Morley
CAPITAL MANAGEMENT

Highlights

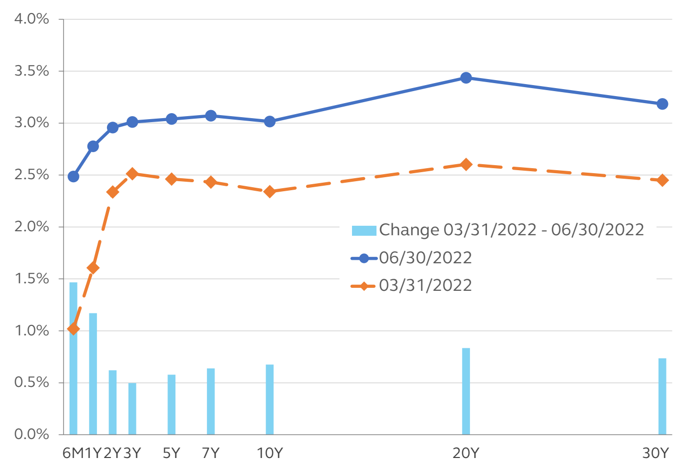
In the second quarter, U.S. Treasuries continued to sell-off and the yield curve flattened with yields at the very front-end rising more than longer dated Treasuries. Over the quarter, the yield on the U.S. ten-year peaked at 3.47%, the highest level since 2011. The bearish rate move was driven by upside surprises in inflation data that showed price increases are broad-based and remain stubbornly high. Consequently, rate volatility remained elevated with the MOVE index reaching recent highs. The Treasury sell-off over the quarter was predominated by a rise in real yields, with the yield on ten-year TIPS reaching as high as 90 basis points in June, as long-term market implied break-even inflation expectations subsided.

Following May's higher than expected CPI release and June's preliminary University of Michigan survey of inflation expectations, the Federal Reserve (Fed) hiked rates 75bps at their June meeting exceeding expectations of 50bps. The Fed also released an updated Summary of Economic Projections (SEP), which indicated that FOMC participants see the Fed Funds rate rising to 3.4% at year's end and to 3.8% next year, from the current Fed Funds target range of 1.5% to 1.75%. Further, the Fed increased their forecast of Core PCE slightly to 4.3% (vs 4.1% in March) for 2022. Normalization of the Fed's $9tn balance sheet commenced in June, with $47.5B in US Treasuries and mortgage-backed securities rolling-off. The pace of runoff is expected to increase beginning in September.

Outlook

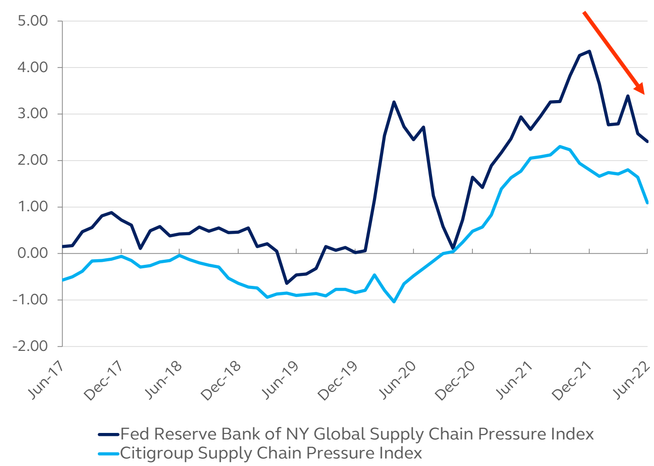
We maintain our view that inflation will continue to be problematic as it becomes more persistent and broad-based. Although we have seen a turn in commodity markets and some improvement in supply chain-related stresses, we continue to see aggregate demand, driven by a strong labor market, providing an upward impetus to inflationary pressures. Therefore, the Fed will be motivated to provide large, front-loaded rate hikes for the remainder of the year. As financial conditions tighten and negative real wages persist, we would expect markets to more fully price-in a recession into the longer end of the curve.

U.S. Treasury Yield Curve



Source: Bloomberg

Supply Chain Pressures



Source: Bloomberg

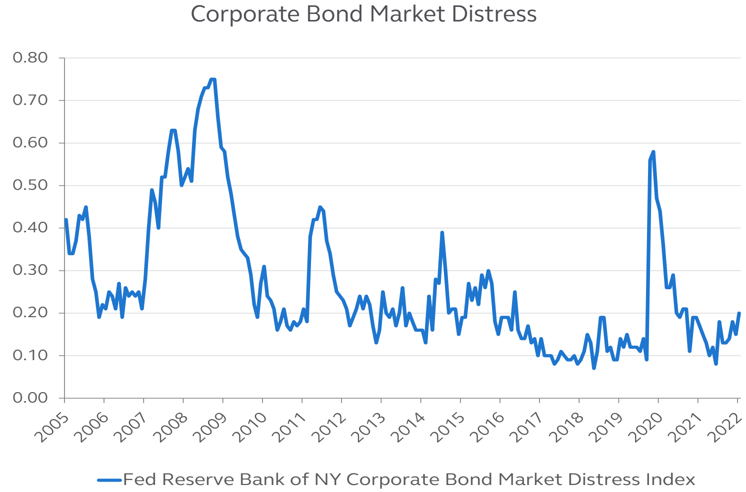
Dan Kang, CFA
Portfolio Manager

Rates/Corporates

Highlights

The Bloomberg U.S. Intermediate Corporate Bond Index generated total and excess returns of -3.92% and -1.78%, respectively, during the second quarter. Year-to-date total and excess returns for the index were -8.97% and -2.41%, respectively. A combination of rapidly rising interest rates and growing concerns of an impending recession weighed on performance.

Given heightened market volatility, issuers remained on the sidelines in the 2nd quarter, despite a robust start to the year for new issuance. Investment Grade primary issuance of $403B was the lowest 2nd quarter issuance since 2013. Investment Grade Retail ETF and mutual fund flows continued to track negative returns with $110B exiting mostly short duration and total return fixed income strategies so far year-to-date.

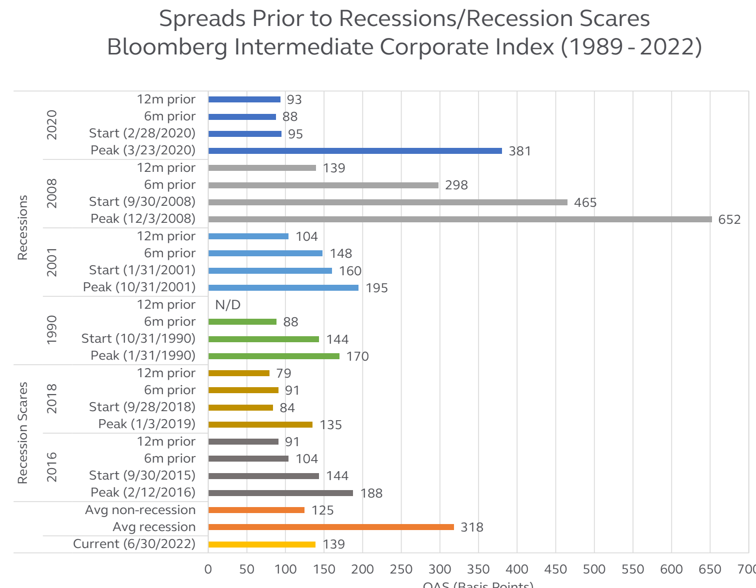


Source: Bloomberg

Outlook

Rate volatility appears to be the main driver of credit spreads presently and we do not anticipate that relationship changing in the near term. Unfortunately, one pre-requisite for a turn in rate volatility would be a peak in the inflation data, which hasn't occurred yet. In the meantime, we would anticipate credit spreads to reflect a mild recessionary scenario as we get closer to 2023. Although current spreads reflect a significant amount of bad news, we believe spreads could widen when the hard data points to a recessionary environment.

As demand wanes for risk assets and central banks remove accommodation, liquidity conditions continue to be challenging in the credit markets. According to The Federal Reserve Bank of New York Corporate Bond Market Distress Index, credit market stresses were evident this year. However, the elevated levels would not indicate a deterioration in market conditions that would warrant a pivot in Federal tightening policies.



Source: Bloomberg

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Please also see disclosures for important information.

Mortgage-Backed Securities (MBS)

Morley Capital Management

Highlights

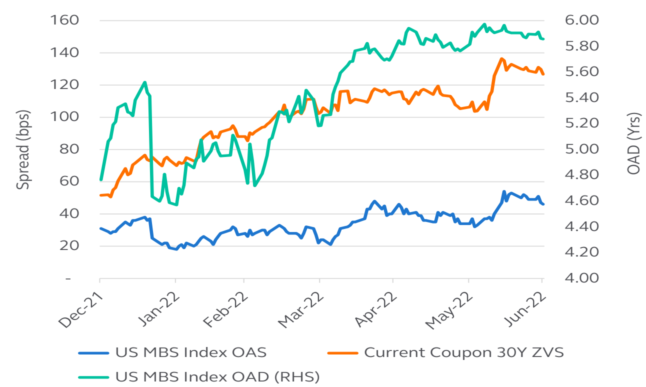
The Bloomberg U.S. Agency MBS Index posted total and excess returns of -4.01% and -0.98%, respectively, during the quarter as rates markets sold off by over 60 bps and risk assets underperformed Treasuries amidst an increasingly uncertain macroeconomic outlook. Hawkish Fed policy aimed at reigning in elevated inflation ignited recession fears, causing rates volatility to surge to levels not seen since the height of the pandemic, driving MBS underperformance.

MBS current coupon zero-volatility spreads (ZVS) widened from +50 bps at the start of this year to close the second quarter at +127 bps, a level not seen since the most distressed periods of the GFC and Covid pandemic. MBS option-adjusted spreads (OAS) widened as well, though less dramatically, from +31 bps to +46 bps due to surging rates volatility, which increased MBS option costs.

The Fed moved aggressively to combat decades-high inflation, hiking the fed funds rate by 50 bps at their May meeting and another 75 bps in June to a 1.50-1.75% range by quarter-end. The committee signaled another 75-bps hike was likely in July, and their median forecast for year-ends 2022 and 2023 rose to 3.375% and 3.75%, respectively. Quantitative tightening began in June with monthly MBS runoff caps of $17.5B through August, stepping up to $35B from September onwards.

Thirty-year mortgage rates surged to as high as 5.8% during the quarter, extinguishing any refinancing incentive across virtually the entire MBS universe, which bears a weighted average coupon of just 3.5%. Aggregate prepayment rates declined steadily to around 9% CPR and the duration of the MBS index extended from 5.2 to 5.9 years during the period. MBS gross/net supply declined to $449B/$140B during the quarter from $612B/$210B in the prior quarter.

MBS Spreads and Duration



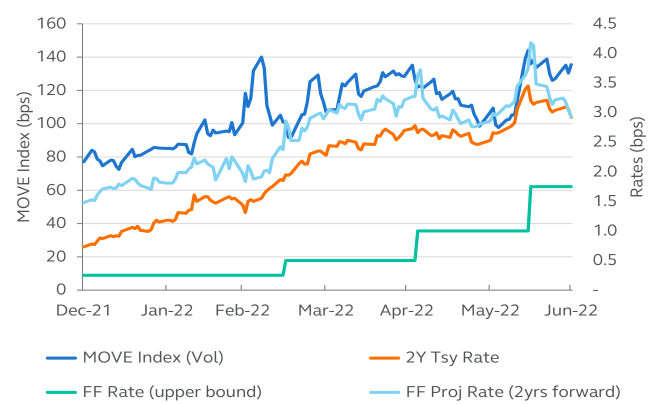
Source: Bloomberg

Outlook

After significant underperformance during the first half of the year we believe the outlook for the MBS sector is significantly more positive. To start, production coupon nominal spreads are at historically wide levels while rates markets have mostly repriced to reflect Fed rate hike expectations. Additionally, volatility closed the quarter near record high levels, which is historically an opportune time to add MBS given upside potential as levels normalize and OAS improve. Supply technicals are also more supportive, with the surge in mortgage rates putting significant downward pressure on both gross and net MBS issuance. In fact, refi-focused products such as 15-year MBS have already seen net issuance revert to negative levels in recent months. Finally, as recession risks increase MBS are expected to outperform credit sectors consistent with prior late-cycle sector performance patterns.

Some notable headwinds remain, however, including reduced bank and overseas demand for MBS. In addition, money managers have covered most of their underweights to the sector and are also facing fund redemptions, reducing support from this group at a time when Fed runoff supply will be increasing. Outright MBS sales by the Fed remain an ongoing risk and continued declines in prepay speeds/paydowns should increase pressure on policymakers to initiate the process sooner. Nevertheless, MBS valuations have cheapened to the point where investors are well compensated for these risks, and we believe the sector now looks attractive.

Rates and Volatility



Source: Bloomberg

Perpetua Phillips
Portfolio Manager

MBS/ABS/CMBS

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Asset-Backed Securities (ABS)

Morley
Capital Management

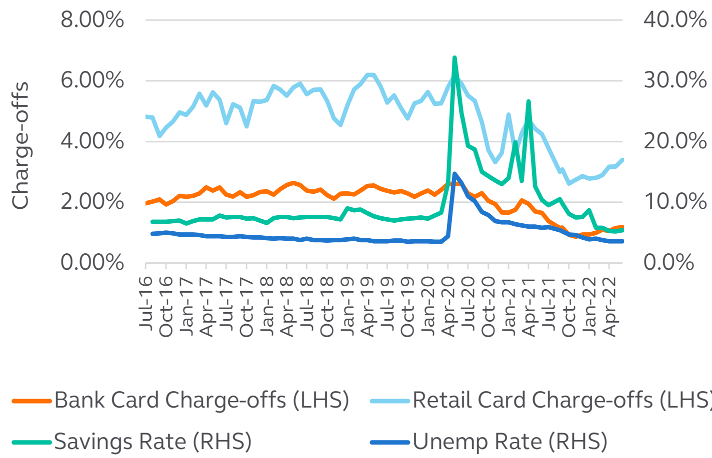
Highlights

The Bloomberg AAA Asset Backed Securities (ABS) Index posted total and excess returns of -0.89% and -0.06%, respectively, during the second quarter. Spreads in the ABS market widened with the OAS to Treasuries of the Bloomberg U.S. AAA ABS Index moving from 47 bps to 61 bps over the period.

The U.S. Consumer Price Index (CPI) in May rose to 8.6% year-over-year. In reaction, the Fed raised the Fed Funds rate by 0.75%, the largest increase in nearly three decades. The Fed is expected to continue the rapid rate increases throughout the remainder of this year. In addition, the Fed will continue to gradually reduce the size of its balance sheet that had quickly ballooned in size during the early stages of its pandemic response. The swift removal of monetary accommodation combined with ongoing supply shocks resulting from the Ukraine war and zero-Covid policies in China stoked recession fears and bouts of extreme risk-off sentiment during the quarter. Continued spread volatility is likely until there is compelling evidence that inflation is coming down and the market gains clarity on Fed policy.

The persistently high inflation caused a substantial increase in Treasury rates during the quarter. The ten-year rate nearly reached 3.50% before settling back close to 3.00% by quarter-end. The two-year U.S. Treasury rate increased 0.62% to 2.96%.

Consumer Health



Source: JP Morgan

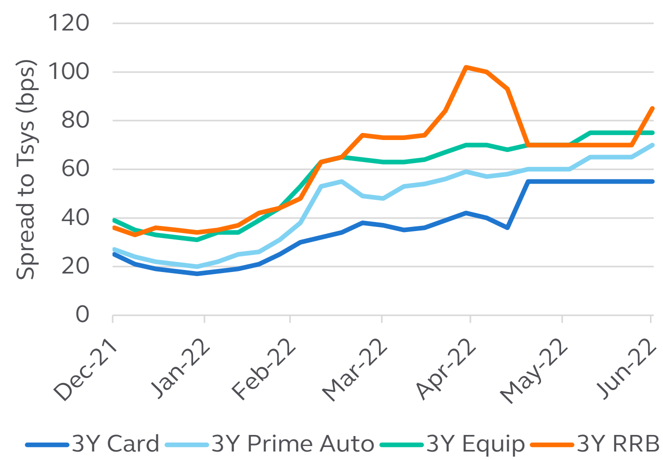
Outlook

Despite elevated inflation, the U.S. consumer remains well supported by a strong labor market and savings accumulated during the pandemic. Although the savings rate is declining below pre-COVID averages, credit card balances are increasing, and stimulus payments remain firmly in the past, consumers still have a large amount of savings available. In addition, the U.S. unemployment rate is holding steady at 3.6%, near the pre-COVID lows, and the fewest number of people are claiming long-term unemployment benefits since the 1970s.

ABS credit performance is expected to normalize, i.e., deteriorate, but at a gradual pace and from exceptionally strong levels. Delinquencies are still at low levels, although we are beginning to see some bifurcation in prime/subprime performance. ABS structures are generally still robust and well protected.

Issuance pace remains brisk; the total ABS new issue supply was $137.6B YTD 2022 versus $126.3B YTD 2021. Investor demand is highly selective with the strongest demand in high quality benchmark names. ABS spreads are at multi-year wides on broad market concerns. Valuations appear attractive when compared to U.S. Treasuries and other short duration alternatives.

AAA ABS Spreads



Source: JP Morgan

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Commercial Mortgage-Backed Securities (CMBS)

Morley Capital Management

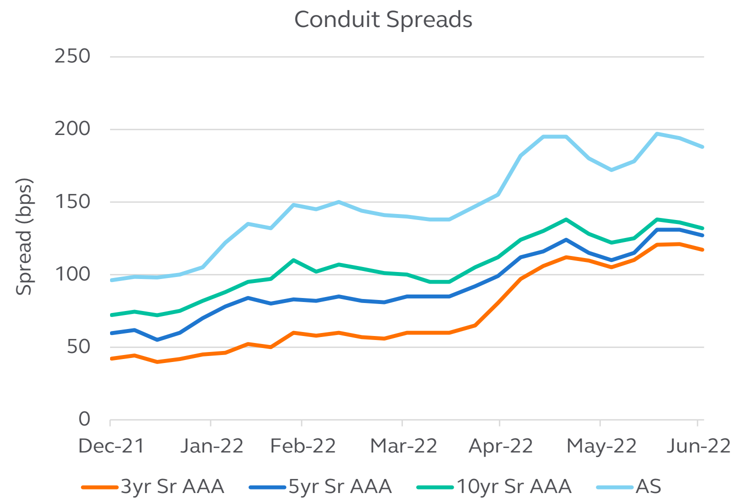
Highlights

The Bloomberg AAA Commercial Mortgage-Backed Securities (CMBS) Index posted total and excess returns of -2.63% and -0.10%, respectively. During the second quarter interest rate volatility, fixed income fund redemptions, and reduced market liquidity resulted in wider spreads and a steeper CMBS credit curve. These factors were headwinds for returns, especially for recently issued, longer duration bonds. Spreads on floating rate SASB bonds also widened during the quarter as fund managers focused on shorter duration bonds priced closer to par to fund redemptions.

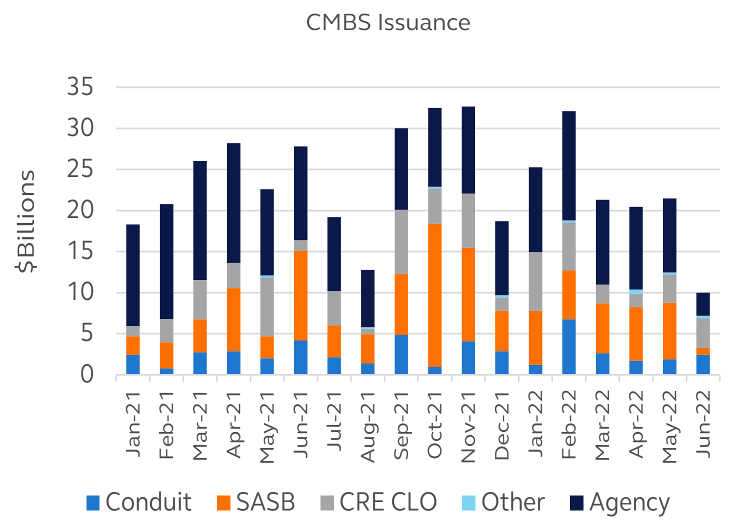
New issue activity started to tail off during the quarter, reflecting the impact that the spike in market volatility and interest rates has started to have on the pace of lending. The $29B of private label issuance was down 35% from first quarter 2022 and down 31% from second quarter 2021. Private label conduit issuance during the quarter was $6B compared to second quarter 2021 issuance of $9B. Private label SASB issuance was $14B compared to second quarter 2021 issuance of $21B. 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 the CMBS credit curve steeper to end 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. 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 half of the year 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



Source: JP Morgan

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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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