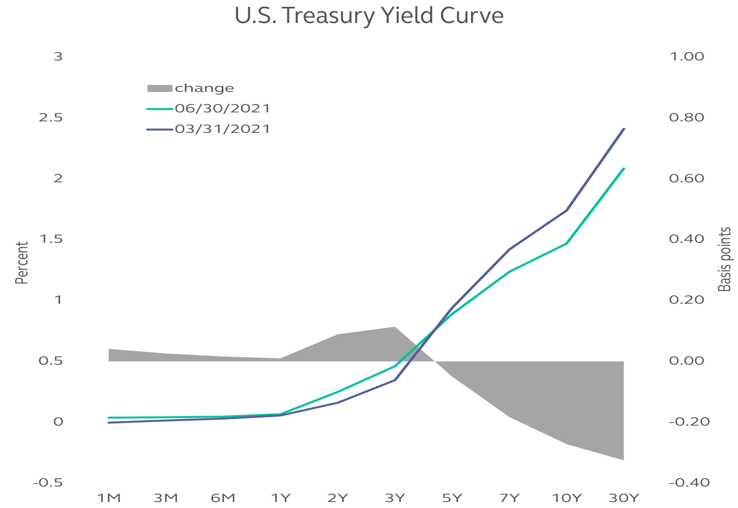
Interest Rate Strategy

Morley Capital Management

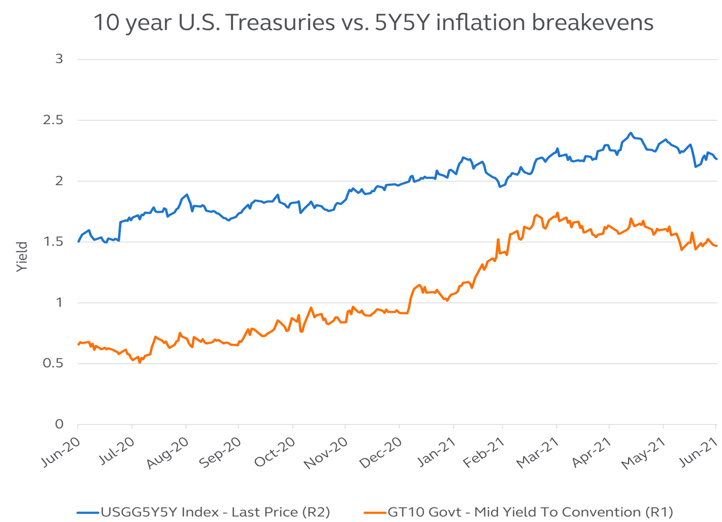
Highlights

For most of the quarter, U.S. Treasury rates traded in a tight range until June where Treasuries made a strong bull flattening move. Longer term inflation expectation drifted lower from elevated levels as the economic data moderated, highlighted by a couple of disappointing monthly non-farm payroll figures. Also, the narrative of "peak" growth, fiscal stimulus, and inflation and increasing concerns about the Delta variant supported declining nominal yields. Despite inflationary pressures unseen for decades, the market accepted the transitory nature of the data. Exacerbating the downward pressure in yields were several technical factors including crowded short positioning, active participation by momentum investors, increased demand from pensions due to favorable funding ratios and lack of Treasury supply.

The June FOMC meeting presented a hawkish surprise as inflationary concerns and the shift in forecasted dot plots pointed to an earlier taper and hiking schedule. Markets have struggled with the Federal Reserve's reaction function under its new average inflation targeting (AIT) regime. While the Fed has been deliberately vague and flexible in its approach, we glean several insights into their framework. The June projection included a significant upgrade in inflation expectation for 2021 and relatively unchanged 2022/2023 period vs. March's forecast. Further, the median FOMC member expects 2 hikes in 2023 vs none in March. The change in policy expectations caused by the inflation upgrade implies a 3-5 year look back period when calculating average 2% inflation and appears not to look through the "transitory" nature of recent inflation.



Source: Bloomberg



Source: Bloomberg

Outlook

The second half of the year should give us more answers to several key questions. First, will we see inflationary forces moderate as unemployment benefits expire in September and supply bottleneck's ease? Second, will more persistent sources of inflation such as owner's equivalent rents and wages show up in the data? Third, will the technical overhang dissipate as we exit the strong summer seasonals? Although Chairman Powell has stated that "substantial progress" pre-requisite has not been satisfied, we would expect that to change soon. We maintain our expectation for a taper announcement in 3Q with an actual taper in 1Q22.

Dan Kang, CFA
Portfolio Manager

Rates/Corporates

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.

Corporates

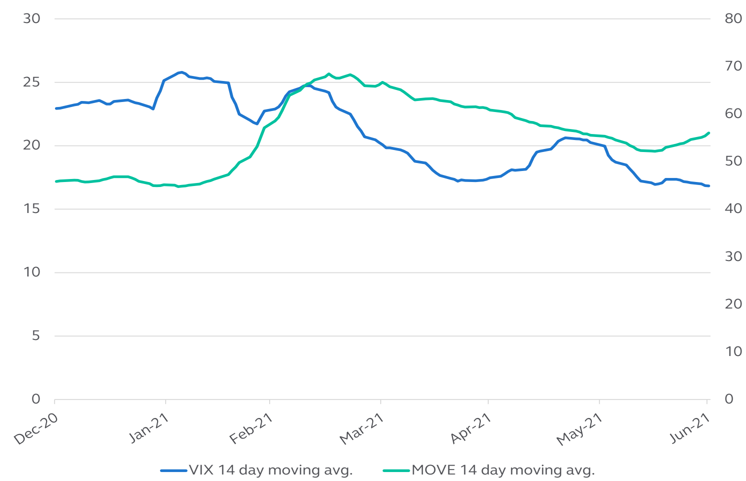
Morley Capital Management

Highlights

The Bloomberg Barclays U.S. Intermediate Corporate Index generated total and excess returns of 1.70% and 0.87%, respectively. For the 1st half of the year total and excess returns were -0.52% and 0.88%, respectively. After a move wider during March, spreads resumed their slow grind tighter as both equity and rate volatility trended lower. Spreads for the Bloomberg Barclays Intermediate Corporate Index ended the quarter at their lowest levels since the mid-90s. BBB rated bonds outperformed during the period led by recovery stories (Finco's, Airlines, REITs and Energy), while higher quality, lower beta segments underperformed (Utilities, Non-cyclicals).

During the quarter, the Fed announced their intent to wind down the Secondary Market Corporate Credit Facility (SMCCF). During the pandemic, the SMCCF was established to buy a mix of front-end corporate bonds and ETFs to support credit market liquidity. With the Federal Reserve's successful communication and high level of credibility, the actual amount of bonds purchased was quite small. Hence, we expect the unwind will be well absorbed by the markets. With the unprecedented introduction of these credit facilities, the market has incorporated explicit Fed support in a tail risk scenario. If we see the Fed pushback on this notion, we could see the lower liquidity premium being priced out of current spreads.

VIX and MOVE indices



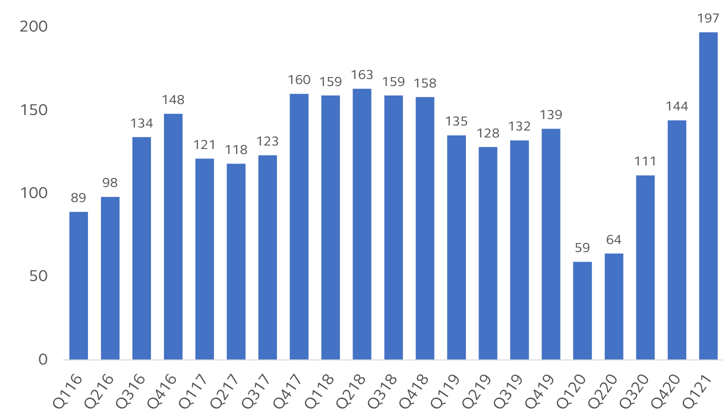
Source: Bloomberg

Outlook

In the 1st half of 2021, realized spread volatility was quite low but we would expect the 2nd half to see an uptick in spread movement. Several potential catalysts include the announcement of a Fed taper of asset purchases, higher than expected inflation prints that challenges the transitory characterization and increasing Covid variant cases as we head into the Fall/Winter months. We believe any spread widening will be limited as the global liquidity environment will not meaningfully change.

The fundamental outlook continues to be strong as the revenue and earnings surprises were maintained at a high level for the 1st quarter. One area of focus is the inflationary cost pressures from supply chain issues and labor shortages. As of now it appears company managements have been able to maintain margins and exhibit some pricing power in the current environment.

# of S&P 500 cos. citing "inflation" on earning calls



Source: Factset

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Mortgage-Backed Securities (MBS)

Highlights

The Bloomberg Barclay's U.S. Agency MBS Index posted total and excess returns of 0.33% and -0.61%, respectively, for the second quarter. Conventional MBS outperformed Ginnie Mae's on a total return basis while shorter maturity (15/20-year) passthroughs led performance on an excess returns basis as long Treasury rates declined and the yield curve flattened. The rally in rates markets was driven by unwinding of reflation trades, slowing economic prints and concerns around the COVID delta variant.

The somewhat hawkish bent of the June FOMC meeting raised concerns about policy tightening errors and extended the Treasury rally and basis underperformance. The committee upgraded their 2021 GDP and inflation forecasts to 7% and 3%, respectively while accelerating the "dot plot" timeline. The median forecast moved to two rate hikes by YE 2023, with several officials projecting a rate hike by YE 2022. Additionally, the Fed began taper discussions, with several participants advocating for a faster reduction in MBS purchases versus Treasuries, but the Committee maintained the monthly pace of MBS purchases at $40B for now.

Net MBS issuance surged to $285B in Q2, driven by rapidly rising home prices, elevated cash-out refinancings and higher securitization rates. However, Fed purchases of $120B coupled with domestic bank demand totaling $130B absorbed the bulk of the supply. Bank demand has been concentrated with a few large institutions and fueled by strong deposit growth relative to loan demand. Overseas investors, led by Japan, took up the slack, adding $50B in MBS during the period.

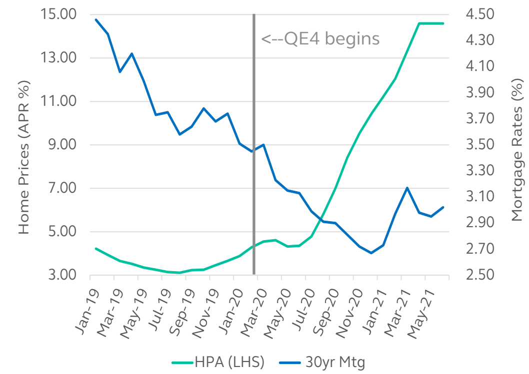
After starting the quarter at 3.17%, mortgage rates drifted lower with Treasury rates and settled under 3%. However, prepayments moderated over the period as rates remain above the 2.65% low reached in Q1 and signs of burnout in higher coupons finally emerged.

Outlook

The recovery in global growth has been uneven and the outlook is tempered by plateauing vaccination rates, the rapid spread of the delta variant, prolonged supply chain disruptions and growing inflation risks that may require the Fed to remove policy accommodation sooner than expected. We expect the FOMC to make a formal taper announcement in the third quarter, with actual tapering of asset purchases occurring in late Q4 or early Q1 2022. Until then the near-term technicals for the sector remain supportive. On the supply side, a typical seasonal decline in housing activity should cap MBS net issuance at $300B in 2H'21 compared to $470B in the first half of the year. On the demand side, the Fed is expected to add another $240B MBS, while excess deposits at banks should fuel purchases upwards of $200B. Furthermore, money managers are already underweight MBS while IG credit spreads have outperformed, potentially prompting reallocations should the basis widen.

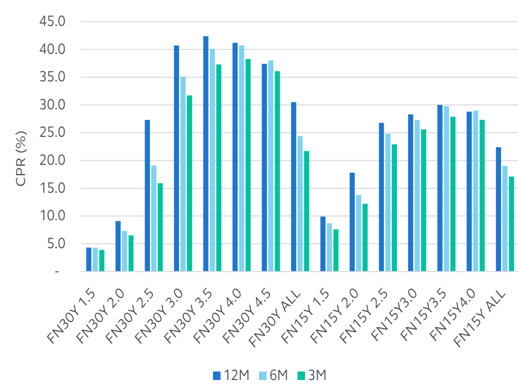
MBS valuations remain rich despite the recent widening in spreads while several new risks have emerged. The Fed could opt to taper their MBS purchases sooner than Treasuries due to valuation pressures in the housing and mortgage markets. Additionally, policy risks have increased with the recent leadership changes at the FHFA, which overseas Fannie Mae and Freddie Mac. The Biden administration is expected to use the opportunity to focus on affordable housing initiatives and expanding the credit box, which could have negative repercussions for MBS supply and prepayments. Therefore, we believe that near-term technicals supporting current valuations will gradually give way to wider spreads as the Fed begins its path towards policy normalization. If they are successful, the MBS market should avoid the type of large-scale, rapid repricing experienced during the QE3 taper and a smoother transition to fair value.

Home price appreciation & mortgage rates



Source: Bloomberg

MBS speeds



Source: Bank of America

Perpetua Phillips
Portfolio Manager

MBS/ABS/CMBS

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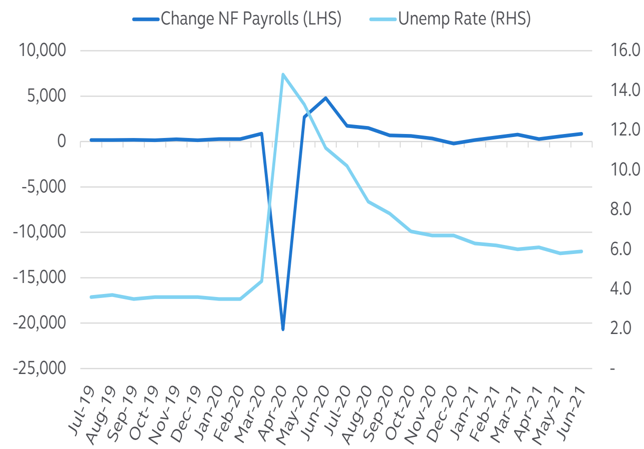
Asset-Backed Securities (ABS)

Morley
Capital Management

Highlights

The Bloomberg Barclays AAA Asset Backed Securities (ABS) Index posted total and excess returns of 0.34% and 0.23%, respectively during the second quarter. Spreads in the ABS market moved tighter with senior tranches of three-year credit card ABS moving 5 bps tighter and senior tranches of three-year prime auto loan and equipment ABS moving 3 bps tighter.

Labor markets



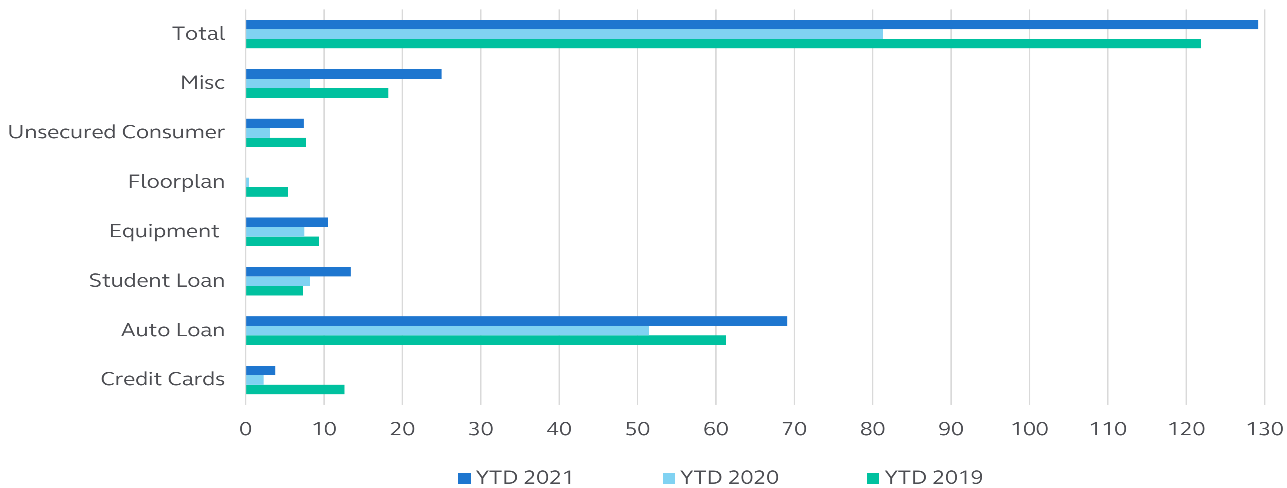
Source: Bureau of Labor Statistics

Outlook

Consumer balance sheets are extremely healthy and delinquency rates are at all-time lows. A large percentage of stimulus checks have been saved and the consumer is positioned to drive growth as the economy reopens. There remains approximately 7 million fewer people employed as compared to the start of the pandemic, but we expect this to improve substantially throughout the remainder of this year.

Year-to-date ABS new issue supply stands at $129 bn, which is higher than the $80bn at the same point last year, but on-pace with YTD issuance during pre-COVID years. Investor demand for ABS remains robust. Valuations appear attractive when compared to U.S. Treasuries and other short duration alternatives.

ABS Issuance



Source: JP Morgan

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Please see Disclosures for important information.

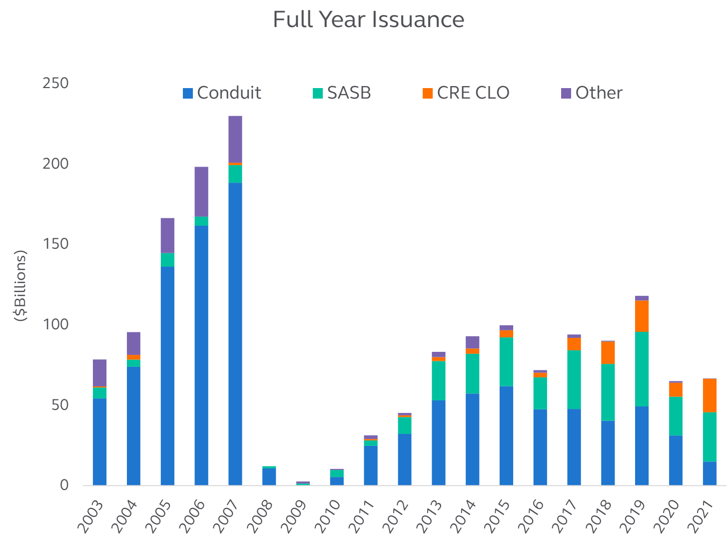
Commercial Mortgage-Backed Securities (CMBS)

Morley
Capital Management

Highlights

The Bloomberg Barclays AAA Commercial Mortgage-Backed Securities (CMBS) Index posted total and excess returns of 1.73% and 0.67%, respectively. CMBS market fundamentals continued to recover from the initial deterioration post the pandemic as delinquency rates have improved each month since July 2020. While loans continue to be resolved either through forbearance or loan modifications, the pace of foreclosures and REO sales picked up during the quarter. The market for distressed properties and debt is being supported by a wall of opportunistic capital. Improving economic activity, recovering real estate fundamentals and favorable supply and demand in the CMBS market along with performance of risk assets generally were constructive for CMBS spreads helping keep spreads firm during the quarter. The decline in Treasury yields, with the 10-year ending the quarter 27 bps lower, helped to revive the bid for yield and support risk assets. Spreads on short duration AAA CMBS were 3bps tighter and long duration AAA bonds were flat.

New issue activity picked up during the quarter as demand for loans improved due to transaction volumes increasing. Private label conduit issuance during the second quarter was $9.03B and the first half 2021 was $14.97B compared to $7.96B and $19.55B respectively in 2020. Demand remained strong for new issue, which kept spreads in a relatively tight range even with interest rates trending lower.



Source: JP Morgan

Outlook

The outlook for CMBS fundamentals will continue to be driven by how quickly economic activity can recover and employees choose to return to work. The rollout of the vaccine and economic activity during the first half of 2021 has improved that outlook. Inflation expectations and the impact on ten-year Treasuries continues to be at the forefront of the market but the Fed is expected to keep the long end from gapping out as it manages the short end. While multifamily and industrial properties have performed solidly throughout the Covid-19 crisis, the pandemics longer term impact on travel and hospitality properties, changes in retail trends and the uncertainty as to what the future holds for office use are still to be determined. However, we expect that the favorable supply and demand dynamics will continue to be supportive of CMBS valuations and structural protections and conservative underwriting will continue to provide protection from a credit perspective.

Disclosures

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The Bloomberg Barclays U.S. Corporate Investment Grade Index is a component of the Bloomberg Barclays U.S. 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 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 Barclays AAA ABS Index represents the asset-backed securities within the Bloomberg Barclays U.S. Aggregate Index.

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

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