Third Quarter 2023

Fixed-Income Sector Views

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Portfolio Management Outlook

Technical Tailwinds and the Prospect of a Soft Landing

Managing through an increase in the range of possible economic and market outcomes.

Recent data and policy developments have fallen firmly in the soft-landing camp, and market performance has reflected this shift. Lower inflation and resilient economic growth caused an upside surprise to second quarter real gross domestic product, business investment is getting a boost from fiscal policy initiatives to onshore domestic production, and the housing market is showing signs of adjusting to higher mortgage rates. Fixed income, especially higher beta credits, delivered solid performance in the first half of the year as spreads tightened.

The Federal Reserve (Fed) has embraced the soft-landing narrative for the moment. This stance is supporting risk assets, but the acceleration in economic activity and the easing in financial conditions are a double-edged sword since a stronger economy would lead to resurgent inflationary pressures. We still expect the lagged impact of 525 basis points of rate hikes to precipitate a recession, but a soft landing would signal that the Fed’s inflation fight is not over. The increase in the range of economic outcomes lends some uncertainty to market conditions, but at the very least this backdrop supports higher front-end rates for longer and continued elevated rate volatility. This dynamic is providing attractive, high quality investment opportunities across our strategies.

Our sector teams share a point of view that is remarkably similar across the market—yields are among the highest seen in the past decade or more, and spreads are generally held in check due to the first half decline in new issuance volume in many sectors. Bank loan coupons are 9 percent, the highest since 2001, contributing to a yield that our sector team believes compensates for rising credit risk. Our investment-grade corporate sector team reports that supply technicals and a natural buyer base for 30-year paper should support longer-duration securities. These technicals will also likely provide secondary market tailwinds for RMBS, CMBS, and other asset-backed securities.

The technical tailwinds are a positive dynamic for portfolio performance, but reinvesting high yields into markets with limited supply could also mute the market’s ability to reprice credit risk appropriately. We are seeing early signs of the turning of the credit cycle. Downgrades are outpacing upgrades and defaults are rising for corporate and municipal credits. As we expected, our sector teams are seeing increased dispersion among credits. In this environment, it is crucial to look for trends in leverage and fixed-charge coverage ratios, upcoming maturity schedules, and exposure to labor pressures. For now, credit issues have been idiosyncratic in nature but over time these kinds of issues have the potential to become more pervasive among industries and/or sectors. We are only a few months removed from the mini banking crisis and challenges in that sector or others could appear at any time. In that vein, we are keenly focused on direct and indirect exposure to commercial real estate, a sector that faces severe headwinds and where our team notes that prices have dropped 11 percent year over year, geographic dispersion is significant, and capital availability is challenging, particularly for office properties.

During this period of elevated uncertainty, focusing on diversification, capital preservation, and maintaining portfolio optionality is key. Fortunately, relatively high yields are available on relatively low-risk assets, which gives us confidence that we can continue to find compelling values even as we take a defensive posture on behalf of our clients.

By Anne Walsh, Steve Brown, Adam Bloch, and Evan Serdensky
Macroeconomic Update

Strong First Half Doesn’t Negate Recession Concerns

U.S. economic activity has been better than expected, but leading recession indicators still argue for caution.

Inflation has cooled off but continues to run well above target. And while near-term disinflation should continue, inflationary risk will remain with the labor market tight. As a result, the Fed continues to try to slow the economy, a strategy it believes is required to get inflation durably back to the 2 percent target. We expect Fed policymakers will deliver a final rate hike in September or November as they try to limit an economic reacceleration that could risk a resurgence in inflation. Quantitative tightening will likely continue at least into early 2024.

Despite the abrupt tightening of Fed policy seen over recent quarters, growth of real gross domestic product has been resilient, aided by a significant fiscal expansion and easing inflation pressures that have boosted real personal consumption. Indeed, headline personal consumption expenditures (PCE) inflation slowed to 2.5 percent on an annualized basis in the three months ending in June from 7.4 percent in the corresponding period a year earlier, helping to lift real income growth and support consumer spending.

Notwithstanding recent stronger-than-expected economic activity, we continue to believe the Fed’s actions will initiate a rise in the unemployment rate, ultimately leading to a recession starting by early next year. A range of leading indicators—including a low unemployment rate, an inverted yield curve, a declining leading economic index, and tightening bank lending standards—suggest a downturn is in the pipeline.

While recession would undoubtedly lead to rising defaults and market selloffs, we continue to believe this recession should be relatively mild in its severity. Moreover, we expect inflation will be brought under control as spending and demand for labor cool, in turn allowing the Fed to start to ease up on its restrictive monetary policy stance as we move through 2024.

By Matt Bush and Maria Giraldo

Despite stronger-than-expected economic activity, we believe the Fed will be successful in its quest for a higher unemployment rate, as leading indicators, such as the Consumer Confidence Survey, suggest a downturn is in the pipeline.
Rates

Positive Outlook for Treasury Returns

Income will be a significant driver of returns for investors.

The volatility in the Treasury market during the first quarter of the year persisted into summer as economic data supported continued aggressive Fed action. Robust employment data and sticky core inflation demonstrated a resilience in the economy that resulted in an increase in expectations for the Fed’s forecasted terminal rate. With the terminal rate destination in flux, the front end of the curve bore the brunt of the volatility, increasing by 85 basis points in yield over the course of the second quarter. The Fed continued its hawkish stance with a 25 basis point increase at its July meeting, and our Macroeconomic and Investment Research Group is expecting an additional 25 basis points hike this fall. But the end of the current tightening cycle is close at hand. We expect the next large move in the Treasury yield curve will be a bull steepening that would be driven by easing of monetary policy in 2024.

As the yield curve flattened, the Treasury market total return of 3.0 percent during the first quarter decreased substantially to 1.6 percent for the first half of the year. However, while the Treasury returns were diminished, the Treasury market index, yielding 4.35 percent as of June 30, looks attractive. Looking ahead, we continue to think that Treasury returns will be positive for the remainder of this year and that income will be a significant driver of this return.

We will continue to take advantage of any Treasury yield backups in the intermediate part of the curve, opportunistically adding to underweight positions. Additionally, given the large increase seen in real yields during the second quarter and the low levels of breakeven inflation rates, we believe owning some inflation protection in our portfolios makes sense.

By Kris Dorr and Tad Nygren

With the breakeven rate—market-implied expectations for average annual inflation over the next five years—low relative to current realized inflation, combined with our view that the Fed will only raise rates once more this cycle, yields on nominal Treasurys and TIPS appear attractive in the near term.

Treasury Nominal and TIPS Appear Attractive in the Intermediate Part of Yield Curve

5-Year Treasury Inflation-Protected Securities (TIPS), Nominal, and Breakeven Yields

![Graph showing Treasury Nominal and TIPS yields]

Despite weakening fundamentals, the performance outlook appears positive.

Despite early signs of deterioration in credit fundamentals, investment-grade credit spreads should continue to be supported over the third quarter by strong technicals, lack of volatility, and historically attractive all-in yields. Primary supply technicals remain favorable. While there continues to be a dearth in long duration and bank issuance, we expect banks to pick up the pace in the third quarter, but issuance of longer duration securities is likely to remain muted.

The traditional investor base for investment-grade corporates has been underweight versus the benchmark due to defensive positioning, but positive mutual fund inflows into high-grade funds should help keep spreads rangebound throughout the third quarter. The yield on the Bloomberg U.S. Investment Grade Corporate Index was hovering just above 5.5 percent in mid-July, which is in the 98th percentile over the last 10 years. We believe this relatively higher yield offers plenty of insulation from a total return perspective: Spreads would need to widen or rates increase by a combined 78 basis points in order to generate a loss over a one-year time horizon. But sectors such as money market funds and short-term Treasurys and Agencies are attractive alternative investments in the 4.75–5 percent yield range, which is likely to prevent investment-grade spreads from tightening materially from current levels.

Second quarter earnings show weakening credit fundamentals, as margins continue to compress and interest coverage trends lower as funding costs have risen. That said, the decline has been measured and these indicators are generally still above pre-COVID levels, but we expect this trend to continue and possibly accelerate into year-end.

Despite the 10s/30s credit curve continuing to flatten on a yield basis, we still see value in long duration securities. The supply technicals and natural buyer base for 30-year paper should continue to support the market throughout the third quarter. We remain cautious about adding to preferred and junior subordinated securities in the secondary market until further clarity around bank regulatory capital is finalized. However, we believe there are certain attractive investments in the asset class with higher current coupon and/or higher reset spread securities, which offer less downside risk. As we enter the summer slowdown, we believe more focus should be on liquidity and diversification.

By Justin Takata

Credit fundamentals are weakening as margins continue to compress and interest coverage trends lower as funding costs rise.

![Graph: Credit Fundamentals Deteriorating Gradually](image)

High-Yield Corporate Bonds
Attractive Yields and Limited Supply Support Performance

Credit challenges persist, but stable spreads and attractive yields lure investors.

The picture for the high-yield corporate bond market is mixed. Performance has been strong year to date, driven by attractive yields and the lack of new issuance. Meanwhile, defaults have increased. In the first half of 2023, 11.1 percent of bonds in the ICE BofA High Yield index were downgraded versus 9.7 percent upgraded, resulting in a negative net migration rate. We remain concerned about the effects of restrictive monetary policy and slowing corporate earnings growth, which suggest that more defaults and credit rating downgrades lie ahead.

The ICE BofA High Yield Index has returned over 6 percent year to date through the end of July, with strong performance across most industries. Yet defaults have increased as some companies wrestle with increasing interest expense and unsustainable leverage ratios. The high-yield corporate bond default rate increased from 1.5 percent to 2.4 percent, according to BofA Research, which remains below the historical average of 3.8 percent. Our forecast puts the 2023 default rate at 3.5 percent and 2024 at 5 percent—a benign cycle compared to history.

Most defaults over the last 12 months came from healthcare, followed by media companies and then telecom and technology companies. We continue to view this default cycle as one driven by idiosyncratic, credit-specific factors rather than industry-specific ones, in contrast to the last several cycles dating back to the 1990s. Many defaults today have been well-known stress situations that were priced with elevated spreads for over a year, thus the lack of a surprise element is avoiding meaningful spillovers.

Despite rising defaults, high-yield corporate bond spreads are 384 basis points over maturity-matched Treasurys, which is tighter than the decade average of 446 basis points and in the 34th percentile over this period. But yields stand at 8.4 percent, which is in the 88th percentile over the same timeframe.

We believe high-yield bond spreads have limited room to tighten further, but current yields continue to appeal to investors, despite more cautious market sentiment surrounding the hardest-hit sectors. This element, combined with limited net new issuance, should keep spreads rangebound in the near term. We remain cautious in our credit selection though, focusing on issuer and industry diversification as well as moving up in the capital stack and looking for higher quality debt, given the broad-based nature of the current default cycle that is still in its early stages.

By Thomas Hauser and Maria Giraldo

The high-yield market has had strong year-to-date performance, buoyed by strong performance across most industries. This is in spite of rising defaults in the sector, which we believe are driven by credit-specific factors, rather than industry-specific ones.

The High-Yield Market Returned Over 6 Percent Year to Date
ICE BofA High Yield Index Total YTD Return by Industry

Bank Loans

Clipping the Highest Coupon in Two Decades

Yields are attractive even after accounting for credit losses in an above-average default environment.

For all the market’s consternation over the bank loan sector’s vulnerability to higher interest rates, one feature that may be getting overlooked is the historically attractive coupons that the sector is paying. The leveraged loan average discount margin to maturity is 573 basis points. When added to the three-month secured overnight finance rate (SOFR) of 5.4 percent, the current yield on the loan market based on the Credit Suisse Leveraged Loan Index was over 11 percent at the end of July. Coupons represent 9 percent of that yield, the highest coupon rate since 2001.

We believe this yield opportunity more than compensates for credit risk, especially for active managers. Our default rate forecast for bank loans is 3.5 percent in 2023 and a range of 5–7 percent in 2024, which means a cumulative default rate from today of 8.5 percent to 10.5 percent by the end of 2024. After applying the long-run trend of 60 percent for the recovery rate assumption, the loss-adjusted yield, assuming constant interest rates, would land between 5.6 and 7.6 percent in this scenario. This is far more attractive than the 4 percent yield on a seven-year Treasury and does not factor asset selection via active management, which should result in a potentially lower portfolio default rate. Floating rate loans also offer duration protection from the risk that the Fed is not quite done with the hiking cycle—a possibly underappreciated risk in an environment in which we have seen resilient economic activity.

While the sector’s yield looks attractive even on a loss-adjusted basis, we still think it is important to monitor the ongoing trend of credit defaults and negative rating migration. The 12-month trailing par-weighted default rate climbed to 1.7 percent as of June 2023, which remains below the historical average of 2.7 percent. The trend of more rating downgrades than upgrades also continued over the last three- and six-month periods, with a downgrade-to-upgrade ratio of 2.4x and 2.5x, respectively. In this environment, it is crucial to look for emerging single-security credit risk since they have been idiosyncratic in nature. Unsustainable leverage ratios, cost pressures, poor balance sheet liquidity, and upcoming maturities have all been among cited reasons for recent defaults across several industries. Some approaches that we take to mitigate this risk include monitoring borrowers’ ability to cover fixed charges, focusing on issuers with pricing power and less margin vulnerability, and keeping a close watch on companies in more labor-intensive sectors such as healthcare, business services, and restaurants that may still be suffering labor shortages and wage inflation.

By Christopher Keywork and Maria Giraldo

Current annualized coupons for leveraged loans are at 9 percent, the highest coupon since 2001, which we believe more than compensates for credit risk.

Leveraged Loan Coupons Produce Highest Returns in Two Decades

Credit Suisse Leveraged Loan Index Annualized Coupon

Municipal Bonds
Cracks Form in Muniland

Wary of a slowing credit cycle and waning technical tailwinds.

While credit fundamentals remain solid for historically stable municipal bond sectors such as state governments and essential utilities, individual income tax revenues have come under pressure due to a fall off in capital gains taxes, causing multiple states to experience year-over-year declines. The median rainy day fund for all 50 states is expected to reach 13.5 percent of budgeted expenditures for the current fiscal year, which began on June 1 for most states, up from 12 percent for the prior fiscal year. However, some cracks have appeared in the riskier sectors of the municipal market. Defaults totaled $958 million through May, 58 percent higher than last year. Defaults were dominated by two sectors, with parking facilities comprising 42 percent of the total, and nursing homes, where the operational impact of COVID has continued to work through financial statements, comprising 30 percent of the total.

Technical tailwinds have allowed tax exempt municipals to maintain returns in 2023—2.1 percent year to date through mid-August—despite rate volatility. Tax exempt mutual funds experienced outflows for most of the second quarter, but these outflows were offset by a decline of 14 percent in new issuance through early August. The period between June and August is expected to experience the largest net supply deficit for the year due to significantly larger principal and interest (P&I) payments than the rest of 2023, which typically get reinvested in the muni market: $47 billion average P&I payments during those three months versus $32 billion average payments for the remaining nine months of a 12-month period.

The overwhelming net cash flows have sufficiently offset slowing secondary trading conditions. Bid wanted volumes—a barometer for mutual fund liquidity needs—are 14 percent higher year over year. Dealer inventories maturing beyond 10 years have increased 21 percent versus 2022, and are 19 percent above their rolling one-year average. Due to the net supply deficit, the ratio of tax exempt yields to Treasury yields has stayed rich—the 10-year ratio is 65 percent, at the low end of the 12-month range of 60–89 percent. However, we advise caution amid signs of a slowing credit cycle and waning technical tailwinds: The influx of P&I payments drops down to just $28 billion per month on average from September to November. Combined with rich current valuations and reduced secondary market liquidity, we expect tax exempt returns to weaken from the latter half of the summer through the start of the fourth quarter.

By Allen Li and Michael Park

Slow secondary market activity and fading technical tailwinds for tax exempt municipals have led to a 21 percent increase in dealer inventories maturing beyond 10 years. We believe these factors, in addition to rising defaults, will lead to weaker tax exempt returns through the start of the fourth quarter.

Dealer Inventories Maturing Beyond 10 Years Have Risen
Dealer Net Positions Maturing 10+ Years Relative to Rolling 1-Year Average

**Asset-Backed Securities and CLOs**

**Commercial ABS Remains Attractive**

Declining primary market issuance helps support spreads.

In the CLO sector, primary market issuance slowed significantly in the second quarter to $22 billion—a 47 percent year-over-year decline—as elevated CLO tranche spreads and rising bank loan prices reduced the economic incentive for sponsors to issue new CLO deals. We expect issuance to remain tepid into year-end and for spreads to remain rangebound. Our preference is to focus on senior CLO tranches given the attractive carry profile and higher credit quality of the tranches. The tiering between top and bottom quartile AAA spreads for new-issue CLOs has increased to 37 basis points compared to less than 10 basis points historically, making it more punitive for lesser-followed managers to issue new deals. Underlying loan fundamentals remain challenged in a higher interest rate environment—net downgrades to CCC and defaults in CLO portfolios in the first half of the year have exceeded 2022 full-year levels. Importantly, recovery rates have trended lower, which could lead to increased volatility for junior CLO tranches. Exposure to healthcare companies and software companies—two of the largest sector weights in CLO portfolios—remain a key focus area due to the elevated level of stress in these industries.

Commercial ABS yields are notably more attractive than similarly rated corporate bonds. The spread differential between commercial ABS and corporate bonds stood at 120 basis points in mid-July, versus a 10-year median of 58 basis points, which ranks in the 89th percentile relative to history. Commercial ABS is a smaller niche market with less liquidity than the corporate bond market, and this lower liquidity means structured credit tends to lag rallies in corporate credit. Since this spread is driven by liquidity rather than fundamentals, we believe it presents an attractive opportunity to increase exposure to certain categories of the ABS market.

Commercial ABS primary market issuance declined 28 percent year to date as issuers avoided borrowing at higher rates. While opportunities in new issue have been modest, investors who have high credit conviction and stepped up to anchor deals were able to achieve favorable allocations. We have been active in data center, fiber, and triple net lease sectors, where we have seen senior investment-grade rated tranches at 6–6.5 percent yields. We expect to see a similar rhythm of issuance over the rest of the year as issuers can no longer defer refinancings or takeouts of non-ABS warehouse debt. Credit performance across ABS is beginning to show differentiation, as some subprime auto and consumer unsecured issuers sustain underlying collateral defaults. Our focus in ABS remains on capturing the complexity premium in commercial subsectors with an emphasis on selecting stronger sponsors and investor-friendly structures.

*By Michael Liu, Scott Kanouse, and Dominic Bea*

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**The spread differential between investment-grade commercial ABS and corporate bonds stood at 120 basis points in mid-July, putting it at the 89th percentile relative to history. This spread is largely driven by liquidity rather than fundamentals, presenting an attractive opportunity to increase exposure to ABS.**

**Commercial ABS/Investment-Grade Spread at 89th Percentile**

<table>
<thead>
<tr>
<th>ABS-Corporate Basis</th>
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<tr>
<td>ABP</td>
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<td>150</td>
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**ABS-Corporate Basis 120 basis points 89th Percentile**

Non-Agency Residential Mortgage-Backed Securities

Technical Market Conditions Are Supportive of Valuations

Housing market and labor fundamentals add to our long-term constructive outlook.

Limited supply should provide a positive technical tailwind for the non-Agency RMBS sector in the second half of 2023. Net new issuance is expected to be $5–10 billion for the rest of 2023 as low origination volumes for purchase and refinance mortgage loans are expected to persist, limiting the amount of loans to be securitized. These factors, as well as the combination of a stabilizing housing market and relatively strong labor conditions, support our constructive outlook for the sector.

New issue volume totaled $30 billion as of mid-August, a decline of 67 percent year over year as elevated rates caused refinancing activity to stall. Additionally, high mortgage rates have discouraged current homeowners with historically low rates on their mortgage loans from selling their homes. Despite inflationary pressures abating, the average 30-year fixed mortgage rate was greater than 7.5 percent in mid-August, its highest level since 2000. As a result, the inventory of existing homes for sale fell to 1.08 million units in May 2023, a record low for the month, and activity slowed significantly in the residential housing market.

Non-Agency RMBS valuations benefited from the low new-issue volume as the housing market and the broader banking system showed signs of stabilization. However, they lagged the spread tightening experienced in more liquid credit markets. For instance, the five-year Bloomberg U.S. Investment-Grade Corporate Bond Index retraced three-fourths of its credit spread widening in the wake of the Silicon Valley Bank collapse, but non-qualified mortgage (QM) AAA RMBS retraced less than half of their credit spread widening over the same period, leaving potential for positive total return over time in a normalizing spread environment.

Current RMBS valuations reflect spreads wider than the long-run averages. We prefer AAA-A rated non-QM RMBS 2.0 mezzanine and senior tranches with stable weighted average life profiles, and RMBS 1.0 backed by loans with significant home equity. These subsectors have offered yields in the 6–6.5 percent range and have routinely traded at discounted dollar prices, which is rare for the sector and improves their total return profile.

By Karthik Narayanan and Roy Park

Faced with the prospect of higher mortgage rates, current homeowners with low rates are largely unmotivated to refinance and sell their homes, which has contributed to a significant slowdown in activity in the residential housing market, and in turn, a decline in home loan issuance.

Non-Agency RMBS New-Issue Volume Is at Historic Lows

Yearly Cumulative Non-Agency RMBS Bond Issuance Volume

<table>
<thead>
<tr>
<th>2019</th>
<th>2020</th>
<th>2021</th>
<th>2022</th>
<th>2023</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0bn</td>
<td>$100bn</td>
<td>$150bn</td>
<td>$200bn</td>
<td>$250bn</td>
</tr>
</tbody>
</table>

Commercial Mortgage-Backed Securities

A Challenged Backdrop with Increasing Idiosyncratic Risk

We remain cautious on the sector.

CMBS is a sector in which we have always maintained very conservative underwriting standards and have generally stayed senior and defensively positioned. That approach is proving appropriate given the significant headwinds facing commercial real estate (CRE) today. The confluence of higher Treasury rates, increasing risk premiums demanded by CRE investors, and capital rationing away from CRE continues to limit capital markets activity. Interest rates on the CRE loans backing CMBS continue to trend higher. One recent conduit CMBS was backed by loans with a 7.2 percent interest rate, compared to 5.9 percent in early 2023 and 3.4 percent in early 2022. Elevated financing costs discourage new CRE transactions and refi

Year to date, approximately 650 of the 9,500 CMBS bonds outstanding have experienced ratings downgrades, mostly due to leveraged exposure to one or more properties experiencing negative credit events. This downgrade wave is a reminder that CMBS investor outcomes can vary from deal to deal, or even from tranche to tranche.

By Tom Nash and Hongli Yang

Agency Mortgage-Backed Securities

Short-Term Headwinds Persist and the Sector Remains Cheap

Stabilized rate volatility is key to the sector’s long-term value proposition.

Agency MBS market sentiment experienced a notable improvement in the second quarter following successful FDIC auctions from forced bank selling that attracted significant buyer interest. Performance confirms this shift, with the Bloomberg MBS Index option-adjusted spread tighter by 11 basis points and excess returns of 0.76 percent in the second quarter. We expect this momentum to continue in the third quarter as market focus shifts from the FDIC sales to the overall favorable macroeconomic environment and relative valuation.

Our long-term bull case for Agency MBS spreads revolves around a stabilization of interest rate volatility. Agency MBS still carry wider spreads than before the Silicon Valley Bank collapse in March, despite a broad market recovery. With inflation showing signs of easing, we anticipate a further reduction in rate volatility this year, which should lower the compensation required for the embedded prepayment option in Agency MBS and contribute to further spread tightening. Within the Agency MBS sector, we favor current production coupon passthrough securities. These typically have higher coupons, are priced around par, and have higher option costs embedded in their high current yield and spread. We believe they offer better total return potential as rate volatility abates. We have increased our exposure in our strategies to this profile and have added more broadly to the sector.

We see a possible headwind in the structural shift in the buyer base of the mortgage market: This year will mark the first in over a decade that neither the Fed nor banks are actively buying, which means there is a need for continued reallocation by money managers from other assets to the mortgage sector to absorb current supply volumes. These flows can be fleeting, and are likely to keep spreads more rangebound in the short term. Current spread levels, which remain attractive relative to history, and the Agency-backed nature of the sector should be enticing to crossover buyers from the corporate credit space where spreads are even tighter. This is especially true for investors who are concerned about the mounting risk of recession, during which Agency MBS tend to outperform credit-sensitive assets.

By Louis Pacilio

Current spread levels, which remain attractive relative to history, and the Agency-backed nature of this sector should entice crossover buyers, especially those concerned about recession risk.

Current MBS Spread Levels Are Attractive Relative to History

30-Year MBS Nominal Spreads

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<tr>
<th>30-Year Current Coupon vs. 5/10 UST</th>
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<tr>
<td>250 bps</td>
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<tr>
<td>200 bps</td>
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Commercial Real Estate
Finding Value in the Post-Pandemic Market

Assessing the effect of secular trends on commercial real estate values.

In the first half of 2023, commercial real estate prices declined by 11.2 percent year over year, according to Real Capital Analytics’ (RCA) national all-property price index, the first retracement since the Global Financial Crisis (GFC). The apartment sector experienced the largest decline at 12.5 percent, down from highly elevated levels, while the industrial sector declined only 2 percent, buoyed by continued demand for warehouse and logistics properties to support the realignment of supply chain networks post-pandemic. Despite the near-term pressure on real estate values, prices for all sectors remain above pre-pandemic 2019 levels.

The two primary drivers of the stress on prices are higher debt costs and reduced availability of capital. Stress in the commercial banking sector is limiting new loan originations from one of the largest capital sources, challenging refinances of maturing loans. Real estate transaction volumes are at the lowest level in the past decade, according to RCA data, as sellers and buyers are unable to close the bid-ask gap. The apartment sector is experiencing a supply-demand imbalance in some cities following robust levels of new construction, causing vacancy rates to rise. The office sector continues to undergo a fundamental shift as the stickiness of hybrid work schedules forces companies to rethink how and where they use office space. Although retail fundamentals remain strong and vacancies are at their lowest level ever reported, weakening of consumer spending in an economic slowdown may cause retail demand to cool.

Despite these challenges, we believe that some of the secular trends accelerated by the pandemic around how and where people choose to live, work, travel, and shop are achieving some permanency and will drive the need for capital reallocation and investment—not in the buildings of yesterday, but a new generation of hard assets necessitated by the evolution of onshoring and re-shoring, population migration, demographic changes, and advancements in technology. Our real estate investment strategy is focused on mission-critical industrial assets, such as logistics properties and warehouses, as well as multifamily properties in undersupplied markets, and other sectors where we see sustainable demand drivers that support long-term value and capital appreciation.

By Jennifer A. Marler and Farris Hughes

Declining Fundamentals Apply Downward Pressure to CRE Valuations

Commercial Real Estate Value Price Index

In the first half of 2023, commercial real estate values declined by 11.2 percent year over year, the first retracement since the GFC. The primary drivers of stress on prices are higher debt costs and reduced availability of capital.
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