4th Quarter 2020

The **consumer** is a significant part of the U.S. economy. Consumers are approximately two-thirds of the American economy. With U.S. GDP at approximately $20 trillion, the consumer represents $13 trillion. This makes U.S. consumers nearly as large as the Chinese economy and three times larger than Japan's economy (the second and third largest economies in the world respectively). Monitoring the consumer involves three broad categories: the labor market, current consumption and sentiment, credit and balance sheet. The decline in payroll employment in March and April amounted to 21.2 million, effectively wiping out job creation for the last ten years. Notwithstanding, May through November has seen a positive 11.8 million new jobs added back. Consumer spending has rebounded as a result of fiscal and monetary stimulus and pent-up demand during the lockdown. As a result, the consumers balance sheet is in a strong position. In the early 1990's, American households saw rising debt payments as a percent of disposable personal income. However, post the 2007-2008 financial crises, debt payments as a percent of income have dropped significantly. U.S. consumers are sitting on $1.3 trillion in excess savings, the equivalent of 6% of GDP. Pent up demand is no longer wishful thinking but rather a real possibility once the economy fully reopens. According to Empirical Partners, $500 billion of expected savings will be the result of pandemic-related behavioral shifts: $350 billion in foregone travel, vacation, entertainment and leisure; $65 billion from reduction in commutation; $65 billion in housing and student loan deferments and $20 billion from lower interest expenses. Lastly, current household revolving credit lines are only 20% utilized, meaning consumers have plenty of borrowing power to fuel post pandemic spending.

There is a strong inverse relationship between economic restrictions and economic output. More restrictions mean less output and vice-versa. From an economic growth forecast it will be critical how the winter months unfold with the pandemic and state-by-state restrictions. This will be key in determining whether economic activity dips once more. Furthermore, the first quarter has generally been a soft spot early in economic recoveries. In 8 of the last 10 business cycle recoveries, there has been a first quarter setback before an expansion continued. In VAAM's view there are many forces not the least of which is the consumer that will result in a strong economic recovery after the first quarter.

VAAM believes there is a greater probability that future **inflation** could be significantly higher than expected. The Federal Reserve has expanded its balance sheet to $7 trillion. Growth in the money supply could lead to higher inflation long-term. Historically M2 money growth has led core CPI by approximately six months. M2 growth YoY has entered into double digits, which in the past has sent core inflation into the 2%-3% range. Several indicators point to future inflationary pressures. Medicare payments are also rising. Health care is one-sixth of the U.S.

economy. Real wages are running at 3.2% higher YoY and eventually these higher wages could lead to higher prices. The US-China trade conflict will likely lead to higher inflation as the supply chain is reconfigured. In addition, the yield curve has become more positively sloped and the 10-year breakeven rate, a measure of market implied inflation, has risen to its highest point in more than 18 months.

The Fed will incorporate prior inflation data as part of a moving average when evaluating a target rate. The trick will be in figuring out what is permanent and what might be temporary. One reason YoY inflation readings are currently low is that there was a dip in prices from March to May when the pandemic first struck. However, come next March that effect will start reaching its first anniversary and the YoY comparisons will be higher as a result. If over the next six months prices on a monthly basis rise by just half as much as they did in November, the Labor Department's headline inflation measure would be up 2.6% on the year by May 2021, with core prices up 2.3% (the Fed's long-term target is 2%). In addition, by next spring millions of Americans will likely have been vaccinated, relaxing safety measures just as warm weather returns. The likely result is a surge in demand, particularly in service categories such as travel. With this rebound in demand, prices could rebound as well. Inflation readings could stay elevated for a while, with core readings on the Fed's preferred measure decidedly above 2%. However, this may not lead the Fed to change its stance.

Federal **debt** levels have become an increasing concern. The federal budget deficit for fiscal 2020 came in at $3.1 trillion, more than double the last record of $1.4 trillion in 2009. Total U.S. debt relative to GDP is at 126%. When the ratio of debt-to-GDP exceeds 90%, there is a pattern that develops where deficits lead to higher debt levels.

An additional concern is the debasing of the U.S. currency due to the budget deficit. The Fed Chairman has said there is no limit to money extension and bond buying. This has the potential to result in further currency weakness and inflation. 16% of U.S. debt is held by foreign investors whose confidence in the U.S. dollar is needed for them to remain in dollar denominated assets. Since the start of the pandemic and resulting government financial back stop, the U.S. dollar has declined 12% from peak to trough.

There is the potential for further pressure on deficits and debt levels due to the bipartisan appeal of a major infrastructure program. There is agreement that the nation's infrastructure is in decline and in need of help. The need is there for roads, bridges, airports, subways, broadband networks, windmills and solar farms. Furthermore, a program of this magnitude would provide jobs and stimulus for the economy.

This brings up the debate of how to finance these increasing deficit and debt levels. **Modern Monetary Theory (MMT)** is receiving increased attention as a foundation for the new assessment of deficit spending and debt accumulation. This new paradigm suggests both that public debt is not a major problem and that government borrowing for the right purposes is actually the responsible thing to do. One of the main points of MMT is that interest rates are much lower than they were in the past. MMT is outlined in Professor Stephanie Kelton's recent book "The Deficit Myth". As an advocate for MMT she asserts that at the federal level we do not need to ask how to pay for things. She says the money has always been there for the spending and always will be. The unfounded fear of the deficit should not be a constraint on spending. MMT relies on the fact that the U.S. government is a currency issuer: it has its own sovereign currency which is the U.S. dollar. Because the U.S. is the exclusive producer of the USD, it can print more of it without help, whenever it needs it. Kelton says a government surplus works like a vacuum - it sucks dollars out of the economy. Whereas a deficit works like a blower - it blows dollars onto the balance sheet. The prevailing system allows monetary policy, set by the Federal Reserve, to steer the economy when it becomes too hot or too cool by modifying the money supply and tweaking interest rates to encourage or discourage borrowing and spending. MMT hands the steering wheel over to fiscal policy, set by the Congress, to achieve economic stability while paying little notice to the deficit. It reorients the government's financial sequence from taxing, borrowing and then spending, to simply spending first. When Congress gives the approval for spending, it instructs the Fed to create money. MMT stresses that inflation (and interest rates), not the deficit, should be the major constraint on spending. Inflation occurs during a thriving economy, when people have more purchasing power and, thus, there is a higher demand for goods. The increase in prices brought on by higher demand sends the value of the currency down. A major risk of MMT is that as debt levels grow relative to GDP, interest rates accelerate and existing debt has to be refinanced at higher levels. If debt is financed at higher interest rate levels, then the interest expense to GDP ratio will rise.

Corporate Bonds

A snapshot comparing Corporate Spreads at the beginning of the year versus the end of 2020 shows a market virtually unchanged. For instance, Intermediate Corporate spreads ended the year unchanged and the 1-3 Corporate Index showed a modest 0.03% increase as shown in the table below. This snapshot, however, does not capture the dramatic changes in the market over the course of the year. The early stage of the pandemic drove spreads wider as the economy entered a deep recession. Fiscal stimulus, Federal Reserve actions, and a gradual re-opening of the economy provided the basis for a strong recovery in the Corporate bond market. By year-end Intermediate Investment Grade bonds had a 1.42% excess return as compared to comparable U.S. Treasury, and the 1-3 Investment Grade Corporate Bond Index returned 0.76% excess return.

Bloomberg Barclays Corporate Spreads & Excess Return

	12/31/2019	3/23/2020	3/31/2020	6/30/2020	9/30/2020	12/31/2020
Inter. Corp. Spread	0.67%	3.85%	2.72%	1.16%	1.02%	0.67%
YTD Change		+3.18%	+2.05%	0.49%	0.35%	0.00%
YTD Excess Return		-12.67%	-8.96%	-2.04%	-0.85%	1.42%
1-3 Corp. Spread	0.33%	3.91%	2.57%	0.67%	0.56%	0.36%
YTD Change		+3.58%	+2.24%	+0.34%	+0.23%	+0.03%
YTD Excess Return		-6.66%	-4.24%	-0.42%	0.11%	0.76%

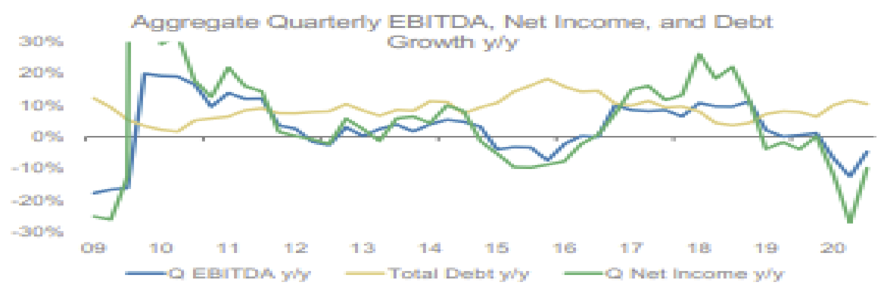
All Spreads & Excess Returns are from the Bloomberg Barclays Corporate Intermediate or 1-3 Corporate Index
All Spreads & Excess Returns are based on Sovereign Yield Curve

Your portfolio is currently overweight corporate bonds despite still high unemployment, the ongoing pandemic, and high corporate leverage. After reducing your exposure to the sector during the first quarter, it was again increased during the second quarter with additional portfolio adjustments made through the remainder of the year. The return to an over-weight position was based on several factors. Markets are forward looking. The best time to purchase risk assets is prior to the actual bottom in economic activity and financial fundamentals. The large fiscal stimulus package passed by Congress, and the monetary actions by the Federal Reserve early in the recession provided support to your investments. The Federal Reserve moves were critical during the early months as corporations issued what became an historical amount of new debt. Total issuance ended the year at $1.66 trillion, $967 billion of net new debt after repayments and maturities. As a comparison, $993 billion of new debt and $350 billion of net debt was issued during 2019. Combined with a decrease in stock buybacks, dividends, and CAPEX, the debt raised cash for financial flexibility during the duration of the economic slowdown.

Source: Bloomberg, Morgan Stanley Research

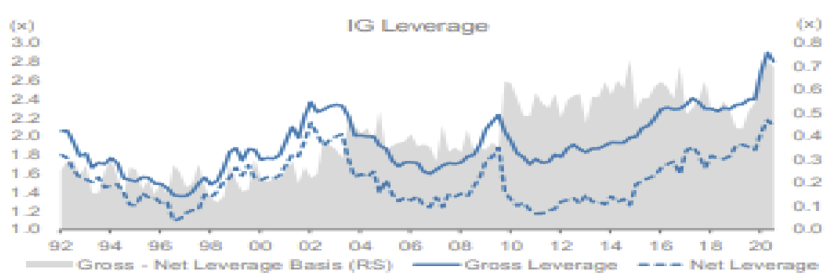
In addition to the improved liquidity position, the rating agencies indicated they would look past immediate 2020 financial results. Their ratings would be on a firm's financial position in 2021 or even later before taking adverse rating actions of investment grade companies. Downgrade risk especially to non-investment grade rating has the largest adverse impact on corporate bond performance. With this risk reduced over the near term, corporate debt became more attractive, supporting the increase in the portfolio's exposure to the sector.

Both EBITDA and Net Income improved from the large declines seen in the 2nd Quarter during the most recent quarter. For instance, EBITDA was down 4.7% year over year versus a drop of 12.5% in the prior quarter. The last 12 months, EBITDA has fallen 5.7%, while total debt is 10.4% higher year over year. With further improvements expected in the final quarter of the year, it is highly likely financial performance bottomed during the second quarter. A quicker recovery than expected by the market. This view is supported by third quarter results in which S&P 500 companies reported extremely strong results versus expectations. Sales exceeded expectations for 82% of the companies and earnings surpassed expectations for approximately 87%. These results are strong as compared to historical results.



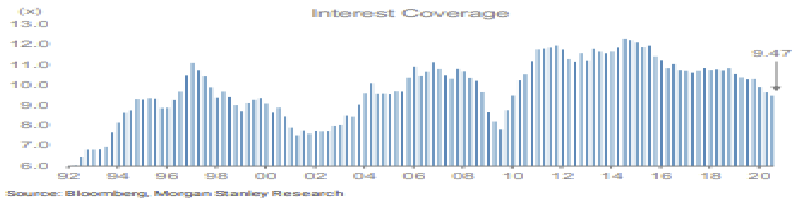
Source: Bloomberg, Morgan Stanley Research

As shown in the chart below, Gross Leverage at 2.8x and Net Leverage of 2.10x, (Left Axis), both improved during the third quarter reflecting the improved EBITDA performance versus 2.9x and 2.18x. Lower rated, cyclical companies leverage remained under pressure. These ratios should continue to improve over the coming quarters as the weak first half of 2020 EBITDA number is replaced by stronger results in 2021.



Source: Bloomberg, Morgan Stanley Research

Interest Coverages (EBITDA/Interest Expense) declined to its lowest level since the last recession, 9.47 times. Even though U. S. Treasury yields are at historically low levels, the lower interest costs for the new debt did not offset the higher debt levels and declining EBITDA over the past 12 months. It is likely that this number is near its low for this cycle.



Over 50% of investment grade issuers have financial fundamentals consistent with a non-investment rating. Though actual Leverage should continue to improve as the economy recovers, lower rated companies have an elevated risk of downgrade and are dependent on a strong economic recovery. Though your portfolio is over-weight corporate debt, it is under-weight the lowest rated corporate bonds. During the third quarter, General Motors/General Motors Financial (Baa3/BBB) was added to your portfolio. At the end of the third quarter, the company had gross leverage of 3.2x based on $29 billion of automotive debt. Leverage is expected to improve this ratio to 1.5x by year-end as the outstanding $10.7 billion revolver is repaid. EBITDA/Interest Expense was 16.1x for the prior 12 months. It had a significant positive earnings surprise for the quarter. We, however, remain cautious on the lower rated segment of the corporate bond market due to ongoing high leverage and potential for rating downgrades. The modest over-weight to the sector is being maintained through a higher quality portfolio and based on improving financial fundamentals. Outperformance for the sector is expected to be limited to the excess interest income earned versus comparable U.S. Treasuries due to tight spreads that limit further capital appreciation.