

Morgan Stanley

INVESTMENT MANAGEMENT



2019 Market Outlook:
Securitized

Positive Outlook for Securitized Supported by Strong Consumer Credit Conditions



GREGORY FINCK

*Managing Director
Global Fixed Income Team*

As the U.S. Federal Reserve (Fed) policy continues to shift from accommodative to neutral, we expect volatility in both rates and credit markets to remain high. Entering 2019, we maintain a positive fundamental outlook on most credit-oriented securitized assets as real estate and consumer credit conditions remain constructive. However, we have concerns that mark-to-market volatility could increase. We continue to have a more cautious view on agency mortgage-backed securities (MBS) due to supply-demand headwinds from the Fed winding down its \$1.7 trillion MBS holdings and from potential reductions in bank holdings of agency MBS. We believe the securitized world is on track to begin 2019 offering higher yields than at the start of 2018, this is largely a function of higher interest rates and wider spreads across many sectors. Given our view of a more range-bound interest rate environment in 2019, we expect the cashflow yields of securitized assets to dominate returns, and we believe these yields offer compelling risk-adjusted opportunities.

Interest Rates and Fiscal Policy

In the U.S., rising interest rates and tightening Fed policy were the dominant themes for 2018. For 2019, we expect between two and four 25 basis-point rate hikes by the Fed, in addition to another interest rate hike in December 2018. Depending on economic conditions, we project terminal Fed Funds rates between 3% and 3.5%, and continued curve flattening with 10-year U.S. Treasury rates also ranging between 3% and 3.5%. We expect unemployment to remain low and wages to continue to rise, while broader gross domestic product (GDP) growth should taper due to global headwinds and the impact from higher rates. This forecast should bode well for credit-related securitized assets, as it implies healthy U.S. household and consumer credit conditions, while also keeping residential and commercial mortgage rates constrained and relatively low by historical standards. We maintained a

DISPLAY 1 Outlook Summary

SECTOR	OUTLOOK	
U.S. Agency MBS	Negative	Cheapened in 2018, but still face supply headwinds
U.S. Non-Agency RMBS	Positive	Not as cheap as the past 10 years, but still a good value
European RMBS	Positive	Low mortgage rates are positive for home prices
U.S. CMBS	Mixed	Risk profiles vary substantially by specific securities
U.S. ABS	Positive	Consumer credit conditions remain healthy
European ABS	Neutral	Positive credit conditions but weaker relative value

relatively short-duration positioning in 2018, due to a concern of rising rates. Although our concern about the impact from higher rates has largely been realized, we continue to maintain a shorter- duration positioning due to the flatness of the curve, which we believe provides minimal compensation for taking on longer duration risks.

In Europe and the U.K., we expect accommodative central bank policies to continue due to modest economic growth and uncertainty surrounding both Brexit and Italy. Although the European Central Bank (ECB) has announced the end of its asset-backed securities (ABS) purchase program, given their relatively low level of ABS purchases, we do not expect this change to have a material impact on European ABS valuations. Low interest rates have had a positive effect on home prices, consumer credit and general economic health across most of Europe, and we do not foresee these conditions to deteriorate any time soon. We expect modestly positive growth to continue within most of the eurozone, although, we believe the U.K. could experience a modest recession due to Brexit impacts.

Agency MBS

2018 was a difficult year for U.S. agency MBS, plagued by rising interest rates, extended durations, widened spreads, increased volatility and supply-demand headwinds resulting from the decline in Fed MBS purchases. Agency MBS, one of the most interest rate sensitive sectors within securitized markets, comprises

the vast majority of the securitized world. Since these securities are largely characterized by fixed rate mortgages, mortgage prepayment speeds play a crucial role in determining the duration of these securities. As interest rates increased in 2018, the large majority of the mortgage market became out-of-the-money from a rate-based refinance perspective, and mortgage prepayment speeds slowed significantly. Considering the rough year that agency MBS had in 2018, we believe that the majority of the damage from higher interest rates and rising volatility has now been realized for the sector, as interest rates are 70 to 100 basis points higher, MBS durations are now more than a year longer, interest rate volatility and mortgage option costs have increased, and nominal spreads to U.S. Treasuries have widened 20 to 30 basis points.¹ However, supply pressure from decreasing Fed purchases will continue into 2019, and possibly accelerate. The Fed began 2018 buying roughly \$20 billion agency MBS per month and ended the year essentially making no new purchases.² The Fed's agency MBS holdings fell by more than \$100 billion over the course of 2018, from \$1.77 trillion to \$1.67 trillion, and we expect the portfolio to shrink to a greater degree in 2019.³ Despite our expectation for agency MBS spreads to widen further in 2019 as a function of weaker demand, we still expect agency MBS to outperform U.S. Treasuries with the additional carry of agency MBS outweighing the impact from widening spreads. Within agency MBS, we continue to favor higher coupon MBS, which offer greater

¹ Source: Citi YieldBook. Data as of November 29, 2018.

² Source: US Federal Reserve. Data as of November 2018.

³ Source: US Federal Reserve. Data as of November 2018.

duration-adjusted carry, and have the potential to benefit from either a stable interest rate environment or a continued rising rate environment.

U.S. Housing Market Fundamentals and Non-Agency RMBS

In 2018, U.S. home prices rose roughly 5% to 6% for the seventh consecutive year, but the impact of rising home prices, in conjunction with rising interest rates, has begun to negatively impact home affordability. Going forward, we project U.S. home price appreciation to closely mirror U.S. economic growth and to be constrained by affordability.⁴ Despite increasingly more challenging affordability, housing demand is still healthy due to a robust economy, and a housing supply that is relatively low by historical standards. This favorable supply-demand dynamic leads us to project that U.S. home prices will rise between 3% to 4% in 2019.

Non-agency residential mortgage-backed securities (RMBS) should continue to perform well in 2019, although to a lesser degree than in recent years. Mortgage market conditions remain healthy with declining mortgage delinquency and default rates, reflecting the strength of the U.S. economy and upward trajectory of home prices. Spreads on non-agency RMBS have tightened significantly over the past several years, and material further spread tightening seems unlikely. We believe that non-agency RMBS still offers reasonably compelling risk-adjusted carry compared to other sectors, and performance in 2019 should largely be a function of cashflow-based returns, with little expectation of price appreciation. Over the past few years, we have reduced our non-agency RMBS holdings from our biggest overweight, to a moderate overweight, but we still remain positive on the sector.

European RMBS

Driven by a low mortgage rate environment and improving economic conditions, we believe that home price appreciation across most of Europe will continue into 2019. We particularly favor RMBS in areas which we believe to have the greatest potential for home price appreciation, especially Spain, Portugal, Ireland and Greece. We also like RMBS in the Netherlands, Germany and selectively in the U.K. Although we expect that home prices will soften in the U.K., we do not expect a material decline largely due to limited housing supply and low mortgage interest rates. Within U.K. RMBS, we have a strong bias towards very seasoned loans. These loans have the advantage of significant embedded home-price appreciation and are held by borrowers who have proven payment histories. Finally, we also favor countries with well-established mortgage lending laws, which facilitate reasonably swift repossession of properties in the event of defaults.

U.S. Commercial Real Estate (CMBS)

U.S. commercial real estate experienced a period of significant growth post crisis, however, prices have stabilized over the past two years and we expect prices to remain relatively flat in 2019. Commercial real estate conditions remain positive with high occupancy levels, rising rental rates and a healthy U.S. economy, but higher interest rates could provide a headwind in 2019. The commercial real estate market is a highly idiosyncratic sector, as credit quality can vary significantly between different asset classes and specific properties. We are generally constructive on the housing sector of commercial real estate, office buildings and distribution centers. We continue to have concerns about retail shopping centers, as the “Amazon effect” continues to impact how consumers shop and the viability of many brick-and-mortar shopping stores.

We are also cautious regarding hotel valuations given the volatile nature of their earnings and valuations.

European Commercial Real Estate (CMBS)

We expect to see diverging trends in European commercial real estate markets, with many European cities becoming beneficiaries of Brexit-related locations, while London will likely suffer from over-building and weakened demand for office space. We have largely avoided U.K. commercial real estate exposure and have a cautious outlook for U.K. commercial mortgage-backed securities (CMBS) in 2019. Although supply of European CMBS remains limited given the dearth of securitizations over the past few years, and sourcing opportunities can be challenging, we remain generally positive on European commercial real estate.

Consumer Credit and ABS

Consumer credit continues to improve in the U.S. with low unemployment, rising wages, increased savings rates, and more conservative consumer debt levels. Credit card debt, auto loans and consumer loans have performed well, and we believe this positive dynamic will continue in 2019. Consumer ABS was one of the few sectors to experience spread tightening in 2018, causing relative value for consumer ABS to appear slightly less compelling than it was a year ago, but we remain positive from a fundamental credit perspective. We favor the relatively short-duration nature of consumer ABS, which limits risk exposure to a potential recessionary environment in 2020 or 2021.

European ABS spreads remain relatively tight, and offer less attractive relative value. Fundamental credit conditions appear generally positive, but vary by country based on lending laws and local economic conditions.

⁴ Source: Bloomberg, S&P CoreLogic Case-Shiller US National Home Price. Data as of September 30, 2018.

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