Interest Rate Strategy

Morley
CAPITAL MANAGEMENT

Highlights

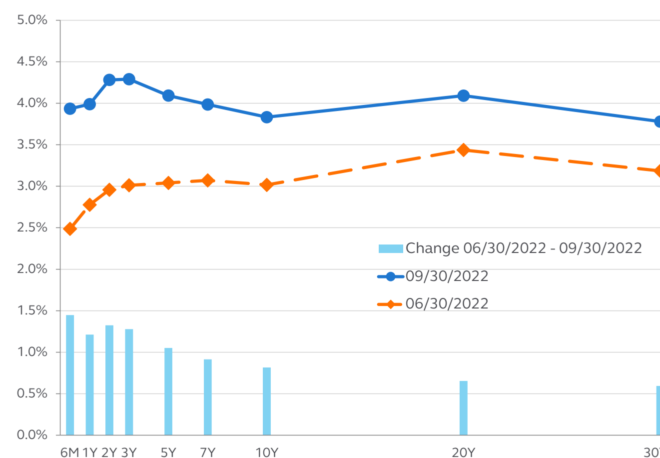
In the third quarter, U.S. Treasuries sold off with the yield curve bear-flattening as persistently high inflation and strong labor markets prompted outsized rates hikes from the Federal Reserve (Fed) and other global central banks. Hawkish commentary and speeches at Jackson Hole and the September FOMC meeting pushed back against the market's initial Fed pivot narrative. The quarter ended with a spike in rate volatility as fiscal policy risks from the U.K. bled into U.S. Treasury markets. The rate sell-off was driven by an increase in real rates as 10-year TIPS ended the quarter at 1.67%, the highest since 2010. In contrast to the hotter than expected August CPI and PCE prints, forward inflation break-evens trended downward close to low 2% levels. The difference between the realized inflation vs expected inflation highlights the large potential for monetary policy error.

With inflation continuing to run well above target, the Fed opted for a third consecutive 75bps rate hike at the September FOMC. As expected, the Fed stepped up its pace of Quantitative Tightening limits to $95B a month in September. The Fed's updated Summary of Economic Projections (SEP) indicated that FOMC participants see the median Fed Funds rate rising to 4.4% (vs 3.4% in June) by year-end, suggesting another 125 bps of hikes at the final two meetings of this year. The Fed's median estimate for year-end 2023 and 2024 was revised upward to 4.6% and 3.9%, respectively. In addition, the Fed increased their forecast of Core PCE to 3.1% (vs 2.7% in June) and unemployment to 4.4% (vs 3.9% in June) for 2023.

Outlook

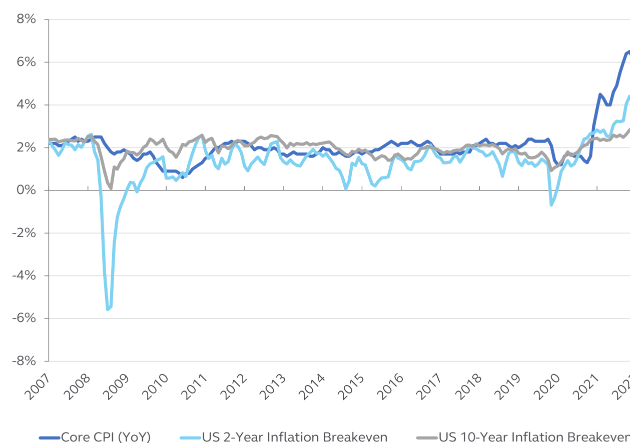
We maintain the view that a near-term Fed pivot should not be expected. Over the last several months, Fed speakers have acknowledged that a recession is a possibility in the pursuit of achieving their inflation targets. We believe that more economic pain is required than what the Fed and market may be expecting to control inflation. At this stage, we are sympathetic to the view that the Fed will continue to hike until something breaks. Although liquidity measures are poor and volatility elevated, financial stability concerns are still distant consideration versus inflationary risks. Therefore, the risk continues to be a higher terminal rate and longer period of restrictive policy.

U.S. Treasury Yield Curve



Source: Bloomberg

Inflation vs Inflation Expectations



Source: Bloomberg

Dan Kang, CFA
Portfolio Manager

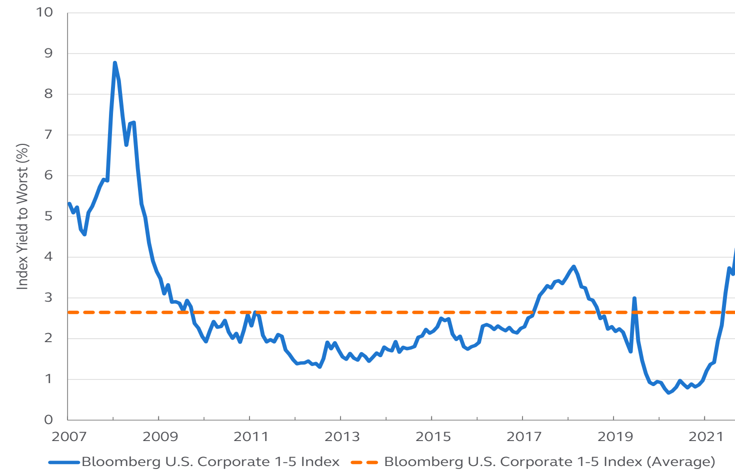
Rates/Corporates

Third quarter 2022

Highlights

The Bloomberg U.S. Intermediate Corporate Bond Index generated total and excess returns of -3.11% and 0.07%, respectively, during the third quarter. Year-to-date total and excess returns for the index were -11.81% and -2.27%, respectively. The third quarter started with a summer rally predicated on a Fed pivot narrative, better than expected economic data countering fears of an imminent recession, and a solid earnings season. However, the macro backdrop deteriorated as inflation prints and Fed speakers pushed back on any imminent change in Fed policy. Volatility spiked during the last week of September when turmoil in the U.K. Gilts market resulted in a global liquidity-event. Consequently, credit spreads ended the quarter at year-to-date wides.

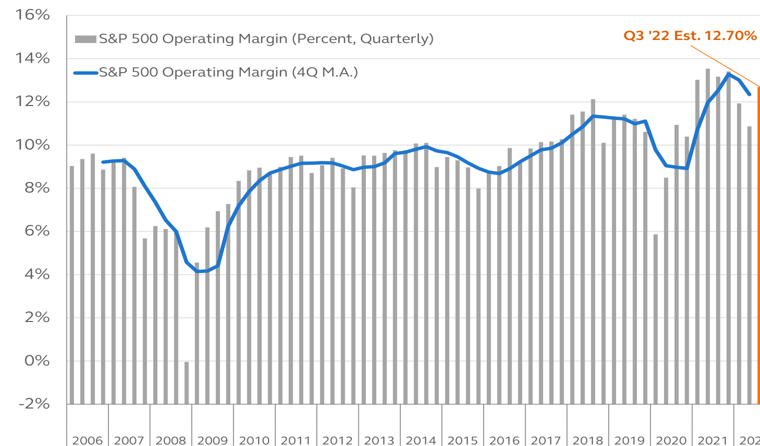
Despite the challenging risk environment, credit spreads were relatively resilient and supported by several factors. First, market technicals were favorable as primary supply underwhelmed, while retail fund flows were generally positive. Second, relatively better than expected Q2 earnings and management outlooks reassured investors on near term corporate fundamentals. Third, all-in yields have become extremely attractive and are at the highest level since 2009. Due to the inverted curve, the front end is particularly attractive with yields +276 bps above their 15-year historical average (93rd percentile), Chart 1.



Source: Bloomberg

Outlook

We continue to have a cautious view on credit spreads in the short and intermediate term and expect a high degree of volatility heading into 2023. Challenging macro fundamentals have yet to translate to micro corporate fundamentals. Managements have been able to pass on cost pressures to their customers and maintain healthy margins, Chart 2. The sustainability of that dynamic will be challenged as demand weakens and labor costs are still high. Further, we believe the positive technical backing credit spreads to be less supportive going forward. We are starting to see retail fund flows turn negative as rate volatility and negative returns drive away investors. Also, overseas investors will continue to see f/x hedging costs rise as the Fed continues to hike rates. Third, we have transitioned to a TINA-less (‘There Is No Alternative’) environment where cash and short-term T-bills are offering attractive options for investors.



Source: S&P Dow Jones Indices

Mortgage-Backed Securities (MBS)

Morley
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Highlights

The Bloomberg U.S. Agency MBS Index posted total and excess returns of -5.35% and -1.69%, respectively, during the quarter, buffeted by hawkish central bank policy, extreme market volatility, and elevated supply relative to weakening demand technicals. Sector performance began the quarter on a strong note but sharply reversed course, punctuated by the worst monthly performance on record relative to Treasuries in September (-1.91%).

Amidst stubbornly high inflation, the Federal Reserve hiked rates by 75 bps for the third consecutive meeting in September and signaled another 125 bps of hikes by year-end. The median dots project the Fed Funds rate at 4.375% and 4.625% for year-ends 2022 and 2023, respectively. With regards to the balance sheet, the Fed ended MBS purchases in mid-September as paydowns on their MBS holdings fell well short of the fully ramped $35B/month terminal runoff cap. Despite this Chair Powell stated that the committee wasn't considering outright MBS sales in the near-term.

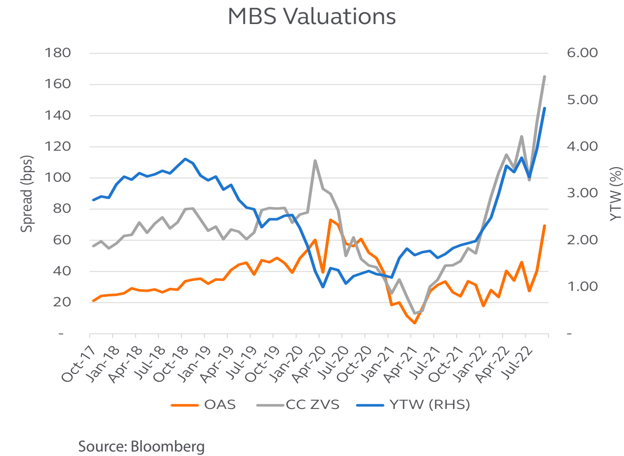
The option-adjusted spread (OAS) of the MBS index widened from +46 bps to +70 bps over the quarter as wider nominal spreads offset the impact of surging implied and realized volatility. MBS current coupon zero-volatility spreads (ZVS) widened from +127 bps to +165 bps during the period. The effective duration of the index held steady near 5.90 years while MBS convexity moved into positive territory (+0.14) as both refi and extension risks faded following the rapid surge in rates YTD.

The thirty-year mortgage rate climbed an additional 100 basis points during the quarter to reach a post-GFC high of 6.70%, leaving only 0.05% of borrowers with a refi incentive. This was reflected in prepay speeds, which declined below 7% CPR in September. MBS gross and net supply was also dampened by higher rates, declining to $372B/$125B in Q3 compared to $449B/$140B in Q2.

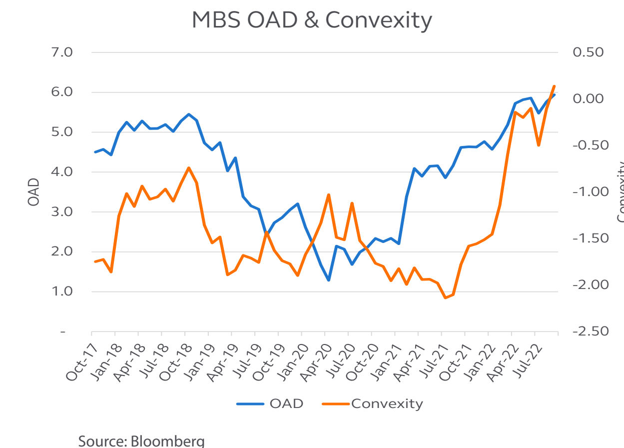
Outlook

Despite historically attractive valuations and cashflow profiles, MBS performance is likely to remain under pressure until there's an end in sight to the Fed's tightening cycle and corresponding volatility. With the Fed becoming a net seller of MBS and banks/REITS/foreign investors largely on the sidelines, money managers have had to absorb the bulk of net supply. As their MBS underweights have been covered and fixed income fund outflows resume, this group has been unwilling/unable to absorb enough supply to support stable spreads. Therefore, in the near term we expect the basis to remain under pressure, along with other risk assets.

For several reasons we believe MBS currently offer a compelling opportunity for longer term investors able to withstand near-term volatility. First, MBS nominal spreads and convexity are at historically attractive levels, offering investors a stable, higher-yielding alternative to Treasuries. Second, periods of elevated volatility have historically been opportune times to buy MBS, which stand to benefit as volatility normalizes. Third, Agency MBS typically outperform credit sectors in weak/recessionary environments and MBS valuations are currently cheap relative to IG credit. Finally, the supply outlook should improve in the coming months due to the lagged effect of higher rates and seasonal factors, while bank demand for MBS could return as loan demand weakens. These factors should ultimately drive a strong rebound in MBS performance, rewarding investors willing to look beyond near-term volatility.



Source: Bloomberg



Source: Bloomberg

Perpetua Phillips
Portfolio Manager

MBS/ABS/CMBS

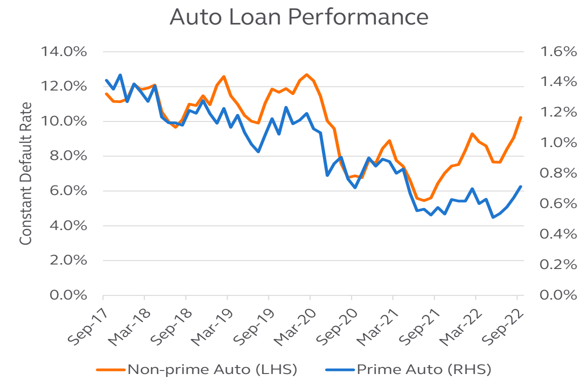
Highlights

The Bloomberg AAA Commercial Mortgage-Backed Securities (CMBS) Index posted total and excess returns of -1.48% and 0.20%, respectively, during the third quarter.

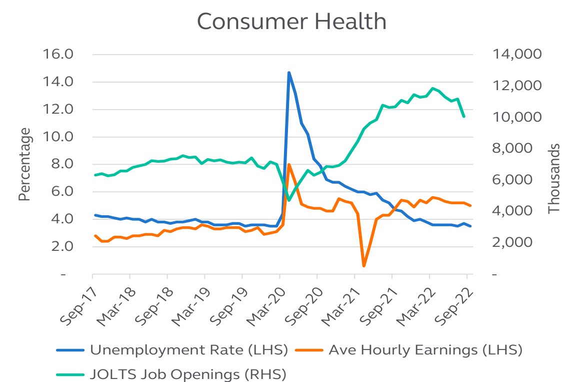
Markets were lifted in July by hopes that deteriorating economic data and falling commodity prices could give central banks flexibility to dial back tightening policies. However, Federal Reserve (Fed) Chair Powell's Jackson Hole speech dashed hopes for an early pivot from tightening and reignited fears of a hard landing. During the speech, Powell emphasized the Fed's commitment to restraining inflation while recognizing that efforts to curtail inflation will bring about softening in labor market conditions and a period of below-trend growth. The Fed followed the August speech by raising the Fed Funds rate by 0.75% in September and signaling its intent to further restrict monetary conditions in the coming months. The Fed's resolute focus on bringing inflation under control, despite the economic cost, 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. Front-end U.S. Treasury yields experienced significant spikes as the two-year rose 1.32% to 4.28%. The two and ten-year yield curve became deeply inverted during the quarter as the market is increasingly concerned that a recession could be on the horizon.

On August 24th, the Biden administration announced a one-time $10k public student loan cancellation initiative for Department of Education loans ($20k for Pell Grants) granted to individuals making less than $125k/yr and households earning up to $250k. Privately-held FFELP loans are not part of the forgiveness program. The Student Debt Relief Plan also granted the seventh and final extension for the payment moratorium on federal student loans through December 31st 2022. The end of the payment pause will have negative knock-on effects on consumer credit performance. Debt cancellation should have a partial offsetting impact. Separately, six states filed a lawsuit challenging the constitutionality of the forgiveness program.



Source: JP Morgan



Source: Bloomberg

Outlook

Despite elevated inflation, 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, job openings are beginning to trend lower, suggesting that restrictive monetary policies are starting to effect labor markets. Although the typical U.S. consumer began the year in an excellent condition due to savings accumulated during the pandemic, 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.

ABS credit performance is expected to normalize, i.e., deteriorate, but at a gradual pace and from exceptionally strong levels. Stable to moderately weaker credit metrics for consumer related ABS is expected for the balance of 2022 and into 2023. Inflation is likely to impact subprime borrowers more negatively than prime borrowers. Higher unemployment and consumer debt increases the risk to the downside. ABS structures are generally still robust and well protected.

Issuance pace remains brisk; the total ABS new issue supply is $195.4B YTD versus $199.8B YTD 2021. Investor demand is highly selective with the strongest demand in high quality benchmark names. ABS is largely tracking macro credit volatility and 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.

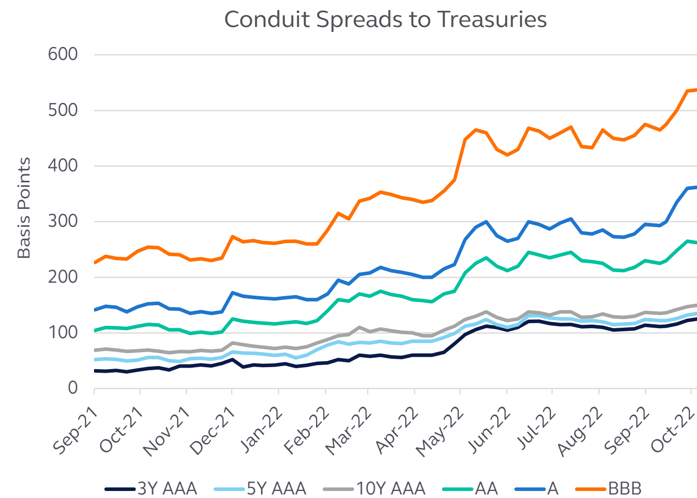
Commercial Mortgage-Backed Securities (CMBS)

Morley
Capital Management

Highlights

The Bloomberg AAA Commercial Mortgage-Backed Securities (CMBS) Index posted total and excess returns of -3.93% and -0.30%, respectively. During the third quarter persistent inflation, interest rate volatility, current and future monetary policy expectations pushed the probability of recession higher, tightened liquidity and resulted in wider spreads and a steeper CMBS credit curve. These factors were all headwinds for fixed rate conduit returns. Spreads on floating rate SASB bonds were pressured wider during the quarter as well.

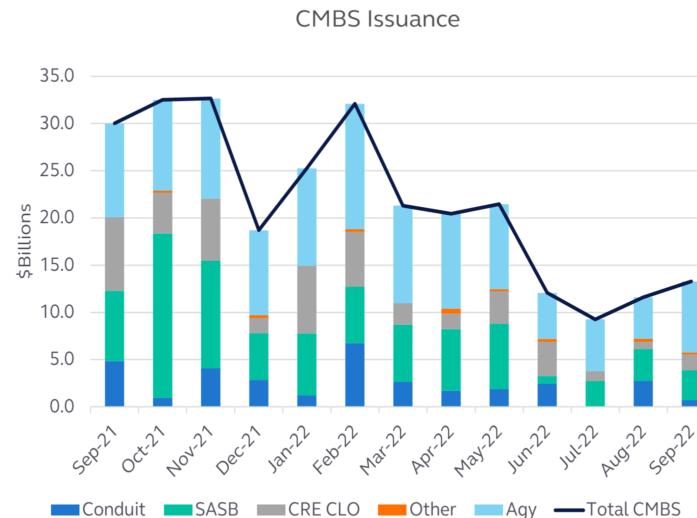
New issue activity almost ground to a halt during the quarter, reflecting the impact that the spike in market volatility and interest rates is having on the pace of lending. The $16B of private label issuance was down 55% from second quarter 2022 and down 31% from second quarter 2021. Private label conduit issuance during the quarter was $3B compared to second quarter 2021 issuance of $8B. Private label SASB issuance was $94B compared to second quarter 2021 issuance of $15B. 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.



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. Historically there has been a strong correlation between job growth and loan delinquencies with a 12–18-month lag. As the probability of a recession increases the risk premium in the market is starting to reflect delinquencies moving higher. This is especially true with office as demand is already being impacted by work-from-home policies and lower office demand even before a potential recession. Market technicals are expected to be supportive of spreads during the rest of 2022 and into 2023 as the move wider in spreads and higher volatility year-to-date has slowed down lending activity, which is expected to result in a slower pace of new issuance to start 2023.



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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