Keeping diversification in mind in the Core market for 2019

The Fed’s tightening and QE unwind, volatility in the investment-grade credit and high-yield sectors and a lengthening credit cycle made 2018 a challenging year for bonds. However, there are potential options in higher-quality areas where we see diversification possibilities in MBS, ABS and CLOs.

Executive Overview

The Federal Reserve’s tightening, its continued unwinding of its quantitative easing (QE) portfolio, increased volatility in investment-grade and high-yield, and concerns over a possible end to accommodative credit conditions made 2018 a challenging year for the bond markets.

Despite cheapening valuations in credit, volatility may be resurfacing as the economic cycle shifts into its later stages. We believe diversification strategies incorporating mortgage-backed securities (MBS) and Structured Finance sectors should continue to be attractive in light of the market’s challenges.

Agency MBS look fairly attractive, both in terms of nominal spreads and the reduction in prepayment risk given the year-end index price of $100.86.

In Structured Finance, we are looking at traditional asset-backed securities (ABS) and high-quality collateralized loan obligation (CLO) markets, with caution in such segments as Non-Agency CMBS.

A Transitional Year

Several important factors made 2018 a transitional year for the bond markets. The Federal Reserve’s (Fed’s) gradual tightening and concerns about economic growth widened spreads in the investment-grade and high-yield bond markets. It also led to a bear flattening in the Treasury yield curve, with short-term rates rising +120 basis points and long-term rates rising only +28 basis points (comparing 1-month bills versus 30yr UST rates). Meanwhile, the Fed’s ongoing reduction of its quantitative easing portfolio has affected conditions in the MBS market. Neither of these Fed moves were unexpected or abrupt, but they have caused an ongoing repricing of what the market considers “normal.”

After a bull run that began nearly 35 years ago, these and other factors indicate that the bond market could be poised to turn bearish. Its underperformance can be seen in the 2018 returns for the Bloomberg Barclays U.S. Aggregate Bond Index, which ended the year flat but was plagued by negative excess returns across most spread sectors. Admittedly, some of this was due to “tape bombs”—the uptick in retailer bankruptcies, China trade sabre rattling, FAANG tech stock retrenchment, oil volatility, and so on.

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This leaves us with a number of questions regarding portfolio strategies in 2019. Will the Fed continue to tighten and if so, how will this and supply and demand dynamics impact the overall yield curve? For risk investors engaged in the credit market, is the cycle nearing its end? Is it time to perhaps engage in other higher-quality markets, such as MBS and Structured Finance? This report will examine these issues and delve into how these factors might drive liquidity conditions and correlations in a higher volatility market environment.

The Outlook for MBS

Our view on rates in 2019 is fairly benign. However, we are dealing with a market that, generally speaking, is starting to reprice against a risk-free rate that is much more attractive than it has been for the last 10 years, when comparing the Fed Fund Rate to shorter-dated bond instruments. That means some sectors within Structured Finance, and even within Treasuries and rates products, are again becoming attractive from a return perspective.

In the Agency MBS market we have been somewhat cautious over the past 12 months, with the expectation that spreads could widen as a result of the Fed tapering program, volatility picking up, and rates selling off. Throughout 2018 we experienced 17 basis points of option-adjusted spread movement from peak to trough, but nominal spreads have undergone a larger impact. With a range of +35 basis points over the 12-month period, the MBS current coupon spread closed the year near multi-year wides at 91 basis points over Treasuries. (See Figure 2.)

Agency MBS is typically viewed as a relatively stable asset class that has historically outperformed competing spread sectors in periods of elevated volatility when comparing Sharpe Ratios in the years following the Financial Crisis. That is useful now since Fed tightening, potential curve inversion, geopolitical risks, tariff headlines, and regulatory constraints in capital markets all point to a heightened risk of renewed volatility in the next cycle.

Agency MBS looks fairly attractive, both from a nominal perspective and from a relative value perspective when incorporating some measure of spread volatility. While corporate bonds generally trade at wider spreads than Agency MBS, the volatility of excess returns increased in 2018 (DWS CIO Office, December 2018), thus driving Sharpe Ratios lower as a result. With yields improving into higher rates and investors looking to diversify under the late cycle economic backdrop, our view is that demand for MBS has been accelerating based on these market actions. This should help absorb the supply associated with the tapering of the Fed’s balance sheet, and limit spread widening.

Also, higher rates have led to slower prepayment speeds as mortgage refinancings fall. Thus there is now less optionality in Agency MBS. The Bloomberg Barclays MBS Index, using analytics from BlackRock Aladdin Solutions, traded at $100.86 at year-end, with a 3.38 percent yield-to-worst and a weighted average prepayment speed of 6.6 CPR.

Although we find Agency MBS attractive, there are some headwinds in the future, mostly related to net supply. Our outlook for 2019 assumes another $400 billion to $450 billion in net supply, including approximately $180 billion from the FOMC balance sheet runoff. We need to ascertain what institutions will replace the Fed as the backstop for the mortgage market. The market expects foreign investors or domestic banks to fill the gap, but neither group would appear to be hard-pressed to buy until they see better valuations or lower volatility, based on our analysis.

In general, even if a renewed period of volatility in 2019 and wider spreads are expected, we are forecasting Agency MBS total returns to remain positive and think that MBS will hold up better than most other spread sectors from a volatility perspective.

![FIGURE 2. MBS CURRENT COUPON SPREADS](source: Bloomberg, CS LOCUS, December 2018.)

Source: Bloomberg, CS LOCUS, December 2018.

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Figure 4: DWS Perspectives on Major MBS Themes

_ Positives: Fundamentally, at the wider end of the range in both nominal and option-adjusted spread. Attractive risk/reward versus competing high quality spread sectors when incorporating recent spread volatility.

_ Negatives: Net supply expected to tick higher with the Fed no longer reinvesting paydowns. Money managers increased MBS allocation earlier this year, but may rotate back into credit as spreads have widened.

_ Constructive toward well-structured legacy cash-flows in CMOs as new issues are “wolves in sheep’s clothing”

_ Nominal spreads are tight, but superior convexity may protect against duration drifts and prepayment risk.

_ Value in long duration discount priced CMOs with locked out cash flows and positive convexity.

_ Agency CMBS in the “belly of the curve” warrants attention since bullet cash flow can provide payment certainty and roll-down.

_ Seasoned loan balance collateral in discount dollar priced pass-throughs to protect against both faster prepayments and duration extension. We would avoid high pay-up collateral in premium sectors in favor of lower payup collateral with favorable borrower characteristics that we think can improve convexity and OAS at marginal cost.

Source: DWS, December 2018.

Forecasts are based on assumptions, estimates, opinions, and hypothetical models or analysis which may prove to be incorrect.
The Outlook for Structured Finance

In 2018, Structured Finance performance was bifurcated into a modestly positive first three quarters of the year and then a very weak final quarter. Sector performance suffered from both heavy issuance—a post-crisis record of $650 billion (DWS data using Bloomberg)—and investor rotation out of spread product during the fourth quarter. Given the sector’s bias toward AAA assets, Structured Finance unsurprisingly outperformed lower-rated spread sectors like corporates and high-yield while underperforming lower beta sectors. Credit conditions in the sector were strong, helped by low unemployment and strong consumer balance sheets. Against that backdrop, higher-quality, fixed-rate assets could be more attractive versus down-in-credit, floating-rate assets. We are forecasting credit conditions to remain benign, however, some retracement from recent low levels can be expected.

ABS

ABS was the only sector in the Bloomberg Barclays U.S. Aggregate Bond Index to have positive excess returns, when compared to equivalent duration Treasuries, in 2018. The sector outperformed other spread sectors due to its higher quality bias (mostly AAA rated), and relatively low duration compared to other spread sectors. Overall, supply has been at a record pace in 2018 totaling $232 billion (DWS data using Bloomberg). Going into 2019, we expect supply to slow slightly as higher-quality, fixed-rate assets could be more attractive versus down-in-credit, floating-rate assets. We are forecasting credit conditions to remain benign, however, some retracement from recent low levels can be expected.

CMBS

CMBS, like other risk assets, underperformed significantly during the large risk-off move in the fourth quarter. Excess returns for the quarter were -105 basis points and the sector finished the year with excess returns of -47 basis points when compared to equivalent duration Treasuries. Traditional conduit deal supply continues to disappoint with total issuance of $41 billion in 2018, well off from the 2007 high of $188 billion (DWS data using Bloomberg). In addition, non-traditional sectors like Single Asset Single Borrower (SASB) and CRE CLOs continue to grow at the expense of traditional conduit CMBS. We expect the rise in interest rates to slow CRE appreciation and retail to continue to be challenged by secular changes in that sector. Long Agency CMBS exhibits some positive characteristics as a defensive sector that could outperform in a selloff and intermediate 3-7 year AAA Non-agency CMBS has the potential for yield improvement.
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CMBS 10YR AGENCY/NON AGENCY BASIS

Conclusion
The credit and fixed income markets could recover and continue to power along in 2019, leaving 2018 looking like an aberration and not a precursor to a more difficult environment. This is not to say there aren’t sectors across the bond market that can be examined for yield or risk-adjusted return opportunities. We believe, however, it is prudent to plan for a more volatile and complex market this year and examine opportunities that might exist across the various sectors of the Core fixed income market.

Source: BBG and DWS, December 2018.

CLOs
CLOs underperformed significantly in the fourth-quarter both from the risk-off move and the demand shift from floating rate to fixed rate assets. The credit curve steepened significantly over the quarter, with AAAs and AAs outperforming while BBs and below underperformed. Further pressuring spreads, the market saw record new supply at $127 billion. The sector delivered a solid total return of 1.27%, outperforming CMBS (+0.78%), but slightly underperforming ABS (+1.77%), all based on respective Bloomberg Barclays index returns. This year, we favor up-in-quality bias given the deterioration quality of the underlying loans and potential for demand to decrease for floating rate assets.

1ML VS. 10YR YIELDS
Historically, when LIBOR exceeded the 10yr, the 10yr usually rallies

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January 2019
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