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INCOME RESEARCH + MANAGEMENT

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We recently caught up with our Corporate and Securitized Traders on recent market developments, including changing trading conventions, yield curves, and forward supply. In our attempt to interpret the alphabet soup of pricing conventions to various curves, we found several themes, one of which is the current inefficiencies embedded within different subsectors. Much like learning a second language, "trader speak" can be confusing, especially across sectors.

Admittedly, some of the information captured below is deep in the weeds. However, we hope to convey the wide variety of trading conventions, knowledge, and understanding that traders in today's volatile markets need to gather and attain to add value and avoid mistakes.

Corporate Bond Market

On the Corporate side, the "bear flattener" has made its presence felt. As anyone paying attention to the US Treasury market knows, yields have risen dramatically, and the curve has flattened. At year end, the 2-year was trading at about 0.75%, half of the 10-year yield; now it is around 4.25%, about 35bps higher than the 10-year. Investment Grade ("IG") corporate spreads have widened about 65bps year to date. The knock-on implications are significant.

There is no longer any Treasury roll-down; in fact, bonds roll up the curve. Some credit curve roll – the phenomenon that shorter corporate bonds usually trade at tighter spreads than longer maturities – remains. Also, flatter Treasury curves should force some steepening in credit curves due to absolute yield relationships. However, in severely dislocated markets, credit curves can become inverted for technical reasons; as dollar prices drop, bond math dictates that shorter bonds' yields rise faster than longer bonds'. We may experience this in specific issuers or if we get a major dislocation.

We are witnessing pockets of inefficiency. For example, 4-year paper is marked inefficiently versus 5-year Treasuries due to the above-mentioned inversion. At the long end, spreads are relatively flat. For LDI buyers of 10+ year, A-rated or better paper that are continuing to derisk, or for those that have hit their yield bogeys, increased absolute yields are attractive. With the average price for the Bloomberg US Corporate Index down over 20 points year to date, there is significant credit convexity building. Investors should be willing to pay up a bit for this, although we continue to see greater "basis-points-per-point penalty" for premium paper than we see a benefit for discounts. Currently, bp/point has expanded a bit and is running around 1.5bps for an average credit.

Market conventions haven't changed with the inversion, or since the pandemic.

- Most traders look at the "G" spread, which is an interpolated spread to the on-the-run Treasury curve.
    - However, with any embedded options, OAS (option-adjusted spread) is typically a more important data point.
- Shorter paper with less than 13 months to maturity continues to trade versus the "E" curve, which is derived from Eurodollar futures.
    - Many buyers focus on absolute yield rather than spread
    - Make whole calls, which have been a significant watch-out in recent years, is no longer worrisome; most make whole calls are well out of the money.

Portfolio trading has continued to ramp up to 7% – 8% of total trading volume. We have found that portfolio trading is quite useful for multi-line item bid wanted in competition (“BWIC”) or offer wanted in competition (“OWIC”) lists, allowing portfolios to get invested quickly or address cash flows efficiently. In the market overall, trading has become more diverse across names and more focused on ETF-owned issues. As a result, dealer balance sheets don’t look the same, with axes often reflecting positions from portfolio trades.

Regarding supply, Investment Grade new issue is running on either side of $1 trillion, depending on the dealer count. September underwhelmed at $75 billion versus initial estimates of $130-$150 billion. Expectations for the year are still hovering around $1.2 – $1.3 trillion. High Yield supply has stalled around $88 billion, down almost 80% versus 2021. The outlook very much depends on the macro-outlook, which has clearly been deteriorating, and volatility, which has been increasing. Issuers tend to stand down on weak, volatile days. Interestingly, given rising rates, Floating Rate Note issuance has been light, with announced issues often being dropped due to lack of investor demand, likely impacted by a lack of SOFR-based buyers with the demise of LIBOR.

Other notable insights included some thoughts around corporate liability management exercises. Most large maturities have been pushed out, so there is no “maturity wall” in either Investment Grade or High Yield. With refinancing rates so much higher, there is little incentive for companies to advance refinance and tender. Finally, on the Special Mandatory Redemption front (“SMR”), we are seeing the opposite of many of the deals from several years ago. Namely, with prices down, the SMR could be a significant benefit to investors; in fact, a recent deal offered a premium to holders to get an extension to the SMR date.

Securitized Bond Market

Traders should be on top of which curves are used, what games a seller may be playing, and alternative ways to value a security other than just spread. To make matters more confusing, different subsectors are traded to different curves. Recently, the most significant change we’ve seen is pricing adopting to the transition away from Libor.

- New issue has mostly driven this transition, as pricing has largely moved from the swaps curve (the “N” curve) to the Treasury curve (the “I” curve); as an aside, to make matters more confusing, the “I” curve for corporates is versus swaps)
- Traders also look at the “Z” spread, which is based on the implied spot curve; in other words, every point on the curve rather than just an interpolation using on the runs. This is important for amortizing bonds. Historically, the “E” curve was used to normalize for amortization, but it isn’t used anymore; the “I” curve does not normalize, so you can get some wonky spreads like “I-35” but “Z15”.
- For Commercial Mortgage Backed Securities (“CMBS”), the “J” curve is used, which uses the on-the-run Treasury curve.
- Agency CMBS use “J” or “I” curves, though new issues are priced to the SOFR-based “P” curve.
- Historically, new issue Small Business Administration Loans (“SBAs”) were priced to spot swaps, but now they are priced versus the 10-year Treasury spot, and once they trade in the secondary, they are still traded to the “N” curve.

- In an interesting pricing convention, SBAs use a speed convention of 5% constant prepayment rate ("CPR"), though seasoned pools can pay 15% – 25%; the Street adjusts for seasoning in pricing. To evaluate these deals further, IR+M uses a proprietary seasoning ramp to help determine appropriate speeds and pricing.

- Collateralized Mortgage Obligations ("CMOs"), Pass-thrus, Adjustable Rate Mortgages ("ARMs"), and Non-Agencies pricing conventions haven't changed.
    - Pass-thrus are priced at a pay-up to To Be Announced ("TBAs") (specified in number of ticks).
        - Differences exist between normal TBA settlement date and shorter periods (you need to adjust for carry and any paydown estimates depending on settlement dates). Investors typically look at 3-month speeds, but many adjust for more recent speeds and/or characteristics. The PSA prepayment model is a prepayment scale developed by the Public Securities Association, and is the typical speed convention – a ramp based on CPR of 0.2% per month in month 1 of production up until the 30th month when PSA levels off at 6% and equals CPR. The PSA convention can be misleading depending on loan count and other factors.
- CMOs are priced to the "I" curve at the PSA ramp.
- ARMs price to the "Z" curve, but switch to dollar price once the tail value comes into play, at around 25 months to reset; currently, tails are valued around $103.
- Finally, Non-Agencies are priced "back of" TBA (i.e., lower than TBA since they tend to prepay faster than Agencies).

Despite all of these nuances, it is important to recognize that different curves and speeds are often used to the dealers' advantage. Our traders are all over the market conventions, our internal analytical tools, and the interplay between price, curve and speed for various subsectors, programs, and collateral types.

Agency Mortgage Backed Securities ("MBS") supply has dropped meaningfully this year due to the higher rate environment, with net issuance at $430 billion, down 30% year to date last year. The recent higher move in mortgage rates should cement this trend. Much of this year's Asset Backed Securities ("ABS") supply has been pulled forward; expect $50 billion of ABS for the rest of the year. In CMBS, private-label supply is mostly done for the year at $94 billion YTD, though estimates are still in the $125 billion range. Collateralized Loan Obligation ("CLO") new issuance has slowed down as the universe of callable deals has decreased so there is minimal refinancing/reset activity. CLO issuance has slowed as the universe of callable deals has decreased so there is minimal refinancing/ reset activity.

Dislocated Markets

In recent weeks, markets have been somewhat dislocated with some short Treasury rates up 40-50bp, corporate spreads 15bp wider and MBS underperforming Treasuries by a point or more. We're happy to have our experienced traders in their seats. In these types of markets, a dealer might tell you, "Any bid is a good bid," or "A bid is worth a thousand words," but sellers (in particular) need to be careful. For example, we were trying to sell a couple million of a 2-year Yankee bank, which in normal markets (even over these past few weeks) should trade around Treasuries plus 85bps; our best bid was Treasuries plus

185bps. That 100bps translates into about two points in price, or $40,000 on a $2 million position. We made the decision not to sell, as we had other alternatives. However, it is easy to see how a forced seller can push the market back quickly. If that bond were to trade, dealers and investors would see the “print” on TRACE (the industry’s Trade Reporting and Compliance System) and immediately be more cautious in further bidding that and similar bonds.

Conclusion

Market knowledge, and understanding the different trading conventions, models, and security nuances, are a few of the keys to successful value-added from trading. Different managers have different styles and relationships with the street. Larger managers are reliant on the liquidity provided by the street due to the sheer size of their trades, whereas smaller managers can be more nimble and strategic. The street views large managers as liquidity providers to them to help their balance sheet, but they view IR+M as a genuine client who they can give customized attention to. We ask our traders to be “firm but fair” with the street.

Manager data provider eVestment shows that portfolio turnover has ranged anywhere from ~20% to ~200% for our core peer group over the past year. At IR+M, we don’t undergo unnecessary trading, as we are always cognizant of transaction costs, but we will take advantage of opportunities that present themselves. We often see “non-economic” sellers, particularly in dislocated markets – investors scrambling to raise cash or reposition, so it is nice to be in a position of strength, with cash or easily saleable assets to be a provider of liquidity. In practice, that means showing a bid that provides our clients with an undervalued security. We are long-term investors and believe that when we are buying a cheap bond, we can live with some near-term volatility. Our team of dedicated traders are not just order-takers, but are sector experts who have a pulse on the market and add value for our clients through their ability to understand sector dynamics and nuances, especially in volatile times.