Summary of Views: AAAMCO Ultrashort Financing Fund & Government and Government Agency Bond & Financing Markets

Week of March 20, 2020

Summary

Like all new, unforeseen shocks in the past, the Covid-19 pandemic ("C-19") is generated tremendous uncertainty and volatility in the U.S. capital markets. The result is a dramatic cheapening of spread assets as investors of all types de-risked investment portfolios, creating relative value opportunities not seen since the 2008 credit crisis. And similar to 2008, the Federal Reserve Bank is repeating - and the federal government will, eventually, repeat – the massive monetary and fiscal measures that helped to right the financial markets in 2008.

Overview

The AAAMCO Ultrashort Financing Fund ("REPYX") has seen it's net asset value per share decline from 10.00 to 9.99, or drop of 0.10%. Overall, the financing markets for government securities has been substantially less volatile than other components of the capital markets, in large part due to the facilities put in place by the Fed even before C-19 struck. The Fund has been able execute all aspects of managing repo positions - raise margin requirements, perform margin calls, reduce borrower positions, invest cash – without any disruptions or delays. The 0.01 decline in NAV per share is a result of wider spreads on the seasoned CMO floater portfolio used by the fund for liquidity purposes.

> Note: REPYX is one of the top performing ultra-short bonds funds in 2020 (see https://www.morningstar.com/funds/xnas/repyx/performance); even though interest rates have fallen sharply, wider spreads in mortgage and credit securities have resulted in under-performance for most short bond funds

The week of 3/16-3/20 may have been the most volatile week in recent history. The S&P 500 Index declined 14.98%, while the iShares Corporate Bond ETD ("LQD") declined 13.25% - a surprisingly large drop relative to the S&P 500 and likely indicative of the lack of liquidity in the capital markets. While U.S. Treasury yields declined across the yield curve, agency MBS valuations lagged; spreads were volatile, but ended the week only 5 bps wider (current coupon 30 year FNMA MBS versus 5-Year Treasury yields)

> Source: Bloomberg

Meanwhile, the front-end of the U.S. government yield curve is extremely well bid as investors reinvest in cash. T-bill yields are negative through December 2020. Government repo rates are less than 10 bps overnight. The Federal Home Loan Banks are able to raise 1 to 7-day money at 0.01%.

So far, the Fed has been the main safety net for the capital markets. With “QE4” now in place, the Fed’s program to purchase Treasuries and government agency MBS should be adequate to stabilize the market. In fact, instead of targeting a specific dollar amount of asset purchases, the Fed has changed it’s language to note that purchases will be large enough to “support the smooth functioning of these markets”. The Fed’s daily operations now include purchases of Treasury securities, agency MBS, and (starting later this week) agency commercial MBS.

https://www.newyorkfed.org/markets/opolicy/operating_polic

REPYX Investment Activity/Counterparty Reviews

- During the week, the Fund reduced positions with a smaller counterparty, which moved positions from the Fund to Pershing, it’s main clearing counterparty.
- The Fund rolled all repo positions with its existing borrowers.
- Reflecting higher market volatility, AAAMCO increased margin requirements on several counterparties. All agreed to these requests.
- AAAMCO asked for cash margin from several counterparties that held positions in which prices declines. All counterparties immediately met these margin calls.
- AAAMCO increased financing spreads to benchmarks for several counterparties, reflecting the sharp decline in benchmark rates
- Fund exposures are in repo backed by agency passthroughs and CMOs (65%) and SBA securities (26%), and outright positions in agency CMO floaters and short duration fixed rate securities (9%)
- All counterparties confirmed that they have multiple sources of liquidity.

Outlook

Benchmark securities and markets (such as U.S. Treasuries and agency MBS passthroughs as well as the repo financing of these securities) should remain orderly given the massive support provided by the Fed. Spreads are likely to remain at historically wide levels for other markets (such as credit) until fiscal stimulus is finalized and the visibility of the C-19 “endgame” and, therefore, the economy becomes clearer.