market volatility, as measured by the CBOE Volatility Index (VIX Index), declined 46.07% QoQ from 25.42 to 13.71. The 10-year US Treasury yield decreased 28 bps QoQ from 2.68% to 2.41% as the market-implied path for the federal funds rate declined in light of accommodative monetary policy communications and a flight to quality over global growth concerns. Furthermore, in the last week of the quarter, the 3M-10yr curve inverted as the Fed abandoned its plan to increase rates in 2019 and decided to end its balance sheet normalization. Nonetheless, it ended the quarter flat while the US Treasury 2s5s remained inverted.

Statement issued by the FOMB during the first quarter, states that “US labor market remained strong but growth of economic activity appeared to have slowed from its solid rate in the fourth quarter” specifically “on slower growth of household spending and business fixed investment”. Furthermore, fourth quarter 2018 Gross Domestic Product (“GDP”), reported during the first quarter of 2019, and increased 2.2% QoQ. During the first quarter of 2019, the US unemployment rate decreased somewhat from 3.9% to 3.8% while average hourly earnings decreased from 3.3% to 3.2%. Furthermore, overall inflation declined. Consumer price inflation, as measured by the Personal Consumption Expenditures (“PCE”) deflator (headline inflation) and Core PCE (core inflation- excludes food and energy) decreased from 1.8% in November 2018 to 1.4% in January 2019 and from 1.93% to 1.79%, respectively (latest reported), below the FOMC symmetric 2% objective.

The FOMC kept the target range for the federal funds rate unchanged during the quarter at 2.25%-2.50% at its January and March meetings. There were no dissents against the actions. In its January statement the Committee stated that, in light of global economic and financial developments and muted inflation pressures, it would be patient as it determined what future adjustments to the target range for the federal funds rate would be appropriate to support its mandate. Furthermore, subsequently, in its March statement, it downgraded its description of the economy and inflation mentioning that growth of economic activity had slowed from its solid rate in the fourth quarter and overall inflation had declined, largely as a result of lower energy prices. Also during the same period previously mentioned, the FOMC announced it would conclude the reduction of its balance sheet in September 2019 but would continue to allow its holdings of agency debt and agency mortgage-backed securities to decline reinvesting the principal payments in Treasury securities across a range of maturities to match the current maturity composition. It also released its economic projections. The median GDP projection for 2019 was lowered from 2.3% to 2.1% while its median headline PCE inflation estimate was decreased from 1.9% to 1.8%. Looking ahead, the FOMC does not anticipate rate hikes in 2019 and only one thereafter in 2020 to 2.6%, even though it kept its longer run Federal funds rate at 2.8%. As of March 31, 2019, the markets were pricing one rate cut by the end of 2019.

Santander Asset Management (“SAM”) believes the FOMC will most likely remain on hold with its current monetary policy stance on the 2Q of 2019 in light of moderate to solid economic data, while it will react by cutting rates if economic data deteriorates. Nonetheless, it believes that if inflation readings keep undershooting the FOMC’s symmetric 2 percent objective by the 3Q of 2019, and a leveled yield curve persists due to low inflation expectations, the FOMC will most likely add accommodation by cutting rates and/or through Quantitative Easing (“QE”) operations after it revises its monetary policy framework in June 2019. Moreover, SAM remains alert to the Fed’s deliberations regarding the longer-run composition of their domestic securities holdings, and its effect on the yield curve and vigilant of economic, financial and geopolitical developments.

Turning to Puerto Rico capital markets, PR municipal bond prices, on average, increased 6.16% during the fourth quarter, as measured by the S&P Municipal Bond Puerto Rico Index. Below we summarize a list of several bond prices movements by issuer for the quarter ending March 31, 2019. All prices mentioned were obtained from Bloomberg Valuation (BVAL pricing).

Puerto Rico General Obligation Bonds (PR GO) - PUERTO RICO-A 8.00% 07/01/35 decreased approximately 3 points from $53.48 to $50.46. Puerto Rico Sales Tax Financing Corp. (COFINA) Taxable- PR SALES TAX FING-A2 4.55% 07/01/2040, which began trading on February 15 at $82.62 increased almost 6 points from $88.12, while the COFINA Exempt- PR SALES TAX FING-A1 4.55% 07/01/2040 began trading at $96.88 and increased approximately 1 point to $98.32. Government Development Bank (GDB) - GDB DEBT RECOVERY AUTHORITY 7.50% 08/20/40, increased approximately 8 points from $67.62 to $75.34.

The following is a brief summary of the events that shaped Puerto Rico markets during the quarter ended March 31, 2019:

Early on January, the Puerto Rico Financial Oversight and Management Board (FOMB) surprised bond markets participants by filing a motion with the US District Court to annul more than $6 billion worth of General Obligation (GO) debt backed by the Commonwealth’s full faith and credit. The FOMB considers that the 2012 and 2014 GO issuances should be annulled because they did not comply with some of the requisites imposed by Article IV of the PR Constitution, the debt limit requirement (Section 2) and the balance budget requirement (Section 7). Later in January, the U.S. Court of Appeals for the First Circuit reversed Judge Swain’s ruling concerning the PR Retirement System (ERS) bonds issued in 2008, were she denied a group of ERS bondholders claim to the assets of the PR Retirement System. Rather, the Court of Appeals declared that ERS creditors satisfied Uniform Commercial Code (UCC) filing requirements and that, in essence, ERS bonds hold a ‘perfect lien’ on the Retirement System’s assets and that, and as a result, the bondholders classify as secured creditors in the Puerto Rico’s bankruptcy proceedings.
During February, the Commonwealth concluded the first adjustment plan under Title III of Puerto Rico Oversight, Management and Economic Stability Act ("PROMESA") law. Moreover, on February 4th, the US District Court Judge Swain approved the SUT revenue split between COFINA bondholders and the Commonwealth. This action settled the dispute between both parties regarding who has the right to the sales-tax revenue stream, splitting the disputed SUT by 53.65%/46.35% between COFINA and the Commonwealth, respectively. Judge Swain also approved the proposed COFINA Plan of Adjustment (PSA), with an effective date of February 12th, where in general, not all inclusive and subject to the right of election each holder, the PSA offered Senior claimants a distribution of COFINA Bonds and cash, in the aggregate, equal to 93.015% of such holders’ allowed aggregate Bond Claims, while it offered junior claimants a distribution of COFINA Bonds equal to 56.414% of such holders’ allowed aggregate Bond Claims. Furthermore, the Commonwealth executed the debt restructuring under the Title III of PROMESA, exchanging approximately $17.9 billion of outstanding COFINA bonds for $12 billion of new COFINA bonds. According to the local government, the COFINA restructuring will provide the island with over $17 billion in debt service savings. The announcement was well received by the markets, causing a rally in COFINA bonds prices. Trading on most of the new COFINA bonds began on February 15, 2019.

Then, on February 15, Judge Torruella along with Judges William J. Kayatta Jr. and O. Rogeriee Thompson from the U.S. Court of Appeals for the First Circuit decided to overturn Judge Swain’s verdict concerning to the Board’s election process, specifically her judgment that the Board is inherently an entity of the Commonwealth’s government. Instead, the Court of Appeals clarified that the Territorial Clause does not displace the Appointments Clause and that the Board Members are “Officers of the United States” subject to the Appointments Clause and therefore would need confirmation from the U.S. Senate. As a result, the selection process of the Board members was deemed unconstitutional. Nonetheless, the magistrates decided to preserve all previous decisions made by the board, including the restructuring of COFINA and GDB, noting that the members acted with the color of Authority (PROMESA) and that the Board Members acted in good faith in moving to initiate such proceedings (Tittle III petitions).

On March, the Unsecured Creditors Committee (UCC) in conjunction with the Commonwealth and the Employee Retirement System (ERS) filed an objection in federal court seeking to void nearly $3 billion in bonds issued by the ERS in 2008 based on the argument that the government entity does not have the inherent power to issue bonds to the public. Moreover, according to the plaintiff, the retirement system could only obtain cash through a direct placement of debt, or through a loan extended by Puerto Rico or the US Federal government. Meanwhile, the federal board’s attorney, Martin Bienenstock, informed on the March’s omnibus hearing that the panel had asked the U.S. Supreme Court to evaluate two recent First Circuit of Appeals rulings: the verdict of the ERS bonds’ lien and the resolution of the Board’s members election process.

Last but not least, during the quarter, the Department of Housing and Urban Development of the United States (HUD) granted the allocation of $9.72 billion of the nearly $20 billion CDBG funds assigned to Puerto Rico, destined for housing, economic development, infrastructure and revitalization of the communities. Also, Puerto Rico’s Governor Ricardo Roselló announced plans to introduce a bill that seeks to transfer some of the essential services that are currently provided by municipalities to a new system of counties in an effort to deal with the fiscal challenges of the municipalities.

SAM will continue to monitor the investment portfolios on a daily basis in order to seize opportunities that may arise due to market inefficiencies in order and make the appropriate adjustments that are consistent with long-term objectives.