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

MD SASS

4Q 2023 Commentary

January 26, 2024

4TH QUARTER SUMMARY

- Treasury yields declined significantly over the quarter, as the FOMC signaled that it has finished the current rate hiking cycle given the progress made in bringing inflation down to target levels. Specifically, the CPI declined from 3.7% in September to 3.1% in November and closed the quarter at 3.4% in December. Fed Chair Powell noted during the December press conference that the FOMC was "very focused" on the risk of keeping the funds rate too high for too long. The Fed's updated dot plot, a chart updated quarterly with Fed officials' key short term interest rate projections, indicated the Fed Funds rate would end 2024 at 4.5-4.75% down 75 basis points from the current range of 5.25-5.5%.

- Intra-quarter, Treasury yields increased in October with the 10-year Treasury yield exceeding 5% intra-month due to strong economic activity and inflation remaining elevated. U.S. real GDP rose by 4.9% annualized during the 3Q23, driven by strong consumption growth. A strong labor market and increased U.S. Treasury supply also added upward pressure to yields. The FOMC indicated that it had not ruled out the possibility of further tightening. The surge in Treasury yields tightened U.S. financial conditions and pushed out market expectations for a pause in Fed rate hikes.

- Market expectations then changed again in November as October CPI came in at 3.2% year-on-year, and the November FOMC statement indicated that the Central Bank was taking additional time to assess the economic impact from prior hikes. Fed Governor Waller's comment at month-end that recalibrating rate cuts was becoming more likely as inflation continued to slow down pulled forward market expectations of the timing for the first rate cut in 2024. By December, the dovish FOMC meeting during which Chair Powell shifted monetary policy from a "higher for longer" regime to prospective rate cuts, led to a strong risk asset rally as non-Government fixed income securities from corporate credit to Agency mortgage-backed securities outperformed government bonds.

POSITIONING OVERVIEW

Overweight short to intermediate duration high-quality structured products. Focus on carry given inverted term structure.

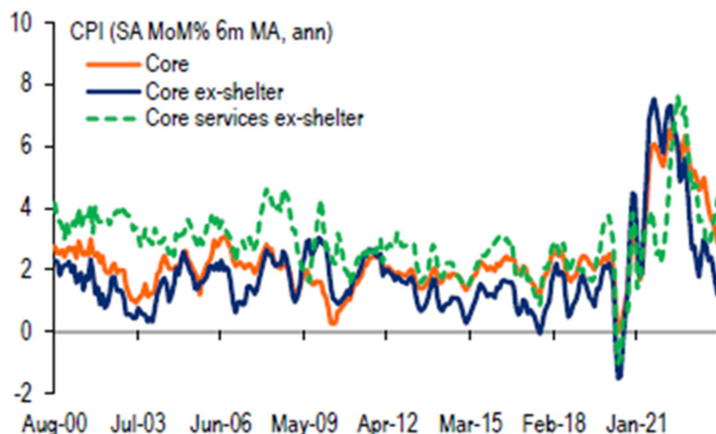
1. **Duration:** Underweight long duration given macro-economic uncertainty
2. **Yield curve:** Prefer short/intermediate 2–3-year duration given carry and curve reshaping
3. **Overweight:** Higher coupon Agency MBS, Agency non-guaranteed securities including Agency credit risk transfers, and other non-Agency RMBS/asset-backed securities
4. **Underweight:** Lower coupon MBS given rich valuation and long interest rate duration

MARKET TRENDS AND INVESTMENT THEMES

Fed Policy Outlook

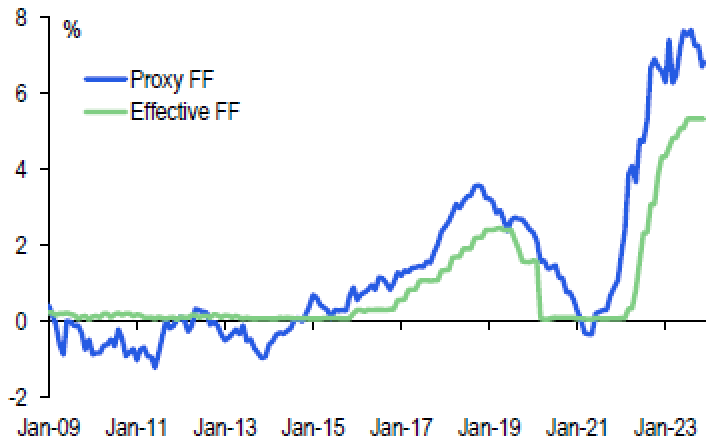
As the trajectory of overall inflation continued to drift lower, Treasury yields fell significantly in Q4. However, the main economic uncertainty for 2024 remains whether the sticky components of CPI, specifically the core services ex-shelter, will decline following that of the more flexible components (Chart 1). Importantly, by adding an additional cut in 2024 in its December dot plot, the Fed is projecting moderating inflation and signaling a desire to reduce the risk of a policy error by keeping the Fed Funds rate too high for too long (Chart 2). In turn, this implies that the inverted yield curve should normalize and provide additional return potential for short duration assets (Chart 3).

Chart 1: 6-month annualized core, core ex-shelter, core services ex-shelter inflation



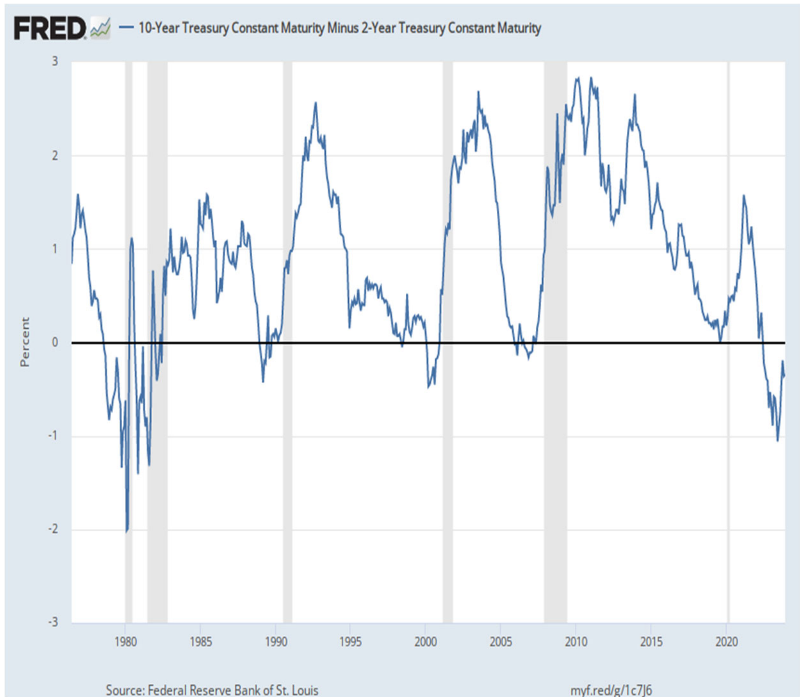
Source: Citibank

Chart 2: Both realized and modeled Fed Funds rates remained restrictive



Source: Citibank

Chart 3: Spread between 2-year and 10-year constant maturity Treasury yields



Source: Federal Reserve Bank of St. Louis

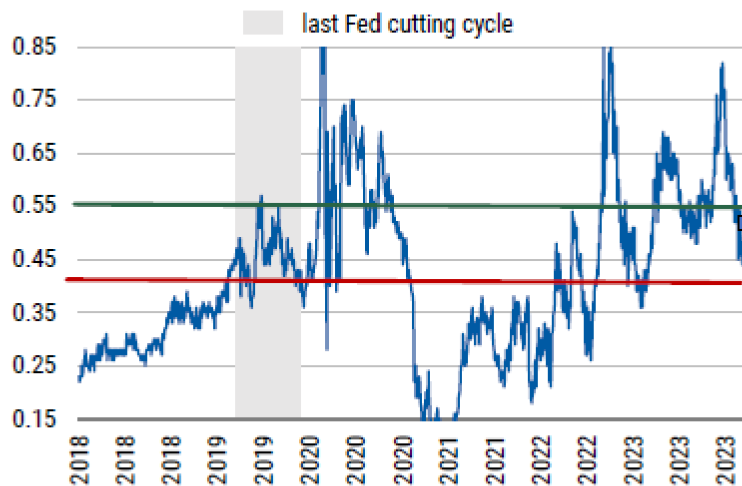
Agency MBS Outlook

Mortgages outperformed Treasuries in Q4 bringing risk-adjusted spreads to the middle of their 1-year range (Chart 4). Last year mortgage spreads were highly correlated with 10-year interest rates, and elevated interest rate volatility explained a large part of Agency MBS underperformance during Q3. As interest rates stabilize in a Fed pause/easing scenario, we see Agency MBS spreads tightening and potential upside for Agency MBS returns. Notably, we saw MBS tighten during the last Fed cutting cycle (Chart 5). Agency MBS have historically performed better during periods of high economic risk (a.k.a a flight to quality).

Chart 4: MBS Spreads in another volatile year: FN 30-year current coupon OAS and annual max/min, bp

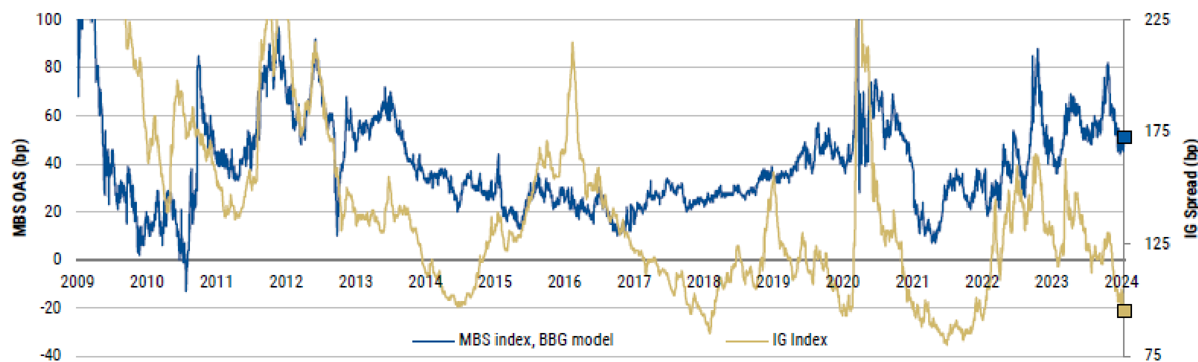
Source: JP Morgan

Chart 5: MBS Spreads tightened during the last Fed cutting cycle



Source: Morgan Stanley

Chart 6: Mortgage and Investment Grade (IG) Index spreads



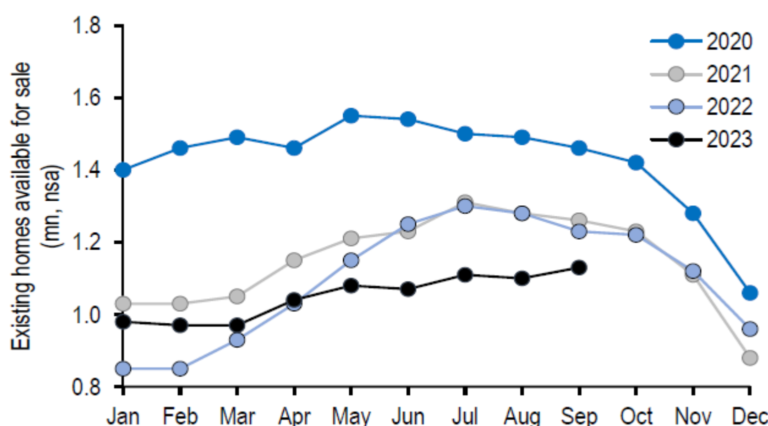
Source: Morgan Stanley

Agency Non-Guaranteed and other Structured Products

Certain Agency-related sectors, including GNMA Project Loans and Agency multi-family credit risk transfers, have lagged the outperformance of more generic Agency MBS. We continue to overweight these sectors given the steady cashflow profile and spread advantage over Treasuries. Housing fundamentals remain strong in the current economic cycle (Chart 7). In addition, we see price return upside given the prepayment sensitivity of the underlying collateral to a decline in Treasury and mortgage rates (Chart 8). Separately, short/intermediate duration ABS backed by prime collateral also lagged recent risk asset outperformance, including prime auto ABS issued by credit unions and fiber network asset-backed securities. To that end, we recently put together a AA-rated sample portfolio with a high single digit yield for an interested investor (Chart 9).

Chart 7: Housing supply remains at historic lows:

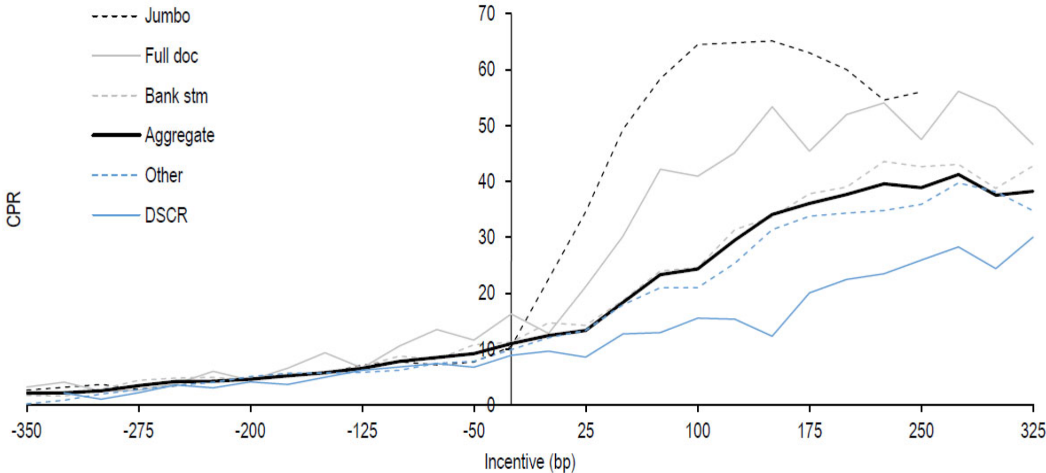
Annual rate of existing homes available for sale (mn, nsa)



Source: JP Morgan

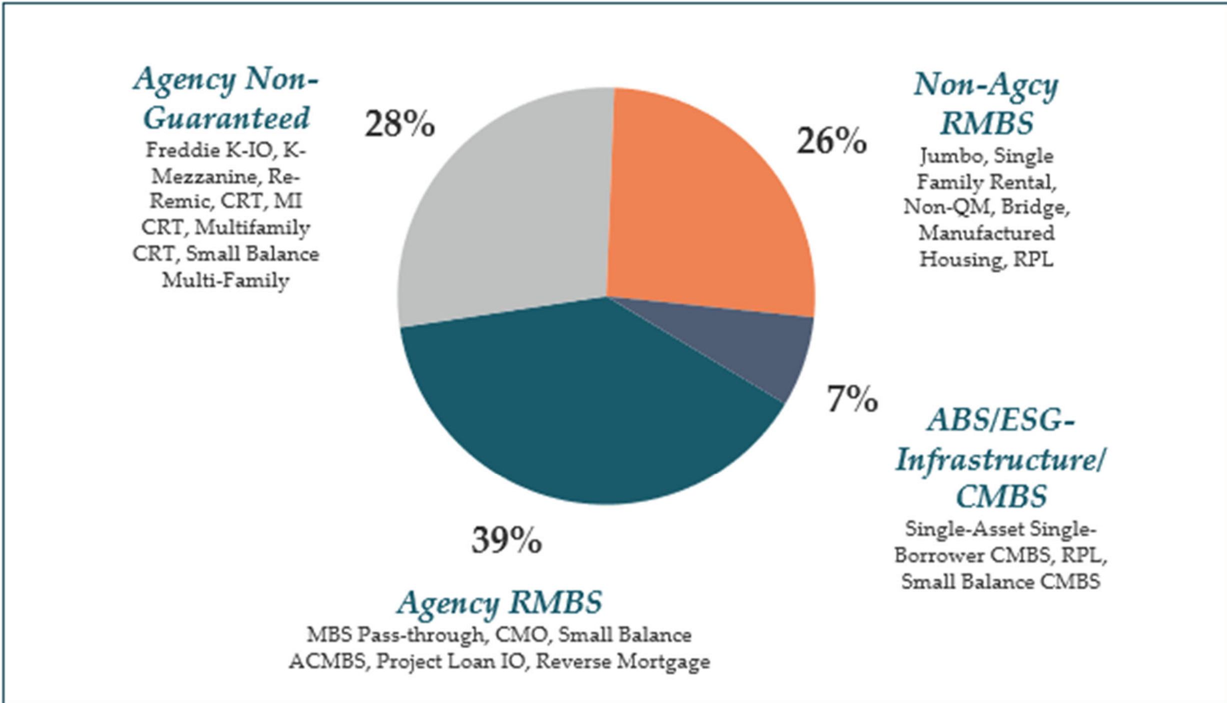
Chart 8: Prepayment sensitivity by documentation type since Jan 2021.

(Refi incentive is calculated over the conforming rate for non-QM)



Source: JP Morgan

Chart 9: Sample structured product portfolio sector allocation



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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