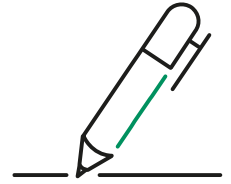


TALKING HEADS PODCAST



By **Daniel Morris**, Chief Market Strategist | **John Carey**, Head of MBS

THERE IS A REASONABLE ALTERNATIVE: MORTGAGE BONDS

Daniel Morris: Hello and welcome to the BNP Paribas Asset Management Talking heads podcast. Every week, Talking heads will bring you in-depth insights and analysis on the topics that really matter to investors. In this episode, we'll be discussing US mortgage-backed securities. I'm Daniel Morris, chief market strategist, and I'm delighted to be joined by John Carey, head of our MBS team. Welcome, John. Happy New Year and thanks for joining me.

John Carey: Happy New Year, Daniel. Great to be here.

Daniel Morris: We all to some degree bear the scars from a painful 2022, at least as far as fixed income is concerned. However, a lot of us came into 2023 expecting better returns, if not good returns as we anticipate at some point lower interest rates if and when the US Federal Reserve starts to cut rates. Maybe what's surprised us so far is that we've seen a sharp decline in Treasury yields already in January. Now that decline seems to be at least partly driven by an expectation that inflation is going to decelerate much more quickly than the market expected, arguably, much more quickly than the Fed seems to expect. That's what has led investors to anticipate the Fed being able to cut policy rates, perhaps this summer. Alternatively, the decline in yields could also be a signal that growth is slowing more quickly than expected. Retail sales, for example, wasn't quite as good as hoped. So with the uncertainty about the outlook for inflation and growth, we are certainly going to see some market volatility. So, that's the environment you have to invest in, John. Let's start with a brief recap of what happened in 2022 or specifically mortgage-backed securities.

John Carey: 2022 was a challenging environment for all financial assets. If we look back at some of the returns in the various asset classes, our mortgage asset class produced a return of about -12%. Investment-grade credit in the US was down 16%. And in the equity markets, we had large-cap stocks in the US down about 10%. We had the S&P 500 down about 20% and we had the NASDAQ down about 33%. Going back to 2022, we came into the year with Fed policy rates at zero, but the Fed was beginning to unwind their quantitative easing programme. They first started by slowing down their asset purchases, then they came to a stop. Then they actually started to reduce the size of the balance sheet, letting both mortgage-backed securities and Treasuries run off. We started with rate hikes in March. We had a total of seven rate hikes, which took the upper bound for the policy rate from 25 basis points to 4.5%. So a challenging environment. I would also mention that volatility was high throughout this period. We look at the MOVE index, which is an index of short-dated options on interest rate futures. The MOVE index hit a high of 160 basis points. We came into the year at around 80 basis points, so a near-doubling of the volatility in the marketplace. The other challenge is this major inversion of the yield curve with the two-year versus 10-year inverting all the way at one point to about -85 basis points, now at about -70 basis points. As I mentioned, a -12% absolute return on the year and also down about -2.25% from an excess return point of view. So it was a challenging 2022 for all financial assets and for the mortgage asset class, too.

Daniel Morris: Could you share with us what your main scenario is in terms of the likelihood of a [Fed policy] pivot? When does the Fed cut rates? What kind of recession or slowdown do we get in the US? Importantly, how is MBS going to perform under those different scenarios?

John Carey: As we came into 2022, policy rates were zero and yields in fixed income were very low. You heard a lot of people refer to the term TINA: There is no alternative. As we turn the page and move into 2023, we've gravitated toward TARA: there are reasonable alternatives, particularly in fixed income. We have the cash rate, the fed funds rate, now at 4.5% and there is yield in fixed income. We look at the mortgage asset class now yielding at about 4.5%. The run rate yield on our fund now is at about 7%. So we're optimistic about turning the page and the opportunity to make strong returns in 2023. This started in the fourth quarter as markets started to anticipate that we had achieved peak inflation and that inflation was coming off the boil. The Fed had tightened a lot, working on slowing down aggregate demand and seemed to be making good progress in that regard. So at this point, we are close, maybe not all the way, but we're getting nearer to the end of the Fed hiking cycle. The market anticipated that late in the fourth quarter of 2022 and we saw some asset classes, our mortgage asset class in particular, respond favourably to this idea that the Fed was nearer to the end of the hiking cycle than to the beginning. Since the last three months, we have an excess return versus duration-matched Treasuries of about 1.5%. We're looking forward to carrying



BNP PARIBAS
ASSET MANAGEMENT

The sustainable
investor for a
changing world

that momentum into 2023. We've seen strong performance already in 2023 from the mortgage asset class, both on an absolute return and an excess return basis.

Daniel Morris: You mentioned TARA. If you're speaking to a multi-asset investor, why should they be looking at MBS as an option in 2023?

John Carey: Going back to 2022, the asset class underperformed meaningfully. It has gotten cheap. Nominal spreads compared to US Treasuries are wide. Our current coupons got out to about 150 basis points on a spread to US Treasuries. The overall index has a spread of about 80 basis points. As you remember, this is a government-guaranteed asset class. If you're comfortable with the US Treasury as a credit, you should be comfortable with these mortgage-backed securities. There really is no credit component to them, just a nice incremental spread. So the one thing is that the asset class is cheap. We have nice yields now and we're also at historic metrics for the asset class. The average dollar price of the index is at a historic low at about USD 90. I mentioned that nominal spreads are wide at 150 basis points. Prepayments – the opportunity for borrowers to pay off their old mortgage and replace it with a new, low-coupon mortgage – no longer exist. We had 30-year mortgage rates down to about 3% in 2021 as the Fed had pinned the funds rate basically at zero. With the rate hikes and the selloff in rates that we've seen, primary mortgage rates today are more like 6%. So there's virtually no opportunity for borrowers to refinance mortgages. We have a stable cash flow now with a nice nominal spread and that the government guarantees. There's a lot to be said for this asset class. What we've seen is the markets price in at least an economic growth slowdown across the globe and perhaps a recession. When we look at fed funds pricing into the future, markets are expecting that the Fed will in fact be cutting rates before the end of the year in response to a slowing economy here. If you have any concerns about a recession, credit and equity markets will be under pressure. That speaks to the case for mortgages with the government guarantee, the high credit quality, the nice current income and an asset that is still a low duration security. You can take advantage of the underperformance and the cheapening of the asset class. It may also line up with your view about how the economic outlook will unfold in 2023. One other thing I would mention is that if we are nearing the end of the Fed rate-hiking cycle, we would expect two things. We would expect that the MOVE index would start to move lower. That would be a positive for the mortgage sector. And we may also start to see a steepening in the yield curve. That would be another positive development for the class.

Daniel Morris: John, thanks very much for joining me.

John Carey: Thank you, Daniel.

