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Principal Asset Management℠

Principal Morley

Interest rate strategy

MARCH 31, 2023

DAN KANG, CFA
Portfolio Manager

Rates/Corporates

Highlights

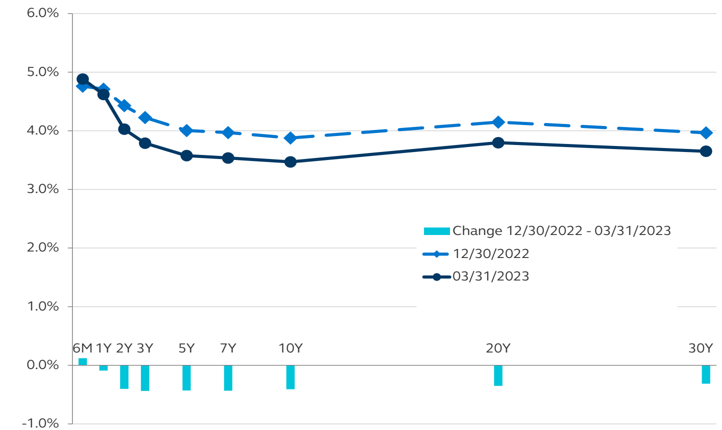
During the first quarter, the yield on the U.S. ten-year Treasury declined from 3.88% at the start of the year to 3.47%. At one point, the 2y10y curve inverted to -108bps, the lowest level since the early 1980s. However, it quickly re-steepened, which historically is indicative of an imminent recession. The volatile and bipolar nature of the rates market continued as data and the market narrative shifted from one extreme to another. January started with a goldilocks scenario coupled with historically attractive yields. Consequently, rates rallied with more supportive and softer inflation prints. The market rally reversed in February with strong labor market data and a reversal of inflation trends which re-priced expectations of an imminent Federal Reserve (Fed) rate cut. The quarter ended with significant market fears of a banking crisis resulting in a flight to quality rally and higher odds of a recession.

To address the growing regional banking crisis, the Fed quickly introduced the Bank Term Funding Program (BTFP) which provided liquidity to banks, allowing them to lend at 100% face value for Treasuries, agencies, and other qualifying assets for up to one year. At the March FOMC, the committee raised the Fed Funds Rate by 25bps, but the Summary of Economic Projections (SEP) showed the median dot of 5.125% at end of 2023, unchanged from the December projections. Although, the SEP did show 87.5bps worth of expected cuts in 2024 versus 100bps in December reflecting a delay of one rate cut into 2025.

Outlook

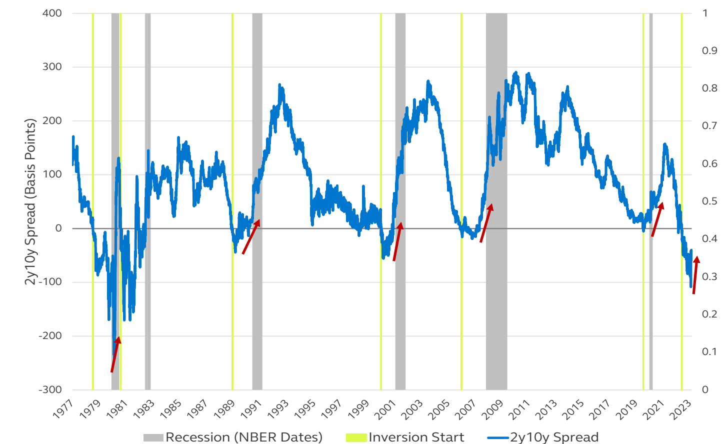
As the year progresses, we would expect the conflicting views of soft versus hard landing to manifest itself into more manic moves in markets. As time passes, we would expect the acute funding stresses of the regional banking crisis to fade, but be replaced with greater concerns over recession risks. The markets are also focused on commercial real estate exposures and the expected tightening lending standards. Prior to the Silicon Valley Bank implosion, banks were already tightening lending standards, and we would anticipate that to continue. We maintain the view that the Fed is closer to the end of its hiking cycle but wary against expecting significant cuts in 2023.

U.S. Treasury Yield Curve



Source: Bloomberg

Curve steepening into recession



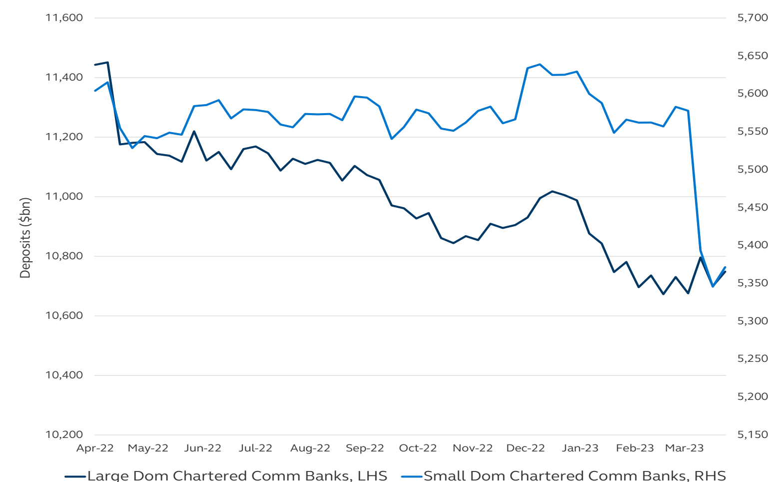
Source: Bloomberg

Corporates

Highlights

In the first quarter, credit spreads were volatile despite ending just 11bps wider for the period. The Bloomberg U.S. Intermediate Corporate Bond Index generated total and excess returns of 2.50% and 0.12%, respectively. The year began with a favorable macro environment versus the pessimistic expectations market participants had coming into the year. Continued progress in lowering inflation while maintaining resilient demand aided the soft-landing narrative. An underwhelming primary calendar for corporate new issuance also contributed to the strong start. First quarter gross issuance totaled $402.9B, which was 13% lower versus Q1 2022. For the quarter, issuance of non-financials was up 23% YoY, while financials issuance was down 41% YoY, with domestic money center bank issuance coming in significantly below expectations.

In March, the credit market faced a banking crisis culminating in the FDIC takeover of Silicon Valley Bank (SIVB) and Signature Bank (SBNY), while the Swiss government orchestrated the takeover of Credit Suisse (CS) by UBS. Bank spreads significantly underperformed non-financials for the month. With the rapid response by regulators, including the new Bank Term Funding Program (BTFP) and the support provided by the largest U.S. banks to alleviate liquidity concerns, the acute regional banking crisis appears to have stabilized for now.

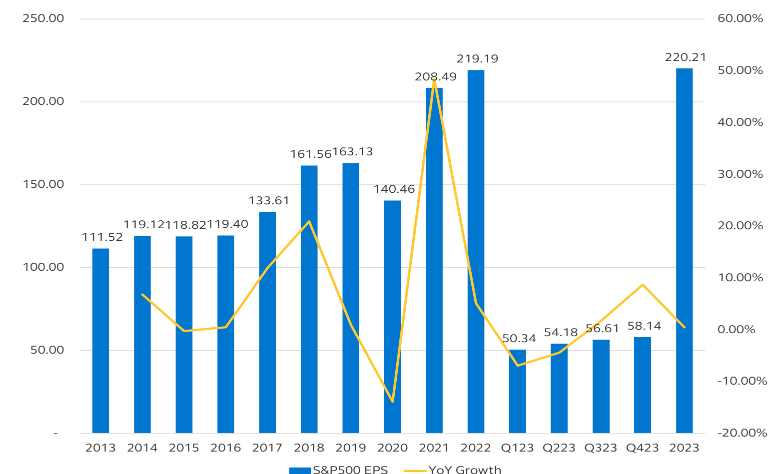


Source: Bloomberg

Outlook

The regional banking credit crisis is consistent with the recent set of risk episodes that we have seen as the Fed began its historic hiking campaign. Over the past year, the U.K. pension LDI margin calls, the FTX fraud, and now the regional banking crisis were revealed as liquidity was withdrawn, volatility rose, and asset prices fell. With the fundamental changes to the banking sector and regulatory oversight, we would not expect a repeat of the Great Financial Crisis. However, tighter financial conditions should result in higher recession probabilities.

With the start of the Q1 earnings season approaching, we would monitor any fallout from the banking crisis. Currently Q1 earnings expectations are for a decline of 6.5%, which marks the largest decline since Q2 2020. Full year expectations are for 1.0% earnings growth, which implies a rebound in earnings growth in the 2nd half of the year. We would expect a more meaningful and prolonged earnings recession if the macro environment deteriorates substantially. Either way, current corporate spreads do not incorporate a recession scenario and reflect a soft landing.



Source: Factset

Mortgage-Backed Securities (MBS)

MARCH 31, 2023

Perpetua Phillips
Portfolio Manager

MBS/ABS/CMBS

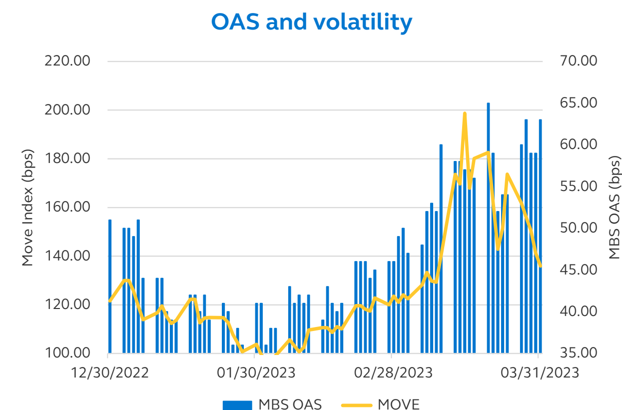
Highlights

The Bloomberg U.S. Agency MBS Index posted total and excess returns of 2.53% and -0.50%, respectively, during a volatile first quarter. Treasury rates rallied sharply in January, retraced higher in February and subsequently rallied in March. The 10-year US Treasury yield traded in a 70 bp range before closing the quarter at 3.47%. Short term rates were even more volatile, with the 2-year Treasury trading in a 130 bp range before ending the quarter at 4.03%. The US Treasury yield curve (2s/10s) reached a peak inversion of -108 bps in March as dueling concerns around inflation and recession risks amplified Fed policy uncertainty and tail risks, with the emergent banking crisis increasing the odds of a hard landing.

In addition to the headwinds from exceptionally high rates volatility, basis performance was buffeted by concerns around the FDIC's liquidation of failed Silicon Valley Bank and Signature Bank's MBS holdings. The two institutions had combined MBS holdings of $90B and speculation around asset sales created significant basis volatility - particularly in lower coupon MBS, which will make up a disproportionate share of the sales. While clarity as to the pace of liquidations wasn't reached by quarter-end, the FDIC subsequently stated that sales will be "gradual and orderly" to limit any adverse impact on market functioning and liquidity.

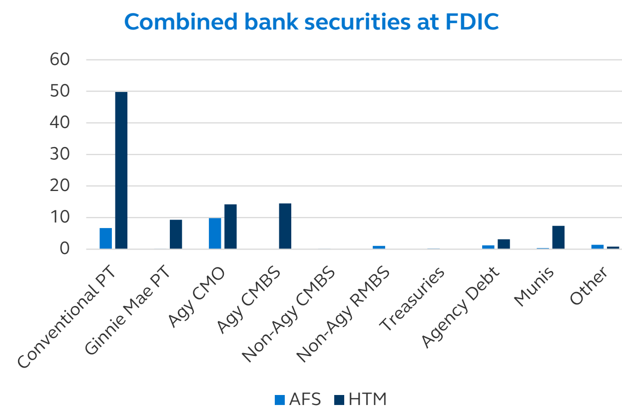
MBS valuations cheapened substantially in light of these fundamental and technical challenges. Current coupon zero-volatility spreads (ZVS) surged from a low of +109 bps in January to +160 bps in March. Option-adjusted spreads widened off a low of +36 bps to close the quarter at +63bps compared to a 10-year average of +33 bps. These headwinds more than offset favorable supply and prepayment factors. Thirty-year primary mortgage rates remained above 6%, leaving most MBS outstanding out-of-the-money to refinance and suppressing net supply to just $27B for the quarter.

OAS and volatility



Source: Bloomberg

Combined bank securities at FDIC



Source: JP Morgan

Outlook

The longer-term repercussions of fiscal and monetary support programs, supply chain disruptions and labor market shifts have created an atypical business cycle with a decidedly uncertain path forward for rates and growth. MBS performance is likely to remain under pressure from protracted volatility as well as supply challenges arising from the seasonal uptick in originator supply, continued Fed runoff and now FDIC bank liquidations. Additionally, regional banks are likely to face greater regulatory and capital requirements, which could dampen their appetite for Agency MBS, though Ginnie Mae collateral could see an HQLA-driven bid.

We believe current valuations are compelling, especially for shorter WAM segments and lower coupons, which have cheapened significantly as a result of the inverted curve, pending bank sales and limited money manager sponsorship. Option-adjusted spreads on 15-year MBS look competitive with longer WAM segments once again and should benefit from negative net issuance as well as stronger demand from banks (lower duration risk) and money managers (short covering). We expect FDIC sales to be manageable ($10-20B/month) and view any related spread widening as a buying opportunity. While elevated volatility may limit near-term spread tightening, the historically wide spreads available on MBS will be earned over time for investors who can manage this risk. The market volatility-smoothing benefits of stable value wrap contracts allow us to take advantage of this unique investment opportunity.

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Asset-Backed Securities (ABS)

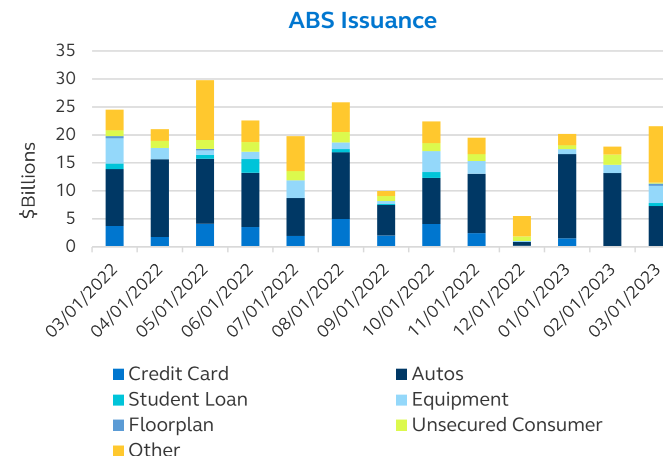
MARCH 31, 2023

Highlights

The Bloomberg AAA Asset Backed Securities (ABS) Index posted total and excess returns of 1.83% and -0.11%, respectively, during the first quarter. AAA ABS spreads moved wider over the quarter in line with other high quality spread sectors. A series of sudden bank failures in March caused regulators to act swiftly to protect depositors and restore confidence. The crisis began with the failure of three U.S. banks that had deposit bases from predominantly technology and crypto sectors. The banking failures led to rapidly spiraling loss of confidence, causing a deposit flight from U.S. regional banks and even a sharp fall in fortune for a European bank. Despite the tumult, the Federal Reserve (Fed) raised rates by 0.25% in March. By raising rates, the Fed made clear that the financial sector turmoil would not deter from efforts to fight inflation. During the quarter, the two-year U.S. Treasury rate fell 0.40% to 4.03%. The two and ten-year US Treasury yield curve continues to be deeply inverted as the market is increasingly concerned that a recession could be on the horizon.

Bank stress is leading to tighter auto lending standards for consumers, requiring dealers to rely more on manufacturer financing sources that can also offer discounted rates to borrowers. This could impact future sales at a time when dealers are seeing increasing inventories. In the used car market, prices have rebounded over 9% from their lows near the end of 2022.

ABS new issuance totaled $59bn in the first quarter as compared to $67bn for the same period in 2022. New issuance for 2023 is expected to be $230bn.

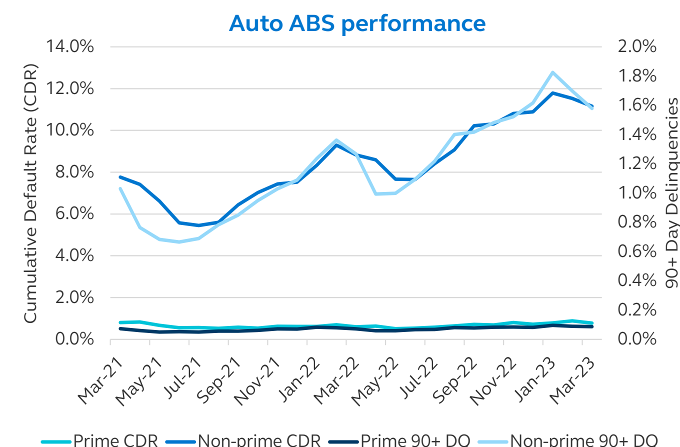


Source: JP Morgan

Outlook

The U.S. consumer remains supported by a strong labor market; both the unemployment rate and new jobless claims are holding steady near pre-COVID lows. However, persistently high inflation is beginning to stress household balance sheets. Due to an inflation rate that exceeds the pace of wage increases, consumers are increasingly relying on credit card debt to maintain spending as savings becomes depleted. However, despite declining savings, household debt-to-income ratios remain near pre-COVID levels and significantly lower than Great Financial Crisis levels. In addition, consumer loan delinquency rates are near pre-pandemic levels, but trending higher from low levels.

ABS fundamentals are supported by low unemployment levels, and delinquency rates among consumer ABS sectors that mostly remain at low levels. However, fundamental factors are weakening at a gradual pace from exceptionally strong levels. Moderately weaker credit metrics for consumer related ABS is expected in the near term. Inflation is impacting subprime borrowers more negatively than prime borrowers. Higher unemployment and growing consumer debt increases the risk to the downside. Within the ABS market we favor AAA issues off prime collateral, which should weather the lingering uncertainty and tail risks around inflation, Fed policy and the economy. Valuations appear attractive when compared to U.S. Treasuries and other short duration alternatives.



Source: JP Morgan

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Commercial Mortgage-Backed Securities (CMBS)

MARCH 31, 2023

Highlights

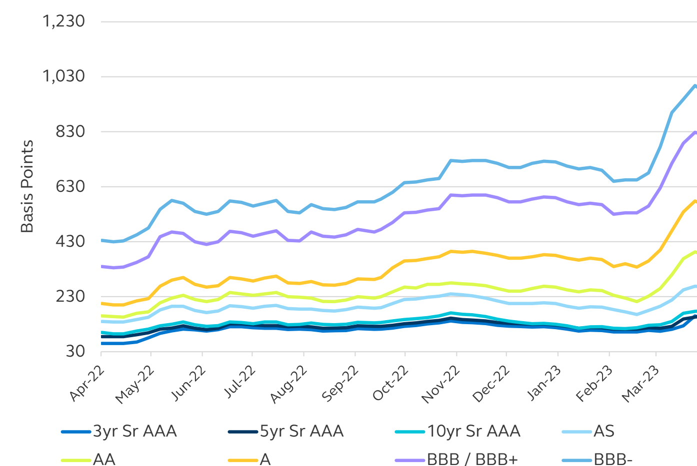
The Bloomberg AAA Commercial Mortgage-Backed Securities (CMBS) Index posted total and excess returns of 1.95% and -0.62%, respectively. During the first quarter, the consistent market risk themes of interest rate volatility, current and future monetary policy expectations and recession fears were compounded by headline office defaults and three regional banks failing late in the quarter. The combination of higher rates, looming recession, office demand and banks tightening lending standards has put commercial real estate, and especially refinancing loans that are maturing in the next 6-12 months, at the forefront of market concerns. These issues weighed on the market and as a result, AAA spreads widened 55bps, AA spreads 135bps, A spreads 180bps and BBB spreads 255bps during the month of March.

New issue activity continued to be materially hampered by slow lending activity due to the impact that the spike in market volatility and interest rates is having on the pace of lending. The $7B of private label issuance was down another 13% from fourth quarter 2022 and down 84% from the first quarter of 2022. Private label conduit issuance during the quarter was $3.3B compared to fourth quarter 2022 of $3.4B and first quarter 2022 of 10.6B. Private label SASB issuance was $2.7B, compared to fourth quarter 2022 of $3.4B and first quarter 2022 of $18.6B. The secondary CMBS market continues to be active, but until real estate equity transactions pick up and bank lending resumes, issuance is expected to remain constrained.

Outlook

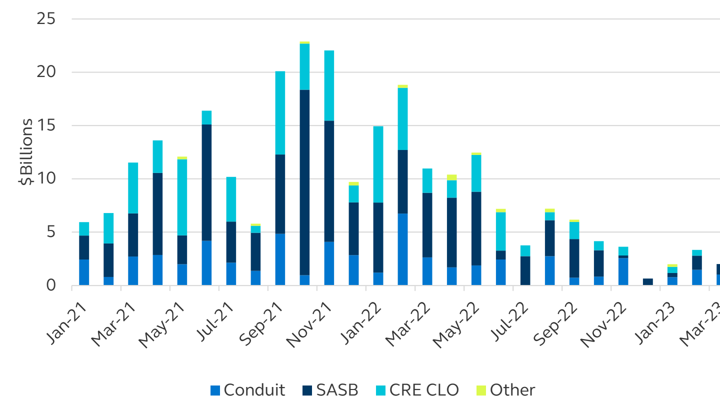
In addition to office loan fundamentals and the performance impact from declining occupancy and income, CMBS investors are also focused on upcoming loan maturities and refinancing challenges given the current rate and credit environment. While the headline number for loans maturing on bank balance sheets in 2023 is high, loans maturing in the next 12 months from 2.0 fixed rate conduit deals are less than 10% of the market at $33B. There are less than 8% of outstanding office loans maturing at $7.9B, and there are just under 16% of retail loans maturing for $14B 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 income levels 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 be determine how far income levels drop.

CMBS Credit Curve



Source: JP Morgan

Private label issuance



Source: JP Morgan

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Important Information

MARCH 31, 2023

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The Bloomberg U.S. Corporate Investment Grade Index is a component of the Bloomberg 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 U.S. Aggregate Index.

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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