LOOMIS | SAYLES

MANAGER INSIGHT

SECURITIZED ASSETS:

Technicals Create Opportunity

WRITTEN BY

The Loomis Sayles Mortgage and Structured Finance Team

Negative technical factors rather than fundamental concerns are driving today's attractive spread levels in high-quality securitized bonds.

Fundamentals in securitized bonds backed by residential real estate and consumer-related assets are strong, but some of their biggest institutional buyers have stepped back from the market for technical reasons after the sharp rise in interest rates. In our view, this gives investors a unique opportunity to consider buying securitized assets at attractive prices and with historically high levels of carry that can provide a buffer in the event of an economic slowdown.

Note: This piece focuses on the strength of consumer and residential real estate, which underlie a significant portion of the securitized asset market; however, we believe fundamentals are decidedly mixed for commercial real estate. Please see our blog post "Commercial Real Estate: We Believe the 'Doom Loop' Continues to Unfold" to learn more about our views on this sector.

Key Takeaways

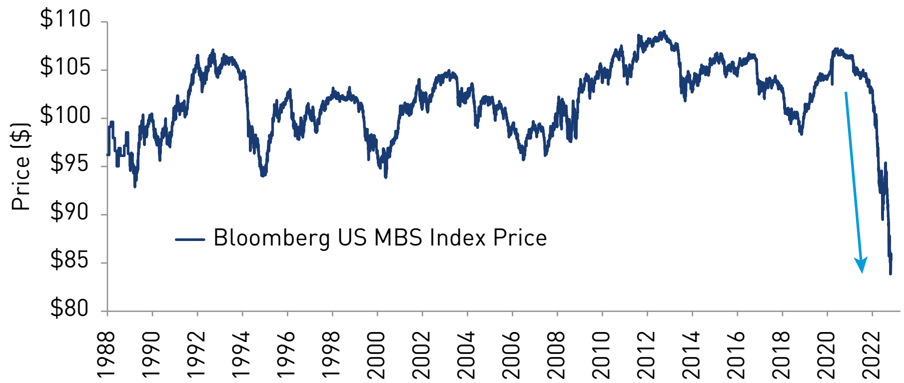
- Challenging technicals have been driven by the sharp rise in interest rates and a slump in demand after US banks and the Fed moved to the sidelines.
- Despite poor technicals in securitized sectors, fundamentals remain positive in consumer credit and residential real estate.
- Given the current levels of high carry and short spread duration in securitized assets, we believe it would take a significant rise in yields to produce negative annual total returns.

2022: A Year of Historic Destruction in Bond Values

In 2021, many market participants expected the Federal Reserve's ultra-easy monetary policy to remain intact for the next few years as the economy recovered from COVID-19. Inflation breakeven rates[i] at the time suggested that few investors expected inflation to spiral higher in 2022. However, inflation did exactly that. With consumer prices soaring, nominal interest rates spiked upward as the market priced in the prospect of tighter monetary policy.

The Fed proceeded to hike its policy interest rate by an aggressive 425 basis points (bps) during 2022 in an effort to drive down inflation. Predictably, the bond market took a historic beating. A decade's worth of real (inflation-adjusted) returns was wiped off the Bloomberg US Aggregate Bond Index. Agency mortgage-backed securities (MBS),[ii] one of the most interest-rate-sensitive fixed income sectors, saw total returns decline by an astounding 12% during 2022.[iii]

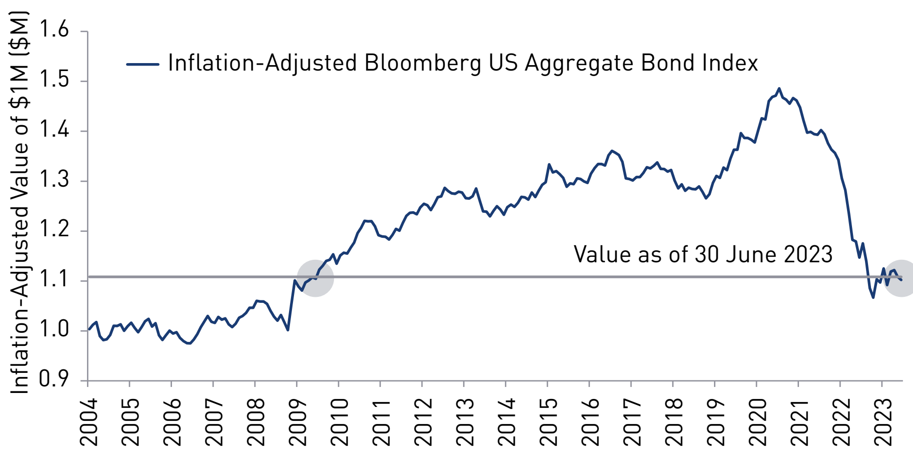
AGENCY MBS SOLD OFF SHARPLY IN 2022



Source: Bloomberg, as of 30 June 2023.
Past performance is no guarantee of future results.

LOST DECADE

Fed rate hikes in 2022 sent inflation-adjusted US bond values back to their 2009 level.



Source: Bloomberg, Inflation-Adjusted US Aggregate Bond Index (LBUSTRUU Index / CPI INDX Index). Data as of 30 June 2023.
Past performance is no guarantee of future results.

Falling Bond Prices Hit US Banks and the Fed Hardest

When COVID was at its height in 2020 and 2021, the Fed and US banks were active participants in the agency MBS market. Banks traditionally had been large MBS holders to take advantage of their spread pickup over low-yielding Treasurys, as well as the strong liquidity and MBS' favorable treatment under bank capital regulations. For its part, the Fed aggressively bought agency MBS during its quantitative easing program during the pandemic to provide liquidity and calm markets.

By the end of 2021, the Fed held $2.7 trillion in agency MBS and US banks held $2.9 trillion, respectively 20% and 16% higher than at the start of that year by market value.[iv] However, these assets sharply sold off in 2022 as interest rates rose rapidly. By the end of September 2022, there were unrealized losses of $438 billion in the Fed's System Open Market Account (SOMA) portfolio agency MBS holdings. US banks collectively were sitting on $690 billion in unrealized losses on available-for-sale and held-to-maturity agency MBS holdings.[v] As a result, many banks did not want to trade their agency MBS holdings to avoid taking these losses on their income statements.

Rising interest rates also had a negative impact on bank liabilities. As the Fed rate hikes continued, customers pulled deposits from low-yielding bank accounts and moved them into money market mutual funds where they could earn better rates. This deposit flight greatly reduced banks' source of cheap funding. To help plug the outflow of deposits, banks began to increase rates on their checking and savings accounts. However, some of the deposit flight damage was already done, and banks needed additional capital to support their required liquidity ratios. As a result, they borrowed from sources like the Federal Home Loan Banks and Fed funding programs to increase their funding even though these entities charged very high interest rates. In sum, the outflow of deposits and the increased cost of capital greatly reduced banks' desire to add assets like agency MBS to their balance sheets.

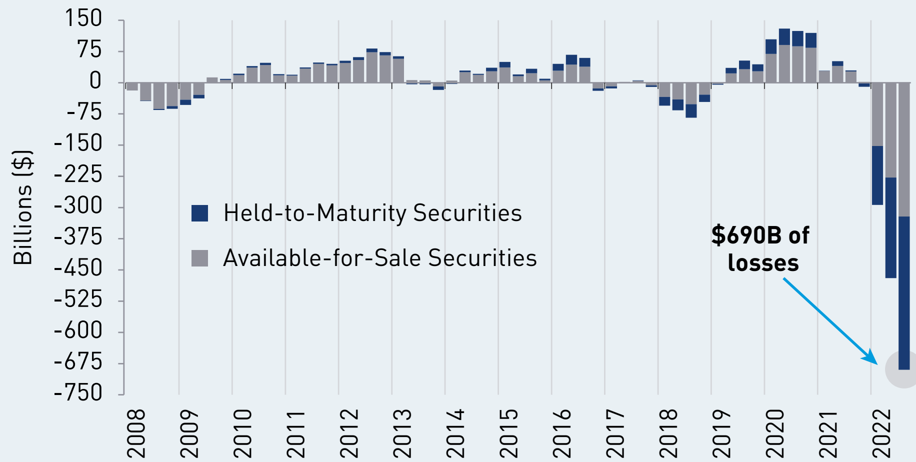
BALANCE SHEET WOES

The Fed's unrealized losses in agency MBS exceeded $438 billion as of September 2022, while US banks were carrying another $690 billion in unrealized agency MBS losses.

	DOMESTIC SOMA PORTFOLIO HOLDINGS ($M)					
	30 September 2022			31 December 2021		
	Amortized Cost	Fair Value	Cumulative Unrealized Gains/ Losses, Net	Amortized Cost	Fair Value	Cumulative Unrealized Gains/ Losses, Net
TREASURY SECURITIES						
Bills	307,878	307,407	(471)	325,956	325,929	(27)
Notes	3,690,110	3,388,633	(301,477)	3,812,476	3,802,434	(10,042)
Bonds	1,875,722	1,490,506	(385,216)	1,778,994	1,923,692	144,698
Total Treasury Securities	5,873,710	5,186,546	(687,164)	5,917,426	6,052,055	134,629
FEDERAL AGENCY AND GSE MBS						
Residential	2,746,855	2,310,190	(436,665)	2,675,057	2,667,752	(7,305)
Commercial	9,444	7,816	(1,628)	10,211	10,068	(143)
Total Federal Agency and GSE MBS	2,756,299	2,318,006	(438,293)	2,685,268	2,677,820	(7,448)
GSE DEBT SECURITIES	2,590	2,745	155	2,610	3,298	688
TOTAL DOMESTIC SOMA PORTFOLIO SECURITIES HOLDINGS	8,632,599	7,507,297	(1,125,302)	8,605,304	8,733,173	127,869

Source: US Federal Reserve, data as of 30 September 2022.
Past performance is no guarantee of future results.

UNREALIZED GAINS (LOSSES) ON INVESTMENT SECURITIES



Source: FDIC, data as of 30 September 2022.
Past performance is no guarantee of future results.

Agency MBS Technicals Weaken as Big Buyers Step Back

During 2022, the Fed and US banks, previously the two biggest buyers of agency MBS, moved to the sidelines. The Fed engaged in quantitative tightening (QT) as banks faced deposit flight and higher borrowing costs. This slump in demand worsened the technical situation for the agency MBS market.

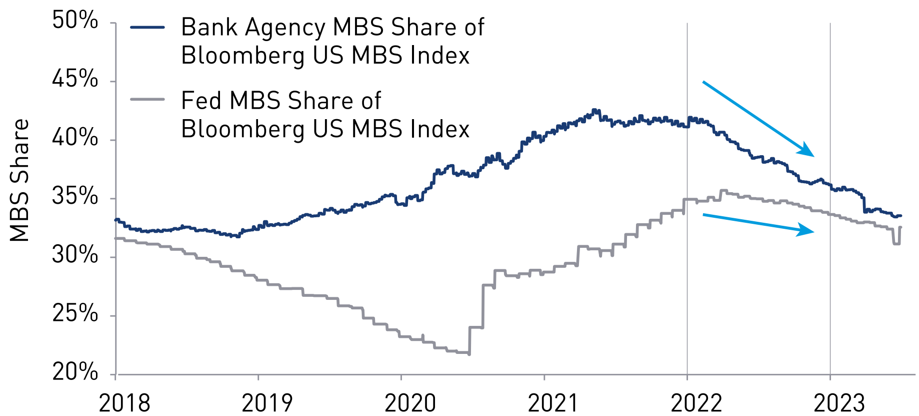
This was exacerbated by the regional banking crisis that emerged in the first quarter of 2023 when the Federal Deposit Insurance Corporation (FDIC) was forced to take over Signature Bank and Silicon Valley Bank. These represented the largest bank failures in US history since 2008. After the FDIC takeover, some $100 billion of agency MBS holdings on the balance sheets of the two failed banks needed to be liquidated, putting further strain on valuations in the sector.

The banking crisis also caused some banking executives to reduce their assumptions regarding deposit duration, given the ease with which customers were pulling cash out of their bank accounts. As duration expectations shortened on the liability side, some banks were unwilling to add duration in their asset portfolios, further reducing bank demand for agency MBS and putting additional pressure on valuations.

As the banks and the Fed stepped back from the agency MBS market, spreads widened dramatically. During the first quarter of 2023, nominal current coupon MBS spreads expanded to a near-decade high, surpassing the highs seen in late 2022 and during the COVID panic in March 2020. The widening in spreads caused agency MBS to significantly underperform comparable fixed income classes. For example, in the three years from 31 March 2020 through 31 March 2023, agency MBS generated a cumulative negative 17% excess return versus investment grade corporate bonds. This underperformance is all the more remarkable given that agency MBS are government guaranteed while corporate bonds inherently carry the risk of principal loss (i.e., credit risk). Not only did the sector underperform, but its volatility reached historic highs. Over the 12 months ending 31 January 2023, agency MBS experienced six instances of monthly excess returns exceeding two standard deviations from historical norms. Statistically, we would have expected just one such monthly move over that period.

ON THE SIDELINES

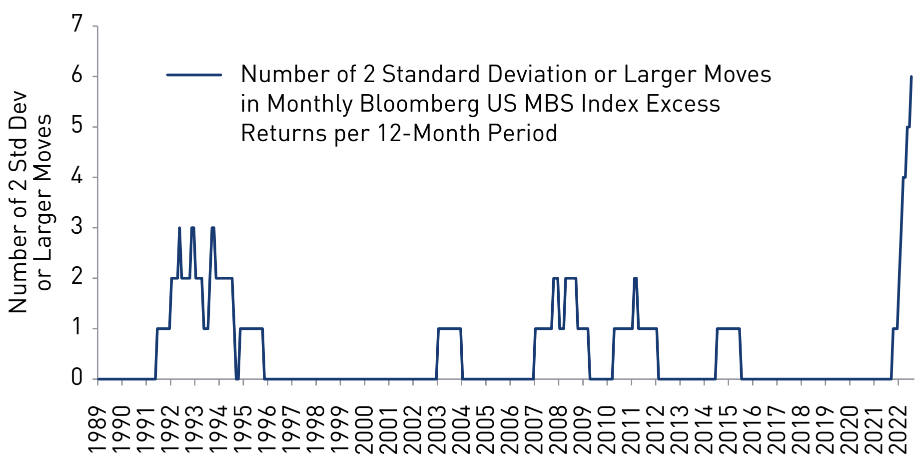
Both the Fed and the US banks pulled back from the agency MBS market in 2022.



Source: Bloomberg. Share of US MBS Index, 2018-2023, .FEDMBSTOT Comdy / LUMSTRUU Index and ALBNTANB Index / LUMSTRUU Index. Data as of 30 June 2023.
Past performance is no guarantee of future results.

VOLATILITY SPIKES

Agency MBS monthly excess returns made six moves of two standard deviations or more in the year ended 31 January 2023, far above the historical average.



Source: Bloomberg US MBS Index. Number of two standard deviation or bigger moves in monthly agency MBS excess returns over Treasurys per 12-month period. Data as of 31 January 2023.
Past performance is no guarantee of future results.

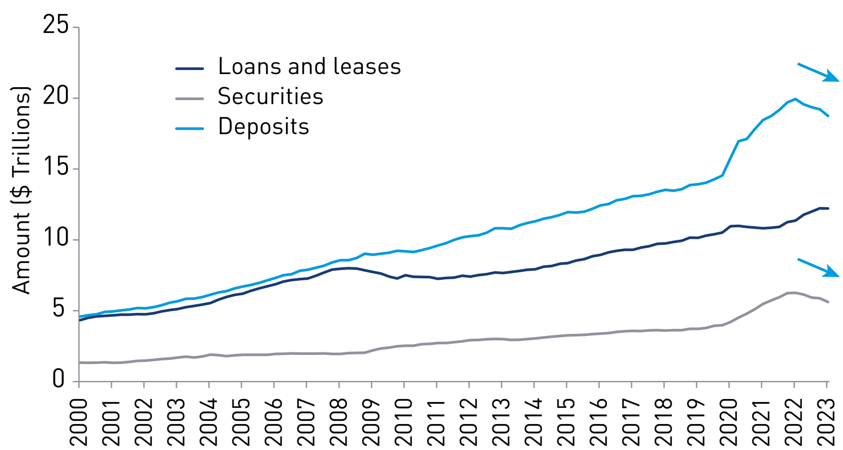
Challenging Technicals Spill Over Into Securitized Credit

Banks have reduced their demand for many types of bond securities on their balance sheets, not just agency MBS. Of note is securitized credit, the third-largest sector that banks typically hold in their portfolios after agency MBS and Treasurys. Securitized credit includes asset-backed securities (ABS), collateralized loan obligations (CLOs), non-agency residential mortgage-backed securities (RMBS), and commercial mortgage-backed securities (CMBS).[vi]

Within this sector, banks have typically been most active in AAA-rated CLOs and ABS—that is, until recently. Starting in the first quarter of 2023, the banks have meaningfully pared back their participation in new issue AAA-rated CLOs and ABS, requiring other buyers with different return objectives to step in and fill the void.

SECURITIES SLUMP

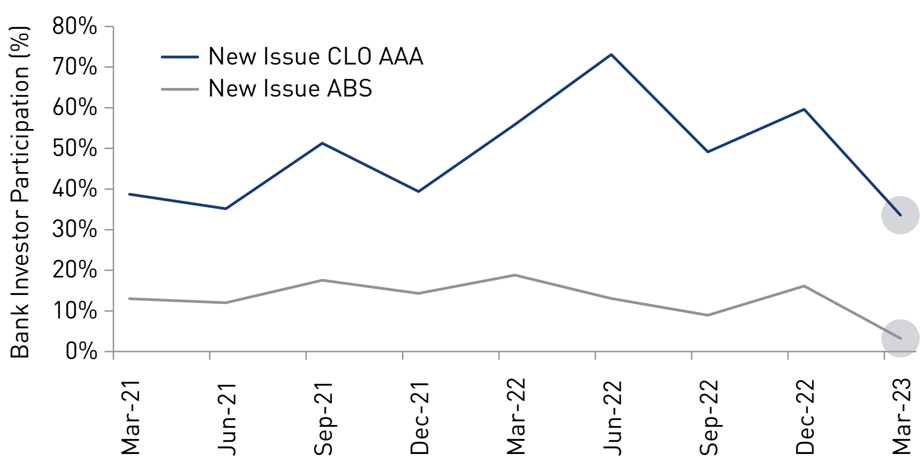
US bank deposit outflows led to lower demand for securities.



Source: US Federal Reserve. US bank deposits, loans and securities holdings in $ trillions. Data as of 31 March 2023. ***Past performance is no guarantee of future results.***

STAYING AWAY

US banks have sharply pared back their participation in new-issue CLO AAAs and ABS, requiring other buyers to step in.



Source: J.P. Morgan Securities. Bank investor participation in new-issue AAA CLOs and ABS, by percentage. Data as of 31 March 2023.
Past performance is no guarantee of future results.

Weak Technicals May Be a Headwind, but Securitized Fundamentals Are Strong

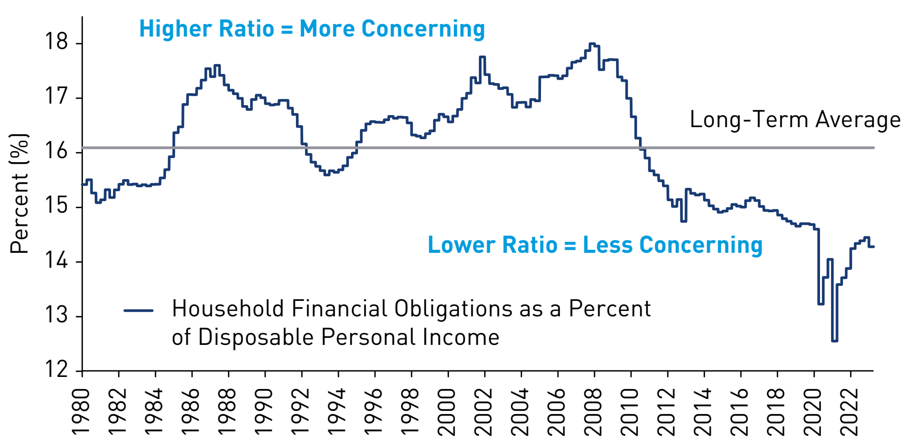
Despite the poor technicals in securitized sectors, fundamentals remain positive, with delinquencies for prime borrowers at or below pre-COVID levels. Over the past year, consumers have enjoyed high employment, strong wage growth, and locked-in rates on historically low fixed-rate mortgages. In 2021, the household financial obligation ratio (financial obligations as a percent of disposable personal income) hit a 40-year low, and it remains well below its historical average today.

Housing fundamentals that underlie RMBS are also positive. Today's housing market is much sounder than it was in 2008, given stricter underwriting standards, high levels of homeowner equity and more frequent use of loan modification programs. Housing prices are also well supported by depressed home inventories, which are the result of the recent trend of borrowers not wanting to give up their low-interest-rate mortgages, and the long-term impact of underbuilding that has left the US short of millions of homes.

On the agency MBS side, prepayment speeds have likely bottomed due to higher interest rates. We believe their bond prices, currently deeply discounted, should steadily benefit from continued turnover in the housing base.

FEELING FLUSH

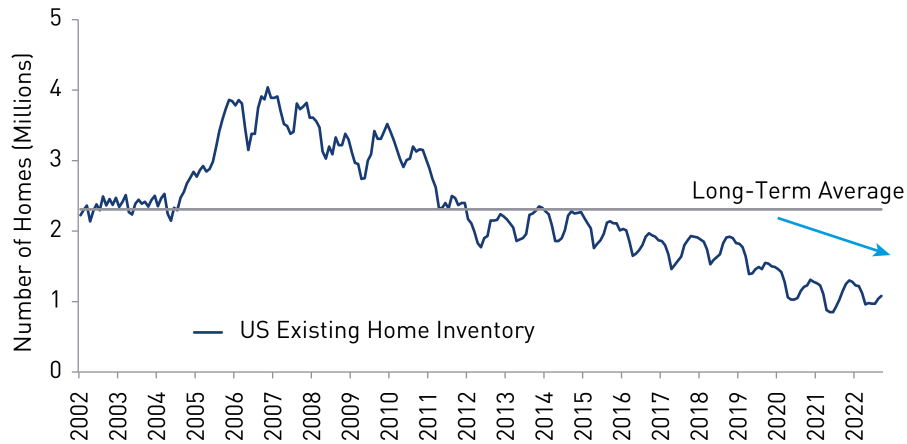
Household finances are in their best shape in 40 years, supporting the fundamentals for securitized assets.



Source: Board of Governors of the Federal Reserve System (US), Household Financial Obligations as a Percent of Disposable Personal Income [FODSP], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/FODSP. Data as of 30 June 2023.
Past performance is no guarantee of future results.

RUNNING LOW

Depressed home inventories are well below the long-term average, another layer of support for housing prices.



Source: National Association of Realtors. Existing home inventory in millions. Data as of 30 June 2023.
Past performance is no guarantee of future results.

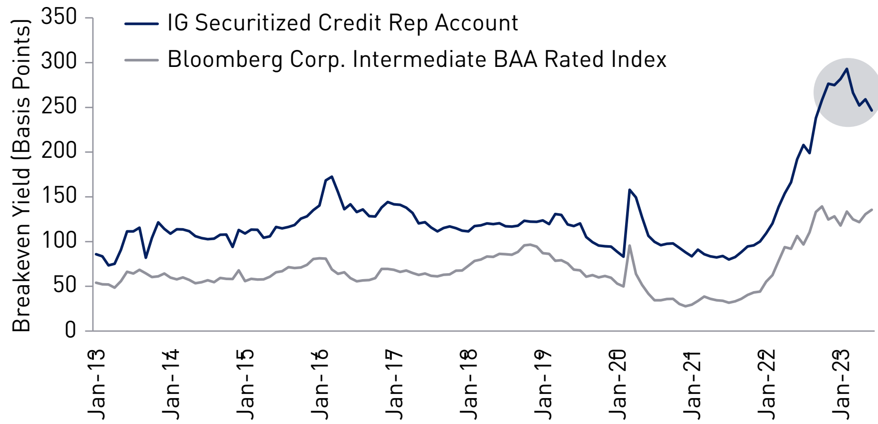
High Carry and Short Duration Make For an Attractive Investment Opportunity

We believe that negative bond technicals rather than fundamental concerns are driving today's attractive spread levels in high-quality residential and consumer-related securitized assets compared to investment grade corporates. In our view, this gives investors a unique opportunity to buy securitized assets with historically high levels of carry. Given securitized assets' high carry and short spread duration, it would take a significant rise in yields in order to produce negative annual total returns. We believe the inverted Treasury yield curve is another reason to consider securitized assets for their higher yields and shorter durations.

There remains the risk that the economic environment could worsen if inflation remains sticky and the Fed needs to hike interest rates further. However, we believe macro pressures would likely show up first in corporate-exposed bonds rather than securitized bonds, given the strong consumer and residential real estate fundamentals we have described. Even if spreads do widen in certain securitized sectors, we believe today's notably high carry should give investors a strong buffer for protecting returns in the event of an economic slowdown. That said, buyers should carefully analyze all aspects of a securitized deal—collateral, structure, sponsor, etc.—before investing.

LARGE BREAKEVEN

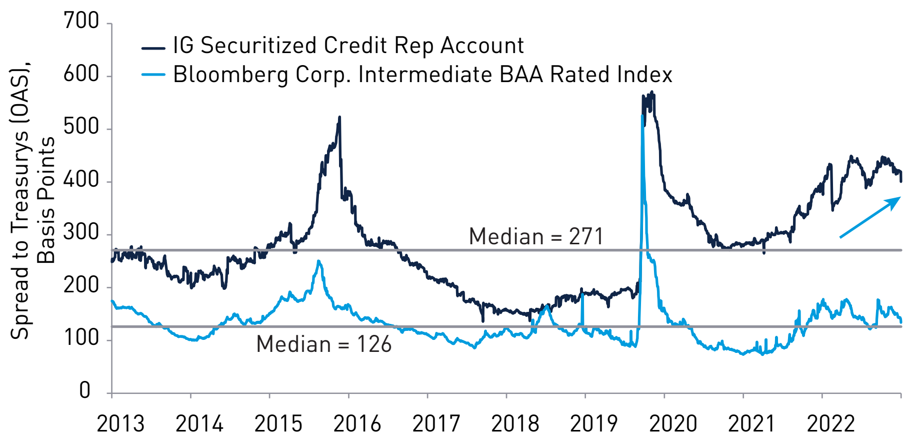
Securitized assets would need to experience a significant rise in yields to produce negative annual total returns.



Source: Loomis Sayles. Data 1 January 2013 – 30 June 2023. Breakeven Yield equals Yield to Worst / Spread Duration.
Past performance is no guarantee of future results.

SUPER SPREADS

Wide spreads on quality securitized assets present a unique buying opportunity for investors.



Source: Loomis Sayles. 10-Year history of spread to US Treasurys in basis points, IG securitized credit and IG corporate BBB rated bonds. Data as of 30 June 2023.
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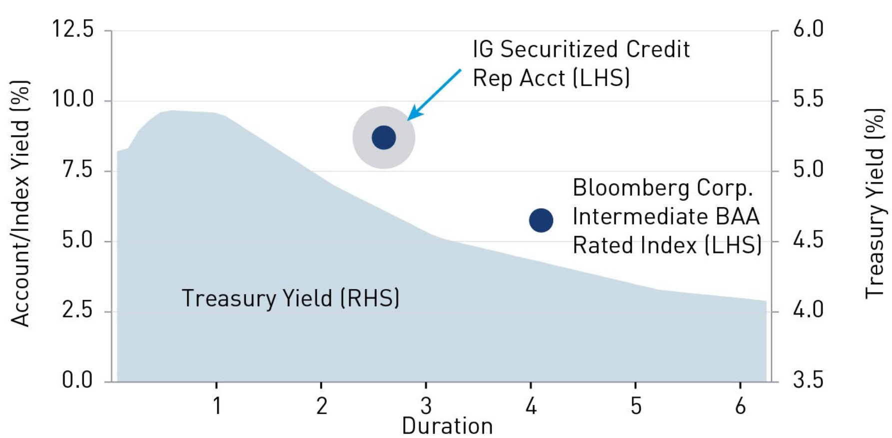
SWEET SPOT

Securitized credit stands apart for its high yield combined with short duration, especially given an inverted Treasury yield curve.



Source: Loomis Sayles, Bloomberg. Yield vs duration, securitized credit and corporate bonds. Data as of 30 June 2023.
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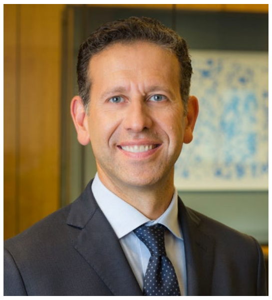
AUTHORS



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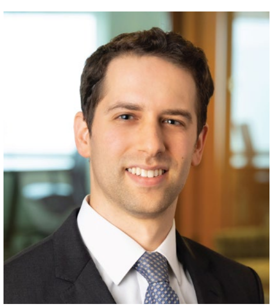

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Endnotes

[i] *The inflation breakeven rate is the difference between the nominal yield on a fixed-rate investment and the real yield on an inflation-linked investment of similar maturity and credit quality. If inflation averages more than the breakeven, the inflation-linked investment will outperform the fixed-rate.*

[ii] *Agency mortgage-backed securities (MBS) are pools of residential mortgage loans securitized, issued and guaranteed by a US government agency, either Government National Mortgage Association (GNMA or Ginnie Mae), Federal National Mortgage (FNMA or Fannie Mae), or Federal Home Loan Mortgage Corp. (Freddie Mac). Agency MBS represent the second-largest segment of the US bond market after Treasurys, and account for roughly 25% of the Bloomberg US Aggregate Index.*

[iii] *Source: Bloomberg, Agency US MBS Index. Data for the year ending 31 December 2022.*

[iv] *Source: Bloomberg Indices: ALCBGOMB Index and .FEDMBSTOT Comdty*

[v] *The US Federal Reserve's System Open Market Account (SOMA) contains assets acquired through open market operations—that is, the purchase and sale of securities in the open market to manage liquidity and acquire assets as collateral for the Fed's balance sheet.*

[vi] *Securitized credit in the US fixed income market is a large and diversified sector. It is generally understood to include: 1) asset-backed securities (ABS), created by packaging various types of consumer debt like credit card receivables, auto loans, manufactured housing contracts, home equity loans and student loans; 2) collateralized loan obligations (CLOs), or securitized portfolios of commercial bank loans issued to smaller companies; 3) non-agency residential mortgage-backed securities (RMBS)—securitized residential mortgages not backed by a government agency, and 4) commercial mortgage-backed securities (CMBS), or securitized mortgages on commercial properties, such as retail, office, industrial, multi-family housing and hotels.*

Disclosure

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