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Principal Asset Management℠

Principal Morley

Interest rate strategy

DECEMBER 31, 2022

DAN KANG, CFA
Portfolio Manager

Rates/Corporates

Highlights

For the full year, Treasury yields ended 2022 sharply higher, as persistently high price pressures forced the Federal Reserve (Fed) to raise interest rates at the most rapid pace in over 40 years. After reaching year-to-date highs in late October, the U.S. ten-year Treasury yield moved lower during the fourth quarter. In contrast to the summer months, realized inflation during the period came in weaker than expected, with easing of goods inflation and commodity prices. Conversely, recent economic data exhibited positive growth momentum and a still hot labor market. The quits rate is still at an elevated level despite job openings moderating.

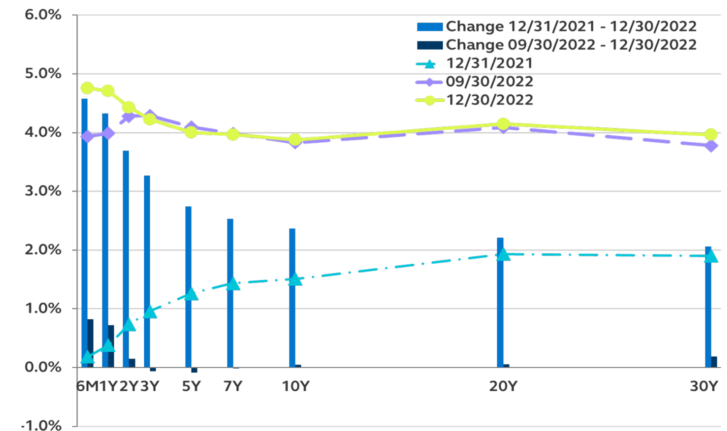
After hiking by 75bps for the fourth consecutive meeting, the November FOMC meeting minutes suggested Fed officials were becoming increasingly concerned about the risk of overtightening. Despite this messaging, the Fed continued to firmly reiterate its hawkish stance to combat inflation but opted to slow the cadence of hikes to 50bps at the December meeting, lifting the Fed Funds target range to 4.25 – 4.50%. The updated Summary of Economic Projections (SEP) for December showed 17 out of 19 FOMC participants projected Fed Funds at greater than 5% at year-end 2023, with the median forecast at 5.1% (vs prior 4.6% in September). Although the Fed signaled it would hold rates at above 5% for the entirety of 2023, market implied expectations are pricing in rate cuts during the second half of 2023.

Outlook

With the recent moderation in realized inflation, we feel more confident that we have seen peak inflation. Although prices are pointing towards a downward trajectory, inflation will still be too elevated for the Fed's comfort. The resiliency of the labor market and wages provides risks to services inflation despite comforting news on the goods sector. Therefore, we still see risks to the market's expectations of several policy cuts by the end of the year.

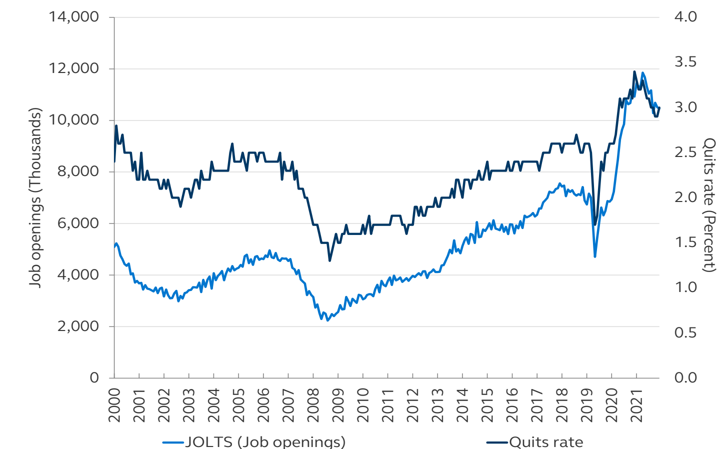
Several developments we are monitoring include an earlier than expected end to China's zero-Covid policies. We would assume the re-opening would be a series of starts and stops, but a full re-opening may provide upward pressure on commodity prices. Also, we are monitoring further changes to the Bank of Japan yield curve control or interest rate policies. Late in the year, the Bank of Japan surprised markets by expanding its ten-year JGB yield target to 50bps triggering a sell-off the global yields.

U.S. Treasury Yield Curve



Source: Bloomberg

Labor Market Tightness



Source: Bloomberg

Corporates

DECEMBER 31, 2022

Highlights

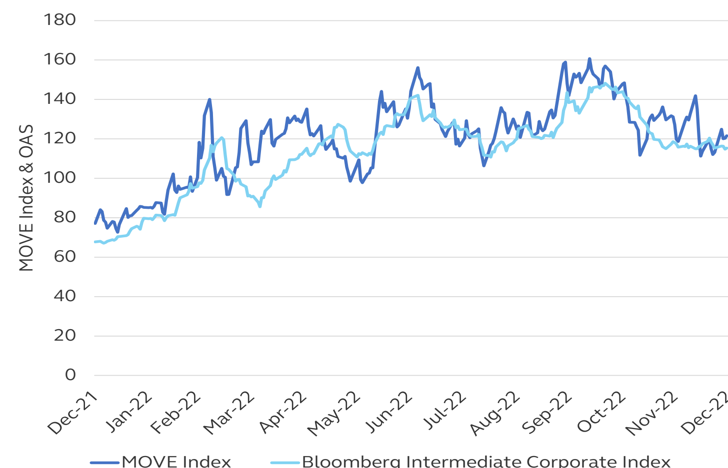
The Bloomberg U.S. Intermediate Corporate Bond Index generated total and excess returns of 2.72% and 1.64%, respectively, during the fourth quarter. For the full year total returns for the index were the worst on record at -9.40%, while excess returns for the year were -0.84%. Interest rates and credit spreads began the fourth quarter at their year-to-date highs owing to upside surprises to inflation and uncertainty regarding the hiking path of the Federal Reserve (Fed) and other global central banks. However, back-to-back lower than expected U.S. inflation readings and an end to the Fed hiking cycle in sight lowered rate volatility. Consequently, spreads broadly rallied into year-end.

IG credit spreads were volatile during 2022 driven by shifting macro data and sentiment. Technical factors were favorable, especially in the fourth quarter, with Q4 2022 gross issuance down -31% vs Q4 2021. Although supply started the year strong, FY 2022 issuance was 15% below FY 2021 levels. Despite negative retail flows and diminished overseas purchases for much of the year, historically attractive all-in yields and cautious investor positioning supported demand. Furthermore, Q3 corporate earnings results came in above expectations with minimal downward revision to management guidance. Over 60% of S&P 500 companies beat consensus estimates for revenues and almost 70% of them beat on the bottom-line. Corporate balance sheets were also in good shape by historical standards, based on metrics such as interest coverage.

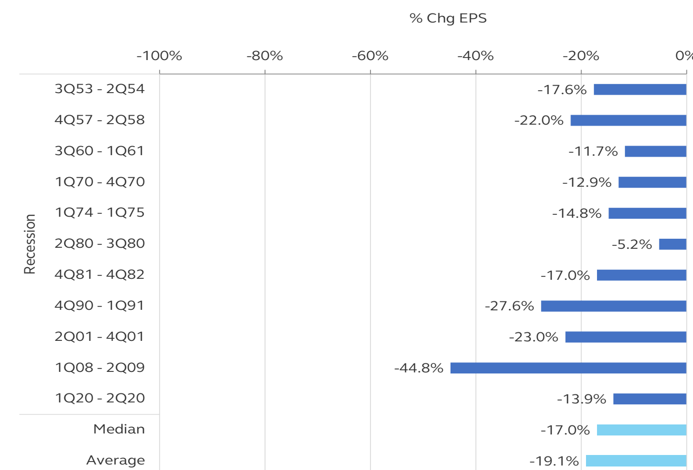
Outlook

We start 2023 on the cautious end of the risk spectrum. First, spreads are at the tighter end of recent trading ranges. Second, the beginning of the year has historically had a heavy issuance calendar. Third, the "long and variable lags" of central bank policies will be more impactful as the year progresses. Near-term, the expected direction of Fed policy will continue to be the primary driver of credit performance. Therefore, data leading up to the February 1st FOMC meeting will be a focus for markets. Further, the recent risk reversal is counter-productive to the inflation goals of the Fed. Therefore, we highlight the risk of a more aggressive push back to the loosening of financial conditions.

The start of the earnings season will provide clues on the upcoming earnings recession. Nominal growth should support top-line growth, but the margin outlooks should be challenged. Fourth quarter earnings consensus is currently for 0% growth, reflecting some of the pessimism. However, earnings have historically declined -19% on average during recessions, while the current consensus is for +3% year-over-year in 2023. Therefore, we would expect management guidance to continue to be revised downward.



Source: Bloomberg



Source: Bank of America

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Mortgage-Backed Securities (MBS)

DECEMBER 31, 2022

Perpetua Phillips
Portfolio Manager

MBS/ABS/CMBS

Highlights

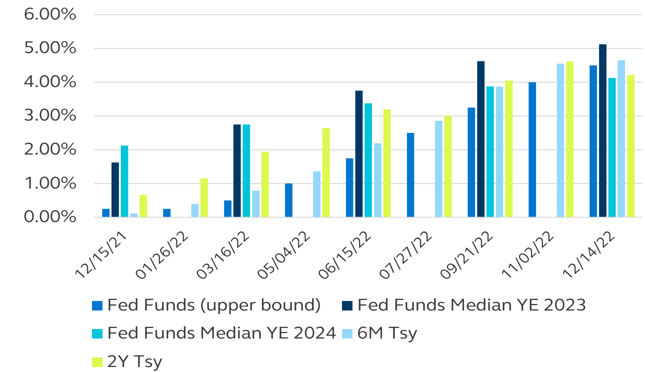
The Bloomberg U.S. Agency MBS Index posted total and excess returns of 2.14% and 1.06%, respectively, during the fourth quarter, partially recovering from one of the worst performance years ever for the sector. Full year total and excess returns were -11.81% and -2.23%, driven by hawkish monetary policy, sustained elevated rates volatility, and an inverted yield curve, all of which drove option costs sharply higher and prompted a marked widening of nominal spreads across the sector.

After running hot for much of the year, October and November inflation prints finally showed signs of decelerating, allowing the Federal Reserve (Fed) to step down to a 0.50% hike at their December policy meeting following four prior 0.75% hikes. For the year, the Federal Funds rate was raised by a total of 4.25% off a lower bound of 0%. The Committee continued to reduce the balance sheet under an MBS runoff cap of $35B/month, although actual paydowns fell well short at just $15-$20B/month during the quarter.

MBS current coupon zero-volatility spreads (ZVS) more than tripled from +50 bps at the start of the year to +179 bps in the middle of the fourth quarter before ultimately closing the year at +137 bps. The option-adjusted spread (OAS) followed a similar pattern, starting the year at +31 bps, reaching a YTD wide of +88 bps in mid-October and finally retracing to +51 bps at year-end. Both spread measures remain on the cheap side of fair from a historical context.

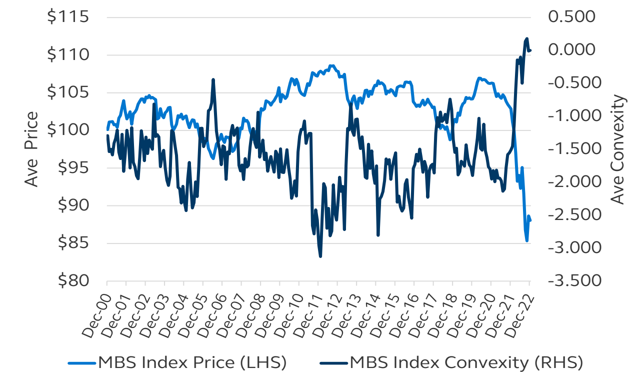
The yield to worst of the MBS index declined modestly over the quarter but increased by 273 bps year over year to close at 4.71%. Accordingly, the index duration extended by over a year to close at 5.8 years. Outstanding mortgages remain deeply out-of-the-money for refinancing as 30-year mortgage rates surged from 3% to 6.40% during the year, while the average coupon of MBS outstanding remained below 2.80%. Conventional 30-year prepayment speeds fell to just 4.4% CPR in December as continued weak housing markets dampened turnover and cash-out speeds. Gross and net supply declined to $258B/$78B for the fourth quarter and $539B/$1.7T for the year.

Fed & Market Rates



Source: Bloomberg

U.S. MBS Index Price & Convexity



Source: Bloomberg

Outlook

After a very challenging 2022 we view the performance outlook for MBS in 2023 as decidedly more positive. With inflation readings easing the Fed should have enough leeway to conclude their historic tightening cycle in the first quarter. Short term Treasury rates have largely repriced to expected terminal Fed Funds levels, which should drive short-dated volatility significantly lower. Net originator supply of MBS is expected to decline to around $250B in 2023, while the Fed could end quantitative tightening in the coming year once their balance sheet reaches target levels. MBS nominal spreads to Treasuries and IG corporates remain cheap and may benefit from flight-to-quality bids in a recession, while bank demand for MBS could improve if loan demand declines. Finally, fixed income fund outflows in 2022 could shift to inflows this year as investors reallocate from equities in a weakening macroeconomic environment.

With absolute yields near 15-year highs, an average dollar price of just $88 and flat/positive convexity profiles, the MBS sector currently provides exceptionally attractive investment opportunities within our stable value portfolios. The sharp and rapid rise in rates over the past year has resulted in most discount coupons having fully extended, while prepayment risks are minimal and in the case of deeply discount priced issues, beneficial in the event rates decline into a modest recession. As a result, we believe the sector currently offers a uniquely attractive opportunity to add high quality, durable yield, liquidity and stability to our portfolios.

Asset-Backed Securities (ABS)

DECEMBER 31, 2022

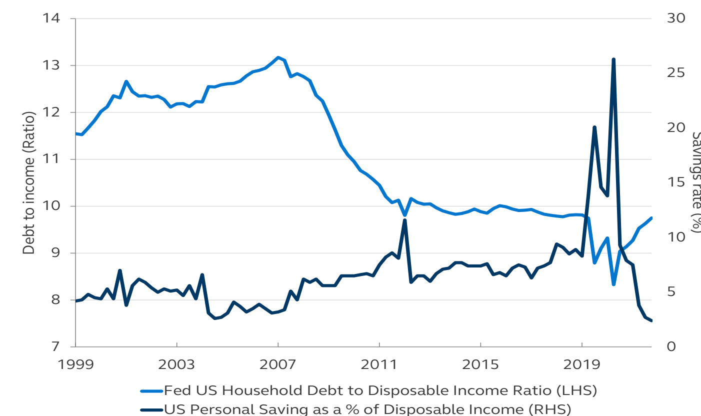
Highlights

The Bloomberg AAA Asset Backed Securities (ABS) Index posted total and excess returns of 0.90% and -0.12%, respectively, during the fourth quarter. Broad markets were lifted during the fourth quarter by signs that stubbornly high inflation may have peaked, which in turn supported the view that central banks may be able to ease up on aggressive tightening measures. After two consecutive months of CPI reports coming in below expectations, the Federal Reserve delivered a 0.50% rate hike in December, stepping down from prior 0.75% rate hikes. During the quarter, the two-year U.S. Treasury rate increased 0.15% to 4.43%. The two and ten-year yield curve continued to be deeply inverted as the market is increasingly concerned that a recession could be on the horizon.

In October, a federal appeals court temporarily stopped the Biden administration from moving forward with its plan to forgive up to $20,000 in federal student-loan debt for millions of Americans. The Justice Department appealed the ruling and the student loan forgiveness plan remains stalled. The Biden administration has turned to the US Supreme Court to seek a reversal of the 5th US Circuit Court of Appeals decision. The high court will hear arguments on a fast-track basis in February, putting the matter on course for a definitive ruling by June at the latest. The White House extended the halt on federal student loan repayments for the eighth time. The freeze on federal student loan repayments, first adopted in March 2020 under President Trump, was set to resume January 1st, but now won't be required until June 30th or until 60 days after legal challenges to President Biden's federal student-debt forgiveness plan are settled.

The pace of ABS new issuance saw heavy supply in the first half of 2022 (on pace with the record issuance of 2021), but slowed materially in Q3 and Q4 ending at $244bn, in line with the pre-covid average. New issuance for 2023 is expected to be $230bn. ABS spreads broadly trailed macro moves to YTD wides and underperformed versus Corporate OAS as measured by Bloomberg before rallying in December. The largest dislocations occurred in Subprime Auto Loans and Unsecured Consumer Loans. Investor demand is highly selective with the strongest demand in high quality benchmark names. We expect continued spread volatility due to tightening monetary conditions and recession concerns.

Consumer Balance Sheet

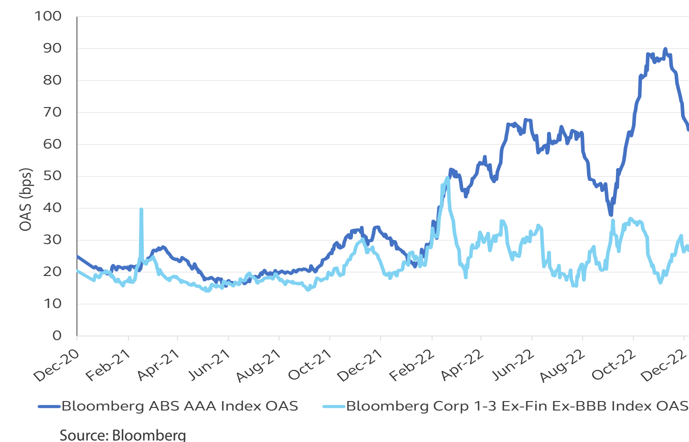


Source: Bloomberg

Outlook

Despite elevated inflation, the U.S. consumer remains supported by a strong labor market; both the unemployment rate and new jobless claims are holding steady near pre-COVID lows. However, job openings are beginning to trend lower, suggesting that restrictive monetary policies are starting to effect labor markets. Although the typical U.S. consumer began the year in an excellent condition due to savings accumulated during the pandemic, persistently high inflation is beginning to stress household balance sheets. Due to an inflation rate that exceeds the pace of wage increases, consumers are increasingly relying on credit card debt to maintain spending as savings becomes depleted. However, despite declining savings, household debt-to-income ratios remain near pre-COVID levels and significantly lower than Great Financial Crisis levels.

ABS vs Corporates Spreads



Source: Bloomberg

ABS fundamentals are supported by low unemployment levels, and delinquency rates among consumer ABS sectors mostly remain at low levels. However, fundamental factors are weakening at a gradual pace from exceptionally strong levels. Stable to moderately weaker credit metrics for consumer related ABS is expected into 2023. Inflation is impacting subprime borrowers more negatively than prime borrowers. Higher unemployment and consumer debt increases the risk to the downside. ABS structures are generally still robust and well protected. Within the ABS market, we prefer up in quality trades over the near term due to lingering uncertainty around inflation, fed policy, and the economy. Valuations appear attractive when compared to U.S. Treasuries and other short duration alternatives.

Commercial Mortgage-Backed Securities (CMBS)

DECEMBER 31, 2022

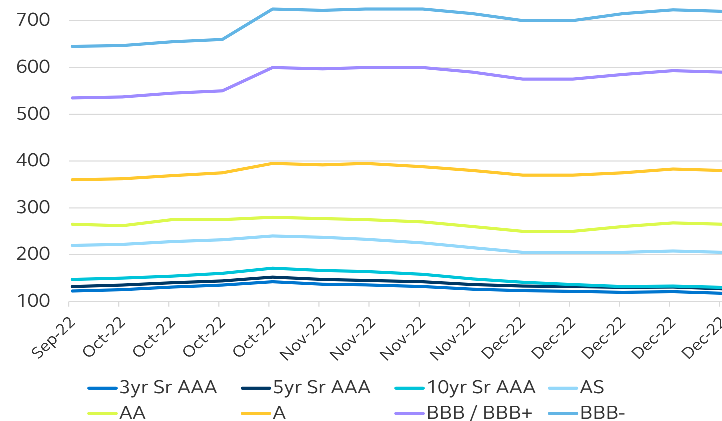
Highlights

The Bloomberg AAA Commercial Mortgage-Backed Securities (CMBS) Index posted total and excess returns of 1.25% and 0.13% in the fourth quarter, bringing full year returns to -10.53% and -0.73% respectively. During the fourth quarter, the consistent themes of persistent inflation, interest rate volatility, current and future monetary policy expectations and recession fears continued to move the market. A liquidity squeeze moved interest rates 50 basis points higher and spreads wider in October, but market conditions improved in November and December and rates ended the quarter relatively unchanged. The CMBS credit curve ended the quarter steeper as AAA spreads tightened 15-20 basis points and lower rated BBB spreads widened 50-60 basis points. Spreads on AAA rated floating rate SASB bonds tightened during the quarter as well.

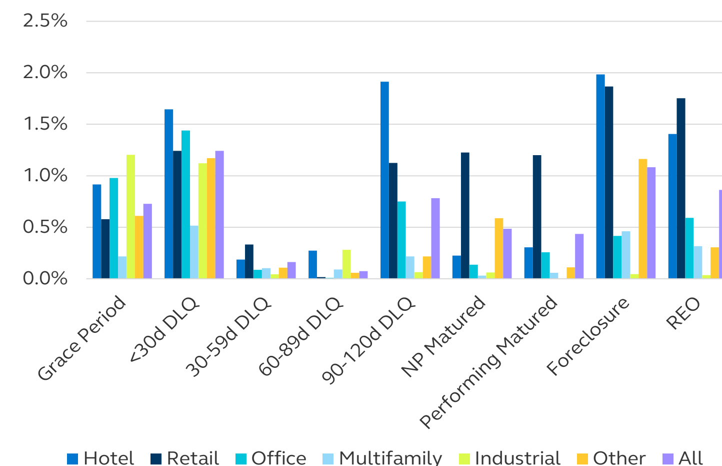
New issue activity continued to be materially hampered by slow lending activity due to the impact that the spike in market volatility and interest rates is having on the pace of lending. The $8B of private label issuance was down another 50% from third quarter 2022 and down 85% from fourth quarter 2021. Private label conduit issuance during the quarter was $3B compared to fourth quarter 2021 issuance of $8B. Private label SASB issuance was $3B compared to third quarter 2022 issuance of $10B and fourth quarter 2021 issuance of $34B. The lower levels of supply helped to lower spread volatility during the quarter, but continued fund flows out of fixed income bond funds and market volatility pressured spreads and contributed to the steepening of the CMBS credit curve during the quarter.

Outlook

The outlook for CMBS has shifted from being driven by the impact of Covid-19 on economic activity to the urgency for the Fed to get ahead of inflation. Investors will be following closely the impact of higher rates and shrinking the balance sheet on economic growth. Historically there has been a strong correlation between job growth and loan delinquencies with a 12–18-month lag. As the probability of a recession increases the risk premium in the market is starting to reflect delinquencies moving higher. This is especially true with office as demand is already being impacted by work-from-home policies and lower office demand even before a potential recession. Market technicals are expected to be supportive of spreads during the first half of 2023 as the move wider in spreads and higher volatility year-to-date has slowed down lending activity, which is expected to result in a slower pace of new issuance to start 2023.



Source: JP Morgan



Source: JP Morgan

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DECEMBER 31, 2022

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The Bloomberg U.S. 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 AAA ABS Index represents the asset-backed securities within the Bloomberg U.S. Aggregate Index.

The Bloomberg AAA CMBS Index represents the commercial mortgage-backed securities within the Bloomberg U.S. Aggregate Index.

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