Second Quarter 2023 Commentary

BNP PARIBAS FLEXI I US MORTGAGE FUND

MARKET REVIEW

Concerns about additional bank failures had markets on high alert to start the second quarter. Next, investors' focus in May turned to the debt ceiling negotiations between Congress and the Biden Administration. A compromise debt ceiling bill passed in Congress in early June averting a government shutdown or default. The labor market remains robust as the July payroll report showed an addition of 209,000 jobs with a downward revision of 33,000 jobs to the prior report. The US economy has proved remarkably resilient in the face of high price levels, aggressive monetary tightening, banking sector turmoil and credit contraction. The well-anticipated 2023 recession has been long delayed and may not come at all this year. Labor markets have been robust, the unemployment rate is very low and economic activity continues to expand at a modest pace. After raising rates for 10 consecutive meetings the FOMC skipped a rate hike at their June 14th meeting. While inflation remains elevated and well above the 2% target, the Fed took a pause in order to assess tighter credit conditions and the long and variable lags associated with adjusting monetary policy. Chair Powell's press conference and subsequent congressional testimony confirmed the market's suspicion that this was a hawkish pause and that still high inflation readings indicate the Fed has more work to do hiking rates.

US interest rates moved higher in the second quarter with volatility still high, although falling from the levels hit in March. Markets eventually adjusted in June to the idea that the Fed rate hikes were not yet done. 10-year US Treasury (UST) yields moved between 3.30% (the lowest of the year) and 3.60% until mid-May before settling between 3.60% and 3.80%, ending the quarter at 3.82%. The rise in yields at the end of the quarter was the result of the highly hawkish comments of the major central bank heads who met in Sintra for the economic forum organised by the ECB. The curve further inverted with the spread between 2-year and 10-year moving to -106 bps. Implied volatility fell with the Move index dropping from 136 to 111. Equity markets were buoyed by the stronger economic performance with broad global equities (MSCI AC World index in US dollar terms) rising by 5.6% in Q2. Higher rates, lower dollar prices and the drop in volatility helped the agency MBS to end the quarter with strong performance. Excess returns for MBS were +76 bps on the quarter and are now positive on the year. Overall, it was a very good quarter for fixed income risk assets. Excess returns were positive for IG credit, +132 bps, high yield, +280 bps and EM USD, +260 bps. The year-to-date absolute return for MBS is 1.87% and the year-to-date excess return is positive at +29 bps.

Mortgage origination rates also moved higher during the quarter and are now hovering around 7.00%. Wider MBS spreads and the pullback in bank lending is keeping mortgage origination rates elevated. The June and April prepayment report showed a sharp increase month over month albeit off of a very low base. Aggregate prepayment speeds for FNMA 30-year moved from 4.1 to 6.2 CPR over the quarter. This was largely driven by additional business days in the collection period in June and April (+2 and +4, respectively). However, speeds were slightly faster than expectation due to higher housing turnover albeit relatively uniform slowdown in May. Home prices peaked in the middle of last summer and high mortgage rates were anticipated to move prices lower slowing turnover. Lock in effects due to high home prices, high origination rates and limited housing inventory are all working to slow the housing turnover component of prepayments and have supported housing markets. Price declines have stalled and have in fact started to reverse upward in many areas of the country. Apart from turnover, prepayments remain well-behaved with virtually none of the outstanding MBS universe with a meaningful incentive to refinance. Absent a significant rally in rates, the expectation is for speeds to increase but not to get substantially faster.

PERFORMANCE REVIEW

BNPP Flexi I US Mortgage returned +0.40% (gross of fees, USD unhedged) in the second quarter outperforming the benchmark return of -.064% by +105bps. The portfolio year to date return of +3.46% has outperformed the benchmark return of 1.87% by +160 bps. Index replication positioning at the start of the second quarter included maintaining a benchmark weight in lower coupons aside from the 30-year 1.5% coupon underweight. Overall, index replication strategies were additive to performance as specified pools in lower coupon 30-year outperformed. Overweight positioning in 30-year 6.5% specified pools also added. TBA dollar rolls are 0 or negative in nearly all coupons so specified pools were preferred over TBA throughout the quarter. The underweight lower coupon 15-year positions based on the view that the sector was very richly valued, slightly detracted from performance in May but were additive in June. Overweight positioning in the MBS basis was also additive in Q2. Off benchmark CRT and CMBS sectors earned good carry with CMBS spreads tighter adding to performance. MBS derivative positions did well as good carry and stable prepayments and the drop in implied volatility offset the further inversion in the yield curve. In June, we added to specified pool positions in lower coupon 30-year 2.0% and 2.5% focusing on loan balance and seasoning. We added to specified pool positions in lower coupon GNMAs. We tactically took some profits on our MBS basis overweight position. We sold two positions in MBS derivatives selling a 100% New York bond into an aggressive bid and selling a seasoned inverse IO.

OUTLOOK

The Fed's aggressive inflation-fighting stance has seen the policy rates move up 5.00% in the last year the quickest pace of rate hikes since the 1980s. The monetary policy tightening and corresponding rise in US interest rates has helped reduce the headline inflation rate from 9% last summer to 4% currently. Still, economic activity remains resilient with the growth in non-farm payrolls averaging close to 300,000 jobs per month and a generationally low unemployment rate at 3.6%. Job openings remain near 10mm and hiring has yet to show much if any sign of a slowdown. Fiscal spending along with corporate and household savings built up during the pandemic are buffering spending and growth. These buffers will eventually be depleted and hiring and economic growth will slow. But for now they have supported the US economy's resilience and deferred the onset of a recession. Further declines in inflation will be tougher to achieve and likely require a more meaningful rise in the unemployment rate. This argues for additional rate hikes from the Fed and a higher for longer monetary policy. Markets have pushed expectations for the first rate cut out into the second half of 2024.

MBS sector performance was strong in June. MBS valuations were very cheap coming in to the month and better investor demand, declining volatility and limited new origination supply all helped drive valuations tighter. Current coupon nominal spreads moved from +184 to +168. Despite the recent tightening, current coupon spreads still look very attractive in our view. Prepayments are well-behaved as refinancing activity is virtually non-existent and housing turnover is subdued due to "lock-in" effects stemming from high origination rates, high home prices and limited homes available for sale. Fixed income fund flows have been positive adding to money manager demand for MBS. The challenges for the sector have been limited bank demand, the further inversion in the yield curve and, while volatility has declined, it remains elevated.

The team maintains an overweight to MBS although they have been tactically adjusting the positioning to take advantage of the recent tightening and strong performance. MBS valuations are in off their recent wides but still look very cheap with current coupon nominal spreads at +170. 10-year UST yields have moved higher and are now above 4.00% as the market adjusts to the Fed's view of higher rates for longer. The Fed policy is very near to the end of the tightening cycle. While this does not mean rate cuts are coming anytime soon, it means volatility can come down and the yield curve can move to less inverted levels. The supply/demand dynamic for MBS is a positive tailwind which could lead to a further rotation from money managers into MBS and out of credit sectors as tighter financial conditions cool the economy and fixed income funds see inflows.

The bias is for higher coupons where nominal spreads are still wide and prepayments have been well-behaved. The MBA purchase and refinancing indices remain near 20-year lows and new origination supply is an anemic $2 billion per day. High home prices and high mortgage origination rates have put a damper on housing activity. A limited number of homes available for sale and a solid jobs market is supporting housing valuations. Any steepening of the curve should help higher coupons outperform lower coupons. Lower coupons look fully valued with tight spreads and less carry. The team maintains a benchmark weight on lower coupons aside from the 30-year 1.5% coupon where they are underweight. TBA dollar rolls are 0 or negative in nearly all coupons so the preference is for specified pools over TBAs. Rolls are better in higher coupon GNMA TBA and the bias is to be overweight the GNMA sector where expectations are for better demand from banks and overseas investors. Overall, the team is underweight lower coupon 15-year and instead prefer specified pools in 20-years. Positioning is also focused on adding to specified pools in higher coupon 30-year.

DISCLAIMER