Q4 2021 Market Commentary

Macro: Spurred by record corporate profits, a booming economy with healthy wage gains and $2.7 trillion of excess savings amassed during the pandemic, risk assets had a strong finish to 2021 as they successfully navigated a "wall of worry", including a Federal Reserve that is becoming less accommodative. The S&P 500 posted an 11.0% return in Q4 and 28.7% for all of 2021, while hitting 70 all-time-highs during the year. However, looking beneath the surface, there are reasons to be concerned about the likelihood for a continued bull market.

The most obvious two issues that threaten to derail the rally across risk assets are inflation and rising interest rates. The Federal Reserve's recent announcement that they will target an end of their QE program in March 2022, along with expectations of interest rate hikes, caused significant flattening of the US Treasury curve. The yield on 2-year Treasury notes rose by 46bp to 0.72%, while the 10-year ended the quarter up only 2bp to 1.51%. We believe the reason the long end did not sell off more, despite the tapering of asset purchases, is that investors fear a Fed policy mistake in the form of excessive hawkishness which could derail economic growth, plunging the US economy into a recession. Once investors are comfortable that the rate of tightening can meet the mandate of controlling inflation and maintaining economic growth, we believe the long end will begin to sell off.

RMBS: Despite robust fundamentals stemming from a 19% HPA increase in 2021, most RMBS sectors saw slight spread widening in Q4 due to post-GFC record supply. CRT saw a massive increase in gross issuance in Q4, with 50% of the new issuance concentrated in B1 and B2 tranches at the bottom of the capital structure. The supply of these long spread duration locked-out tranches proved difficult to digest and triggered temporary spread widening, although spreads did firm up in December as investors put money to work at wider levels. Record supply also weighed on spreads of Non-QM and Jumbo 2.0 tranches across the ratings spectrum.

Trading activity was muted across Legacy RMBS sectors. Most of the supply came from AON liquidations from hedge funds who acquired these positions in March 2020. Spreads were largely unchanged with Q4 returns ranging from 0.3% to 1% across Legacy RMBS sectors while calendar year 2021 returns came in at 5.5-6%, as Legacy RMBS were largely insulated from the move higher in rates. Positive performance catalysts included accelerated principal forbearance recoveries that reached more than 80% in Q2 2021 (Nomura Research). Another tailwind for Legacy RMBS has been a significant decline in liquidation severities that have decreased in aggregate from 55% in 2020 to 28% in 2021 (Nomura). Legacy RMBS sectors also continued to benefit from optional redemption activity in 2021 with 60 deals, totaling $1.5 billion in collateral, being called.

One of the more prominent themes in the RMBS space in 2021 was a considerable decline in secondary trading activity compared to 2020. According to BofA Research, trading volumes declined by 39% in 2021, from $141 billion in 2020 to $86 billion for non-investment grade RMBS tranches. In addition to a lack of spread volatility, investors have been sitting on abundance of cash which makes them less willing to sell existing holdings.

CMBS: CMBS supply for 2021 was the highest since 2007, with $155 billion in private label issuance and $180 billion in Agency CMBS issuance (JPM Research). SASB and CRE CLOs led private label issuance with $77 billion and $45 billion, respectively, as issuers found better execution in multifamily, industrial and office sectors via SASB/CRE CLO structures. With the Fed announcing its tapering plans and the Omicron variant again threatening travel and hospitality industries, market participants struggled to absorb the increase in CMBS supply and spreads widened in Q4. The deluge of new issue SASB deals pushed OTR AAA SASB spreads to around 90bp while BBBs widened to the high 100's. There is plenty of dispersion among secondary SASB deals, with retail and hotel deals trading much wider relative to multifamily, industrial, and mixed-use properties. Similar spread movements were observed in the CRE CLO space, which consists primarily of transitional multifamily properties. Nevertheless, CRE CLOs had very strong performance in 2021 as AAAs tightened by 5bp and BBBs tightened by 80bp for the year.

The CMBS delinquency rate saw its first uptick in 18 months in December, with a 19bp increase to 4.57% (Trepp), with most of the increase being due to several large office loans in NYC and Chicago becoming delinquent. CRE prices are projected to have increased 16% in 2021 according to CPPI indices with Industrial and Multifamily leading the way at 17%. However, the CRE market continues to be quite bifurcated with new Class A properties decoupling from older Class B & C structures. Troubles with older Class B & C are evident when looking at liquidation/sale or new appraised values versus appraisals at origination, with some properties suffering 90%+ declines from issuance levels.

ABS: 2021 was a banner year for ABS new issues with a record $263 billion in gross supply (JPM) compared to $175 billion in 2020. While other structured credit sectors saw spreads widen due to a deluge of new issue supply, only Private SLABS and Subprime Auto ABS saw a meaningful spread widening into year-end. The remainder of ABS sectors continued to trade close to their 2021 tights, which are the tightest spread levels since the GFC.

Given substantial economic tailwinds in the form of low unemployment, a tight labor market, rising wages and healthy consumer balance sheets, fundamental credit performance has been strong across all ABS sectors. Unprecedented amounts of fiscal stimulus has helped drive delinquencies to record lows across many ABS sectors. While both defaults and delinquencies are expected to normalize to higher levels in 2022, there should be sufficient excess spread in ABS deals to comfortably absorb higher expected losses.

CLOs: The CLO market also saw record issuance in 2021, with $184 billion in new supply, pushing the outstanding CLO total to just over $800 billion. The new issue deluge weighed on CLO spreads with AAAs widening by 7bp to 108bp in Q4 2021, while BBBs saw 8bp of spread widening to 325bp (Palmer Indices). For the year, CLOs posted solid returns with BBs as the best performers, posting 9.6% total return in 2021 (BofA). Underlying leveraged loan prices were stable in Q4 with LSTA Index price ending the quarter flat at 98.6, close to a 7 year high. Despite retracing all of the 2020 spread widening, CLOs are still attractive compared to High Yield Bonds from a relative value perspective. There was also a record amount of refinancing and resets of CLO tranches in 2021 as CLO managers took advantage of cheaper funding and higher loan prices. Many 2019 and 2020 deals that were issued at higher funding spreads were refinanced in 2021. Improved earnings, IPOs, deleveraging, M&A and refinancing activity were the primary drivers of ratings upgrades to leveraged loans in 2021. The rating upgrades have greatly improved par Over Collateralization coverage for a vast majority of CLO tranches, in addition to defaults on underlying leveraged loans having dropped to a nine year low.

TRUPS CDOs had a very strong year both in terms of credit fundamentals and pricing. Strong bank balance sheets, record earnings and significant M&A activity reduced the number of banks on FDIC's "Problem Bank List" to just 46, the lowest number since 1984. Defaults and deferrals on underlying TRUPS have been hovering near-zero while Fitch changed its rating methodology on TRUPS CDOs, which is expected to result in numerous ratings upgrades to Investment Grade (IG).

Structured Notes: Structured notes had a difficult quarter, with the yield curve flattening by 62bp in Q4. This curve flattening was primarily due to a rise in the 2-year swap rate, as the interest rate market started to price in Fed rate hikes in 2022. Lower multiple CMS floaters were the worst affected securities, while higher multiple securities saw more limited losses. We saw increased selling in December following the FOMC meeting, as some institutional holders were looking to reduce their Structured Note exposure in anticipation of further yield curve flattening.

Portfolio Attribution & Activity*: Structured Credit Value posted a slight beat, on a gross-of-fees basis, relative to the Barclays US Aggregate index. Unrealized losses were a drag on portfolio returns, as most structured credit sectors experienced mild spread widening in Q4. Most of our pricing losses came from Corporate Structured notes, due to 62bp of curve flattening in Q4 2021. The majority of these securities pay interest based on the spread between the 30- and 2-year swap rates which is multiplied by a factor ranging from 4 to 20, subject to a coupon cap. Curve flattening caused projected coupons to decline and therefore had a negative impact on prices. Carry was around 100bp in Q4 with Corporate Structured notes, CMBS and RMBS sectors providing the bulk of carry returns.

During Q4, we increased our allocation to cash and Treasuries, due to a dearth of opportunities with a desirable risk-reward profile. Due to the unprecedented supply wave in 2021, coupled with expectations of additional supply in 2022, there may be opportunities to add structured credit paper at wider spread levels moving forward.

In RMBS, we have reinvested paydowns and added some exposure to 2018-2019 vintage Non-QM and RPL subordinate tranches, close to par. These bonds are close to optional call redemption date but offer positive carry to call while spreads to maturity are over 250bp for BBB and BB rated tranches. These are safe short-duration investments, that are also attractive to banks given their low 20% capital charges. In CMBS we added 2017 vintage Small Balance Commercial fixed rate tranches at wider spreads relative to similar duration IG paper. We have also reinvested paydowns from CLO redemptions into other de-levering single-A rated CLO tranches from lower tier managers at discount margins around 300bp. These CLO tranches provide over 100bp of excess spread relative to single A tranches from top tier managers, while having higher MVOC and par subordination amounts.

Q4 2021 Portfolio Attribution

SECTOR	ALLOCATION	RETURN	ATTRIBUTION
RMBS	35.0%	1.09%	0.38%
CMBS	15.9%	1.49%	0.24%
ABS	2.9%	0.74%	0.02%
CLO/CDO	14.0%	1.32%	0.18%
CORP	16.5%	-4.72%	-0.78%
GOVT	6.9%	-0.51%	-0.04%
Cash	8.8%	0.00%	0.00%
Total		100.0%	0.01%

*Attribution represents Net-of-fees mutual fund performance

Q4 2021 Portfolio Outlook: Moving into 2022, interest rates will continue to be at the forefront of economic activity. While the long end of the curve may rally initially on policy mistakes and recession fears, we think the long end will gradually rise with the 10-year reaching 2.25%. We expect economic growth to moderate substantially, to 2.5% this year, though we don't think a recession is likely in 2022.

From a portfolio perspective, we expect to maintain ample liquidity, with our cash and Treasuries allocation between 10-15%. Given that spreads are close to post-crisis tights, we expect to source most of our returns for this year from carry and opportunistic trading. Spread volatility should also increase compared to 2021 given the Fed's increasingly aggressive tightening stance. Leveraging our team's deep valuation and trading expertise, we continue to find select opportunities across the securitized sectors and have targets in all sectors should we encounter a risk-off market.