Interest Rate Strategy

Morley CAPITAL MANAGEMENT

Highlights

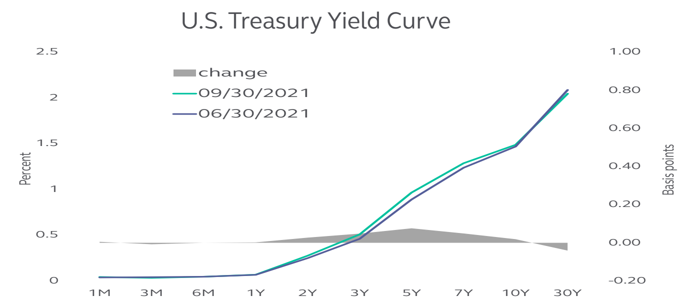
During the summer doldrums, the Treasury markets experienced a perfect storm of technical factors that exacerbated the bull flattening impulse of the rates market. First, the Treasury general account (TGA) balance declined by $1.5T through the year which effectively reduced Treasury issuance. With the $80B in monthly Treasury purchases, the Federal Reserve was effectively buying all the net supply during the summer months. Second, private pension funds rotated into fixed income as their funding ratio improved. At the end of May, the Milliman 100 Pension Funding Index (98.7%) was at the highest levels since 2007 due to higher rates and strong equity performance. Third, crowded short positioning in the 1Q and CTA momentum strategies all pressured rates lower during the quarter. Fourth, robust foreign demand continued as U.S. Treasuries provided an attractive option in a negative yielding world.

At the September FOMC meeting, Chairman Powell gave the clearest signal yet that the substantial progress goal was close at hand, and a tapering announcement was imminent. We would expect an announcement at the November meeting with tapering beginning shortly afterwards. Also, we would assume a monthly reduction in asset purchases of $10B of Treasury securities and $5B of Agency MBS, with the tapering concluding sometime mid-2022. Yields responded with a strong bear flattening to end the quarter, as both the FOMC and Bank of England meetings were perceived to be hawkish.

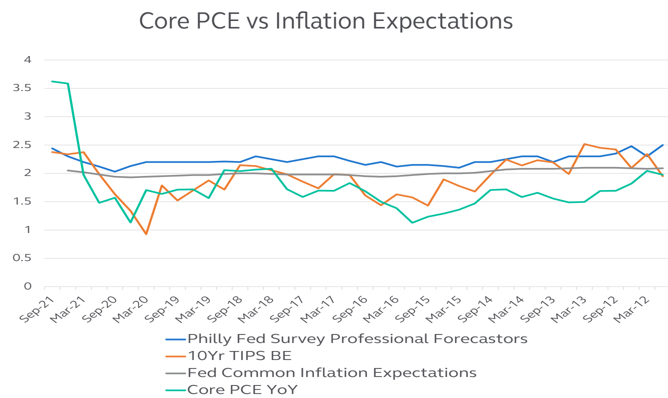
Outlook

As the market moves past the uncertainty around tapering, the focus for rate markets will be the timing and pace of hikes. With the persistent inflationary pressures evident in recent data, markets have pulled forward their expectations on an initial hike. Unfortunately, clarity on the transitory nature of the price pressure will take longer to realize. Even if we see some abatement of the supply bottlenecks, we could see more permanent sources of inflation permeating the data. Inflation expectations, housing costs and wage inflation have all been recently pressured. Although not as troubling as the Core PCE figures, measures of inflation expectations have drifted upward. Also, increased shelter costs tend to lag the inflation in housing prices and have started to creep into the data. Finally, the tightness of the labor market continues to defy the significant pool of unemployed labor putting pressure on wages.

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.



Source: Bloomberg



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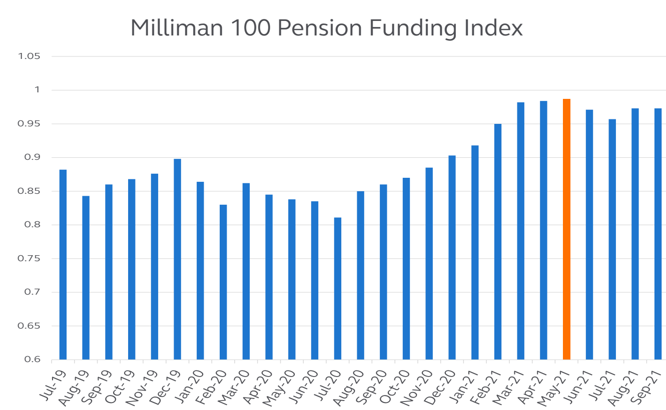


Source: Milliman

Dan Kang, CFA
Portfolio Manager

Rates/Corporates

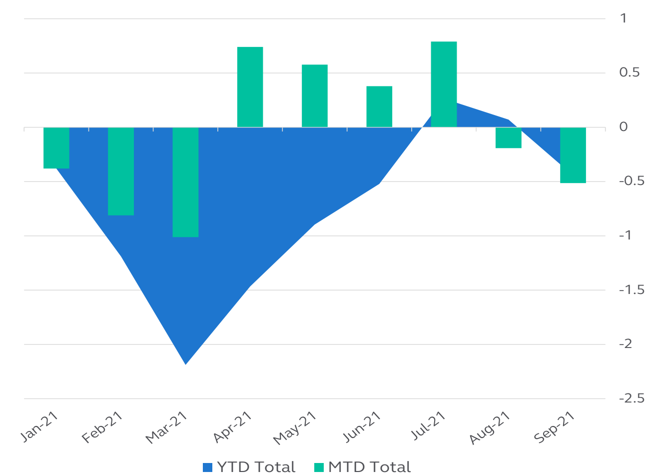
Highlights

The Bloomberg U.S. Intermediate Corporate Bond Index generated total and excess returns of 0.08% and 0.06%, respectively. After reaching 20-year lows in spread to Treasuries, the Intermediate Corporate Index drifted wider during the summer months. Slowing global growth due to persistent supply chain issues, rising Delta variant cases, China property developer woes and decades high inflation prints all weighed on investor's minds. Despite the 2nd highest September new issuance on record, elevated equity and rate volatility and a clear signal by the FOMC for an imminent taper, credit spreads ended the quarter at the tighter end of recent ranges.

During this period of muted excess returns, lower quality BBB's and cyclical recovery/re-opening sectors (travel, leisure, energy) outperformed. Laggards include higher quality credits, metals & mining, gaming and transportation services companies.

Although Corporate indices generated positive excess returns for the quarter, total year-to-date and September absolute returns were negative due to the rising Treasury yields. Historically, retail fund inflows have lagged the direction of total return performance. Therefore, we will monitor any changes to retail investors demand resulting from recent negative returns.

Total Returns Intermediate Corporate Index (YTD and MTD)



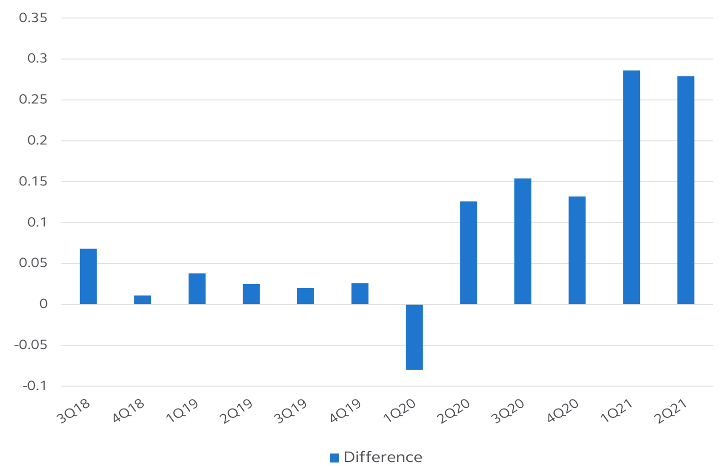
Source: Bloomberg

Outlook

We maintain a view that we are in a volatile, but range-bound environment for the foreseeable future. Despite the cloudy macro outlook, the positive fundamental picture is still intact. We are closely monitoring the 3rd quarter earnings season for any erosion in profit margins due to the well documented challenges surrounding supply chain, labor shortages and commodity inflation. The upcoming earnings season will be challenged to repeat the past five quarters of outsized sales/earnings beats; however actual sales and earnings growth should be significant. During the past 5 quarters, actual earnings of the S&P 500 companies have exceeded estimates by 19.1% vs the 5-year average of 8.4%. Also, during this most recent period, 84% of S&P 500 companies beat their earnings estimates vs the 5-year average of 76% of companies.

As we head into end of the year, we would expect positive seasonality and pro-cyclical economic data to support spreads. Also, we would expect headlines surrounding the infrastructure bills/debt ceiling, persistent inflation, and potential 5th Covid wave to increase volatility.

S&P 500 Actual vs Expected Earnings



Source: Factset

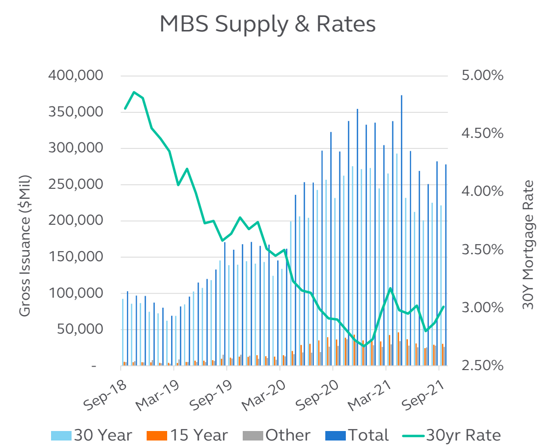
Mortgage-Backed Securities (MBS)

Highlights

The Bloomberg U.S. Agency MBS Index posted total and excess returns of 0.10% and 0.03%, respectively, for the third quarter. The modest move in Treasury yields QoQ belies significant intra-period volatility arising from a surge in COVID-19 cases, mounting inflationary pressures, U.S. government funding and debt ceiling negotiations, and credit concerns around Chinese real estate behemoth Evergrande. The 10-year Treasury yield fell to 1.17% in early August before rebounding to close the period little changed at 1.49%.

At the September 23rd FOMC meeting Fed officials signaled that they could begin QE4 tapering as early as November and conclude by mid-2022, implying a faster pace of reductions ($5B/mo MBS, $10B/mo Treasuries). Additionally, the dot-plots moved forward the timeline for rate hikes, with the median projection indicating liftoff by year-end 2022. The Committee's more hawkish stance stemmed from rising inflation concerns, with their median core PCE projection for next year rising to 3.7% from 3.0% as supply chain bottlenecks and labor shortages are proving less transitory than previously expected.

MBS issuance remained elevated with gross and net supply totaling $810B and $191B respectively, during the quarter. However, MBS spreads widened only modestly as Fed and bank purchases continued to absorb originator supply. In addition, mortgage rates rose alongside Treasuries, closing the quarter above 3% and reducing refinancing incentives. Prepayment speeds continued to moderate with September aggregate 30-year and 15-year speeds settling in the 20-24% CPR range and higher coupons continuing to exhibit prepay burnout.

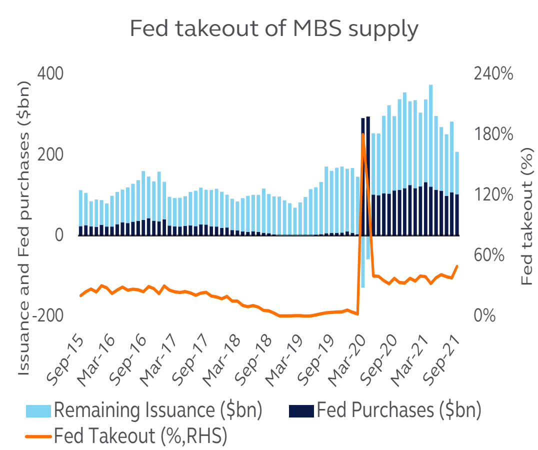


Source: Bank of America, Bloomberg

Outlook

The MBS sector faces some key challenges ahead as the U.S. economy recovers from the pandemic and rising inflation pressures prompt the Fed to transition away from exceptional policy support. We expect the FOMC to formally announce QE4 taper plans at their November 3rd meeting with rates liftoff sometime in the second half of 2022. This should continue to put upward pressure on rates, bringing negative convexity and extension risks to the forefront, particularly for cusp coupons in the 30-year sector. In addition to waning Fed support, bank purchases of MBS could decline following a nearly two-year buying binge as deposit growth slows. Dollar roll specialness in Fed-supported coupons should decline in coming months, requiring OAS to widen from currently negative levels. In addition to monetary policy risks, the sector is facing new challenges from housing finance regulators rolling out affordable housing initiatives that introduce new sources of prepayment uncertainty. Finally, near-20% home price appreciation over the past year could boost conforming loan limits to $625,000 next year, further worsening convexity within the sector.

The news is not all negative for MBS, however. Rising rates should temper prepayments and origination supply while the Fed is expected to buy $180B of MBS before QE4 concludes. Although they haven't yet addressed the topic, we expect they will also continue reinvesting paydowns on their MBS holdings for some period after QE purchases end. This stock effect should provide ongoing support for the basis as the Fed and domestic banks collectively own $6T MBS. Furthermore, money managers are currently underweight MBS, which have underperformed other fixed income sectors YTD. Reallocations from this group along with support from yield buyers should prevent an excessive widening of MBS spreads and we would view any meaningful cheapening as a buying opportunity.



Source: Bank of America

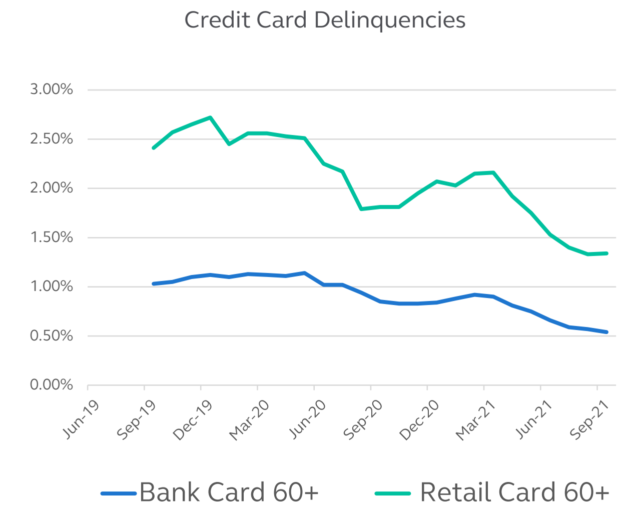
Perpetua Phillips
Portfolio Manager

MBS/ABS/CMBS

Highlights

The Bloomberg AAA Asset Backed Securities (ABS) Index posted total and excess returns of 0.02% and 0.01% respectively, during the third quarter. Spreads in the ABS market widened modestly with the OAS to Treasuries of the Bloomberg U.S. AAA ABS Index moving from 16 bps to 20 bps over the period, due largely to a widening of swap spreads.

Several concerns surfaced during the third quarter, including a surge in COVID-19 cases, mounting inflationary pressures, fiscal negotiations in the U.S. over government funding and the debt ceiling, and significant credit events in Chinese real estate. Although this led to periods of market volatility, economic fundamentals remain on solid footing. In fact, the progress made towards economic recovery gave the Fed confidence to signal that it will likely soon begin removing accommodation. The Fed signaled at its September meeting that it is likely to announce a taper to its bond purchases at its next meeting in November and complete the tapering process by mid-2022. A Fed hiking cycle may begin as early as late-2022.

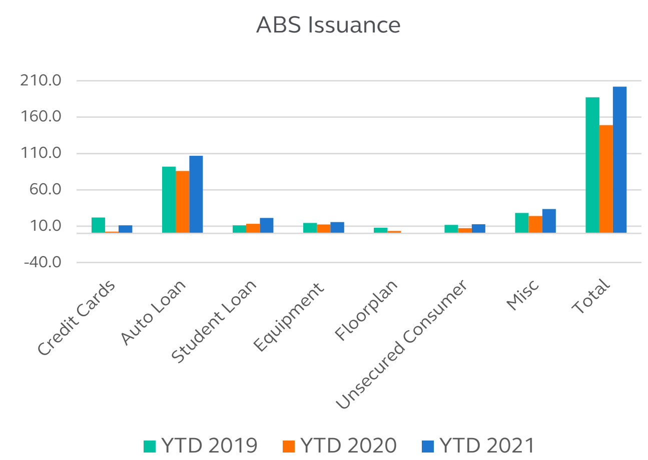


Source: JP Morgan

Outlook

Consumer balance sheets are extremely healthy and delinquency rates remain near all-time lows. Although the Delta variant somewhat slowed the pace of labor market improvement, we expect a robust pace of new job gains throughout the remainder of this year as the number of new COVID-19 cases slows.

Year-to-date ABS new issue supply stands at $201bn, which is higher than the $141bn at the same point last year and during pre-COVID years. However, net issuance is near zero. ABS fundamentals are supported by strong consumer balance sheets and declining unemployment levels. Delinquency rates among consumer ABS sectors remain near record lows. Investor demand for ABS continues to be robust. Valuations appear attractive when compared to U.S. Treasuries and other short duration alternatives.



Source: JP Morgan

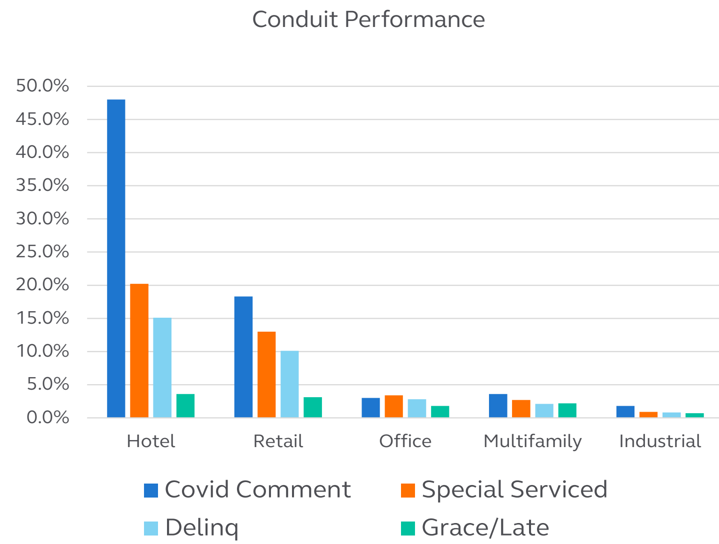
Commercial Mortgage-Backed Securities (CMBS)

Morley
Capital Management

Highlights

The Bloomberg AAA Commercial Mortgage-Backed Securities (CMBS) Index posted total and excess returns of -0.04% and -0.04%, respectively. CMBS market fundamentals continued to recover from the initial deterioration post the pandemic as delinquency rates have improved each month since July 2020, but higher interest rates, marginally wider spreads and a steeper CMBS credit curve were headwinds for returns, especially for recently issued, longer duration bonds. The increase in Treasury yields, inflation fears, and Chinese growth concerns resulted in a spike in volatility in September which pushed CMBS spreads wider. Floating rate SASB bonds and seasoned fixed rate CMBS outperformed fixed rate conduit as demand remained strong for new issue SASB bonds and short duration.

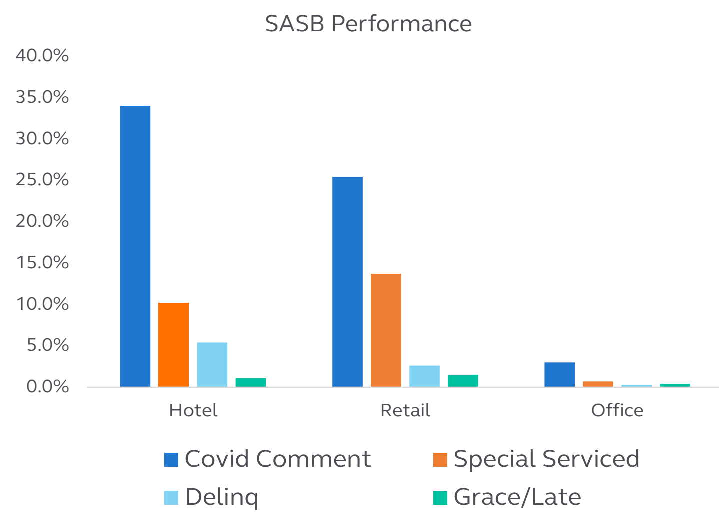
New issue activity ended the quarter strong as the $20B of private label issuance in September was the highest monthly volume since before 2010, driven by SASB and CRE CLOs. Private label conduit issuance during the third quarter was $8.4B and YTD 2021 was $23.3B compared to $4.96B and $24.5B respectively in 2020. Private label SASB issuance during the quarter was the most impressive at $14.9B and $45.5B YTD compared to $5.6B and $15.8B respectively in 2020. Demand was tested in the conduit market by supply and a pick-up in market volatility, which pushed spreads wider and the CMBS credit curve steeper to end the quarter.



Source: Citi, Trepp

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. While the Delta variant of Covid-19 has slowed the recovery, the outlook remains optimistic as Delta passes. 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.



Source: Citi, Trepp

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Morley Capital Management

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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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