M.D. Sass Securitized Fixed Income Market Review & Outlook

MD SASS

1Q 2023 Commentary

April 27, 2023

SUMMARY

- Risk assets started the new year with strong gains across markets. Market expectations that central banks might be closer to an inflection point in their current interest rate hiking cycle drove interest rates lower in January. However, risk assets gave up their early gains in February as robust economic data prompted market concern that any near term pause in policy rate hikes might be postponed. Market volatility spiked in March with the collapse of Silicon Valley Bank and Signature Bank in the US. Financial sector distress was also evident in Europe as UBS agreed to buy Credit Suisse in a deal brokered by regulators. Intervention by central banks and banking regulators prevented further financial fallout.

- Economic data was mixed during the first quarter of 2023. While the latest Core Personal Consumption Expenditure (PCE) Index indicated that inflation was moderating, the labor market stayed tight as the unemployment rate for March fell back to 3.5%. For the quarter, the Bloomberg U.S. Aggregate Index returned 2.96%, recouping part of the -13.01% loss from 2022. Across major spread sectors, Agency MBS excess returns over Treasury were -0.50%, driven by high interest rate volatility. Investment Grade Credit generated an excess return of +0.21% during the quarter. The Treasury yield curve shifted lower across the term structure, with both the 2-year and 10-year Treasury yields lower by 40bps.

MARKET TRENDS AND INVESTMENT THEMES

POSITIONING OVERVIEW

Market weight on spread product. Keep interest rate and spread durations short. Emphasize carry and favor short to intermediate duration given inverted term structure.

1. **Duration:** Moderate long duration bias given macro-economic uncertainty
2. **Yield curve:** Prefer short/intermediate 2-3 year duration given carry and curve reshaping
3. **Overweight:** Higher coupon Agency MBS, short duration CMOs, Agency CMBS and floating rate/short duration Non-Agency RMBS such as Credit Risk Transfer
4. **Underweight:** Lower coupon MBS given longer spread duration and supply technicals.

Fed Policy Pivot

In early March, Chair Powell had prepared the market for a possible 50bp hike in the policy rate before the regional bank crisis. Subsequently, the regional bank crisis and tighter credit conditions' impact on economic growth led to a significant market repricing of the front end of the yield curve. The unprecedented data dependence (aka uncertainty) by both the Fed and the market in turn spurred significant interest rate volatility (Chart 1). By the end of March, a seemingly contained banking crisis once again shifted both the Fed's and the market's focus back to inflation, even as the March FOMC meeting minutes revealed Fed staff projecting a "mild recession" later this year. The implication is that the fixed income sectors whose valuations are most directly driven by interest rate volatility, including Agency MBS (Chart 2), should benefit the most as the Fed policy rate approaches its expected peak in the current cycle.

Chart 1: Volatility across various asset classes - Percentile of 3-month implied volatility since 2010
Source: Morgan Stanley

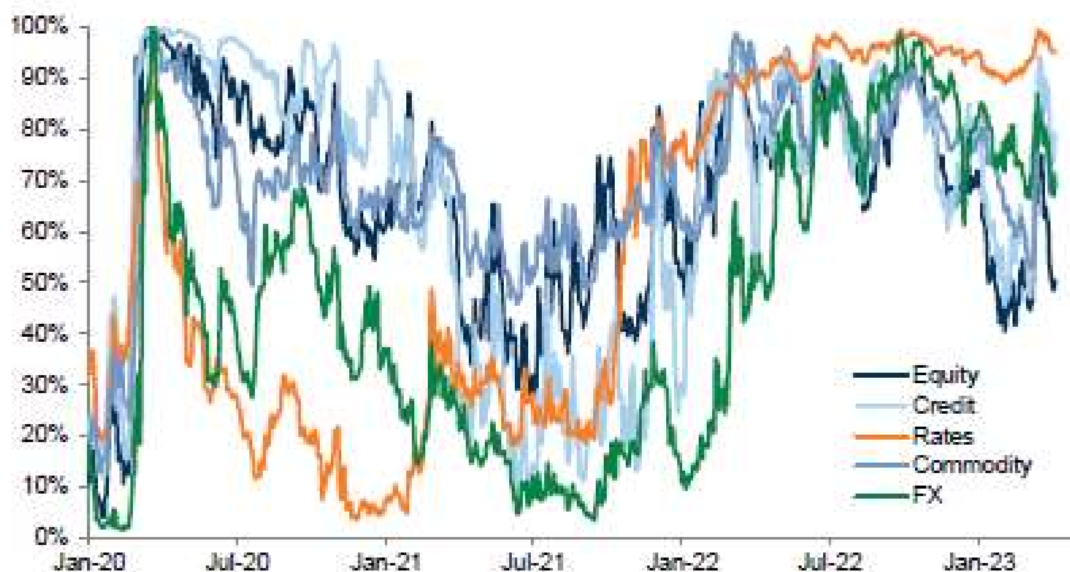
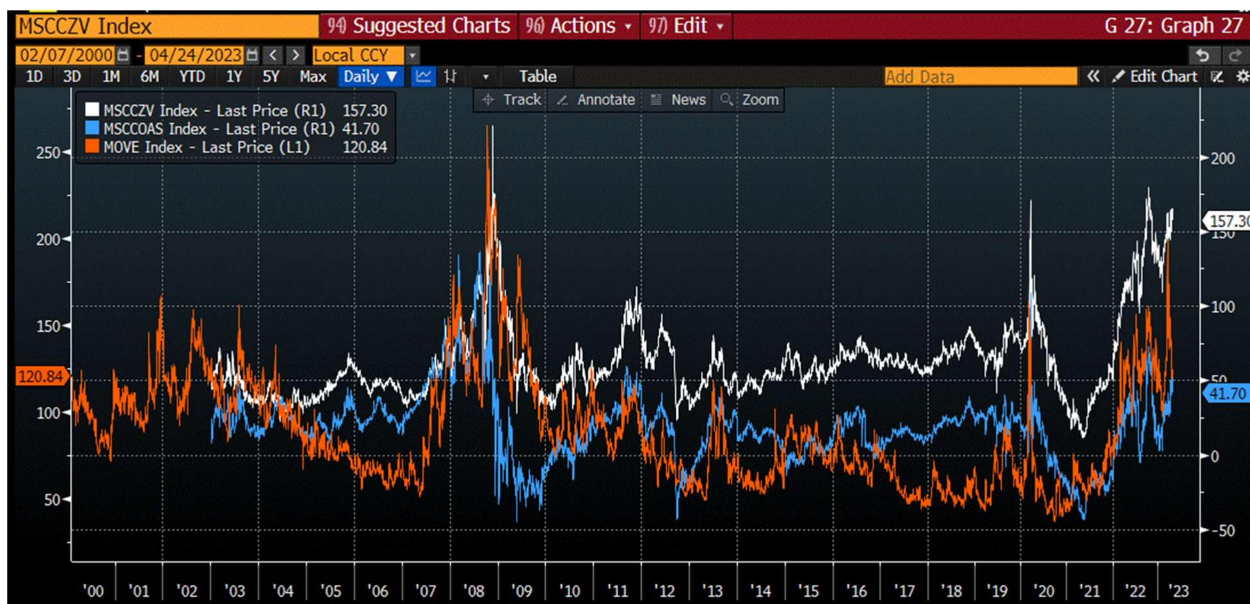


Chart 2:
Agency Mortgage Zero-Volatility Spread (MSCCZV) / Option Adjusted Spread (MSCCOAS) /
ICE BofA Interest Rate Volatility Index (MOVE)
Source: Bloomberg



Agency MBS Outlook

Cross-Sector Relative Value

With the significant increase in interest rate volatility due to bank turmoil in March, Agency MBS lagged Treasuries by the end of the quarter. This followed a year when the sector generated negative excess returns on par with 2008. Currently, we believe Agency MBS valuations are cheap on a relative and historical basis and have again approached that of the 2020 pandemic and the 2008 global financial crisis (GFC). As interest rates stabilize, we see the opportunity to capture Agency MBS returns that we believe are attractive. Market disruption caused by bank failures and uncertainty about how the FDIC's liquidation of SVB's Agency MBS portfolio will be absorbed have weighed on mortgage performance, providing additional risk premium priced into Agency MBS and allowing for investment opportunities that we believe are attractive, and MBS performance has stabilized thus far in April. In contrast, non-financial investment grade credit spreads have returned to early March pre-banking stress level (Chart 3). Historically, Agency MBS have done better during prior periods of high economic risks (flight to quality). Last but not least, net Agency MBS supply should remain low at the current level of mortgage rates, especially taking into account tighter lending conditions (Chart 4).

Chart 3: Mortgage spreads look wide to corporate spreads
Source: Morgan Stanley

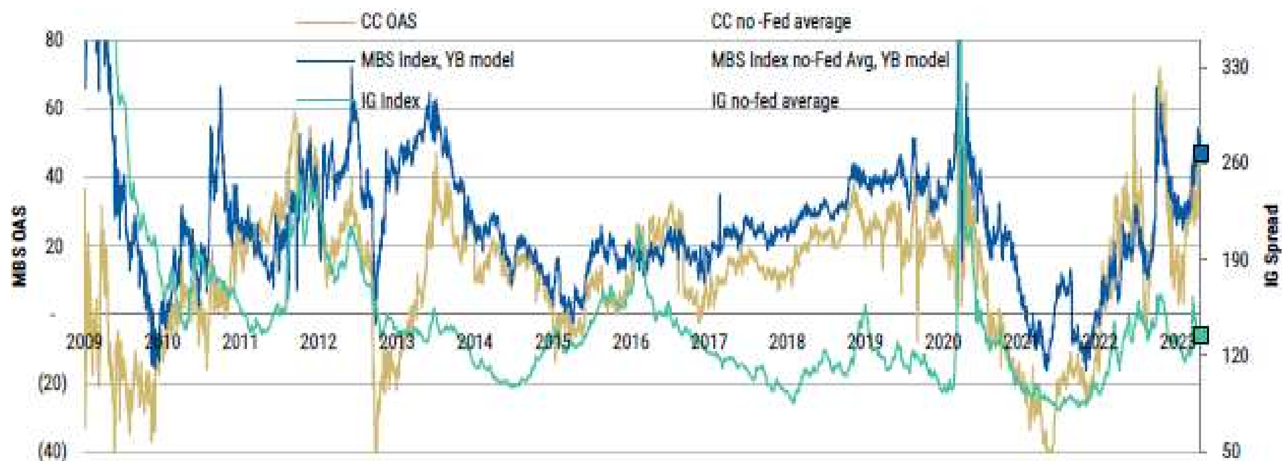
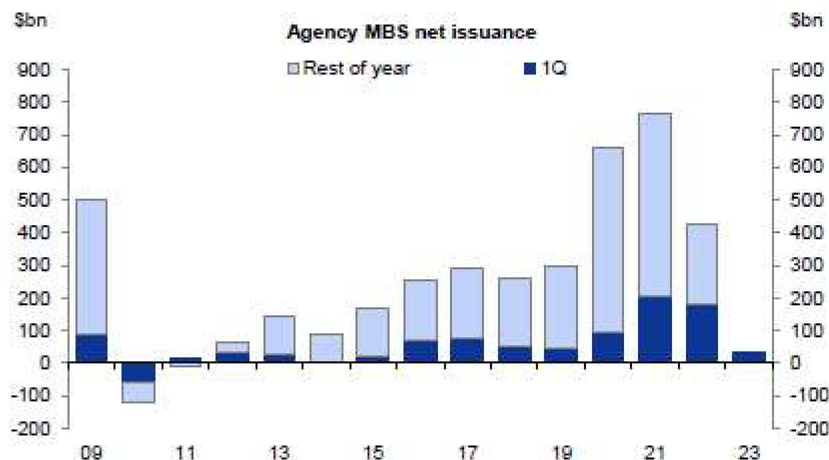


Chart 4: The supply backdrop in Agency MBS will likely remain low given mortgage origination outlook
Source: Goldman Sachs



Yield Curve Positioning

As the yield curve remained extremely inverted in both spot and forward markets, there has been significant inflow into money market funds and other short-term programs including the Fed's Overnight Reverse Repo Facility (RRP). While carry per unit of interest rate duration currently favors the shortest duration assets, the market is pricing in lower short term interest rates later this year (i.e., due to Fed Funds rate cuts). Short duration

assets, including Agency MBS, might benefit the most as the Treasury yield curve eventually steepens with shorter maturity yields decreasing more relative to longer maturity yields as the Fed eventually pauses and eases monetary policy conditions. Currently, our Short Term Agency strategy (~2 year duration, government-backed portfolio) offers a higher yield than the Bloomberg Aggregate Bond Index with 6.33-year duration: 5.35% yield vs. 4.40%.

Chart 5: US money market fund AUM vs. bank deposits, $tn.
Source: Citi Research, ICI, Federal Reserve Bank

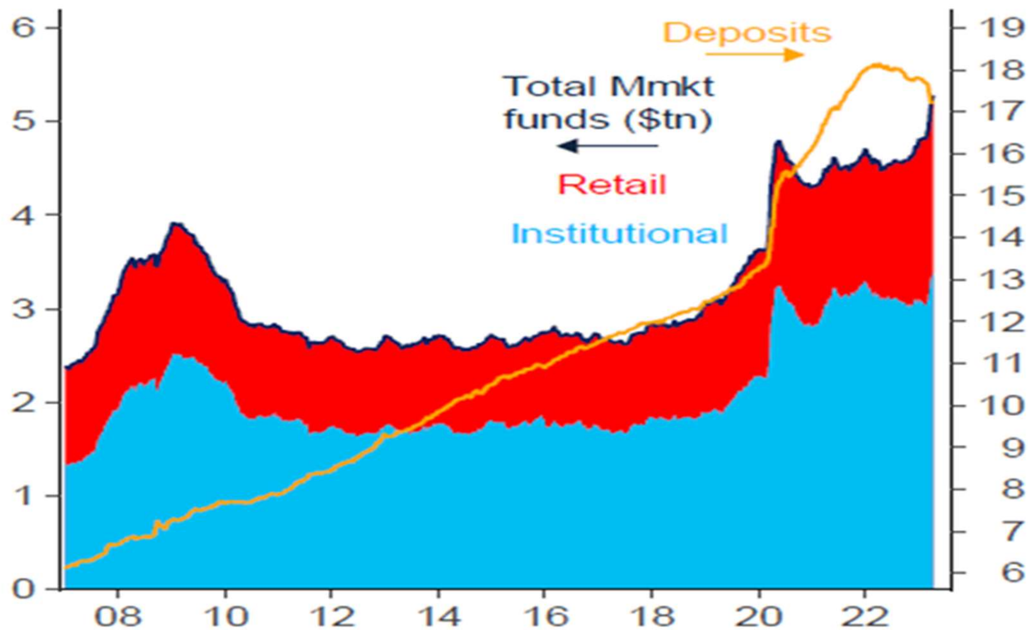
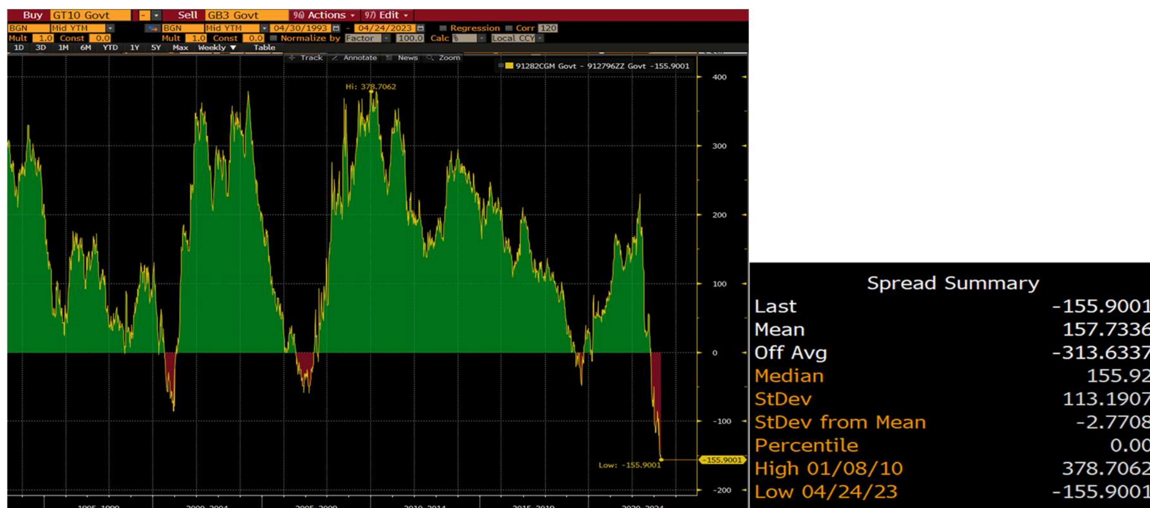


Chart 6: 10-year Treasury vs. 3-month T-bill spread
Source: Bloomberg



Mortgage Credit

Given the sector's underperformance relative to IG credit in March, mortgage-backed securities backed by Agency eligible collateral and Non-guaranteed Agency mezzanine securities currently offer a spread advantage over Treasuries at levels approaching that of the COVID pandemic. With challenging conditions in the commercial real estate (CRE) financing market, we believe there are attractive investment opportunities in both Agency and Non-Agency CMBS backed by multi-family properties. Unlike other CRE sectors, the multi-family sector has benefited from the undersupply of single-family housing in the post-GFC era. The current high mortgage rates and low affordability has made rental housing, including multi-family, the only alternative for many prospective home purchasers. Indeed, the sector's net operating income remains strong. Our focus on "Agency-grade" multi-family properties also benefit from Agency underwriting and loss-sharing partnerships with some of the largest originators in the industry.

Chart 7: The decline in occupancy rates has been more pronounced for office than other types of properties
Source: Goldman Sachs

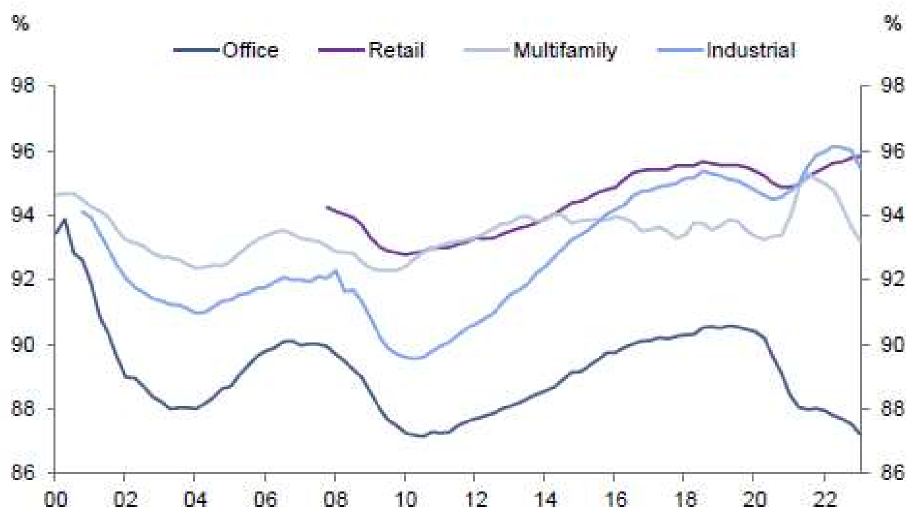


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Chart 8: Freddie Mac multifamily credit performance and metrics for Feb 2023

Source: Freddie Mac

Delinquency Status			
Status	**Count**	**UPB (In $M)**	**% of Portfolio**
Current	14,687	$318,495.5	99.9%
30 Days	6	$53.7	0.02%
60 Days	4	$36.5	0.01%
90 Days	20	$185.7	0.06%
Foreclosure	2	$50.5	0.02%
REO	2	$14.1	0.00%
TOTAL	14,721	$318,836.0	100.0%

Debt Coverage Ratio (DCR)		
DCR Range	**Count**	**% of Portfolio**
< 1.0	428	2.2%
1.00-1.10	140	0.7%
1.10-1.20	197	1.0%
1.20-1.50	1,626	9.2%
> 1.50	12,330	86.9%
N/A		
	14,721	100.0%

As always, we welcome the opportunity to further discuss our views and your investment needs at any time.

Sincerely,

Lipkee Lu
Director of Fixed Income

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