Interest Rate Strategy

Morley
CAPITAL MANAGEMENT

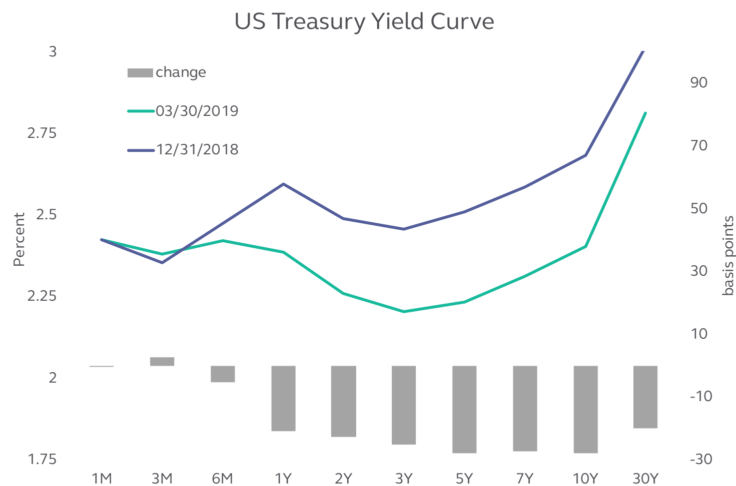
Highlights

Treasury rates fell further during the first quarter of 2019 and the yield curve inverted out to the 3yr maturity. Rates on the 2-yr US Treasury fell 22 bps to yield 2.26% at quarter-end. The 10-year US Treasury Bellwether finished the quarter at 2.40%, a drop of 23 bps. The trend toward lower rates is a continuation of the previous quarter's trend and reflects expectations of slower US Gross Domestic Product (GDP) growth.

The Federal Reserve (Fed/FOMC) further supported the bullishness in bonds with a pivot toward a more dovish policy at its March meeting. The FOMC removed projections of any rate hikes in 2019, previously it projected two. The Fed is taking a wait and see approach pledging to be patient in determining its next move.

Outlook

We expect rates will drift slightly higher over 2019 with the curve normalizing to a positive slope. With the Fed paused, concerns that an overly hawkish disposition was constraining growth had given way to speculation that the next move was toward lower rates in the foreseeable future. That speculation now seems to have been overbought and, looking out to early 2020, appears to be a 50/50 proposition.



Source: Bloomberg

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Portfolio Manager

The financial market outlook is based on current market conditions. There is no assurance that such events or projections will occur and actual conditions may be significantly different than that shown here. The potential for profit is accompanied by the possibility of loss.

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Highlights

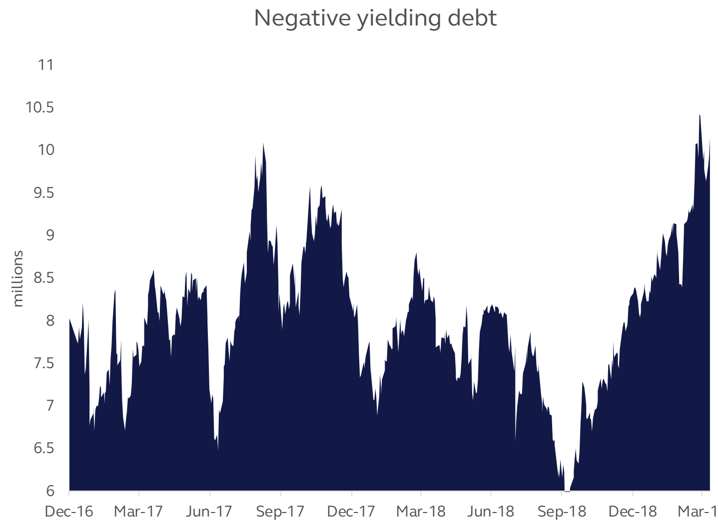
The Bloomberg Barclays Corporate Investment Grade Credit Index posted positive total and excess returns of over Treasuries of similar duration of 5.14% and 2.73%, respectively for the quarter. Spreads dramatically tightened in January and proceeded to grind in for the rest of the quarter. Corporate spreads retraced 75% of the 4th quarter risk sell-off and ended the period at 119 bps.

Many of the risks that drove the 4th quarter tumult, were dramatically reduced year-to-date. First, global central banks have shifted to a more accommodative stance over the past few months. Specifically, the Fed's policy pivot helped dampen spread volatility during the quarter. Second, positive headlines regarding China/US trade negotiations aided sentiment. Instead of escalating trade rhetoric, markets have seen both sides working towards a negotiated settlement. Third, demand returned significantly from both overseas and retail investors. A combination of lower currency hedging costs and an increased universe of negative yielding debt aided the return of Asian investors. Supply was more limited as March year-to-date gross and net new issuance declined 1.1% and 17.3%, respectively. Finally, recession fears abated with data indicating a slower but stable economic outlook.

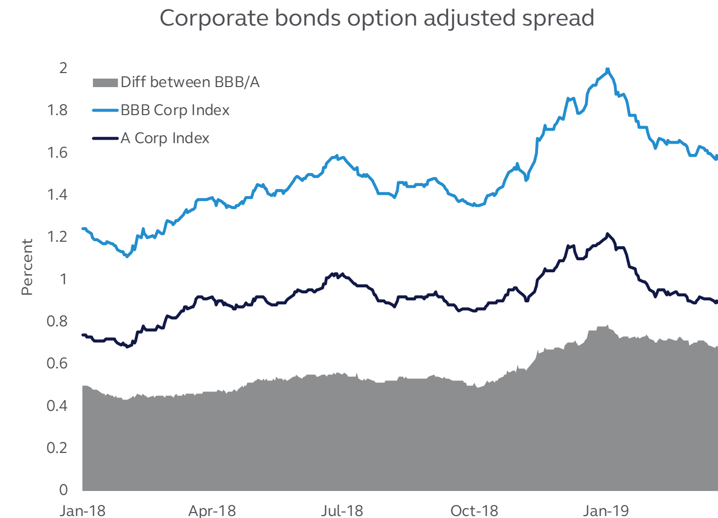
Outlook

We have a near term positive view of risk assets due to the macro and technical factors discussed above. A combination of an accommodative global central banks and larger evidence of economic green shoots should be supportive of spreads. However, due to relatively tight valuations we expect only carry type returns.

Further, the decompression in spreads based on quality from last year has reversed as BBB corporates spread ratio versus A-rated trended toward 3rd quarter levels. We continue to have a benign view of BBB exposure and do not see large portions of the BBB universe falling below investment grade. With a non-recessionary economic environment and many of the largest BBB issuers having significant financial flexibility, we see BBB risk as security selection issue more than a systematic risk.



Source: Bloomberg



Source: Bloomberg

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Mortgage-Backed Securities (MBS)

Morley
Capital Management

Highlights

The Bloomberg Barclays US agency MBS Index posted positive total and excess returns of 2.17% and 0.28%, respectively, during the first quarter following a volatile end to 2018. Lower coupons led both total and excess returns across tenors as Treasury yields retreated by 20-30 bps over the period and prepayment concerns resurfaced. While credit sectors were the biggest beneficiaries of the Fed's dovish pivot, this was also a positive for MBS from a rates/volatility standpoint as the MOVE and VIX indices declined by 12% and 46% YTD .

Supply technicals were positive during the quarter as gross mortgage origination totaled a modest $230B - down nearly $50B from the 1st quarter of 2018, while net issuance was a meager $34B. On the other hand, the Fed's announced plan to end balance sheet reduction at a terminal level of approximately $3.5T by September 2019 was neutral/slightly negative for the basis since MBS paydowns under the $20B monthly cap will be reinvested in Treasuries rather than new MBS.

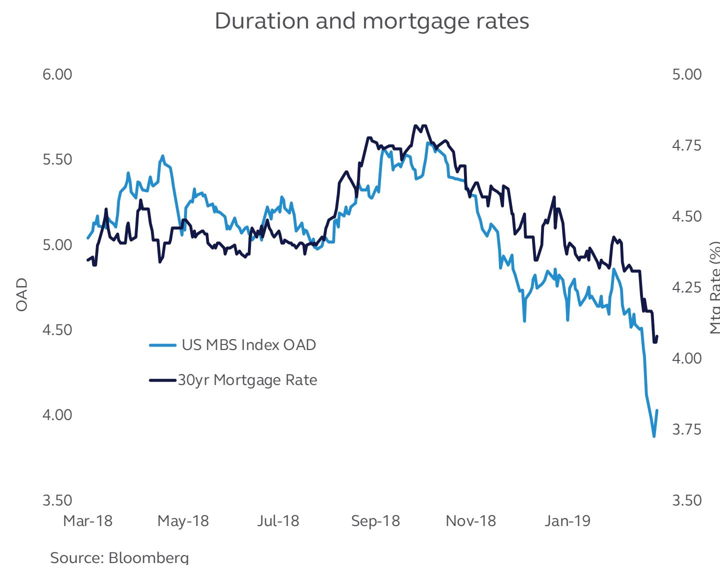
The option-adjusted duration of the MBS index shortened from a peak of 5.6 years in November to 4.0 years at the end of the 1st quarter as mortgage rates declined by 70 bps. Prepay risk increased but has been contained to newer vintages with higher gross weighted average coupons/loan sizes. As a result, only around 30% of mortgages outstanding were in the money to refinance.

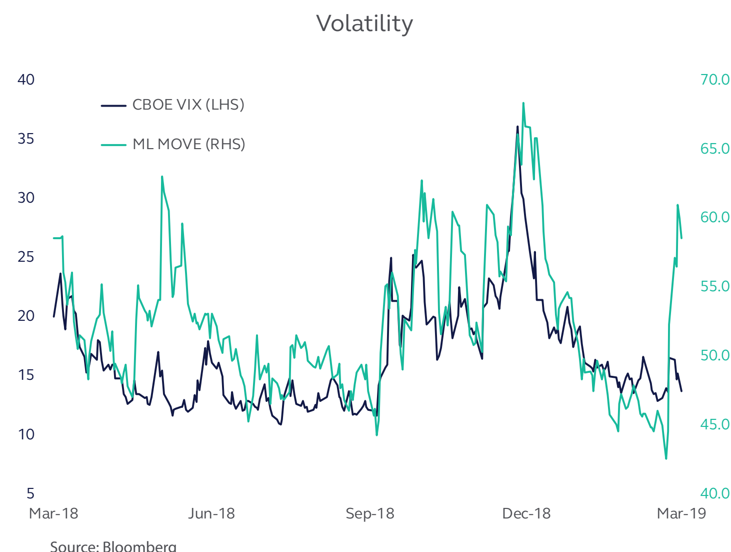
Outlook

With central banks demonstrating their commitment to supporting economic growth and price stability, MBS nominal spreads have recovered from the wides reached in December. MBS valuations have repriced for a stable rates/volatility outlook that leaves little room for error in supporting option adjusted spreads at current levels. This leaves the sector vulnerable to any uptick in volatility arising from market disruptions or a change in policy course at the Fed, which could increase with appointments of Stephen Moore and Herman Cain to the board of governors.

MBS investors will be faced with additional uncertainties arising from the UMBS transition, new leadership at the FHFA and the development of concrete plans for GSE reform. The UMBS transition has the potential to impact market liquidity, worsen TBA deliverables and weaken dollar roll markets. Additionally, Mark Calabria – the new FHFA director, could take administrative measures to reduce the GSE's footprint ahead of any legislative measure. While the latter is unlikely to occur ahead of the 2020 elections, the former could be introduced relatively quickly in the form of lower conforming loan limits, investor/cashout loan exclusions or adjustments to LLPAs, all of which could impact MBS supply and prepayment profiles.

Overall, the MBS sector offers high quality carry, reliable liquidity and a lower market beta that should perform well in low/moderate risk environments. We find value in market segments with lower option costs derived from underlying collateral characteristics and deal structures given the marginal compensation received for taking convexity risk in the current low volatility environment.





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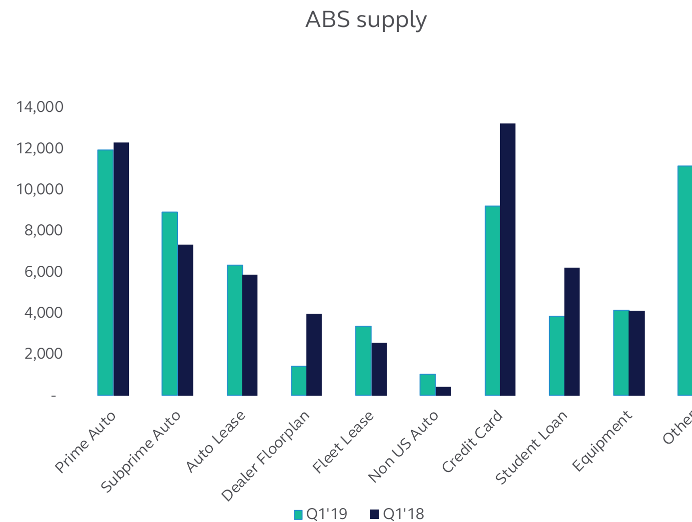
Highlights

The Bloomberg Barclays AAA ABS Index posted positive total and excess returns over Treasuries of similar duration of 1.47% and 0.39%, respectively for the quarter. Risk assets performed well during the first quarter of 2019, rebounding from the fourth quarter sell-off. Dovish commentary from the Fed was the primary reason for the recovery in risk assets. Additional factors contributed to the strong quarter, including the end to the partial US government shutdown and progress in US-China trade negotiations.

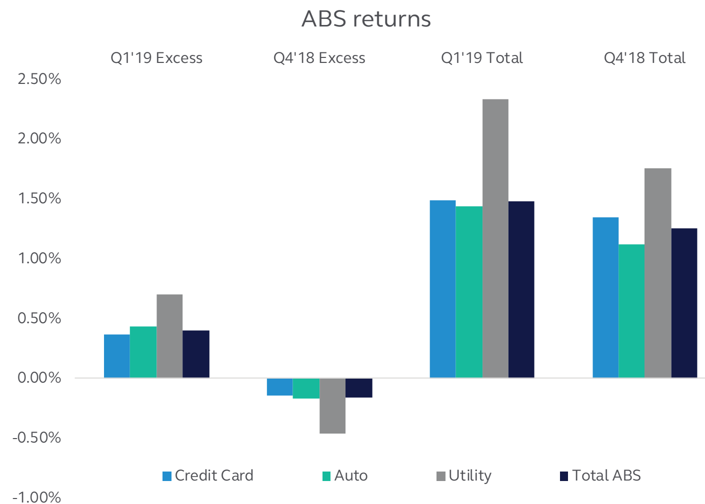
Supply for asset backed securities year-to-date is $57B. This is lower than the $65B issued in the first quarter of 2018. Total supply expected for 2019 is $230B, which is the same amount that was issued in 2018. Prime auto loan ABS is the largest asset class in annual issuance. This sector has a short weighted-average life and requires continued investment to maintain investment exposure. Auto performance is gradually weakening both seasonally and cyclically, but not to levels that would threaten ABS with potential downgrades or losses. ABS spreads gradually tightened throughout the quarter, after ending 2018 at their widest levels of the year.

Outlook

The U.S. consumer remains healthy and the unemployment rate continues to decline below 4%. A near full employment economy is supportive of the consumer and collateral performance. Collateral performance in post-crisis ABS issuance has been strong as underwriting standards and access to credit remain generally conservative. Expectations are for stable 2019 performance for the sector as consumers benefit from moderate economic growth and low unemployment. Credit card charge-offs are expected to slowly rise over time as revolving credit usage expands. Performance in the auto sub-sector is gradually weakening both seasonally and cyclically, though not to levels that would threaten ABS with potential losses.



Source: BofA Merrill Lynch



Source: BofA Merrill Lynch

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Highlights

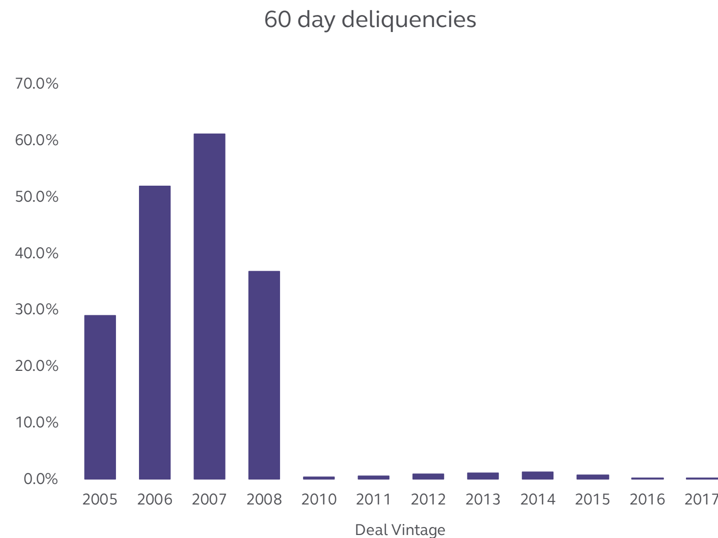
The Bloomberg Barclays AAA CMBS Index posted positive total and excess returns over Treasuries of similar duration of 1.04% and 3.07%, respectively, for the quarter. Total private label CMBS issuance in the 1st quarter was around $20.6B and Agency CMBS was $20.5B $22.4B (-8%) and $30.1B (-32%) respectively for the 4th quarter. Overall, fun¬damentals and commercial real estate pricing remained firm during the quarter as the rally in 10-year interest rates helped support capitalization rates keeping expectations for income growth positive. The delinquency rate on loans originated after the Great Financial Crisis remain historically low and well within expectations for seasoned loans for the real estate recovery that started in 2012. low interest rates and conservative underwriting standards have helped support strong loan performance.

The technical factors of lower conduit CMBS supply and few sellers during volatile periods to support the relative performance of CMBS during the 1st quarter. Spreads recovered from the late 2018 volatility induced widening; spreads on AAA-rated and AA-rated bond tightened 20bps, A-rated spreads tightened 45bps and BBB-rated spreads tightened over 60bps.

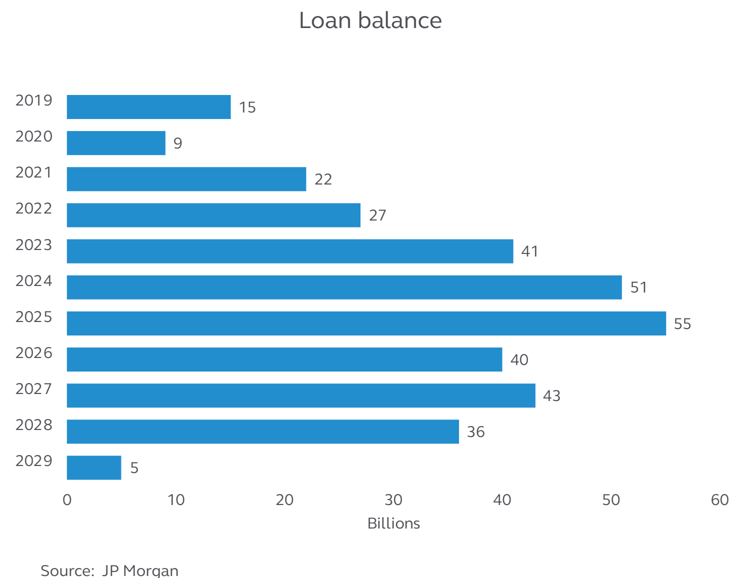
Outlook

Looking forward, the late cycle performance of CMBS should continue to be exposed to idiosyncratic risk in real estate markets, such as exposure to energy, student housing or overbuilt hotel markets. One systematic risk in the CMBS market is exposure to loan maturities. Ten-year conduit loans are currently at a cyclical low for loan maturities considering that there were no conduit loans originated in 2009 and over $10B originated in 2010. This reduces the systematic risk of loan maturities during a potential market downturn over the next 12-24 months.

Our outlook continues to support the relative value of short duration CMBS as default driven cash flow volatility should be low and spreads are attractive relative to alternatives in the market.



Source: JP Morgan



Source: JP Morgan

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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 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.

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