Highlights

As rates fell during the fourth quarter, the yield curve inverted between the 1 yr and 3 yr tenors. The yield on the 2 yr US Treasury fell 32 bps to 2.50% at quarter-end. The 10 yr Bellwether Treasury finished the quarter at 2.65%, a drop of 41 bps. The bull flattening, in contrast to the previous quarter's bear flattening, is reflecting concern that the monetary policy of the Federal Reserve (Fed) is at risk of overshooting the neutral rate in spite of the Federal Open Market Committee's (FOMC) belief that rates are still below the target.

The shift in rates was a strong reversal of the previous quarter's rising trend and was driven by a host of risk-off factors in other markets as well as the bond market. Expectations of slower US Gross Domestic Product (GDP) growth, a shift in expectations toward more dovish monetary policy, and the growth-slowing impact of the trade standoff with China were all bullish for US Treasuries. These factors have overwhelmed more bearish concerns regarding strong employment and increased Treasury supply.

Outlook

We expect the curve to remain flat to inverted with rates drifting higher over 2019. It now appears that the Fed has maneuvered itself enough room for a pause in rate hikes, partially alleviating concerns that an overly hawkish disposition hastened the trend toward slower growth.

The Office of Management and Budget is projecting the 2019 fiscal budget at over a trillion dollars. Higher budget deficits are typically accompanied by higher Treasury borrowing that, along with Fed balance sheet run-off, could lead to $1.7T in net new issuance. Participation in the Treasury market by foreign buyers has been flat over the last several years and the Fed continues to unwind its Treasury holdings. We expect these technical dynamics to place some upward pressure on rates.

Source: Bloomberg

Mark Kummerer, CFA
Portfolio Manager

Morley Capital Management

Highlights

The Bloomberg Barclays Corporate Investment Grade Credit Index posted total and excess returns over Treasuries of similar duration of -0.18%, and -3.10% respectively for the quarter, bringing the 2018 total return to -2.51% and excess return of -3.15%. Spreads gapped out 47 bps during the quarter, capping one of the worst quarterly performances for credit. As markets de-risked, BBB-rated bond spreads decompressed from A-rated bonds. Markets continued to focus on the relative size of the BBB market versus the high yield market and the implications for potential fallen angels. As the year ended on a weak note, December posted only $8B in new issuance, the lowest volume in 23 years.

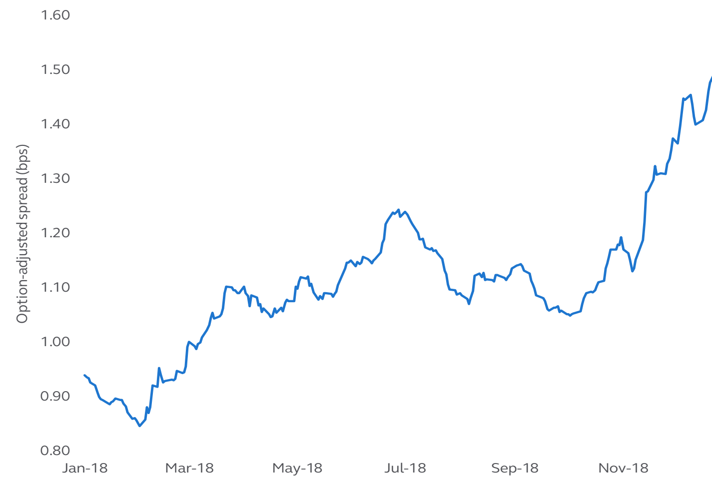
The risk-off period was driven by the combination of growing concerns over Fed policy error, slowing global growth, plunging oil, escalating trade tensions and weakening earnings outlooks. Recession probabilities were elevated due to drop in asset price indicators (flatter treasury curves, higher spreads, lower value in equities), though there were few signs from economic indicators. During the quarter, several large issuer downgrades (GE, Pacific Gas & Electric, ABInbev) added to the concerns of the credit market.

The fourth quarter capped a challenging year for investment grade bonds with spreads widening 60 bps for 2018. A combination of significant withdrawal of Asian buying, an initiation of trade tariffs by the Trump administration, the re-emergence of European risks (Brexit, Italian budget), higher cash yields and substantial M&A-related financing, all pressured spreads prior to the large sell-off in the fourth quarter.

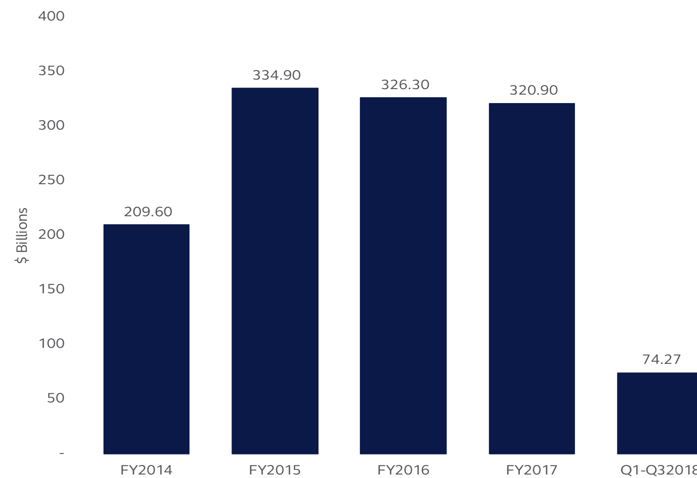
Outlook

For 2019, we maintain a cautious stance in credit; however, we expect investment grade cash to generate positive excess returns. Many of the sources of volatility will remain in place as the economy operates in a late cycle environment. Without the support of central banks, we would expect magnified spread movement for any macro or company specific missed expectations. Further, technicals in the credit market have become more challenging as foreign buyer demand has become less consistent. We expect new issuance to decline in 2019.

Supporting our spread and excess return expectations is our view that a recession is not expected for 2019/2020. Further, U.S. Federal Reserve Chairman Jerome Powell and other members of the Fed have become more dovish in recent weeks which has decreased the risk of policy error and increased the chance of a soft landing. Finally, China has become more proactive in its stimulus measures which should support the global economy. The wild card continues to be the trade spat between the U.S. and China. Although the prevailing winds of optimism has supported asset prices so far, we think it is prudent to wait for the March 1st deadline for any conclusions.



Source: Bloomberg



Source: Federal Reserve

Dan Kang, CFA
Portfolio Manager

Please see Disclosures for important information.

Mortgage-Backed Securities (MBS)

Highlights

The Bloomberg Barclays US Agency MBS Index posted total and excess returns over Treasuries of similar duration of 2.11% and -0.31%, respectively, for the quarter, bringing the 2018 total return to 1.04% and excess return of -0.25%. Negative excess returns were driven by increased supply from the Fed's balance sheet runoff, elevated market volatility and cross-sector spread widening. Lower coupon MBS posted the best relative performance during the quarter while higher coupons outperformed for the year.

Market sentiment turned sharply bearish in the fourth quarter on escalating China trade tensions, plunging oil prices, government shutdown fears and weaker global growth indicators. Despite this, the FOMC proceeded with a 25 bps rate hike in December. While MBS couldn't keep pace with the 40 bps rally in Treasuries, the sector outperformed credit sensitive sectors given investors' flight to quality and liquidity.

The prepay environment remained benign despite the nearly 50 bps retracement in primary mortgage rates from near 5% during the quarter due to extensive seasoning and policy measures addressing aggressive servicer practices in Ginnie Mae multi-issuer pools. However, 2018-originated higher weight average coupon pools have notably worse convexity profiles and TBA/roll markets repriced accordingly.

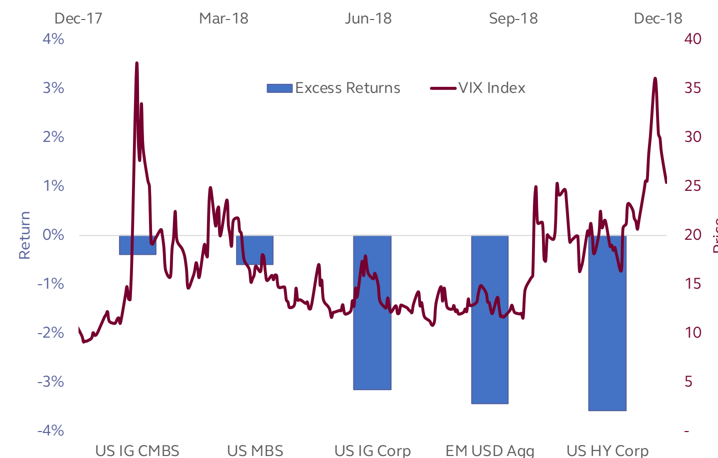
Outlook

Following the rapid tightening of financial conditions arising from the fourth quarter equity market corrections, the Fed appears to be charting a more patient, dovish course for 2019. This alleviates one major concern for risk assets and should result in a more stable interest rate outlook and improved risk sentiment. This is a clear positive for the MBS sector from a volatility standpoint but lessens the flight to quality appeal of the sector and could prompt reallocations out of MBS back into IG credit, which was particularly hard hit in the fourth quarter.

MBS nominal spreads to Treasuries have partially recovered from the wides reached in November, but there are several potentially disruptive developments on the horizon which MBS investors must contend with. New leadership at the Federal Housing Finance Agency, Joseph Otting and Mark Calabria, will be focused on reducing the government sponsored enterprise's (GSE) footprint in housing finance. They could take non-legislative actions towards that goal such as reducing conforming loan limits for conventional MBS. Ginnie Mae will also have a new acting president, Maren Kasper, following Michael Bright's recent resignation. Finally, the Uniform MBS (UMBS) transition date of June 3rd is fast approaching, with the potential to disrupt liquidity in the near term as market participants work through the pool exchange process and navigate new UMBS forward settling/roll markets.

MBS performance near term should benefit from limited seasonal supply and a more stable rate outlook under a less hawkish Fed. The spread advantage versus Treasuries and lower market beta should support the sector in flat to down markets while tempering performance relative to credit sectors in a renewed risk-on market.

Source: Blackrock Aladdin



Source: Bloomberg

Perpetua Phillips
Portfolio Manager

Please see Disclosures for important information.

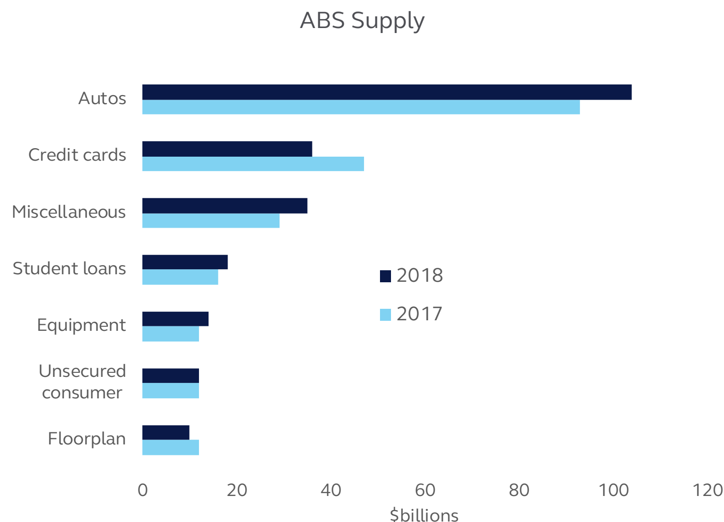
Highlights

The Bloomberg Barclays AAA ABS Index posted total and excess returns over Treasuries of similar duration of 1.23% and -0.16%, respectively for the quarter, bringing the 2018 total return to 1.70% and excess return of 0.06%. Total ABS issuance for 2018 was $229B, up 3% year-over-year. Auto ABS was the largest asset class with $103.6B in issuance for the year, a new record high annual sector total, surpassing the previous peak of $101B in 2005. All sub-sectors have had year-over-year increases in new issuance, except credit card ABS which is running at net negative supply with around $43B in maturities versus $34B in ABS issuance. ABS spreads ended 2018 at their wides of the year, after having started with a rally to their tights in January.

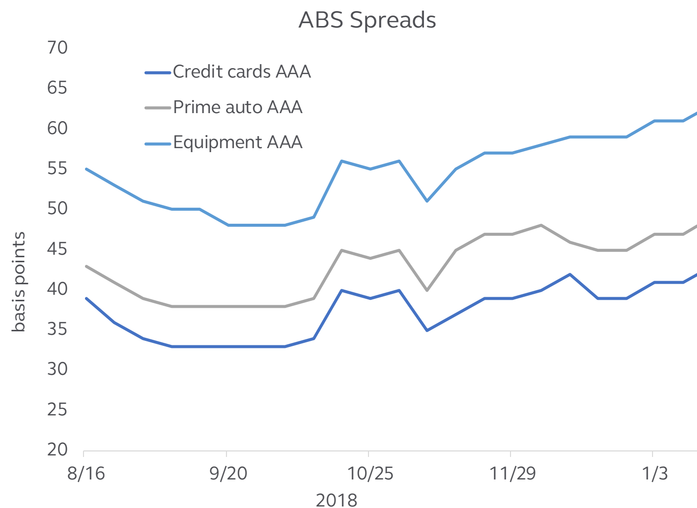
Volatility returned during the fourth quarter, causing large declines in all major risk market segments. The overall macro tone was negative, led by concerns regarding a potential deceleration of economic growth and plunging oil prices. In addition, concerns about trade wars, Brexit, and the Italian fiscal situation weighed on market sentiment.

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: JP Morgan



Source: JP Morgan

Perpetua Phillips
Portfolio Manager

Please see Disclosures for important information.

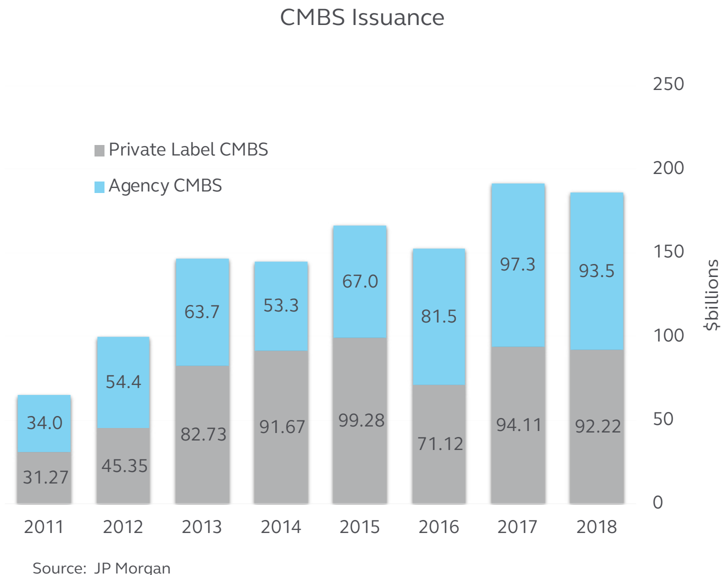
Commercial Mortgage-Backed Securities (CMBS)

Morley Capital Management

Highlights

The Bloomberg Barclays AAA CMBS Index posted total and excess returns over Treasuries of similar duration of 1.72% and -1.12%, respectively, for the quarter, bringing the 2018 total return to 0.78% and excess return to -0.39%. Total private label CMBS issuance in the fourth quarter was around $22B and Agency CMBS was $28B, bringing issuance year-to-date to over $185B. For the year, conduit issuance was down 15% at $41.5B, single-asset issuance was marginally lower at $35.4B and Commercial Real Estate Collateralized Loan Obligation issuance doubled at $14B. Similarly, among Agency CMBS, Freddie Mac K bonds led the way with $61.6B of the $93.5B issued. Freddie issuance was up 9% year-over-year. Overall, fundamentals and commercial real estate pricing remained strong during the year with capitalization rates remaining stable and positive income growth for all property types. The delinquency rate on loans originated after the Great Financial Crisis remain historically low as the real estate recovery that started in 2012, with low interest rates and conservative underwriting standards, has helped support strong loan performance.

The technical factors of lower conduit CMBS supply and few sellers during volatile periods during the year helped to support the relative performance of CMBS during the year. The material increases in market volatility to end the year widened AAA spreads and steepened the credit curve on recently issued CMBS. Spreads on more seasoned bonds held in much better, however, supported by strong fundamentals and little supply in the market.



Source: JP Morgan

Mark Kummerer, CFA
Portfolio Manager

Outlook

The late cycle performance of CMBS should continue to be exposed to idiosyncratic risk in real estate markets such as exposure to energy 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.

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Disclosures

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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.

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