Interest Rate Strategy

Morley
CAPITAL MANAGEMENT

Highlights

U.S. Treasury rates continued to climb during the third quarter and the yield curve continued to flatten. Rates on the 2-yr U.S. Treasury rose 29 bps to yield 2.82% at quarter-end. The U.S. 10-yr Treasury Bellwether yield finished the quarter at 3.06%, an increase of 20 bps.

The U.S. economy continued to show strong momentum with employment and survey data supporting Gross Domestic Product (GDP) growth of 4.2% in the second quarter. The unemployment rate was reported at 3.7% for September with solid job growth and higher wages. Average hourly earnings have risen 2.7% year-over-year which could have a longer-term impact on inflation though is likely more supportive of personal consumption growth in the near term. The Core Personal Consumption Expenditures (PCE) index is up only 2% year-over-year.

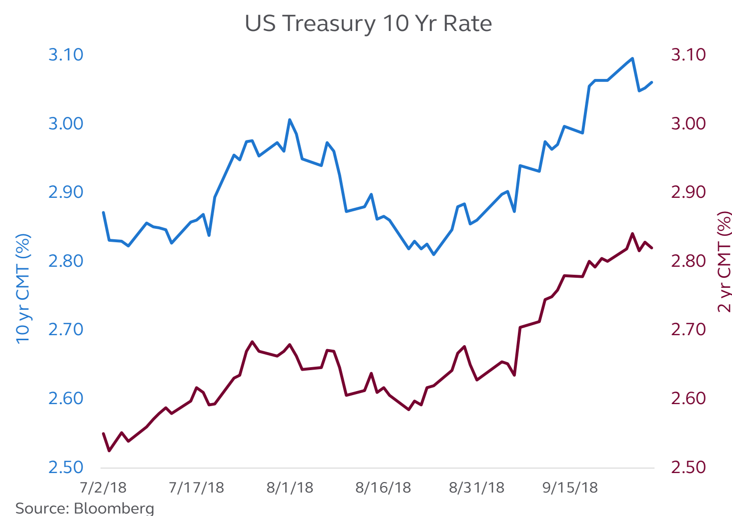
Solid economic performance and constrained labor markets alongside low price pressures encourage narrative for further rate increases from the Federal Open Market Committee (FOMC.) Committee members seem to agree with the policy of gradual increases as evidenced by only slight differences in their projections. Fed dot plots indicate that a clear majority, 12 of 16 members, support another rate increase in December with strong support for at least two increases next year. The federal funds futures market implied probabilities indicate that the Fed is unlikely to take a pause anytime soon, in spite of concerns about the flattening yield curve.

Markets are not expressing much concern that the economy is overheating to the point of producing higher inflation. Breakeven rates on Treasury Inflation Protected Securities (TIPS) have expanded only 15-20 bps year-to-date. The Fed's measure of market implied inflation expectations, the 5-yr Breakeven Inflation Rate, stands at 2.13%, a modest increase indicating market complacency regarding inflation pressures.

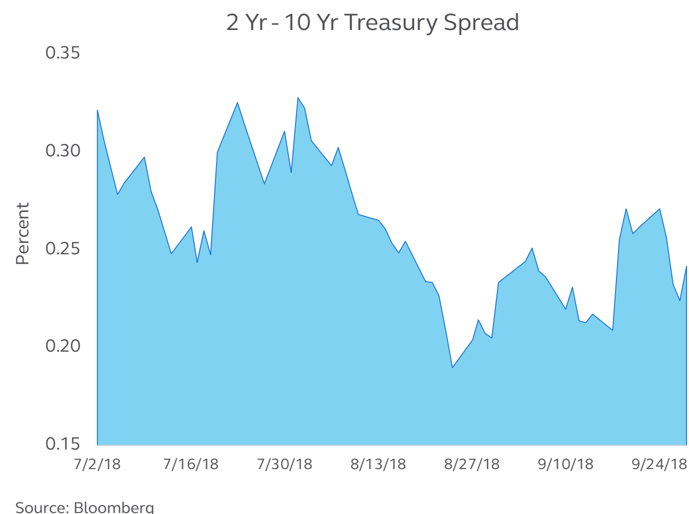
Outlook

Rates in most developed economies are at 3-month highs, though, the relative attractiveness of rates in the U.S. continues to provide a valuation case for domestic bonds. For example, the 10-yr U.S. Treasury has a 259 bp advantage over 10-yr German notes and is trading above 3-month average spreads against virtually all developed economy debt. Borrowing needs are increasing as budget deficits rise, the Fed is no longer a major buyer so, as expected, Treasury issuance increases, which could be a technical counterforce to the valuation story.

Taken together, we expect conditions to place continued upward pressure on rates along with further curve flattening. As has been the case since the curve began to flatten, we anticipate brief periods of bear steepening though longer-term trends should remain intact unless interrupted by sudden changes in growth fundamentals or unpredictable events.



Source: Bloomberg



Source: Bloomberg

Mark Kummerer, CFA
Portfolio Manager

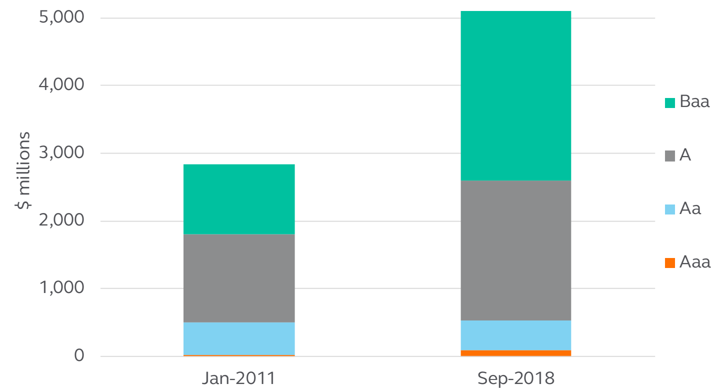
Please see Disclosures for important information.

Morley Capital Management

Highlights

The Bloomberg Barclays Corporate Investment Grade Credit Index posted total and excess returns of 0.97% and 1.60%, respectively, over comparable duration Treasuries. After a difficult first half of 2018, spreads rallied 17 bps during the third quarter to end at 6-month tights. The catalysts for the spread compression were continued solid economic momentum, de-escalating trade fears and upward earnings surprises. After an agreement to resolve trade barriers with Europe and a renegotiated trade deal with Mexico and Canada in sight, risk appetite returned.

As expected, gross and net new issuance tracked lower during the quarter. Gross and net new issuance year-to-date are down 14.1% and 37%, respectively. Despite market fears about the primary issuance calendar in September, the market absorbed the $138.7B in issuance well, including several large new issues, such as Cigna's $20B financing of Express Scripts and Nestle's $8B deal to acquire the distribution rights for Starbucks products globally.



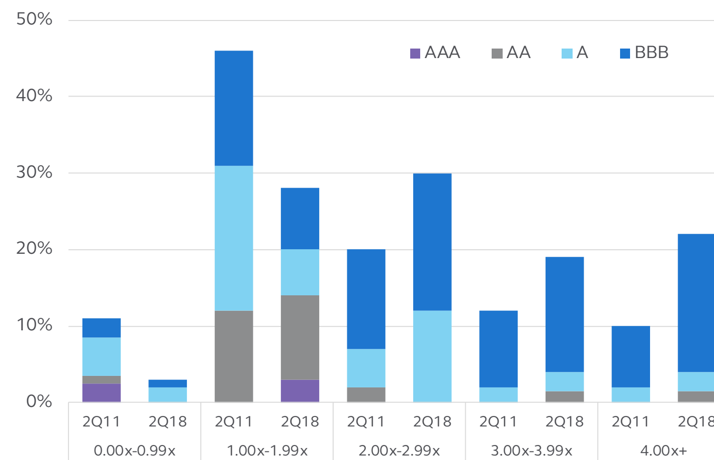
Source: Bloomberg

Dan Kang, CFA
Portfolio Manager

Outlook

Absent any macro shocks, we would expect credit spreads to be range-bound for the remaining part of the year. We still have a favorable environment for credit risk including a strong U.S. economy, double digit earnings growth and supportive technicals. Near term risks include increased foreign exchange hedging costs for foreign investors, relatively tight valuations and less supportive central banks.

Over the past year, there has been a focus on the tremendous growth in BBB-rated corporate securities. Although the size of the credit market has increased significantly post-financial crisis, the BBB quality bucket has grown faster and now totals $2.5T, which constitutes 49% of the U.S. Corporate Investment Grade Index. The relative size of the BBB market compared to the high yield market raises concerns about the next downgrade cycle. We have highlighted that credit fundamentals have deteriorated over the past several years; however, we do not foresee negative investment implications in the near term. First, we believe the economic/credit cycle has more room to run. Second, many of the levered BBB credits are in relatively non-cyclical sectors (Telecom, Consumer Staples, Healthcare). Third, many of the credits are in the process of deleveraging after completing a large debt-financed acquisition. Therefore, we continue to monitor any credits that are not executing on their commitments to de-lever.



Source: Morgan Stanley Research, FTSE Fixed Income LLC, Bloomberg

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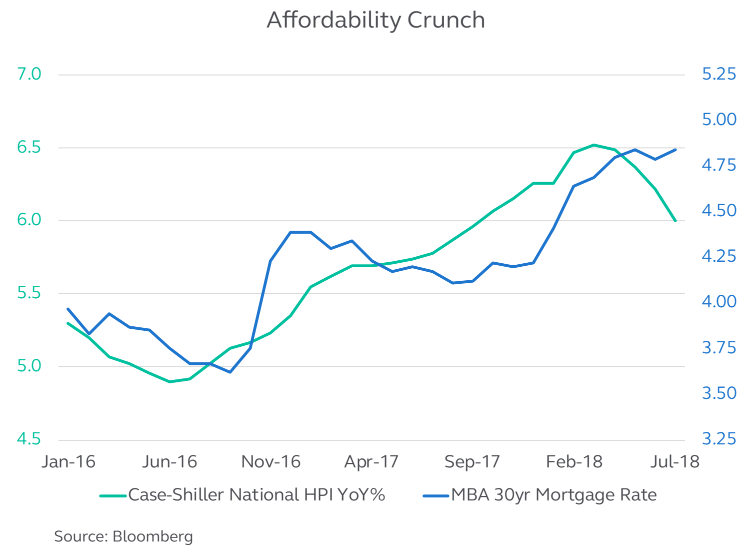
Highlights

The Bloomberg Barclays U.S. Agency MBS Index posted total and excess returns of -0.10% and 0.27%, respectively, for the quarter. 15-yr MBS outperformed 30-year counterparts on a total return basis, -0.02% versus -0.11%, given shorter effective durations and less negative convexity into the 25 bp rate selloff. Excess returns on 30-yr MBS outperformed 15-yr, 0.30% versus 0.05%, as long rates rose less than short-intermediate tenors and the yield curve flattened by 10 bps.

A seasonal uptick in net issuance to $91B along with $40B in runoff from the Fed's MBS portfolio was readily absorbed by the market. Money managers bought over $70B MBS during the quarter as valuations cheapened relative to investment grade credit. Volatility remained muted despite the selloff in rates, which was led by the Fed's well-telegraphed quantitative tightening.

Mortgage rates moved higher with the Fed's increase of the federal funds rate and compressed across products, with 30-yr rates nearing 5.0% and 15-yr/hybrid ARMs in the 4.25-4.5% range, crimping affordability.

Over 90% of mortgages outstanding have no incentive to refinance, having been originated in low rate environments during the Fed's quantitative easing period. As a result, prepayment speeds continued to converge around 10-12% CPR across tenors and coupons. While dampening prepay risk, this also compressed yield spread differentials across MBS coupons.



Source: Bloomberg

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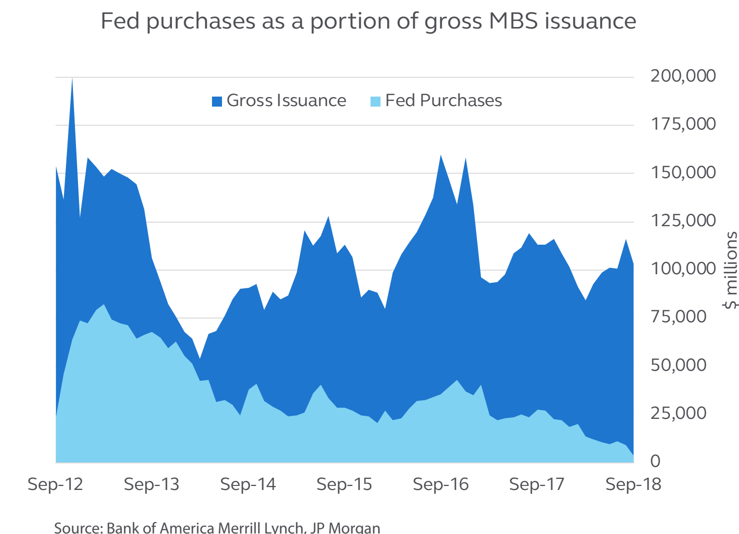
Portfolio Manager

Outlook

MBS valuations have improved with the widening in nominal spreads relative to investment grade credit year-to-date. However, OAS levels have been supported by the prolonged period of rangebound rates and low volatility engineered by accommodative central bank policy. As the Fed reverses course with quantitative tightening we expect to see rates, volatility and risk premiums increase. In addition, the Fed will effectively be ending its MBS reinvestment purchases into year-end as runoff caps ramp up to the full $20B per month in the fourth quarter.

We believe the best MBS investment opportunities during the tightening cycle are in seasoned/loan balance 15yr/20yr specified pools and front end CMOs. With shorter effective/spread durations, better convexity and limited Fed balance sheet representation these assets are less exposed to the downside risks emanating from the end of the quantitative easing era.



Source: Bank of America Merrill Lynch, JP Morgan

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Highlights

The Bloomberg Barclays AAA Asset Backed Securities (ABS) Index posted total and excess returns of 0.48% and 0.29%, respectively, for the quarter. The Bloomberg Barclays AAA Commercial Mortgage Backed Securities (CMBS) Index posted total and excess returns of 0.39% and 0.69%, respectively, for the quarter.

Total ABS issuance through the third quarter was up 6% year-over-year at $188B. All sub-sectors have had year-over-year increases in new issuance, except credit card ABS which is running at net negative supply with around $37B in maturities year-to-date versus $30B in ABS issuance. Credit card balances continue to grow to over $829B in total balances, only 4% below the 2006 pre-crisis peaks. Yet, esoteric ABS issuance has exceeded that of credit cards. Spreads for off-the-run names and sectors continue to benefit from a risk-on sentiment, especially in shorter duration bonds.

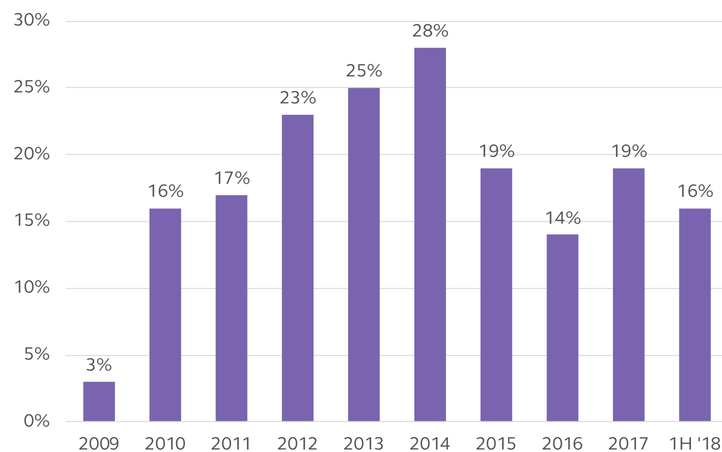
Total private label CMBS issuance in the third quarter was around $20B and Agency CMBS was $38B, bringing issuance year-to-date to over $173B. Single-asset deal issuance has exceeded conduit at over $29B. Similarly, among Agency CMBS issuance, Fannie Mae DUS bonds, backed by single properties are dominating flows with over $36B in issuance. In contrast, the Fannie Mae GeMS deals, backed by multiple properties and structured with tranches, have had very little issuance in 2018. Overall, fundamentals and pricing have been very strong year-to-date with capitalization rates trending at historically low levels. Capitalization rate spreads are tight to the 10-yr Treasury, around 250 bps.

Outlook

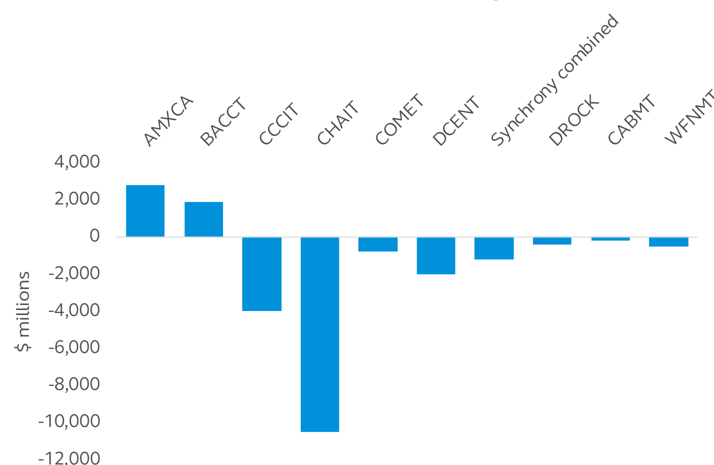
Technical factors offset any fundamental risks building up in CMBS. Only $10B of loans are expected to mature through 2019, of which 86% are current. Positive net supply continues to be absorbed easily; however, lending in the commercial real estate market has recently shifted away from CMBS and more toward financial companies and debt funds, indicating that lower quality loans are in the structured product space. Rental growth is slowing, cap rate spreads are historically low, and CMBS subordinate bond valuations are very tight. The AAA to BBB- spread differential has dropped to a 7-year low, reflecting less relative value to other asset classes. That said, although harder to find, there is still value in shorter bonds where credit enhancement is high.

ABS credit curves have also flattened to a level where less liquid names and or lower quality credits are not being compensated with spread. The ABS market has become a sector with more credit-risk bonds as new sectors emerge. These sub-sectors are interesting when their spreads are materially wider to on-the-run benchmark issuers and/or provide a pickup to comparable corporate bonds. The current spread pickup is not attractive for many of these bonds.

Fixed income dollars have moved into shorter duration funds, reflective of investor views on interest rate movements. Structured products naturally fit in the short duration space and have seen a pickup in demand. There are still opportunities to pick-up spread against short duration corporate bonds, however it is becoming more difficult to mitigate the interest rate impact. Higher yielding shorter bonds can offset some of the expected Fed hikes. In contrast, longer duration bonds and tighter spread products are disadvantaged with unpredictable curve moves and overall increases in yield.



Source: CMBS Market Watch, September 27, 2018



Source: Consumer ABS Weekly, October 4, 2018

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The Bloomberg Barclays US Agency Mortgage-Backed Securities (MBS) Index tracks agency mortgage backed pass-through securities (both fixed-rate and hybrid ARM) guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC).

The Bloomberg Barclays AAA ABS Index represents the asset-backed securities within the Bloomberg Barclays US Aggregate Index.

The Bloomberg Barclays AAA CMBS Index represents the commercial mortgage-backed securities within the Bloomberg Barclays US Aggregate Index.

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