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

MD SASS

3Q 2023 Commentary

October 27, 2023

3RD QUARTER SUMMARY

- Treasury yields rose during the quarter, as the market repriced a "higher for longer" restrictive monetary policy regime. Economic activity remained resilient with a strong labor market and real long-term rates rising to their highest level in over 20 years, with most of the increase occurring since June in the face of moderating inflation. Specifically, June CPI rose 0.2% month over month following a 0.1% increase in May, and 2nd quarter GDP growth of 2.1% also exceeded consensus. While the FOMC raised the Fed Funds rate by 25bps in July, its indication of a data-dependent gradual approach and market speculation that the July hike could be the last kept Treasury yields, especially short maturities, within a tight range. The Fed's staff is now assigning a higher probability of a soft economic landing in contrast to the beginning of the year when most were predicting the U.S. would now be in a recession.

- In August, the market became concerned that further rate hikes this year might be possible given robust US economic data. Fitch downgraded the US's AAA rating to AA citing "expected fiscal deterioration… and erosion of governance". A day later, the US Treasury announced a larger than expected quarterly bond sale which would likely stretch into 2024. The announcement contributed to a sell-off in Treasuries that sent 10-year yields to their highest levels of 2023. The Fed also noted there was further work to be done on bringing inflation down towards their target at the annual Jackson Hole symposium.

- As expected, the Fed did not raise rates at its September meeting and left the policy rate unchanged at 5.25%-5.5%. However, the September "dot plot" of Fed Funds projections by the committee was more hawkish than the June one, as the median Fed funds rate projections for 2024 and 2025 were higher by 50bps at 5.125% and 3.875%, respectively. The FOMC also projected a lower unemployment rate of 4.1% at year-end 2024, down from 4.5%. Importantly, the Fed continues to expect inflation to fall back to 2.5% by 2024. As the market repriced more modest rate cuts in 2024, the 10-year Treasury yield reached 4.57% at quarter end, the highest level since the Global Financial Crisis. The Bloomberg US Aggregate Index declined 3.23%, for the quarter. Across major spread sectors, Agency MBS' excess return over Treasuries was -0.81%, driven by substantially higher interest rate volatility. Investment Grade Credit generated an excess return of +0.03% during the quarter.

POSITIONING OVERVIEW

Continue to overweight short duration and high-quality 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 ABS and Non-Agency RMBS
4. **Underweight:** Lower coupon MBS given rich valuation and long interest rate duration

MARKET TRENDS AND INVESTMENT THEMES

Fed Policy Outlook

The September minutes noted that all participants agreed that the FOMC "was in a position to proceed carefully", as the last several months' data indicated slowing inflation (Chart 1). However, the committee stressed that inflation remained "unacceptably high" and the "need to see more data indicating that inflation pressures were abating", with rising energy prices and the autoworkers' strike posing near term upside risks to inflation. Currently, the Fed is projecting a moderate rate cut in 2024 compared to prior forecasts (Chart 2). The Treasury yield curve, particularly the real yield component compared to the inflation expectation component, repriced significantly higher as a result (Chart 3). Chair Powell noted positive real interest rates indicating that monetary policy remained restrictive. The aforementioned higher rates led to tightening financial conditions, which could mean less need for the Federal Reserve to raise interest rates further.

Chart 1: The pace of disinflation has quickened.
Source: Goldman Sachs

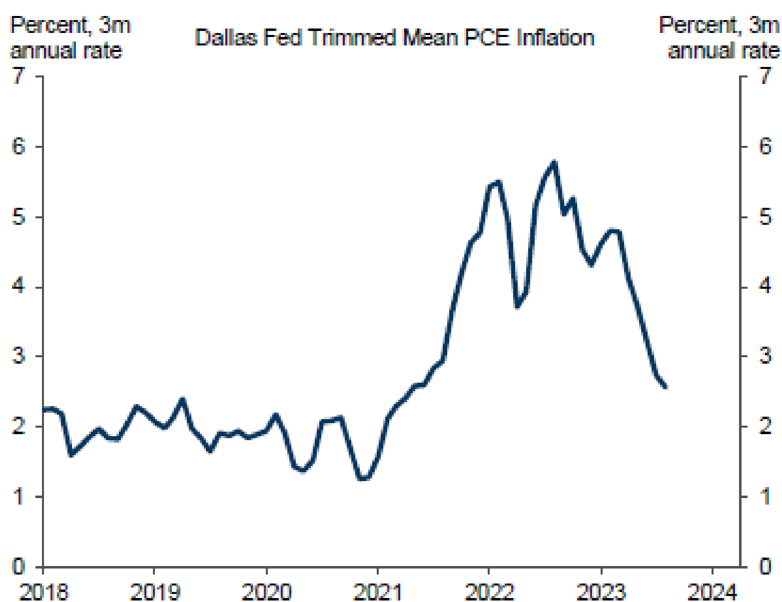

Chart 2: Federal Reserve September Dot Plot
Source: Bloomberg

Projection Central Tendencies and Short Term Implied Target Rates					
Curves	2023	2024	2025	2026	Longer Term
FOMC Dots Median	5.625	5.125	3.875	2.875	2.5
Fed Funds Futures - Latest Value	5.46	4.66	4.405	4.3	
OIS - Latest Value	5.457	4.515	3.597	3.348	

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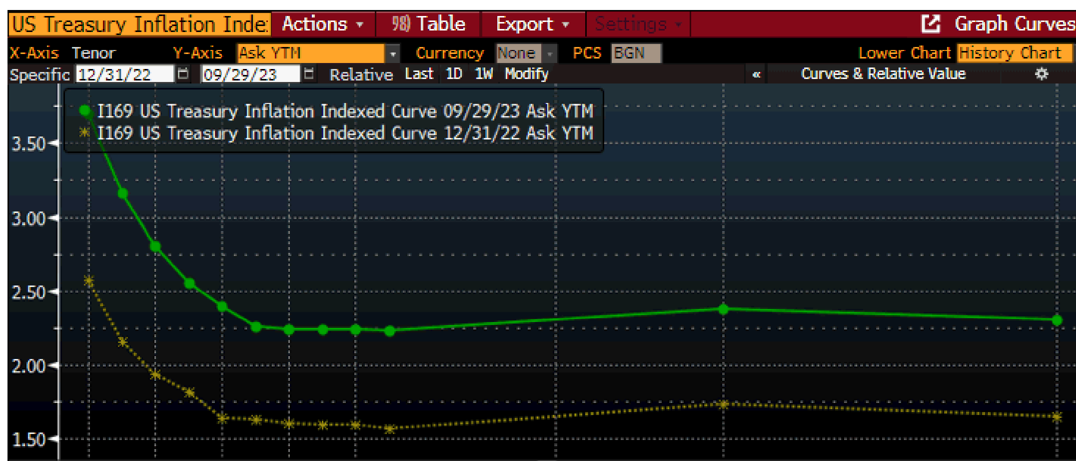
Chart 3: U.S. Treasury Inflation Protected Securities (TIPS) Real Yields.
Source: Bloomberg



Agency MBS Outlook

Mortgages underperformed Treasuries in Q3 due to elevated interest rate volatility and lack of sponsorship from traditional investors including banks. Currently, Agency MBS valuations are extremely attractive, approaching/exceeding that of the 2020 pandemic and the 2008 global financial crisis (Chart 4-5). As interest rates stabilize in a "soft landing" scenario, we see significant upside for Agency MBS returns (Chart 6). Alternatively, notwithstanding year-to-date Agency MBS underperformance relative to credit (Chart 7), if further monetary policy tightening eventually leads to a recession, Agency MBS have historically performed better during periods of high economic risk (a.k.a, a flight to quality).

Chart 4: U.S. 10-year Treasury yield and MBS current coupon yield.
Source: BMO

Chart 5: MBS current coupon spread over a blend of 5-year and 10-year Treasury yield.
Source: BMO

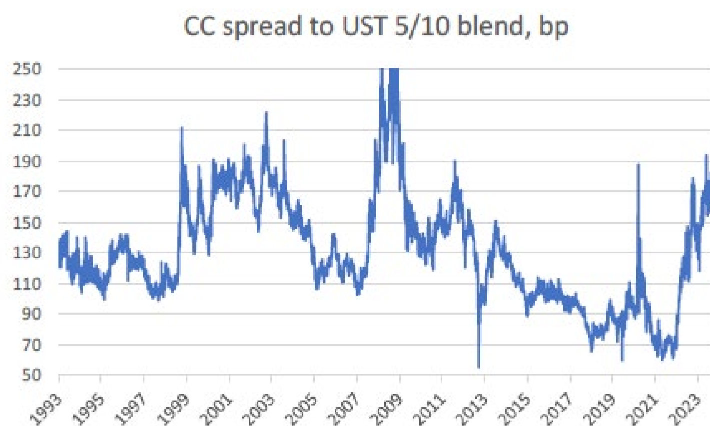


Chart 6: Mortgage tend to underperform into periods of peak uncertainty and outperform afterwards.
Source: Goldman Sachs

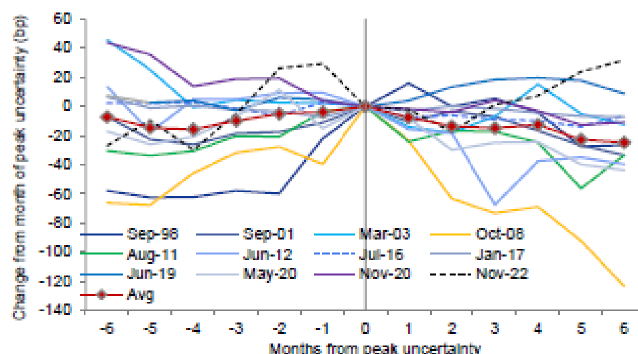
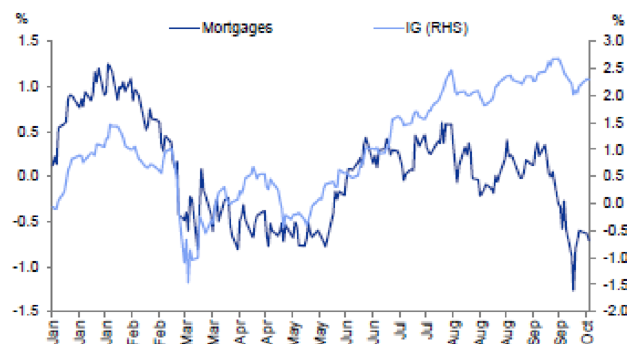


Chart 7: YTD Agency MBS excess return over Treasuries, relative to corporates.
Source: Goldman Sachs



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Yield Curve Positioning

The U.S. Treasury yield curve steepening accelerated during the quarter. Historically, the yield curve has typically steepened to a positive slope in each easing cycle (Chart 8). Currently, the Fed's new "higher for longer" policy regime has led to investors demanding a higher term premium for holding longer maturity securities. In turn, higher intermediate and long end yields have tightened financial conditions further, which reinforces the Fed's eventual pausing of monetary tightening (Chart 9). The short end of the yield curve should benefit the most from this monetary policy normalization. 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, 2) In turn, this implies short duration assets, including Agency MBS, might benefit the most as the Treasury yield curve reshapes.

Chart 8: Yield curve steepened to positive slope in each easing cycle
Source: Barclays

Chart 9: 10-year and longer maturity Treasury yields increased more than shorter maturity Treasury yields.
Source: Bloomberg

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Other Structured Product

In addition to Agency MBS, other structured products, including short duration ABS backed by prime collateral, also lagged recent risk assets outperformance. For instance, AAA-rated prime auto loan ABS spreads are at their widest levels since March 2020 during the peak of the COVID pandemic lockdown. Recently, credit unions, one of the largest retail auto lenders, have started tapping ABS securitization funding. Given the more limited ABS performance data of credit union issuers, new issues command a larger concession to other issuers such as banks and specialty finance prime lending companies (Chart 10). Overall, prime/higher FICO borrowers continue to outperform non-prime/lower FICO borrowers (Chart11). Separately, we also continue to overweight mortgage-backed securities backed by Agency eligible collateral and Non-guaranteed Agency mezzanine securities given the spread advantage over Treasuries. We remain optimistic on Agency grade residential MBS performance given housing fundamentals.

Chart 10: New Issue Prime Auto ABS Spreads.
Source: Citibank

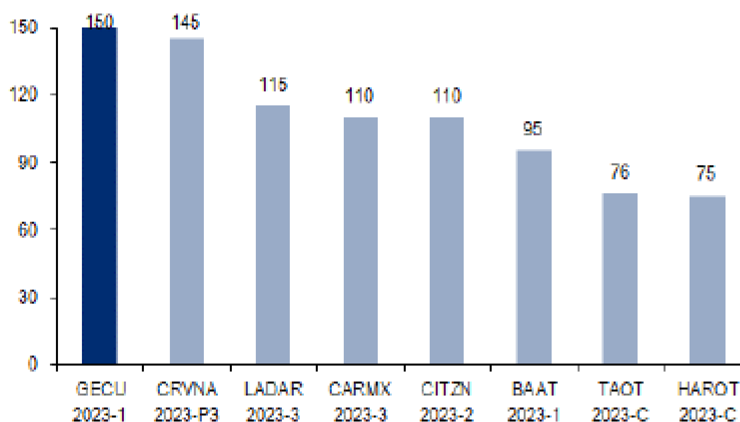
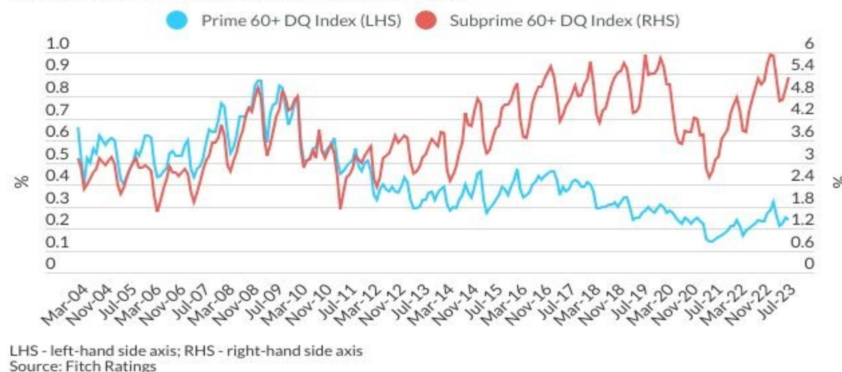


Chart 11: Auto Loan ABS Delinquency Indices - Prime collateral credit performance remaining steady.
Source: Fitch Ratings



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

Sincerely,

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Director of Fixed Income

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