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Principal Asset Management℠

Principal Morley

Interest rate strategy

JUNE 30, 2023

DAN KANG, CFA
Portfolio Manager

Rates/Corporates

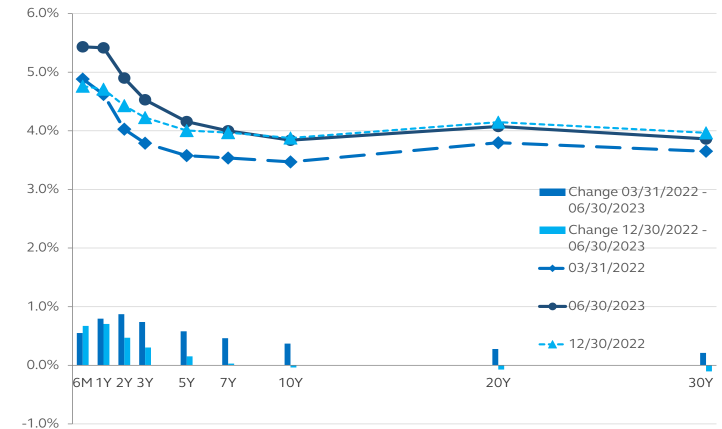
Highlights

During the second quarter, the yield curve bear-flattened, with the yield on the U.S. ten-year rising 37 bps to 3.84%. Despite the Federal Reserve (Fed) opting to keep rates unchanged at the June meeting, the updated Fed Dot Plot suggested policymakers would raise rates twice more this year. In response, the market priced-out rate cuts this year and the 2-year yield reapproached 5%. The Fed continues to stick to its "higher for longer" messaging, as measures of core inflation remain uncomfortably high, and the labor market and consumer continue to show signs of resilience. The re-steepening of the curve in March amid regional bank failures was short-lived as imminent recession fears receded, with the 2y10y curve retesting cycle lows below -100 bps at quarter-end. Moreover, a temporary resolution to the U.S. debt ceiling and a possible end in sight to Fed rate hikes helped fuel a rally in risk assets. Rate volatility also subsided, with the MOVE Index dropping back toward 100 after peaking near 200 in March.

Outlook

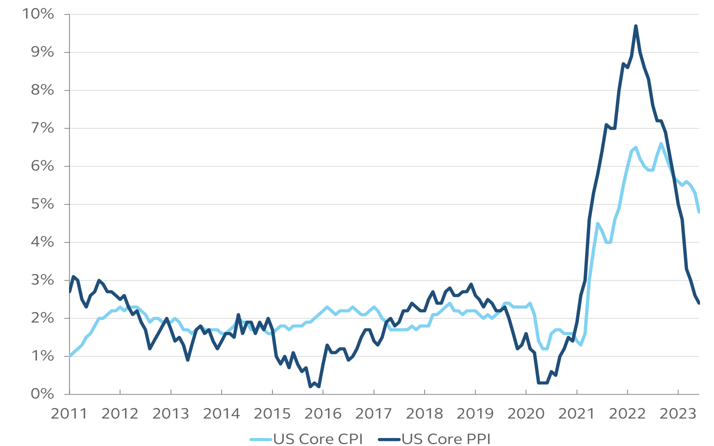
With the resilience in the economic data, a July hike appears to be assured while additional hikes are still debatable. With the acute stresses of the regional banking crisis in the rear-view mirror, we will return to the growth and inflation factors in determining the future rate path. Although inflation has fallen from its peak levels, it is still above the comfort level of central bankers. In the 2nd half of this year, inflation trends should benefit from falling used car prices and housing costs while the dramatic decline in PPI points to "pipeline" disinflation. Similarly, labor market tightness and subsequent wage pressure have lessened from the peak levels. Key indicators show a broad normalization in labor markets including rising initial jobless claims, a lower average work week, lower quit rates and lower job openings. However, a more meaningful deterioration in labor market conditions is likely required to achieve the Federal Reserve's inflation targets. We would expect wider cracks in the labor market as we approach the end of the year.

U.S. Treasury Yield Curve



Source: Bloomberg

Core inflation



Source: Bloomberg

Principal Morley

Principal Asset Management℠

Corporates

JUNE 30, 2023

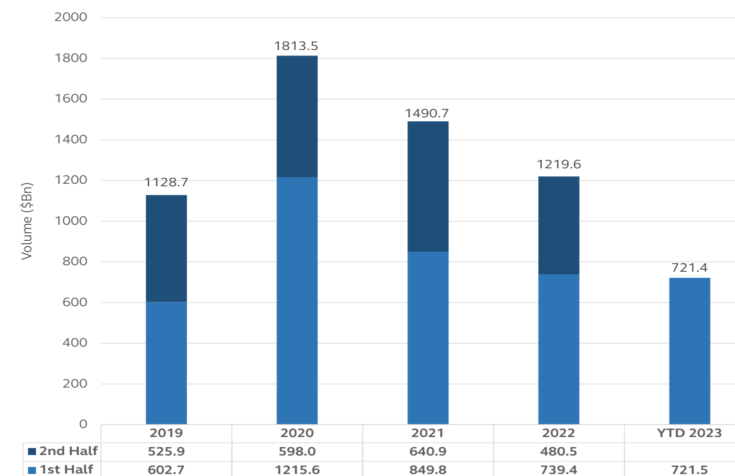
Highlights

During the second quarter, Investment Grade (IG) credit spreads tightened as the sector recovered from the regional banking crisis in March. The Bloomberg U.S. Intermediate Corporate Bond Index delivered a total return of -0.16% with an excess return of 1.10% for the period. The index's option-adjusted spread (OAS) narrowed from 127 bps to 109 bps (-18 bps) in Q2 and has tightened by 7 bps year-to-date. This tightening was supported by a more favorable macro environment than initially anticipated, as the economy remained resilient despite the Federal Reserve's tightening measures. The current high all-in investment grade yields are driven by higher risk-free yields, while corporate fundamentals have stayed strong with corporate earnings surpassing expectations.

Market technicals also contributed to positive performance for the sector in the second quarter. Regional banking stresses and subsequent market volatility led to subdued supply at the start of the quarter, but new issuance rebounded strongly in May. Consequently, IG gross issuance for the first half of 2023 was the fourth highest first half issuance in history, only trailing the three prior years (-2% vs YTD 2022, -15% vs 2021, and -41% vs 2020). Demand was supported by the return of overseas investors and retail investors. High Grade funds experienced positive fund flows for 25 out of the first 27 weeks of the year totalling $122B versus an outflow of $157B for the full year 2022. Foreign demand for investment grade credit surged to $119B YTD vs $52B for the full year 2022 according to Citigroup.

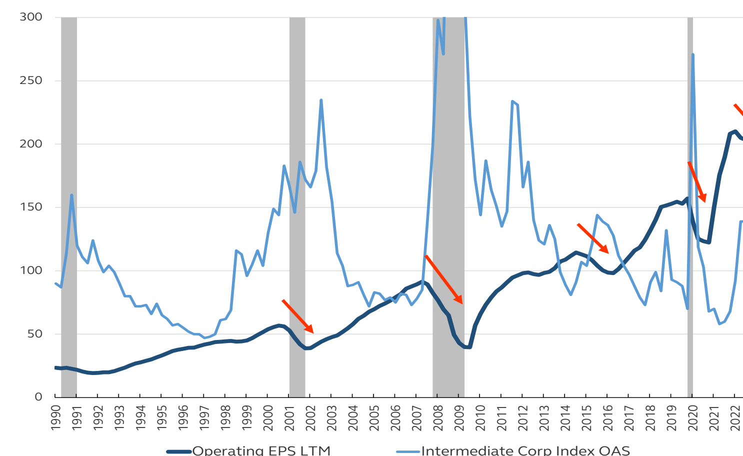
Outlook

For the second half of the year, we would expect a further slowdown in economic activity with a potential recession towards year end. The current consensus for second quarter earnings is a decline of -9% yoy which would represent trough earnings for this cycle. In addition, expectations are that earnings will rebound during the second half of the year. However, this would be inconsistent with historical patterns where earnings growth bottoms at the tail end of recessions. Fundamentals have peaked for now; however, the deterioration has been modest so far. An earnings trajectory consistent with past recessions should result in a more meaningful fall in credit metrics. In the meantime, the technical backdrop continues to be supportive as relatively heavier issuance in the first half may lead to lighter activity for the rest of the year. Demand for yield will continue to be robust as rate volatility has settled as we near the end of the Fed hiking cycle.



	2019	2020	2021	2022	YTD 2023
2nd Half	525.9	598.0	640.9	480.5	
1st Half	602.7	1215.6	849.8	739.4	721.5

Source: Morgan Stanley



Source: Bloomberg

Principal Morley

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Mortgage-Backed Securities (MBS)

JUNE 30, 2023

Perpetua Phillips
Portfolio Manager

MBS/ABS/CMBS

Highlights

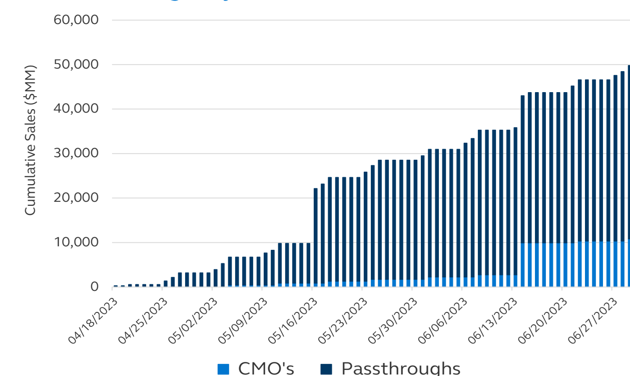
The Bloomberg U.S. MBS Index posted total and excess returns of -0.64% and +0.76%, respectively, during the quarter as rates markets sold off and risk markets rallied. MBS investors navigated a host of headwinds including a glut of new supply, U.S. debt ceiling negotiations, Fed policy uncertainty and surging yields. The two-year Treasury yield climbed by 87 bps to 4.90%, while the ten-year rose 37 bps to close the quarter at 3.84%. The yield curve (2Y/10Y) inverted a further 50 bps to close near a record low of -106 bps.

Supply technicals were challenging for MBS during the quarter, as net originator supply accelerated to $66B and Fed balance sheet runoff added another $58B. On top of this, the FDIC's liquidations of the failed Silicon Valley and Signature Bank's holdings began in mid-April. Over $50B in Agency passthroughs and CMOs was sold during the quarter, met by surprisingly strong demand. The introduction of upsizing options accelerated the pace of liquidations as the quarter progressed. Money managers absorbed the bulk of supply, supported by positive taxable bond fund flows, while banks remained largely sidelined.

A decline in rates volatility off March banking crisis-highs provided early support for the basis. Volatility measures moved higher again in May but abated later in the quarter following the deal to suspend the U.S. debt ceiling and the FOMC's decision to hold rates steady in June following their May hike. MBS spreads to Treasuries rallied sharply, with the current coupon nominal spread declining off a high of 183 bps to close the quarter at 157 bps while the OAS of the MBS index fell 19 bps to close the period at +50 bps.

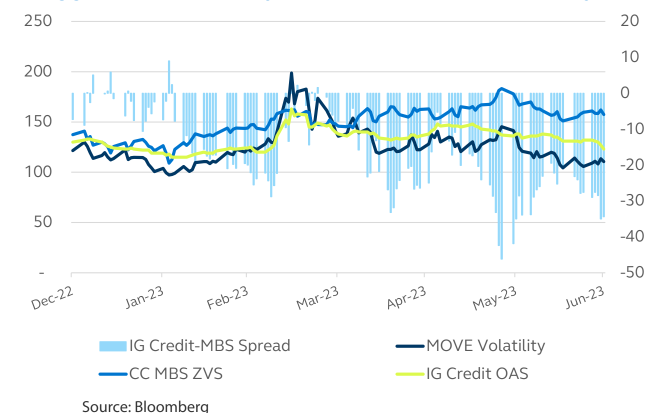
Thirty-year primary mortgage rates rose with the broader market selloff, approaching 7% by quarter-end. MBS prepayment rates and cashflows have been remarkably stable as most homeowners are locked into substantially lower mortgage rates. June prepay speeds averaged just 6% CPR despite the month typically representing the peak in housing turnover.

FDIC liquidations of Silicon Valley Bank/Signature Bank Agency MBS totaled $50B in Q2



Source: Bank of America

Agency MBS performance lagged IG credit this year due to elevated volatility



Source: Bloomberg

Outlook

We believe the headwinds that have tempered MBS performance YTD will become tailwinds going into the second half of the year. Originator supply is expected to decline following the seasonal peak in summer issuance, while nearly 70% of the FDIC sales have been completed as of early July. Meanwhile, a resumption in bank demand later this year could provide a sizeable performance boost once deposit flows stabilize. The prolonged and significant inversion in the yield curve suggests recession risk remains high while credit conditions are tightening, which could shift banks' focus from loans to securities. Indeed, now that they've successfully completed Fed stress tests, larger banks may just be waiting on clarity around new capital requirements and regulatory frameworks before implementing such changes.

Rates volatility has been the greatest headwind to sector performance over the past year. The MOVE volatility index has averaged around 125 since the Fed commenced rate hikes last year, compared to the longer-term average of around 60. We believe the Fed is nearing the end of this historic tightening cycle and the ensuing normalization in volatility will become a powerful tailwind to MBS performance. Notably, elevated volatility has been the primary force driving MBS valuations to historically cheap levels relative to investment grade credit and we believe this is poised to reverse over the coming quarters. In addition, MBS have historically outperformed other spread sectors in late cycle/recessionary environments and are thus positioned for strong forward performance in the second half.

Asset-Backed Securities (ABS)

JUNE 30, 2023

Highlights

The Bloomberg AAA Asset Backed Securities (ABS) Index posted total and excess returns of -0.14% and 0.58%, respectively, during the second quarter. Despite another turbulent quarter, risk markets ended with gains as economic data continued to show pockets of strength. Markets navigated fallout from the banking crisis, a prolonged political battle over the U.S. debt ceiling, and restrictive central bank policy. Despite these headwinds, markets were buoyed by resilient labor markets and improvement in inflation. Strong employment levels supported continued consumer spending which in turn helped drive economic growth in the first half of the year and better than expected company earnings results. The fact that the Federal Reserve (Fed) has been able to make progress on inflation without causing major cracks in the labor market provided hope that a soft landing may be possible. During the quarter, the two-year U.S. Treasury rate increased the most, rising 0.87% to 4.90%. The five-year yield rose 0.58% to 4.16% and the ten-year rate increased 0.37% to 3.84%. The two and ten-year yield curve became more deeply inverted during the quarter as risks to the economy remain substantial.

The Supreme Court struck down the Biden Administration's student loan forgiveness plan in a widely expected outcome. Given the resumption in required payments, there is a potential for delinquencies to increase moderately in other forms of consumer debt. Delinquency rates have continued to move modestly higher, particularly for the most at-risk consumer segments. In the used car market, prices have resumed their move lower, dropping 10% during the second quarter, reversing gains seen during the first three months of the year.

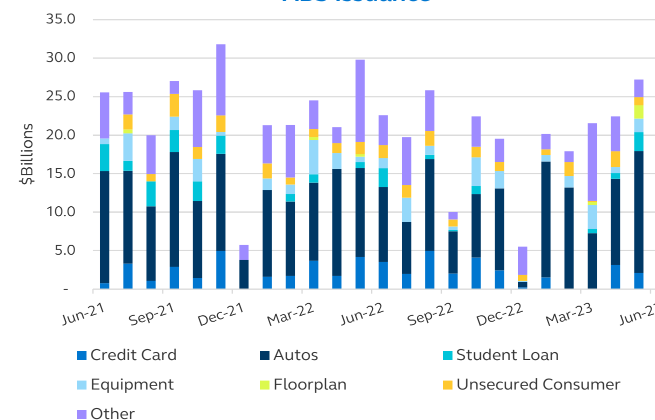
ABS new issuance totaled $70bn in the second quarter as compared to $73bn for the same period in 2022. On a year-to-date basis, $129bn has been issued in 2023 compared to $142bn for the first half of 2022. However, issuance trends have not been evenly distributed across sectors. For example, prime auto ABS issuance is up 27% year over year as banks and other issuers look to diversify funding sources. Total ABS new issuance for 2023 is expected to be $230bn. ABS spread moves were broadly in line versus the Corporate OAS as measured by Bloomberg.

Outlook

Both the unemployment rate and new jobless claims in the U.S. remain near pre-COVID lows. Hiring remains resilient, particularly due to manufacturing reshoring as companies seek to reduce their vulnerability to supply chain disruptions. In addition, U.S. investments in chips and electric vehicle battery production continue to drive hiring. However, consumers are increasingly relying on credit card debt to maintain spending as savings built up during COVID becomes depleted. In addition, student loan borrowers will face further headwinds as student loan payments are set to resume.

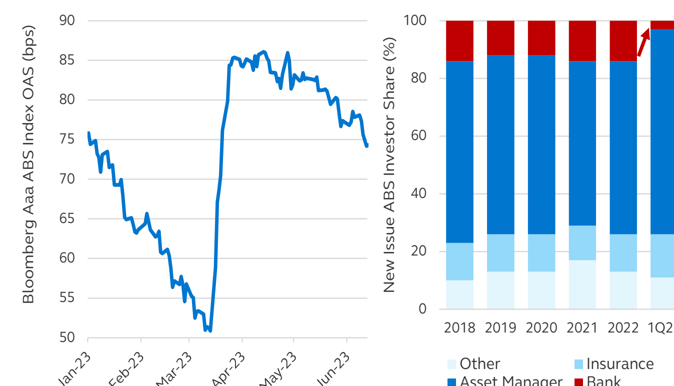
ABS fundamentals remain on solid footing, supported by low unemployment levels. Although consumers are facing headwinds and delinquency rates are rising from low levels, ABS structures have proven their resilience through multiple economic cycles. Pricing remains attractive following the March banking crisis that pushed spreads significantly wider. Banks have historically comprised a meaningful portion of the ABS new issue investor base, but their demand dropped dramatically amid deposit flight in March. The wider spreads from the supply-demand imbalance, together with the resilient ABS structures, presents a compelling opportunity to investors.

ABS Issuance



Source: JP Morgan

Wider ABS spreads on market technicals



Source: JP Morgan and Bloomberg

Commercial Mortgage-Backed Securities (CMBS)

JUNE 30, 2023

Highlights

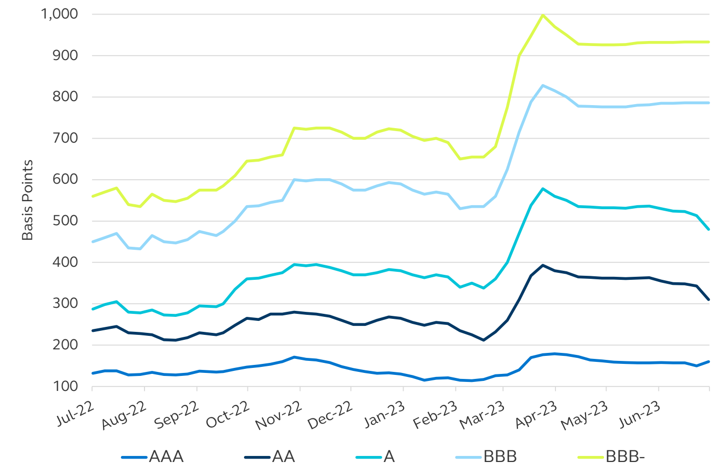
The Bloomberg AAA Commercial Mortgage-Backed Securities (CMBS) Index posted total and excess returns of -0.57% and 0.86%, respectively, during the second quarter. During the quarter, the consistent market risk themes of interest rate volatility, current and future monetary policy expectations and recession fears were softened by the regional banking crisis from March being contained to a few banks. However, the combination of higher rates, looming recession, softening office demand and banks tightening lending standards has kept commercial real estate, and especially refinancing loans that are maturing in the next 6-12 months, at the forefront of the market. The CMBS market did experience a relief rally as the regional banking sector stabilized with AAA spreads ending the second quarter 20bps tighter, AA spreads 70bps tighter, A spreads 80bps tighter and BBB spreads 30bps tighter according to JPMorgan.

New issue activity picked up during the quarter for both conduit and SASB issuance. However, issuance for the first half of 2023 was still down 63% from the first half of 2022, primarily driven by lower SASB issuance. The $10.5B of private label issuance, during the second quarter, was up 75% from first quarter 2023 but down 50% from second quarter of 2022. Private label conduit issuance during the quarter was $6.1B compared to first quarter 2023 of $3.3B and second quarter 2022 of $6.0B. Private label SASB issuance was $4.4B compared to first quarter 2023 of $2.7B and second quarter 2022 of $14.3B. The secondary CMBS market continues to be active, with signs that real estate equity transactions and bank lending are picking up, issuance is expected to be 5-10% higher during the second half of 2023.

Outlook

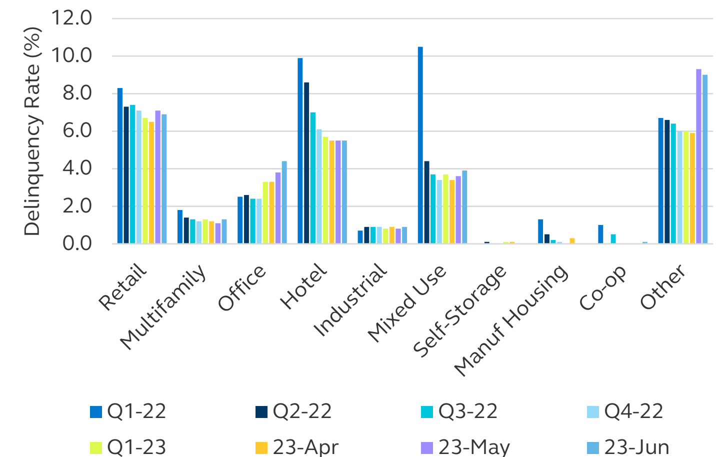
The outlook for CMBS remains primarily focused on refinancing loans maturing in 2023 and office loan fundamentals, including how far income will decrease as occupancy and rents have yet to find near-term equilibrium. While the headline number for loans maturing on bank balance sheets in 2023 is high, loans maturing in the next 12 months from 2.0 fixed rate conduit deals is just over 10% of the market at $34B. There are less than 9% of outstanding office loans maturing at $9.1B and there are just over 15% of retail loans maturing for $13.7B, consisting mainly of regional mall loans from the 2012-13 vintages. The real test for the market will be how well 2.0 CMBS underwriting holds up with property level incomes under pressure, especially for office. Current market pricing implies that term defaults will also increase along with maturity defaults. Our outlook is that 2.0 CMBS should protect from term defaults becoming systematic but the depth and duration of the recession, if it happens, will determine how far income levels drop.

CMBS spreads across the capital stack tightened off wides reached during March regional banking crisis



Source: JP Morgan

Conduit delinquencies trending downward across property types except office



Source: Citigroup

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Important Information

JUNE 30, 2023

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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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