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

MD SASS

2Q 2023 Commentary

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2ND QUARTER FIXED INCOME COMMENTARY

- The Federal Reserve and regulators' quick response to the regional banking crisis, including the launching of the Bank Term Funding Program (BTFP), the lifting of the deposit insurance limit, and the acquisition of First Republic by J.P. Morgan were instrumental in restoring investor confidence in the financial system. With economic data showing a resilient economy carrying into the third quarter, a strong labor market and moderating inflation (even though core inflation is still well above the Fed's 2% target), the Fed continued to indicate a further Fed Funds rate hike of 0.25% at the upcoming FOMC meeting. The recent debt ceiling deal in early June simply suspended it until January 1, 2025, after the November 24 presidential election, and conveniently postponing the risk of a U.S. government default.

- The FOMC raised the Fed Funds rate by 25bps in May. By removing earlier guidance that additional policy tightening might be necessary, Chair Powell indicated that the FOMC was considering a more gradual approach in Fed Funds policy. The Summary of Economic Projections showed a median funds rate projection of 5.625% by the end of 2023, representing an increase of 50bps over the rates that were kept constant at the May meeting.

- During the second quarter, the Treasury yield curve flattened significantly between the 2-year and 10-year maturities, with the 2-year Treasury yield moving higher by 87bps while the 10-year yield was higher by only 37bps, reflecting the market's continued repricing of the Fed's policy path. With market consensus gradually pushing out near term recession risk and shifting toward a "soft landing" scenario as the base case, overall fixed income spread products outperformed Treasuries in Q2. The Bloomberg U.S. Aggregate Index returned -0.84%, for the quarter. Across major spread sectors, Agency MBS' excess return over Treasuries was +0.76%, driven by moderating interest rate volatility and attractive valuations. Investment Grade Credit generated an excess return of +1.26% during the quarter.

FIXED INCOME POSITIONING OVERVIEW

Overweight structured product.
Neutral interest rate duration and overweight short maturity spread durations.
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 rich valuation and long interest rate duration

MARKET TRENDS AND INVESTMENT THEMES

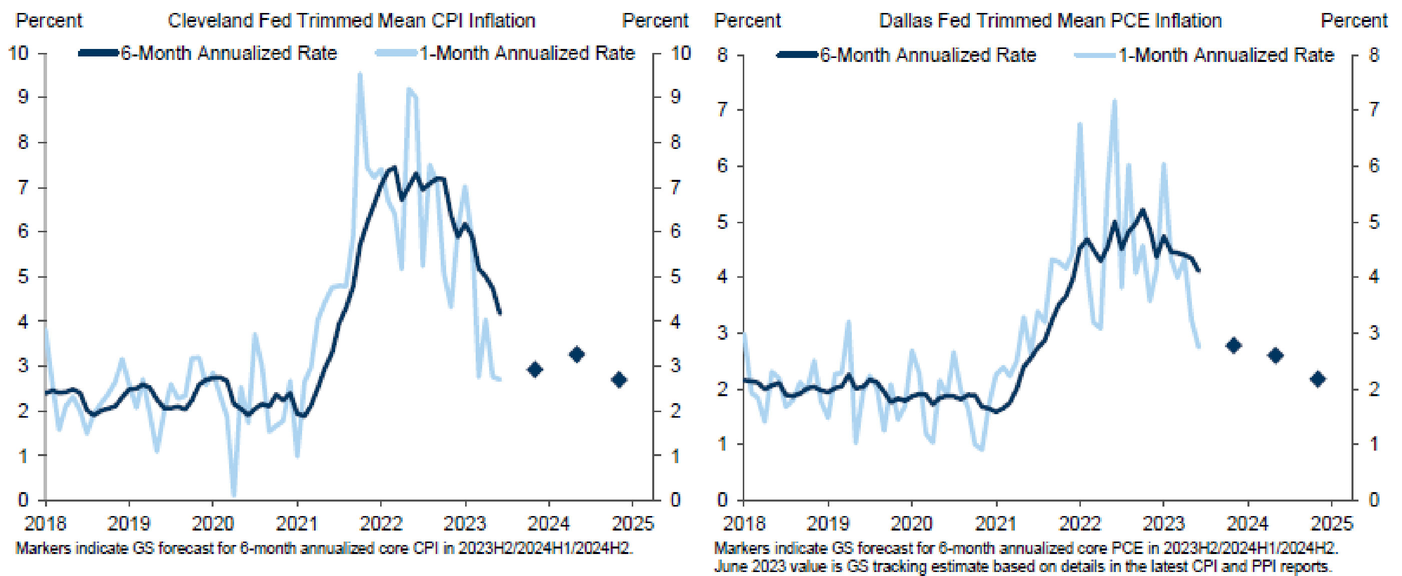
Fed Policy Pivot

Importantly, given resilient economic data, the June FOMC minutes indicated that the Fed staff saw the possibility of the economy avoiding a recession as "almost as likely as" entering a mild-recession. The market was caught off-guard as economic data continued to exceed expectations, as reflected by the economic surprise index (Chart 1). During the quarter, the market priced out the probability of rate cuts by year end, instead of incorporating the Fed's additional 50bps of projected rate hikes into forward rates. While the June FOMC meeting continued to characterize inflation as "unacceptably high", certain Fed statistics have started to indicate a moderating trend in inflation. It is this trend that will drive a future Fed policy pivot in light of resilient economic data (Chart 2).

Chart 1: Bloomberg economic data surprise index

Source: Bloomberg

Chart 2: The pace of disinflation has quickened



Source: Goldman Sachs

Agency MBS Outlook

Mortgages outperformed Treasuries in Q2 due to declining interest rate volatility (Chart 3) and the orderly liquidation of FDIC's securities portfolios it took over from failed Signature Bank and Silicon Valley Bank. This was the second time MBS generated positive quarterly excess return since the Fed started raising rates at the end of 2021. Even after the recent outperformance, Agency MBS valuations remain attractive and approaching that of the 2020 pandemic and the 2008 global financial crisis (Chart 4). As interest rates stabilize, we see significant upside for Agency MBS returns. Importantly, if further Fed policy tightening eventually leads to a recession, Agency MBS have historically done better during prior periods of high economic risks (a.k.a. a flight to quality).

Chart 3: The ICE BofA interest rate volatility index (MOVE).

Source: Bloomberg

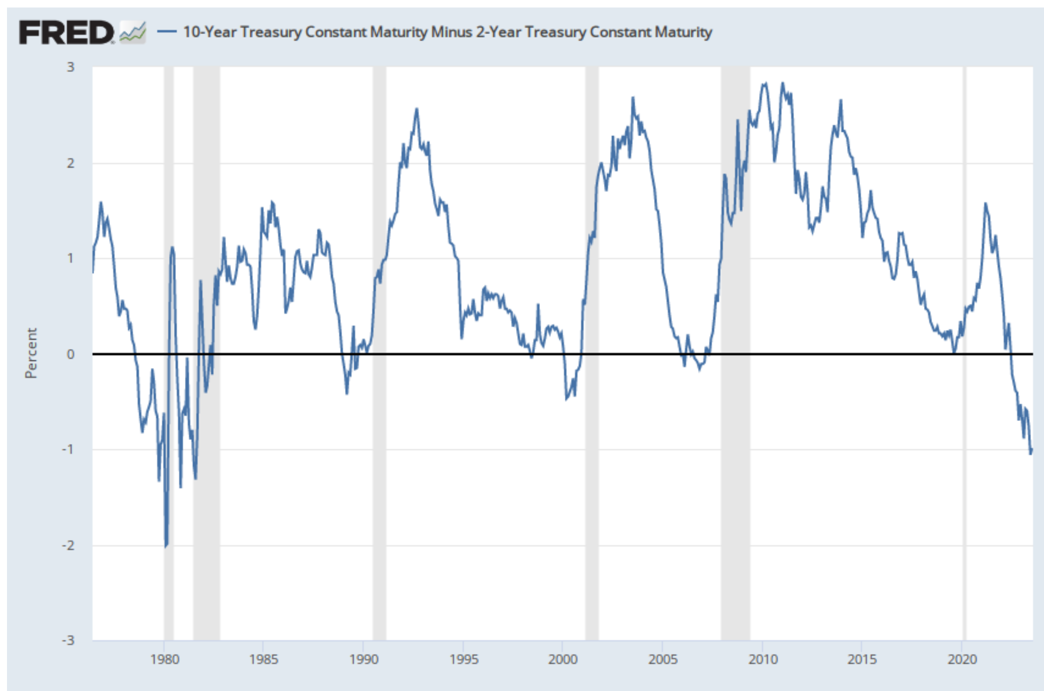
Chart 4: Mortgage spreads remain attractive to historical levels (Current coupon MBS spread over 10-year Treasury)

Source: Bloomberg

Yield Curve Positioning

The U.S. Treasury yield curve inversion deepened in June after the FOMC dot plot indicated that the committee would likely raise rates two more times this year (Chart 5). This was because keeping short term rates at such a high level for a longer period of time implies a higher likelihood of the economy entering a recession, and subsequently the Fed would need to be more aggressive cutting rates. As the yield curve remained extremely inverted, the implication is two-fold for fixed income investors: 1) It doesn't pay to extend in duration, as carry per unit of interest rate duration certainly favors shorter duration assets, and 2) In turn, this implies 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.

Chart 5: Yield spread between 10-year and 2-year maturity Treasuries



Source: Federal Reserve Bank of St. Louis

Chart 6: Fed Dot Plot implying 1% lower Fed Funds rate by 2024

Projection Central Tendencies and Short Term Implied Target Rates

Curves	2023	2024	2025	Longer Term
FOMC Dots Median	5.625	4.625	3.375	2.5
Fed Funds Futures - Latest Value	5.365	4	3.91	
OIS - Latest Value	5.356	4.039	3.062	

Source: Bloomberg

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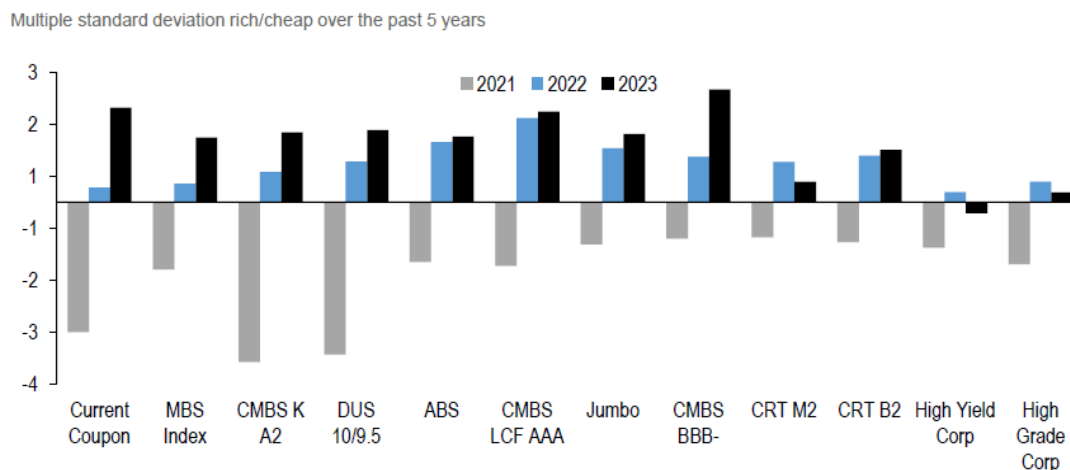
Mortgage Credit

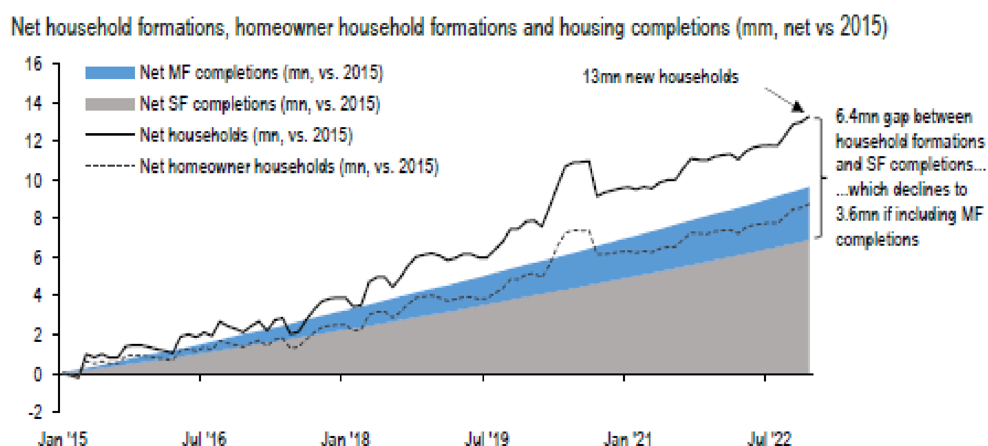
In addition to Agency MBS, other structured products including Non-Agency RMBS and short duration ABS backed by prime collateral have also lagged recent risk asset outperformance. Currently, mortgage-backed securities backed by Agency-eligible collateral and Non-guaranteed Agency mezzanine securities offer a spread advantage over Treasuries at levels approaching that of the COVID pandemic (Chart 7). As for housing fundamentals in relation to Non-Agency RMBS, the low housing supply relative to demand implies limited downside for housing prices. High mortgage rates have pushed affordability lower, which in turn limits new construction and further restricts housing supply (Chart 8). In all, we remain optimistic on Agency-grade residential MBS credit performance.

Chart 7: Structured Product attractive relative to Corporate Credit



Source: J.P. Morgan

Chart 8: Years of underbuilding (since 2015) resulted in 3.6mm housing units gap



Source: J.P. Morgan

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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