Mortgage-backed securities sector commentary

Executive summary

- Both short- and long-term Treasury yields declined during the second quarter, as the Federal Reserve Board ("Fed") indicated it may soon lower interest rates.
- The overall taxable bond market, as measured by the Bloomberg Barclays U.S. Aggregate Index, gained 3.08% during the second quarter. The spread sectors also moved higher over the quarter.
- Despite several headwinds, Western Asset Management ("Western") expects global growth to remain resilient on the back of steady U.S. growth, improving domestic conditions in Europe, and signs that sustained monetary and fiscal stimuli across Asia are gaining traction.
- Western continues to view residential mortgage-backed security and commercial mortgage-backed security valuations favorably relative to fundamental and technical conditions.

Market recap

U.S. Treasurys generated a positive return during the second quarter, as both short- and long-term yields declined (yields and prices move in the opposite direction). The spread sectors (non-U.S. Treasurys) also rallied over the quarter. After yields generally moved higher in April, trade concerns dominated May and led to a risk-off environment for much of the month. Yields then moved sharply lower as the Federal Reserve Board ("Fed") indicated it was getting closer to lowering interest rates. Similar accommodative messaging by the European Central Bank (ECB) also contributed to falling global bond yields.

Looking at the U.S. economy, according to the Commerce Department, first quarter 2019 gross domestic product (GDP) annualized growth was 3.1%. In contrast, the economy expanded 2.2% during the fourth quarter of 2018. The acceleration in GDP growth during the first quarter of 2019 was attributed to positive contributions from exports, personal consumption expenditures, nonresidential fixed investment, private inventory investment, and state and local government spending. These movements were slightly offset by a negative contribution from residential fixed investment. Imports, which are a subtraction in the calculation of GDP, decreased.

The labor market remained tight during the second quarter. The unemployment rate was 3.6% in both April and May—equaling the lowest rate since December 1969. The unemployment rate then ticked up to 3.7%. However, this was partially due to an increase in the workforce participation rate, as it rose from 62.8% in May to 62.9% in June.

The manufacturing sector continued to expand, but the pace moderated during the second quarter. According to the Institute for Supply Management's Purchasing Managers Index (PMI), the manufacturing sector expanded for the 34th consecutive month in June, with a reading of 51.7, versus 52.8 in April. (A reading below 50 indicates a contraction, while a reading above 50 indicates an expansion.) Twelve of the 18 industries measured by the PMI expanded in June.

According to the National Association of Realtors (NAR), existing-home sales rose 2.5% on a seasonally adjusted basis in May versus the previous month's sales. The NAR also reported that the median existing-home price for all housing types was $277,700 in May 2019, up 4.8% from May 2018. Finally, the inventory of homes available for sale in May was at a 4.3-month supply at the current sales pace. In contrast, there was a 4.2-month supply in the previous month.

The Fed kept its target rate unchanged in a range between 2.25% and 2.50% during the second quarter. However, at its meeting in June the Fed said, "The Committee continues to view sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee's symmetric 2 percent objective as the most likely outcomes, but uncertainties about this outlook have increased." In his press conference after the meeting Fed Chair Powell stated, "The case for somewhat more accommodative policy has strengthened."

Both short-term and longer-term Treasury yields fell sharply during the second quarter. When the period began, the yield on the 2-year Treasury was 2.27%, and it ended the quarter at 1.75%. Its low for the period of 1.71% occurred on June 25, and it rose as high as 2.41%, on April 16. The yield on the 10-year Treasury began at 2.41% and it ended the quarter at 2.00%, equaling its low for the period. Its peak of 2.60 occurred on April 16.

The overall taxable bond market, as measured by the Bloomberg Barclays U.S. Aggregate Index, gained 3.08% during the second quarter. The spread sectors also moved higher, as the Fed and a number of other central banks leaned toward introducing more accommodative monetary policies. In addition, signs of moderating global growth and uncertainties over U.S.-China trade negotiations triggered several flights to quality. Higher-yielding spread sectors also generated positive results during the quarter.

Looking at structured product for the second quarter, legacy non-agency mortgage-backed security (MBS) spreads were marginally tighter, with below-investment-grade securities tightening as much as 5 basis points (bps) and investment-grade securities tightening 3 bps. Spreads were mixed for credit risk transfer securities (CRTs), with investment-grade securities tightening 2 bps, while below-investment-grade securities widened 15-25 bps. Commercial mortgage-backed security (CMBS) spreads were tighter for the quarter across the quality spectrum, whereas AAA- and BBB-rated securities tightened 5 and 35 bps, respectively. Finally, asset-backed securities (ABS) exhibited mixed results during the quarter. Rental car five-year BBB-rated securities tightened 19 bps, while subprime auto four-year BBB-rated securities widened 5 bps.

Outlook

We continue to view residential MBS and CMBS valuations favorably relative to fundamental and technical conditions. We believe the current moderate growth environment is accretive for real estate and consumers. We believe this backdrop and the investments available in the MBS and ABS market offer investors an attractive return profile with good carry.

The U.S. housing sector continues to show positive improvement year over year. Home price growth rates are expected to continue increasing, albeit at a slower rate than in the prior few years. The credit quality of new non-agency MBS is expected to remain strong, due to improved underwriting standards, thorough third-party reviews and modest growth in home prices. The lack of mortgage credit is the largest constraint to an improvement in housing, but there has been some easing at the margin. In legacy residential MBS, servicer behavior (modifications, stop advances, etc.) may cause cash flow dispersion across different sectors and bonds, creating relative value opportunities.

Investment risks

All investments are subject to risks, including possible loss of principal. Investments in bonds are subject to credit risk, inflation risk, income risk and interest rate risk. As interest rates rise, bond prices fall, reducing the value of an investment. Asset-backed, mortgage-backed or mortgage-related securities are subject to prepayment and extension risks.

Glossary

A **basis point (bp, or bps)** is one one-hundredth of one percent (1/100% or 0.01%).

Agency and non-agency mortgage-backed securities (MBS) are bonds backed by payments on mortgage loans and can be created by private entities (non-agency) or by government-sponsored enterprises (agencies) that issue MBS. Unlike U.S. Treasury securities, debt securities issued by the federal agencies and related investments may or may not be backed by the full faith and credit of the U.S. government. Even when the U.S. government guarantees principal and interest payments on securities, this guarantee does not apply to losses resulting from declines in the market value of these securities.

The **Bloomberg Barclays U.S. Aggregate Index** is a broad-based bond index comprised of government, corporate, mortgage and asset-backed issues rated investment grade or higher and having at least one year to maturity. Please note that an investor cannot invest directly in an index.

Commercial mortgage-backed securities (CMBS) are a type of mortgage-backed security that is secured by the loan on a commercial property. A CMBS can provide liquidity to real estate investors and to commercial lenders. As with other types of MBS, the increased use of CMBS can be attributable to the rapid rise in real estate prices over the years.

Credit risk transfers (CRTs) serve as a way for government-sponsored enterprises (GSEs) to share credit risk with the private markets.

A **credit spread** is the difference in yield between two different types of fixed income securities with similar maturities. References to spreads in this commentary are comparisons to U.S. Treasury securities.

An **investment-grade rating** (AAA, AA, A, BBB, for examples) is one that indicates that a municipal or corporate bond has a relatively low risk of default. Bonds with below-investment-grade ratings (BB, B, CCC, for examples) are considered low credit quality and have a higher risk of default.

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U.S. Treasurys are direct debt obligations issued by the U.S. government and backed by its "full faith and credit." The U.S. government guarantees the principal and interest payments on U.S. Treasurys when the securities are held to maturity.

The core **personal consumption expenditures (PCE) index** measures the prices paid by consumers for goods and services without the volatility caused by movements in food and energy prices, to reveal underlying inflation trends.

An investor cannot invest directly in an index. Unmanaged index returns do not reflect any fees, expenses or sales charges.