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

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1Q 2024 Commentary

April 30, 2024

SUMMARY

- Treasury yields increased significantly during the quarter, as the FOMC continued to push out the timing of the first interest rate cut. Resilient U.S. economic data and inflation's stalled downward trajectory led to the market repricing the path of Fed rate cuts. Specifically, CPI increased from 3.4% in December to 3.5% in March; U.S. GDP grew at an annualized rate of 3.4% in Q4 2023; and nonfarm payrolls were robust during the quarter. For the first time since Oct 2022, the ISM manufacturing index crossed the 50-level indicating expansion. Strong economic activity also raised concerns over increasing wage pressures.

- The Fed kept the Funds rate unchanged at 5.25-5.5% during the quarter. Chair Powell emphasized that the Committee needs greater confidence that "inflation is moving sustainably towards 2%" during the FOMC press conference. That said, the Fed's updated March 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%. As the Fed prepared the market for the shift in monetary policy from a "higher for longer" regime to prospective rate cuts, spread products from corporate credit to Agency mortgage-backed securities outperformed.

POSITIONING OVERVIEW

Overweight short duration and high-quality structured product. Neutral interest rate duration, focus on carry and favor short to intermediate duration given inverted term structure.

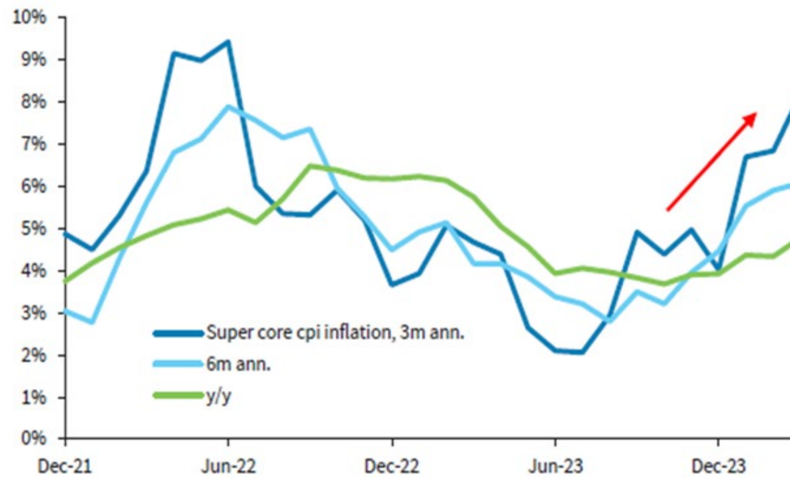
1. **Duration:** Neutral duration bias given macro-economic uncertainty
2. **Yield curve:** Prefer short/intermediate (2-3 year) duration given carry and inverted term structure
3. **Overweight:** Higher coupon Agency MBS, Agency non-guaranteed securities including Agency multi-family credit risk transfer, and other non-Agency RMBS/asset-backed securities
4. **Underweight:** Lower coupon MBS given negative carry and long interest rate duration

MARKET TRENDS AND INVESTMENT THEMES

Fed Policy Outlook

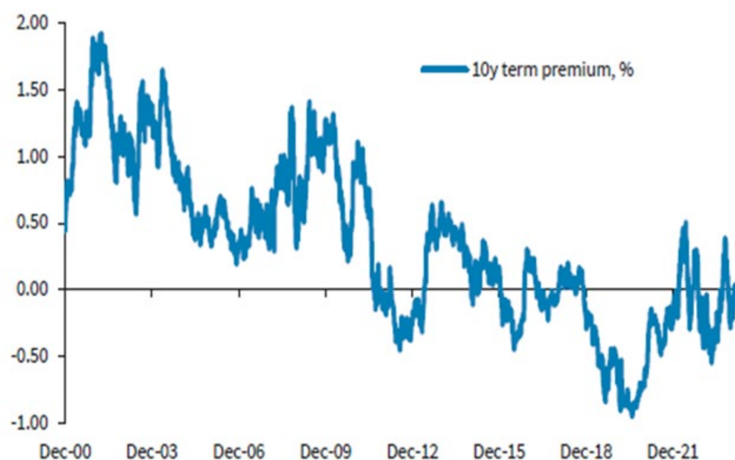
As the downward trajectory of overall inflation stalled in Q1 (Chart 1), Treasury yields increased significantly. Some of the key components of CPI, namely rent/owner's equivalent rent (OER), and core services ex-shelter, will most likely drive the outlook for inflation this year. For the Treasury yield curve, the implication is that in a weaker economic growth scenario, front end yields should decline as the market braces for more Fed rate cuts. In contrast, if price data comes in stronger than expected, longer maturity Treasuries should increase more given the still low yield curve term premium (Chart 2). Agency MBS and other structured products should benefit in either scenario given greater exposure to the front end of the yield curve.

Chart 1: Core services ex-shelter (Super-core) CPI reaccelerated



Source: Barclays Capital

Chart 2: Term premium in long-dated rates still low



Source: Barclays Capital

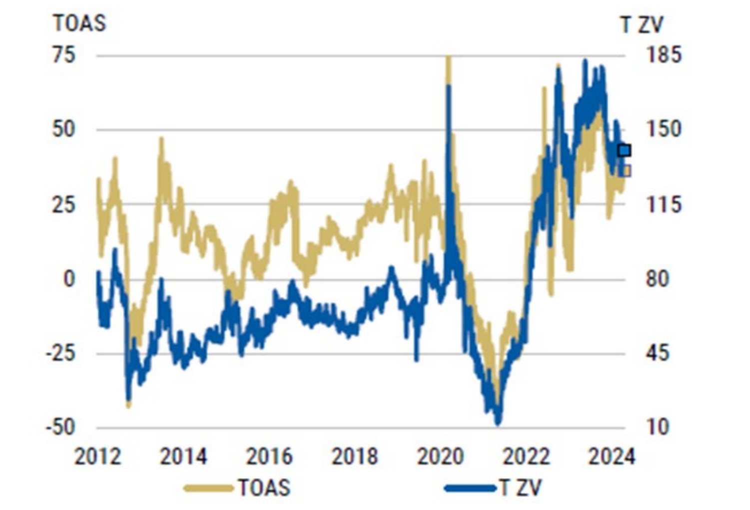
Agency MBS Outlook

Mortgage performance was in line with Treasuries in Q1. Interest rate volatility remained elevated given the uncertain Fed policy path, and compressed risk/volatility adjusted spreads (Chart 3). On the other hand, valuations remained attractive relative to the last Fed rate cutting cycle (Chart 4). Barring persistently higher than expected inflation data, as interest rates stabilize in a Fed pause/easing scenario, we see Agency MBS spreads tightening and potential upside for Agency MBS returns. Lastly, as Agency MBS lagged corporate credit, and if further monetary policy tightening eventually leads to a recession, Agency MBS should provide diversification from credit during periods of higher economic risk (a.k.a a flight to quality event).

Chart 3: Interest rate volatility remained elevated (1-year forward 10-year implied rate volatility)

Source: Barclays Capital

Chart 4: Agency MBS valuation remained attractive



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, continued to lag 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, as reflected by low mortgage delinquency rates (Chart 5). In addition, given the high current mortgage rates, which have reduced cash-out refi opportunities (Chart 6), there's been

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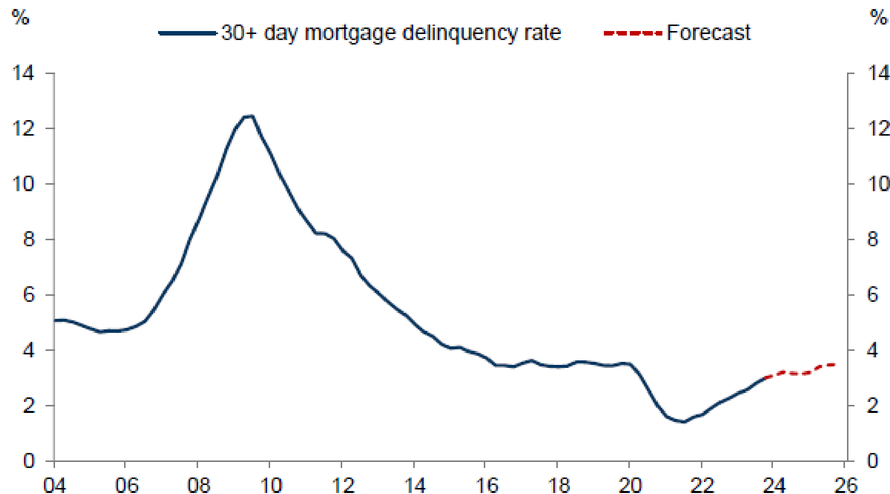
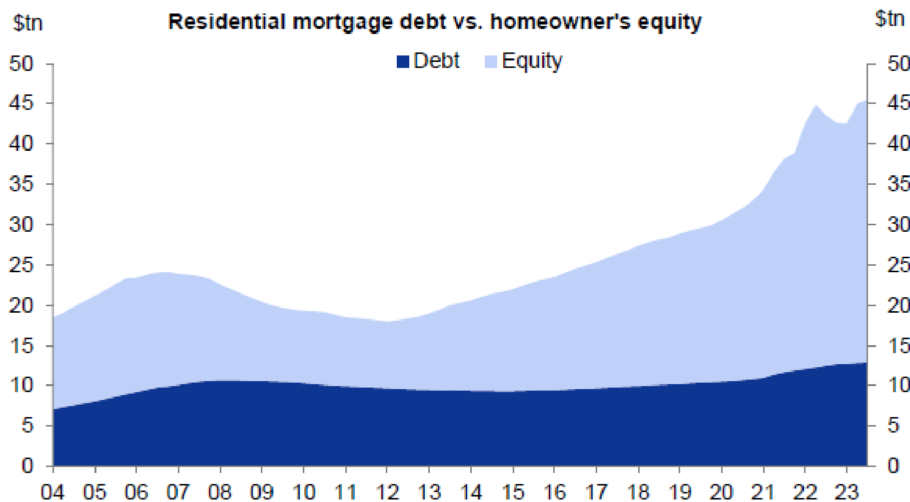
an increase in second lien and closed end second mortgage origination. These new product lines command higher new issue spread concessions. In response to the higher volumes, Freddie Mac recently proposed purchases of single-family closed-end second mortgages.

Chart 5: Mortgage delinquency rate remained low



Source: Goldman Sachs

Chart 6: Breakdown of U.S. residential housing value into mortgage debt and homeowners' equity



Source: Goldman Sachs

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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