Interest Rate Strategy

Morley
CAPITAL MANAGEMENT

Highlights

The Federal Open Market Committee (FOMC) raised the federal funds rate by 25bps to a range of 0.75% to 1.0% at its March meeting after leaving rates unchanged at the January meeting.

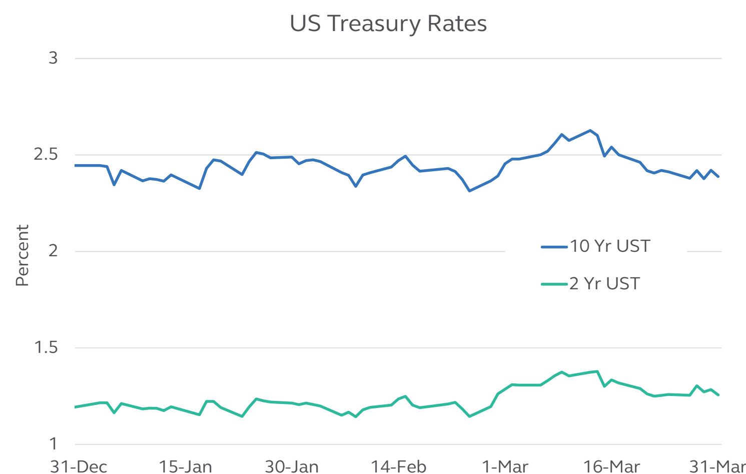
After the 10-year Treasury rate increased by 56bps from Election Day to the start of 2017 as a result of Trump's expected reflation moves, rates were range-bound throughout the first quarter. The 10-year Treasury traded between 2.31% and 2.63% during the period. Shorter maturities showed little more volatility; the 2-year remained between 1.14% and 1.38%, finishing out the quarter at 1.25%, indicating that investors had well anticipated the FOMC's March rate increase. The slope of the curve, as measured by the spread between the 2-year and 10-year Treasury, flattened by 15bps to end the quarter at 113bps.

From the post-election perch, the bond market settled into a wait and see approach to the incoming Trump administration. Having already anticipated some of the effects of promised policies to provide fiscal stimulus through massive infrastructure spending and tax policy, participants were looking for legislative follow through. By the end of the quarter those prospects were dampened by the failure to repeal the Affordable Care Act, which drew into question whether the Republicans have sufficient unity to agree on other legislation. Meanwhile, hard data shows that President Trump inherited an economy that seems to be on solid footing. US Gross Domestic Product (GDP) grew at an annual rate of 1.9% in the fourth quarter of 2016, though models indicate that the first quarter of 2017 may see a slightly weaker growth rate. Unemployment fell to 4.5% and the Initial Jobless Claims four week average of 250k is at a level not seen since the late 1960's. Important to bond market participants is the impact of these factors on inflation. The Consumer Price Index (CPI) March report of 2.7% YOY increase (2.2% ex food and energy prices) and the Fed's closely watched core Personal Consumption Expenditures (PCE) Price Index also known as the PCE Deflator, was up 1.8% YOY, edging toward the 2% Fed target.

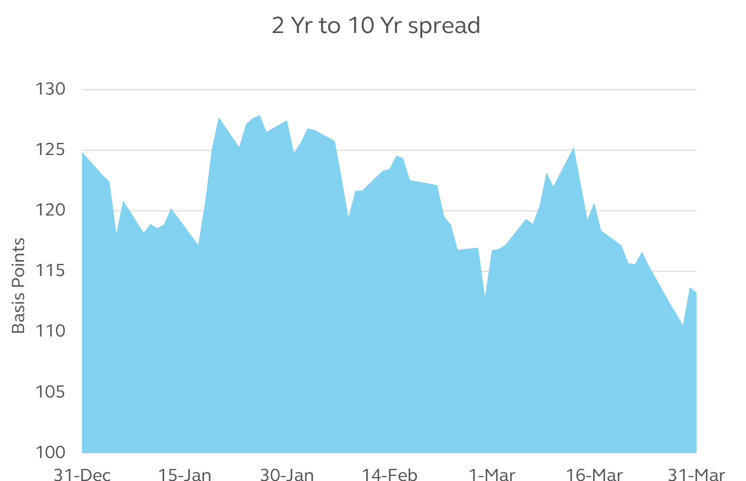
Outlook

We believe political events will continue to have significant impact on the bond market, including the prospects for adding fiscal stimulus through increased infrastructure spending and tax cuts. If it becomes apparent the Trump Administration and Congress can launch meaningful spending measures it seems likely the reflationary mindset of the market will resume.

Communication from the FOMC is clear that along with data dependent rate increases, the tapering of balance sheet repurchases is on the table for late 2017/early 2018. Should this unfold, along with hard data confirmation that US growth remains solid, upward pressure on rates will likely resume; however, should any agents of growth falter, market participants may expect rates to move in a different direction.



Source: Bloomberg



Source: Bloomberg

Mark Kummerer, CFA
Sr. Portfolio Manager

Morley
Capital Management

Highlights

The Bloomberg Barclays US Corporate Investment Grade Index posted a total return of 0.94% and an excess return of 0.56% over US Treasurys for the first quarter of 2017. The risk-on Trump Trade from the fourth quarter of 2016 continued throughout most of the quarter, but lost steam in March as Congress failed to pass healthcare reform. This led to concerns in the market regarding timing of more meaningful policy initiatives such as tax reform/cuts, infrastructure spending, and regulatory roll-back. The 'reflation' trade that had pushed Treasury rates higher and stoked more corporate bond buying in the fourth quarter also slowed as rates ended the quarter mostly unchanged.

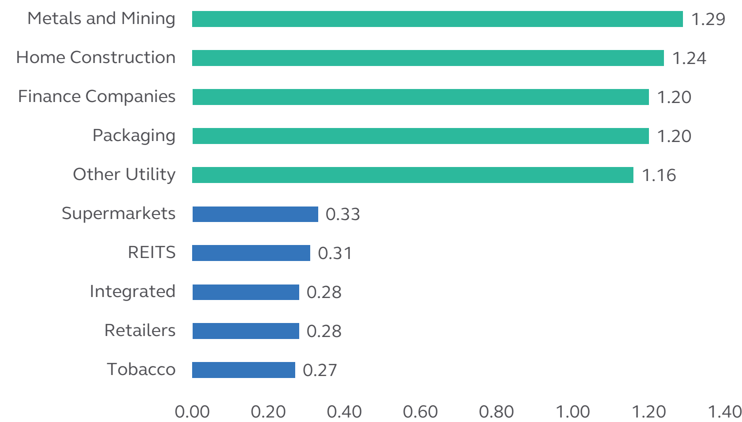
Lower quality BBB-rated corporates outperformed A-rated bonds throughout the first quarter as investors embraced risk, and the spread between the groups tightened to historically low levels. Outperforming sectors include higher beta industries that may benefit from the Trump Trade. Commodity (reflation) and finance companies (higher rates, lower regulation) were the biggest beneficiaries of Trump's themes. The underperforming sectors were lower beta and those with structural challenges, such as retail and retail REITs that are facing secular shifts resulting from consumer habits to online purchasing. Macy's, Kohl's and BestBuy all reported disappointing earnings during the quarter.

Investment grade new issuance defied expectations of lower supply relative to previous years as the first quarter resulted in a quarterly record of $390B, up 10% versus the first quarter of 2016. A continued low rate environment combined with less certainty around timing of potential overseas cash repatriation led issuers to be opportunistic. Lack of merger and acquisition (M&A) activity in the pipeline combined with pre-funding, however, leads us to expect that issuance will taper off throughout the year.

Outlook

Despite the volatility and uncertainty stemming from Washington, we continue to be constructive on credit risk. We believe the economy is on a positive trajectory without the need for additional fiscal stimulus. We also see a supportive technical backdrop as net supply is expected to decline significantly. M&A-related debt issuance totaled $275B in 2015, a record year, and $220B for 2016. The decline last year was the result of a significant decline in jumbo-sized M&A as several deals halted due to regulatory concerns. With the current M&A pipeline, we expect debt-related issuance to continue to decline to less than $200B for 2017.

Bloomberg Barclays Corp Index Top and Bottom 5 by Excess Return



Source: Bloomberg

S&P 500 Index versus Overall US Corporate Index

Source: Bloomberg

Dan Kang, CFA
Head of Credit

Please see Disclosures for important information.

Mortgage-Backed Securities (MBS)

Morley Capital Management

Highlights

The Bloomberg Barclays US Agency MBS Index posted total and excess returns of 0.47% and -0.17%, respectively, for the first quarter. The 15-year sector outperformed 30-year on a total return (0.59% vs 0.45%) and excess return (0.04% vs -0.21%) basis. Nominal spreads to Treasurys widened 10-15bps on 30-year MBS though only 1-5bps on 15-year while implied volatility declined as the 10-year Treasury traded within a 30bps range.

Gross issuance of Agency MBS totaled $322B during the quarter. Net issuance of $85B was absorbed by total return investors, who took advantage of the relative cheapening in MBS versus investment grade corporate bonds. After buying a combined $230B in Agency MBS last year, demand from banks and foreign investors waned this quarter. Ginnie Mae MBS prices were particularly impacted by this lower sponsorship and by housing policy uncertainty, exemplified by the reduction in FHA mortgage insurance premiums announced in January under the Obama administration that was subsequently rescinded by the Trump Administration on its first day in office.

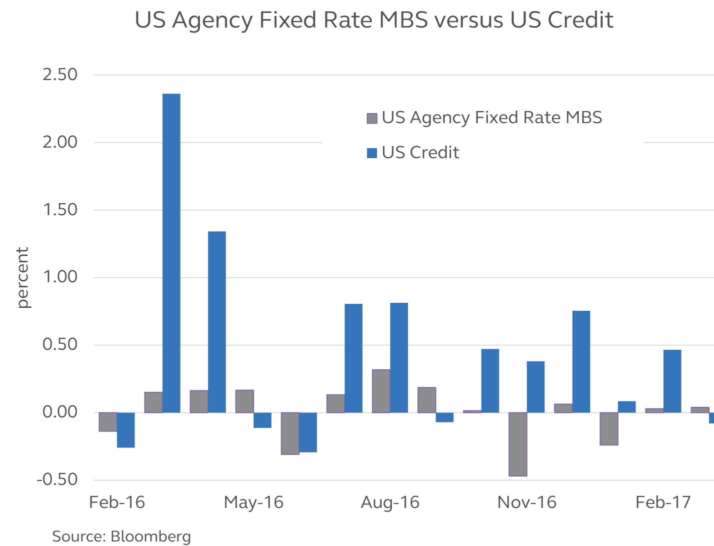
The Fed raised the target federal funds rate by 25bps at its March meeting and noted its preference to taper both Treasurys and Agency MBS purchases in a "passive and predictable manner." This was a more dovish outcome for MBS investors, who had expected the Fed to primarily taper MBS reinvestments and possibly conduct outright MBS sales. Chairwoman Yellen indicated the tapering decision is based on qualitative factors rather than quantitative targets, reinforcing the late 2017/early 2018 timeline for an announcement of tapering.

Outlook

Failure to pass the American Health Care Act late in the quarter illustrated divisions within the Republican Party and suggests fiscal stimulus measures and regulatory overhauls under the new administration may be harder to implement than markets had assumed. The resultant outlook for a more measured pace of GDP growth suggests the Fed may take a more gradual approach to removing monetary accommodation. Notably, several FOMC members have suggested that balance sheet reduction could limit the number of rate hikes needed this cycle, which lends support to basis/carry trades and could prompt renewed demand for Agency MBS.

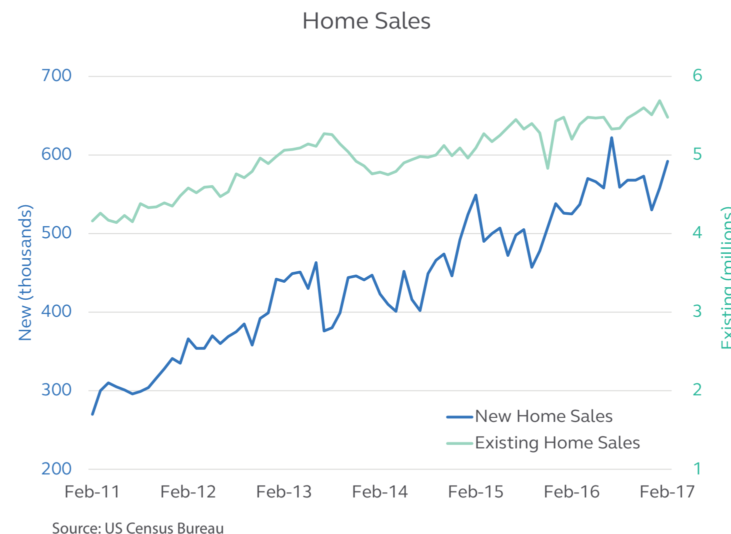
Downside risks to the sector include a potential increase in purchase loan origination and MBS supply arising from higher home sales, which would have the greatest impact on the 30-year and Ginnie Mae markets. Being primarily a refinancing product, 15-year MBS should fare better given expected net negative supply of $20-25B this year along with investor demand for securities with shorter average maturities.

Our base case expectation is for two additional Fed rate hikes this year with a tapering announcement at the December FOMC meeting. MBS spreads could recalibrate 10-15bps wider into the second half of this year based on Fed policy and seasonal peaks in issuance during the spring and summer months. We expect spreads will ultimately retrace a significant portion of widening, consistent with prior tightening cycles, as demand from high quality yield buyers resumes. In addition, the effect from the Fed owning nearly a third ($1.76T of $6.1T) of the outstanding Agency MBS will continue to support the market for years to come given its MBS holdings are skewed to lower coupons that will roll off slowly (around $10-15B per month.)



Source: Bloomberg

Perpetua Phillips
Sr. Portfolio Manager



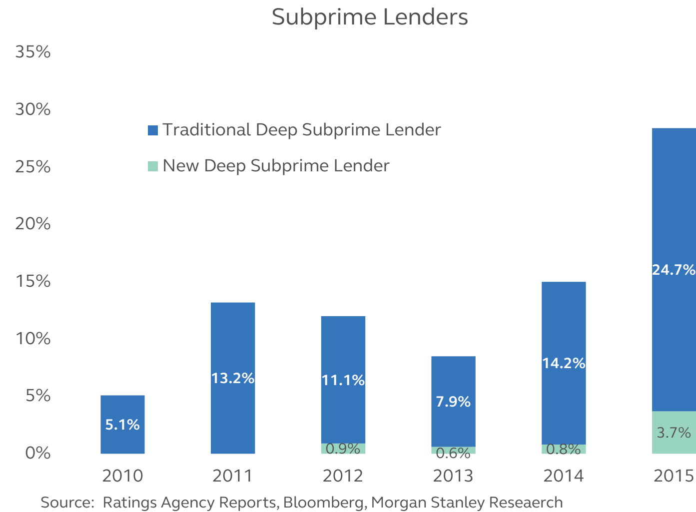
Source: US Census Bureau

Highlights

The Bloomberg Barclays AAA Asset-Backed Securities Index posted total and excess returns of 0.51% and 0.19%, respectively, for the first quarter. New issuance volume in March was the largest monthly volume in the last eight years, at $25.5B. The total issuance for the first quarter was $58.9B. Spreads on 3-year fixed auto ABS tightened 9bps and credit card ABS tightened 17bps. Although, spreads moved tighter, absolute yields were higher, given the move in Treasurys and the swap curve.

Auto ABS issuance increased year-over-year with over $29B in new paper. Issuers took advantage of tight spreads and a robust market to get ahead of the expected impending onslaught of used cars that will pressure prices. According to the National Auto Dealer Association, wholesale prices of used vehicles dropped 1.6% in February from January. The Manheim index is still hovering around historical highs of around 124 though it has come off its high of 127.8.

Credit card ABS had a robust first quarter with over $15B of new issuance, compared to around $3B a year ago. As new deals were over-subscribed, issuers were able to upsize while keeping spreads tight. Close to $51B of credit card ABS are maturing this year, so overall supply is still expected to be net-negative. New issue 3-year credit card spreads are printing below 20bps. Compared to first quarter last year, when Discover's new 3-yr issue came in at 56bps, spreads have materially compressed.



Source: Ratings Agency Reports, Bloomberg, Morgan Stanley Reseaerch

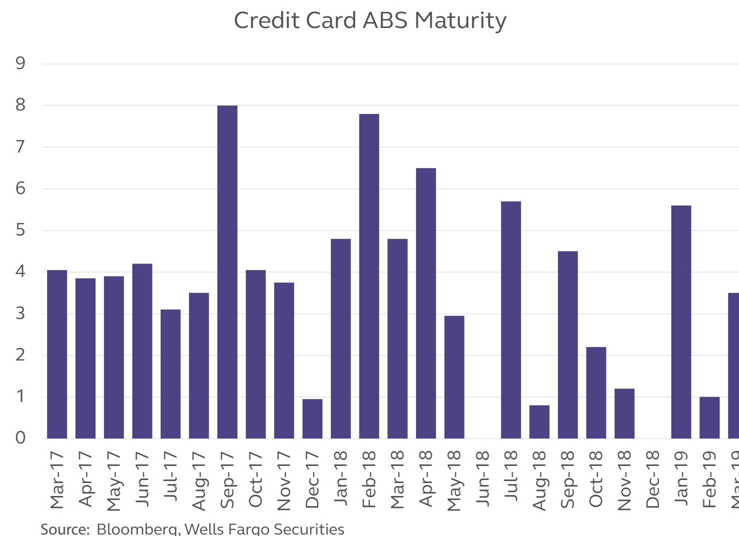
Rupa Raman, CFA
Head of Structured Credit

Outlook

First quarter spreads tightened across the board, with the most movement in subordinate bonds and off-the-run sectors. The credit curve has been very flat with no real pickup for riskier sub-sectors such as auto leases or retail credit cards. Consequently, the higher quality trades are preferable, until investors are compensated for less liquid and more credit sensitive sub-sectors.

Given good economic data, including low unemployment and rising wages, there is a bigger concern regarding the deteriorating credit metrics of Auto ABS. Declining residual values for Auto ABS continues to be an overhang for subordinate classes as well as subprime auto. We believe the newer entrants in the space, notably issuers with private equity backing, are most susceptible to further deterioration, especially if economic data worsens.

2-year swap rates have been printing above 30bps and 3-year swaps have been above 25bps throughout the first quarter. The swap spread has provided an additional advantage to structured products versus corporates in the short end of the curve. 1-month LIBOR has been hovering around 1%, providing an attractive yield for floating rate paper. Although credit spreads are at the tighter range of the last 24 months, the pickup to Treasurys offers a compelling case for many ABS bonds.



Source: Bloomberg, Wells Fargo Securities

Please see Disclosures for important information.

Commercial Mortgage-Backed Securities (CMBS)

Highlights

The Bloomberg Barclays AAA Commercial Mortgage-Backed Securities Index posted total and excess returns of 0.79% and 0.02%, respectively, for the first quarter. Total year-to-date private label issuance reached $14B, significantly less than the $17B in the first quarter of 2016. Agency CMBS issuance was in line with 2016 with over $49B in new issuance for the first quarter.

Commercial mortgage debt outstanding reached $3T at the end of 2016, with over $1.1T of multi-family loans. Lenders have all increased exposure, leaving fewer loans to be securitized in the CMBS market. Outstanding loans in the conduit CMBS market dropped to $459B.

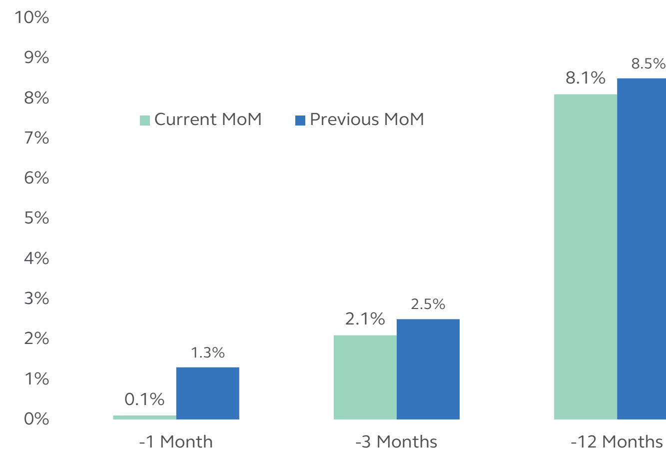
Moody's/RCA Commercial Property Price Indices in January were up 8.1% YOY and 23% above the December 2007 peak. Commercial real estate (CRE) price appreciation has slowed down in the first quarter with the three-month growth rate of 2.1% in January versus the 2.5% three-month growth rate recorded in December.

Outlook

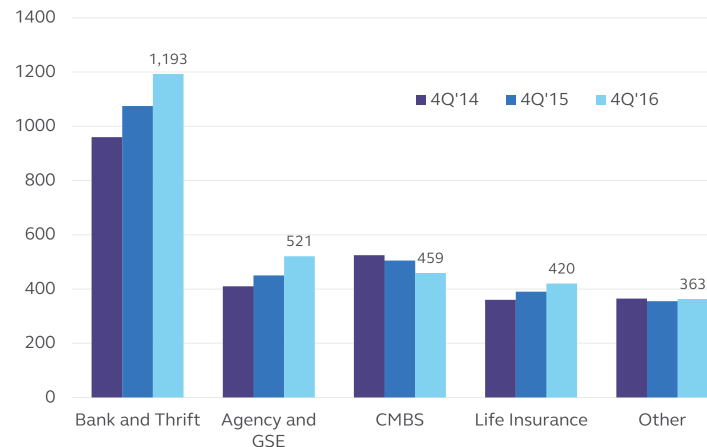
CRE valuations have benefited from low rates, higher net operating incomes (NOI), and favorable lending terms. Price appreciation has slowed with NOI growth rates declining for the first time since 2010. The dominant sub-sector has been multi-family, recovering 243% from peak-to-trough losses. However, with the boom in apartment construction in recent years, we expect rents to stagnate impeding further NOI growth and pressuring valuations.

The supply/demand imbalance has kept spreads relatively rich and tight to Corporates and ABS. Over $23B of conduit paper has matured in the first quarter with very little new issue supply. The new deals are all risk-retention compliant with small front-pay AAA tranches. Although underwriting is cleaner with higher NOI debt yields, prepayment risk is a concern for deals with small A1 classes and premium A2 and A3 classes.

Retail headlines, regarding store closures and vacancies at large malls, dominate the credit concern in CMBS. A handful of dealers have recommended shorting the subordinate CMBX Index tranches as a way to take advantage of retail weakness. Although there is retail risk across the board, the front-pay AAA tranches have limited credit loss potential. They could, however, extend if the target loans cannot mature. We are avoiding Class B mall maturities for tranches that rely on maturities rather than natural amortization payments.



Source: Moodys/RCA, Morgan Stanley Research



Source: Mortgage Bank Association and Citi Research

Rupa Raman, CFA
Head of Structured Credit

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Disclosures

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The Bloomberg Barclays US Corporate Investment Grade Index is a component of the Bloomberg Barclays US Credit Index which includes publicly issued U.S. corporate and foreign debentures and secured notes that meet specified maturity, liquidity, and quality requirements within the Bloomberg Barclays U.S. Aggregate Index.

The Bloomberg Barclays US Agency Mortgage-Backed Securities (MBS) Index tracks agency mortgage backed pass-through securities (both fixed-rate and hybrid ARM) guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC).

The Bloomberg Barclays AAA ABS Index represents the asset-backed securities within the Bloomberg Barclays US Aggregate Index.

The Bloomberg Barclays AAA CMBS Index represents the commercial mortgage-backed securities within the Bloomberg Barclays US Aggregate Index.

The S&P 500 Index is a market-value-weighted index of 500 stocks that are traded on the NYSE, AMEX, and NASDAQ. The weightings make each company's influence on the index performance directly proportional to that company's market value.

The Manheim Used Vehical Value Index is a measure of wholesale prices adjusted for mix, mileage and season.

The Moody's/RCA Commercial Property Price Index (CPPI) measures United States commericial real estate prices.

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