Interest Rate Strategy

Morley Capital Management

Highlights

In the first quarter, the U.S. Treasury curve sharply bear-flattened as concerns surrounding the Omicron variant shifted to geopolitical concerns surrounding the Russia-Ukraine conflict. Geopolitical concerns, coupled with ongoing inflationary pressures and a more hawkish tone by the Federal Reserve led to a risk-off tone across markets. Over the quarter, the 2 year U.S. Treasury yield rose 160 basis points and the 10 year Treasury yield rose 83 basis points, both settling at 2.34% for a flat 2s/10s spread to end the quarter. Other parts of the Treasury curve inverted in March, such as the 5s/10s and 7s/10s. These large rate moves coincided with high volatility in the Treasury market, with the MOVE Index reaching as high as 140 in March, the highest level since 2020. As inflation data continued to print levels unseen in decades, geopolitical tensions exacerbated the inflation risk due to commodity spikes and worsening supply-chain woes.

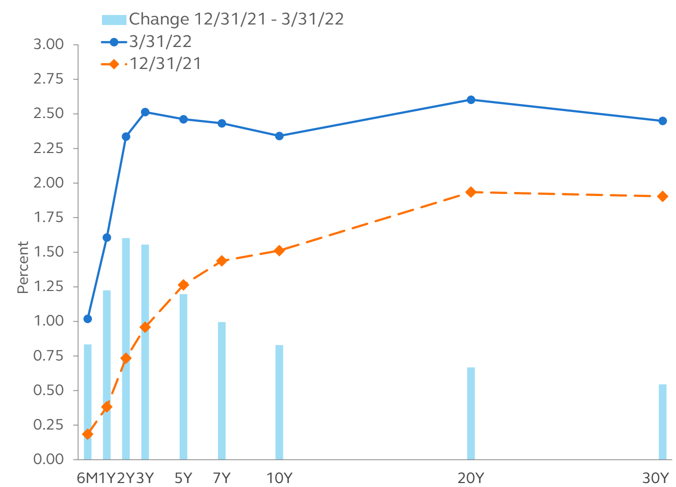
At the March FOMC meeting, the Fed hiked rates by 25 basis points and indicated a near-term reduction in its balance sheet. The Fed's Summary of Economic Projections (SEP) implied seven 25 bp hikes this year, or an implied Federal Funds Rate of 1.88%, while the median dot for 2023 indicated 3.5 hikes, or a 2.8% target rate. The long-term neutral rate was projected to be around to 2.4%. In late March, markets began pricing 50 basis point hikes at the May and June meetings, following hawkish comments from Fed speakers including Chairman Powell.

As revealed during the March meeting minutes, FOMC members proposed to cap the monthly pace of roll-offs from the balance sheet at $60b in Treasuries and $35b in Agency MBS, which is roughly double the peak rate of $50b per month during the 2017-19 tightening cycle. The Fed will likely phase in the caps over a period of three months and approve the plan at the May meeting.

Outlook

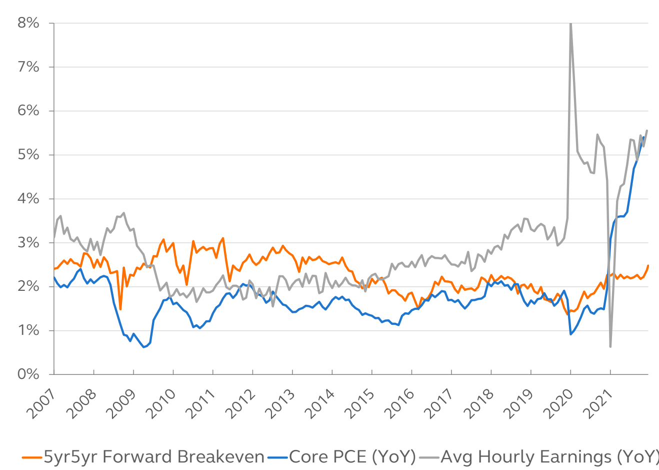
Despite a significant amount of tightening priced into the rates market, we still expect yields to rise over the course of the year. With an economic imperative to combat inflation, we see multiple 50 bp hikes over the next several FOMC meetings. Further, we see significant risk of going beyond the neutral rate if inflation remains uncomfortably high for most FOMC members. Inflation expectations are elevated but not unhinged, allowing the Fed to rebuild its inflation fighting credibility. We expect the medium-term trend of flatter curves to still be intact during this hiking cycle.

U.S. Treasury Yield Curve



Source: Bloomberg

Inflation vs Inflation Expectations



Source: Bloomberg

Dan Kang, CFA
Portfolio Manager

Rates/Corporates

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Corporates

Morley Capital Management

Highlights

The Bloomberg U.S. Intermediate Corporate Bond Index generated total and excess returns of -5.26% and -0.74%, respectively, in the first quarter. The Fed signaling a steeper tightening path and Russia's invasion of Ukraine in mid-February, led to a risk-off sentiment across markets. The backdrop of spiking rates and equity volatility weighed on corporate spreads through mid-March, before sharply reversing into quarter-end.

During the quarter, companies opportunistically pulled forward their debt issuance ahead of expected Fed hikes, while demand from investors was mixed. Primary investment grade issuance was the third highest quarter in history, totaling $465B (+3% yoy), led by Financials and M&A/spin-off related financings. March 2022 set a single month record for M&A/spin-off debt-related financing including the $30B issued for the Discovery/Warner Media transaction. During the first quarter retail bond funds experienced $28B in net outlfows compared to $324B in inflows during the first quarter of 2021. For the quarter, short duration strategies experienced the most outflows. Higher yields attracted Asian investors during the quarter, resulting in increased buying of U.S. investment grade debt.

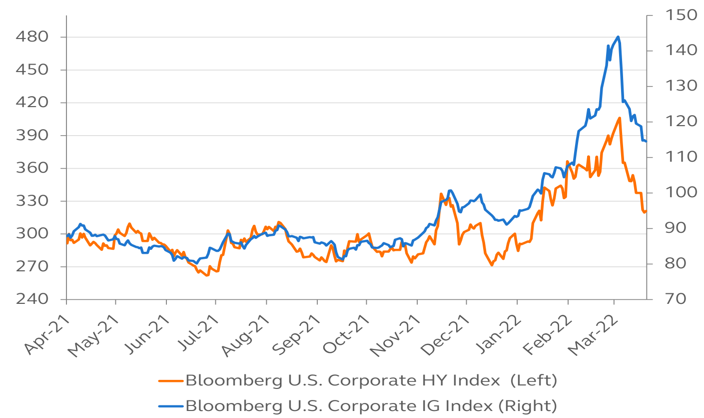
Despite some technical weakness, credit market fundamentals remained strong. Aggregate credit metrics returned to pre-Covid levels with continued upward ratings migration. During the quarter, there were approximately $40B in rising stars, including Kraft Heinz ($16B), with no fallen angels. The relative underperformance of investment grade corporate bonds versus high yield bonds indicated that the market sell-off reflected technical factors versus fears of fundamental deterioration in credit quality.

Outlook

After a challenging start to the year, investment grade bonds experienced the worst total returns in decades. This usually portends continued weak retail flows into the asset class. However, we would expect supply trends to be more favorable over the course of the year, as both the early year pull-forward issuance dynamic and higher rates reduces opportunistic issuance.

With the brief inversion of the Treasury curve, fears of recession have risen. We believe those concerns are pre-mature, but we will continue to be on "Recession Watch." While the recent inversion may not have lasted long enough to warrant a signal, during the last four yield curve inversions corporate bonds on average, generated positive excess returns three and six-months afterwards. Over the medium-term, we expect spreads to widen as the market incorporates higher recession risks.

Bloomberg IG vs HY Index OAS

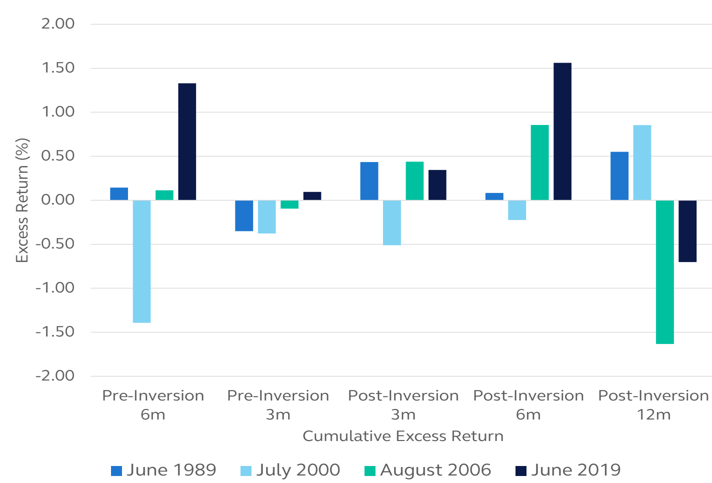


Bloomberg IG vs HY Index Performance

12/31/2021 - 03/31/2022	U.S. Corporate IG Index	U.S. Corporate HY Index
Total Return	-7.69%	-4.84%
Excess Return	-1.45%	-0.92%
OAS Chg (bps)	22	38
OAS Chg (%)	24%	13%

Source: Bloomberg

3m/10y Yield Curve Inversions
Bloomberg Intermediate Corporate Index Excess Return



Source: Bloomberg

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Mortgage-Backed Securities (MBS)

Morley Capital Management

Highlights

The Bloomberg U.S. Agency MBS Index posted total and excess returns of -4.97% and -0.71%, respectively, during the first quarter amidst a sharp move higher in rates and volatility. Elevated inflation and a hawkish pivot in Federal Reserve policy caused the yield curve to flatten across the maturity spectrum. The 10-year Treasury yield rose by 83 bps and the 2-year yield by 160 bps, with both closing the quarter at 2.34%.

The sharp move higher in interest rates caused implied volatility to surge by 40% over the quarter, increasing option costs on MBS. This, along with a challenging supply-demand outlook as the Federal Reserve begins quantitative tightening caused MBS spreads to widen by over 50 basis points, driving basis underperformance versus Treasuries.

The FOMC raised rates for the first time since 2018 at their March 16th meeting, bringing the fed funds target to 0.25-0.50%. Their quarterly economic projections included significant upward revisions to inflation forecasts while the dot plots signaled 7 rate hikes this year (with 50-bps moves possible) as the Fed front-loads policy tightening. The committee discussed plans to begin reducing their balance sheet as early as May by allowing up to \$35B/month in MBS (plus \$60B/month in Treasuries) to run off after a 3-month ramp-up period. Outright sales of MBS were considered appropriate after balance sheet runoff was “well under way”.

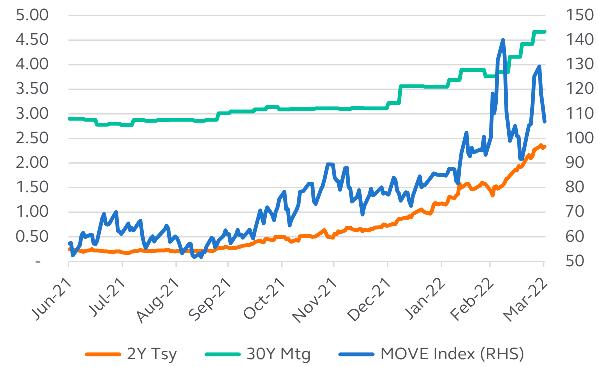
Primary mortgage rates rose by over 150 bps during the quarter, rendering 95% of MBS outstanding out-of-the-money to refinance and causing the MBS index duration to extend to 5.2 years. MBS supply remained robust at \$614B gross and \$216B net of paydowns but is expected to decline as higher mortgage rates constrain purchase and refinancing activity in the months to come.

Outlook

The dramatic market moves over the quarter have mixed repercussions for the MBS sector. On the positive side, valuations are more attractive following the sharp widening in nominal spreads, while the rapid surge in mortgage rates has effectively ended the refinancing wave of the past two years and should also temper supply. The duration of the MBS universe is almost fully extended, improving the overall convexity profile. Additionally, implied volatility has surged and may be close to peaking, which should benefit MBS as it moderates to more normal levels. Finally, a large share of MBS outstanding is locked up at the Fed (\$2.7T) and banks (\$2.9T), which limits tradeable supply, particularly for lower coupons.

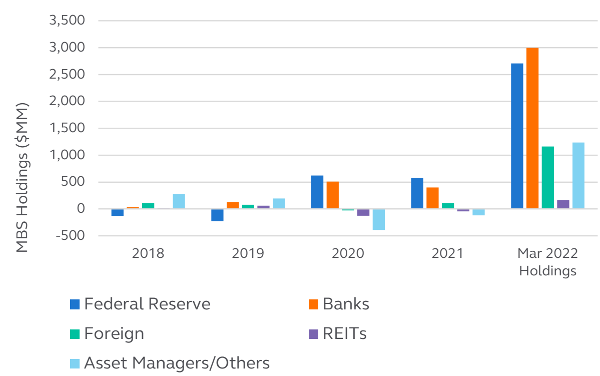
The sector faces key challenges arising from quantitative tightening, however. We expect dollar roll markets to weaken as gross Fed MBS purchases end over the next few months, likely leading to further spread widening. Furthermore, MBS markets are likely to begin pricing for the impact of outright MBS sales by the Fed well in advance of implementation. With most of the Fed’s MBS holdings deeply out-of-the-money to refinance it is likely that paydowns on their MBS book will average less than \$25B/month, raising the risk of outright MBS sales later this year if they desire a runoff pace closer to the \$35B/month cap. Coupled with \$475B net supply this year the technical headwinds for the sector may outweigh improved fundamentals and valuations. We therefore remain cautious, finding better opportunities in other structured products sectors.

Rates and Volatility



Source: Bloomberg

MBS Holdings Change



Source: Citi

Perpetua Phillips
Portfolio Manager

MBS/ABS/CMBS

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Asset-Backed Securities (ABS)

Morley
CAPITAL MANAGEMENT

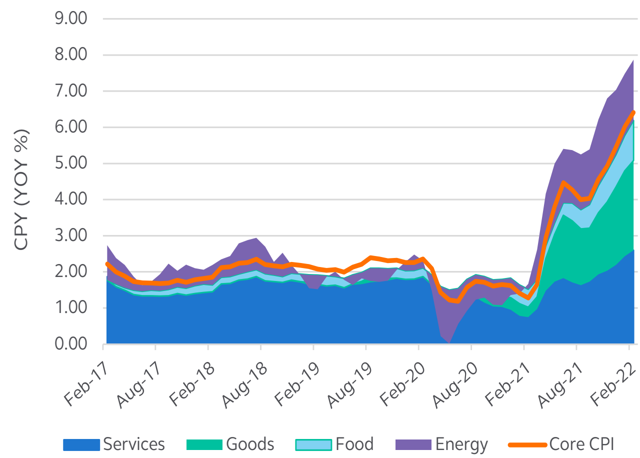
Highlights

The Bloomberg AAA Asset Backed Securities (ABS) Index posted total and excess returns of –2.91% and -0.27%, respectively, during the first quarter. Spreads in the ABS market widened with the OAS to Treasuries of the Bloomberg U.S. AAA ABS Index moving from 31 bps to 47 bps over the period.

Market volatility skyrocketed in the first quarter as investors began repricing for a more aggressive global monetary tightening cycle and reacted to Russia's invasion of Ukraine. Russia's invasion came as the market was already in a fragile state due to elevated inflation and imminent central bank tightening, causing a risk-off tone across global financial markets. Inflation continued to trend above expectations during the quarter, leading to a dramatic shift in outlooks for central bank rate increases. Following a 0.25% rate increase in March, about 2.00% of further Federal Reserve (Fed) hikes are now expected by the market this year, including a strong possibility of 0.50% increases at each of the next two Fed meetings. The U.S. Consumer Price Index (CPI) in February rose to 7.9% year-over-year, the highest level in four decades.

The U.S. Treasury curve continued to flatten to the point of within 1bp inversion on 2s/10s. The two-year U.S. Treasury rate increased 1.60% to 2.34% and the five-year rate increased 1.20% to 2.46%. Rates on the long end of the curve also increased as the ten-year yield rose 0.83% to 2.34% and the thirty-year rate increased 0.54% to 2.45%.

Consumer Prices



Source: Bureau of Labor Statistics

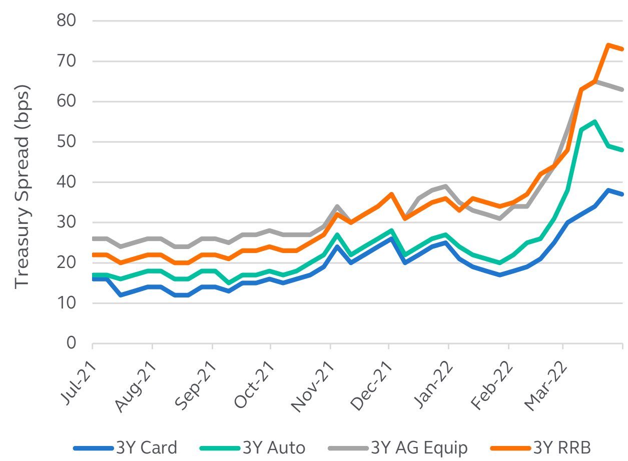
Outlook

The total ABS new issue supply was $65.3bn in 1Q22 versus $60.3bn in 1Q21. ABS fundamentals are supported by strong consumer balance sheets and declining unemployment levels. Delinquency rates among consumer ABS sectors remain near record lows but increased notably in February, especially for subprime borrowers. Delinquencies should decrease in March and April as consumers receive their tax refunds.

Investor demand for ABS softened as a number of factors complicated a clear vision of the near-term outlook including heightened geopolitical risks, pending rate hikes and inflation's path. However, investor optimism returned at the end of the quarter as ABS valuations were at attractive levels compared to other fixed income sectors.

The SFA (Structured Finance Association) consulted with ABS industry participants to form a consensus regarding a suitable replacement of the Eurodollar and LIBOR-based swap curves during the quarter. These LIBOR-based benchmarks are being phased out and are currently used to price fixed-rate ABS bonds. Expectations are for the ABS market, both primary and secondary, to adopt benchmarking to Treasuries with the switch occurring on April 11th, 2022.

AAA ABS Spreads



Source: JP Morgan

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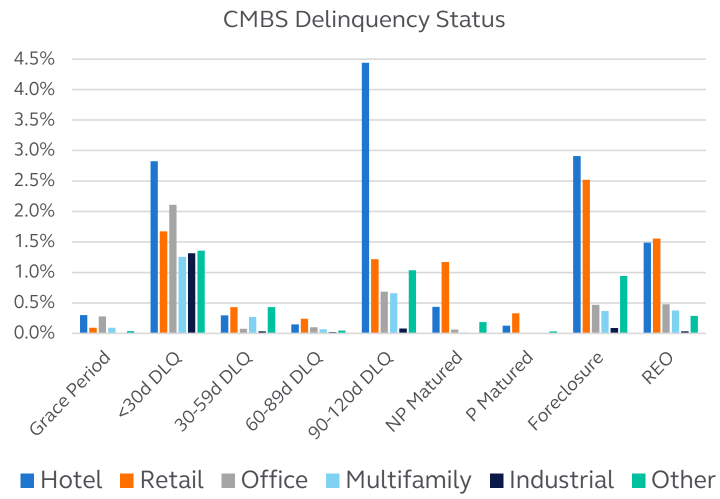
Commercial Mortgage-Backed Securities (CMBS)

Morley Capital Management

Highlights

The Bloomberg AAA Commercial Mortgage-Backed Securities (CMBS) Index posted total and excess returns of -5.54% and -0.50%, respectively. CMBS market fundamentals continued to recover from the initial deterioration post the pandemic as delinquency rates have improved each month since July 2020, with the exception of a slight uptick in December. During the first quarter higher interest rates, wider spreads and a steeper CMBS credit curve were headwinds for returns, especially for recently issued, longer duration bonds. The war in Ukraine, persistent inflation and a much more hawkish Fed spiked market volatility and pushed CMBS spreads wider. Floating rate SASB bonds and seasoned fixed rate CMBS outperformed on-the-run fixed rate conduit given their shorter duration profile.

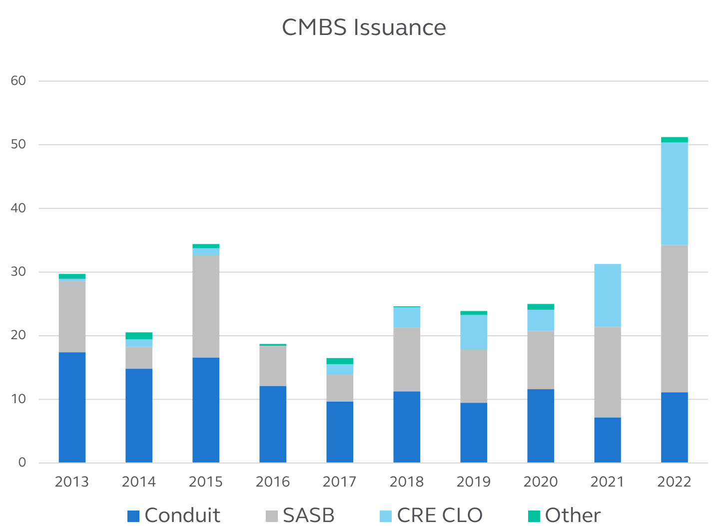
New issue activity ended the quarter at record levels for the first quarter of the year. The $51B of private label issuance was the highest first quarter volume since before 2010. Private label conduit issuance during the first quarter was $11B compared to first quarter 2021 issuance of $7B. Private label SASB issuance was $23B compared to first quarter 2021 issuance of $14B. Demand was tested in the conduit and SASB market by the heavy supply, fund flows out of fixed income bond funds and the spike in market volatility, which pushed spreads materially wider and the CMBS credit curve steeper to end the quarter.



Source: JP Morgan

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. Strong job growth has typically resulted in lower loan delinquencies with a 12-18 month lag. The gain in jobs as the economy comes out of Covid should be positive for loan performance, supporting CMBS fundamentals if the economy does start to slow down. Looking forward, longer term trends in office use may start to weigh on leasing activity in certain markets. Market technicals are expected to be supportive of spreads during the second half of 2022 as the move wider in spreads and higher volatility during the first quarter has slowed down lending activity, which is expected to result in a slower pace of new issuance for the remainder of 2022.



Source: JP Morgan

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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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