TCW

INSIGHT

VIEWS FROM TCW'S FIXED INCOME INVESTMENT TEAM

A Longer Prelude to Rate Cuts

FIRST QUARTER 2024

Navigating the Macro Maze

Synchronicity has a certain simplicity. It often emerges unexpectedly, yet its effects profoundly ripple through systems. This became evident in the first quarter of 2024, as central banks globally signaled readiness for monetary easing.

The Swiss National Bank led, becoming the first advanced economy to cut rates. Europe looks set to follow by June with the Fed now pushing out cuts to later in the year. Despite mixed inflation and supportive growth data, the Federal Reserve (Fed) maintained its rhetoric of three rate cuts starting late in the second quarter. Weaker employment and inflation data from Europe prompted the European Central Bank (ECB) and Bank of England (BOE) to also point toward cuts.

However, economic data may still challenge policymakers, creating dissonance in the global picture. The seemingly resilient U.S. consumer notably increased growth expectations. While inflation trended lower, headline numbers remain stubbornly above the Fed's target. This shifting view on rate cut timing propelled the dollar to top Group of Ten (G10) currency performance. The Treasury market, entering the year pricing in seven rate cuts, now expects three, and the odds of moving toward accommodative policy appear to be trending lower. Equities and other assets responded with vigor.

The central bank policy shift from headwinds to tailwinds palpably affected market volatility, which receded amid renewed investor confidence. Capital markets opened, facilitating record corporate bond, Collateralized Loan Obligation (CLO), and securitized credit issuance. Spreads tightened across credit sectors, reflecting a newfound risk appetite.

Yet concerns lingered amidst the optimism. Commercial real estate remained vulnerable, particularly for regional banks. Micro-trends hinted at labor market fragilities, while geopolitical risks simmered. The run-down of excess savings and increased delinquency risks added complexity.

Navigating these macroeconomic currents requires nuance. Balancing duration, quality, and sector exposure is crucial to capture upside potential while mitigating downside risk. The risk of central bank synchrony moving toward central bank divergence calls for prudent risk management. As economic outlooks and central bank policies diverge, the market appears to be at risk of increased volatility.

This isn't just higher for longer. It's nervous for now.

– Jerry Cudzil

Mr. Cudzil is a Generalist Portfolio Manager in TCW's Fixed Income group, a team that oversees over $170 billion in fixed income assets including the over $50 billion MetWest Total Return Bond Fund, one of the largest actively managed bond funds in the world.

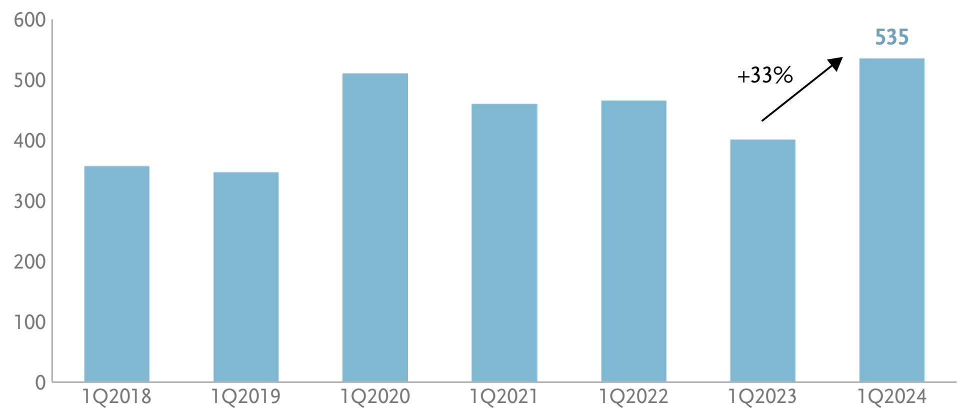
Investment Grade: Supply Meets Demand

The credit markets remained resilient throughout the first quarter of 2024, underpinned by higher yields and confidence in the sustainability of benign ("Goldilocks") economic outcomes. Risk assets remained unfazed by economic data that has been mixed over the recent weeks. Notably, weaker retail sales and higher than expected inflation readings (Consumer Price Index (CPI), Producer Price Index (PPI)) cast doubt on the continued health of the consumer and the disinflationary narrative. Still, the overarching market view remained sanguine, boosted by a "dovish" Fed and impending rate cuts, which propelled risk assets to new highs (U.S./Europe/Japan equities) and credit spreads to cycle tights.

After staging an impressive rally in the final two months of 2023, investment grade (IG) credit spreads continued to grind tighter into the new year, compressing another 9 basis points (bps) in this first quarter of 2024. Spreads exhibited relative stability, trading in a tight 16 bp (+83 to +99) band throughout the quarter, while rate volatility also moderated somewhat, though it continued to exceed spread volatility. This combination of tight spreads and more stable (albeit elevated) yields prompted a surge in issuance to a record $535 bn in the quarter, a 33% increase versus the same period a year ago. Demand for long-dated corporate bonds (defined as maturities greater than 11 years) continued to outpace supply, a dynamic that has driven 10-30's curves to the flattest levels outside of periods of severe distress. As mergers and acquisitions (M&A) transactions rebound off the lows, we expect volumes to accelerate as higher equity valuations and improved investor sentiment provide a supportive backdrop for deals. This should translate into higher M&A-related financings, including a higher proportion of longer-dated corporate bond issuance.

Investment Grade Credit Issuance (bn)

IG corporate issuers are responding to investor demand with a record amount of 1Q2024 new issue volumes.



Source: Bloomberg, BofA Global Research

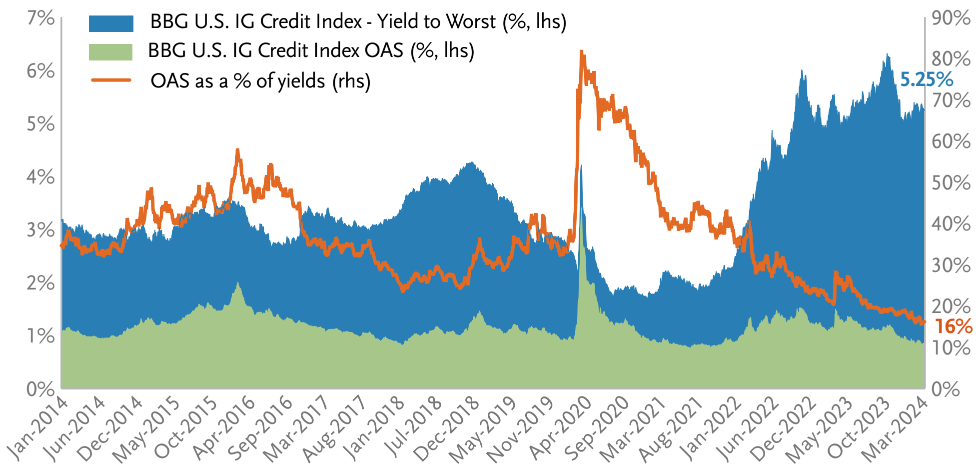
Thematically, the demand for yield continued to be a driver of spread compression. IG credit yields of 5.25% remain high by historical standards, while spreads of +85 bps over Treasuries are within spitting distance of the post-Global Financial Crisis (GFC) tights. Accordingly, the spread-to-yield ratio has reached a new (16-year) low of 16%. In other words, the relationship between spreads and yields that has been decoupling over the past two years has become more asymmetric. This implies lower excess returns going forward as spreads reach their floor, but higher total returns given elevated yields.

Whether you're in the inflation versus deflation camp, soft versus hard landing camp, spreads are already priced to perfection. The Bloomberg U.S. Investment Grade Credit Index (IG Credit Index) Option-Adjusted Spread (OAS) of +85 bps over Treasuries is trading well through long-term averages.

The beta compression witnessed over the past several months has driven the BBB-A basis to a cycle low of 35 bps, so the extra spread for going down in quality is minimal. Additionally, term premiums are flat across both spread curves and yield curves, which means the compensation for extending maturities is marginal. For example, front-end corporate bond yields of 5.21% are just 25 bps lower than 30-year corporate bond yields (5.46%). This all points to a strategy of yield capture rather than one of spread compression. We are in a unique environment where investors can still earn attractive returns without reaching down the quality spectrum or taking on more duration risk. In other words, you can capture yield while still playing defense. Perhaps you can even have your cake and eat it too.

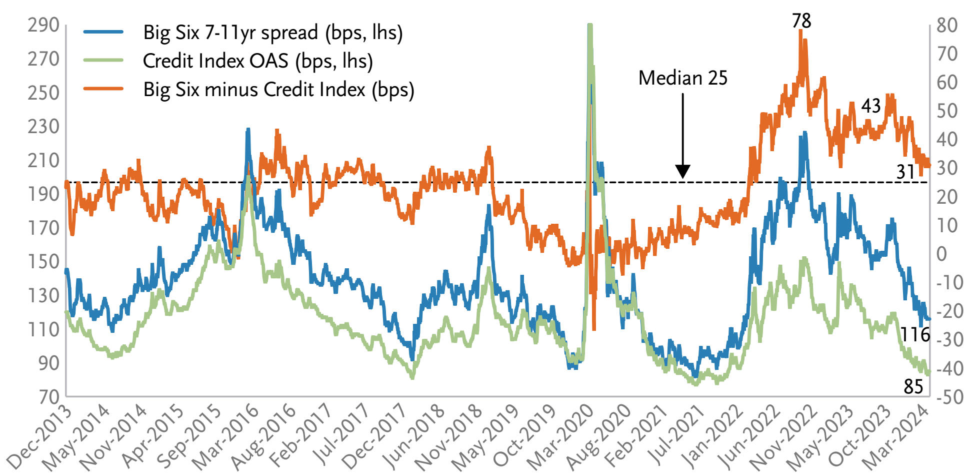
Spread to Yield Ratio

The Spread to Yield Ratio of 16% has not been this low since 2007



Source: Bloomberg

The basis between the Big Six U.S. banks and the broader IG market compressed to 31 bps at the end of Q1 2024 from 43 bps at the start of the year.



Source: Bloomberg, BofA Global Research

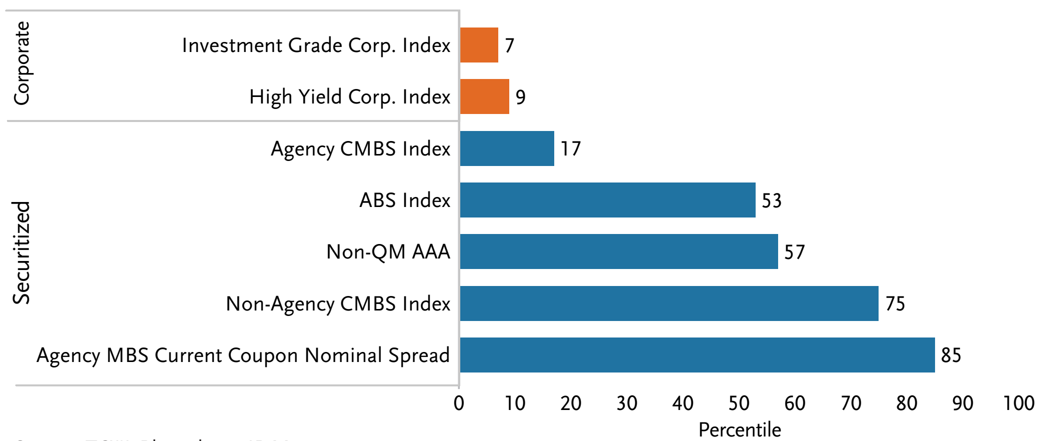
– Tammy Karp

Ms. Karp is a Senior Portfolio Manager and Trader in the Fixed Income group where she trades investment grade securities and cross over corporate securities and is a Portfolio Manager for the MetWest Corporate Bond Fund.

Agency Mortgage-Backed Securities: A Historic Mean Reversion Story in the Making

After a barrage of bad news over the past two years, the valuation story in agency mortgages has yet to fundamentally turn a corner. The Bloomberg U.S. Mortgage-Backed Securities (MBS) Index reported returns of -0.14% last quarter, trailing other fixed income assets. As a result, agency MBS remains the cheapest asset class in the high-quality bond market, with spreads currently at the 85th percentile of 10-year ranges.

Spreads Current Value Percentage (Last 10 Years)

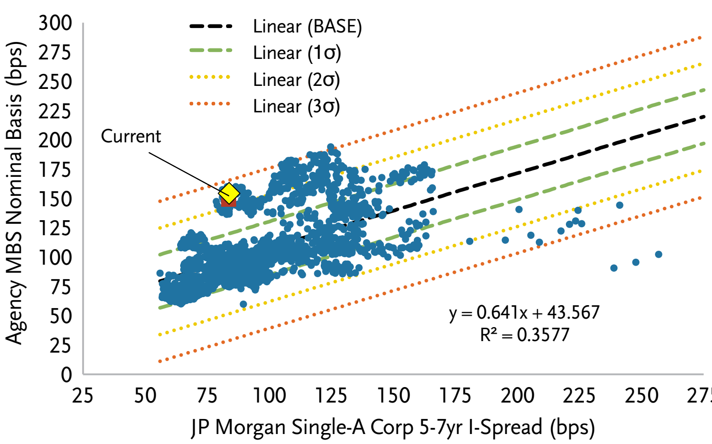


Source: TCW, Bloomberg, JP Morgan

With investment grade (IG) corporate returns continuing to fly high on soft-landing dreams, the IG-MBS basis has moved even deeper into negative territory, with current coupon agency MBS today offering a 50 bps spread pick-up over the IG Corporate Index. This implies that agency mortgages are approximately 70 bps cheaper than the average valuations of corporates in the last decade. In fact, the current coupon agency mortgages have been trading at a spread premium to IG corporates for over 18 months, marking the most significant inversion of the IG-MBS basis in the last decade.

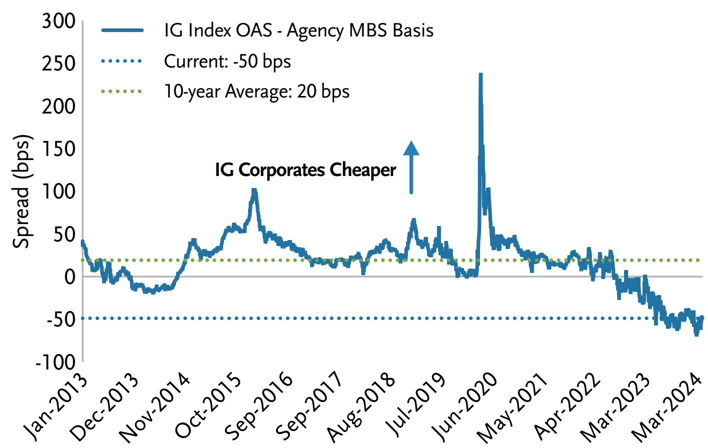
Telling a similar story, current coupon spreads remain at roughly 2-standard deviation cheap levels relative to comparable single-A corporate bonds looking back over the last decade. This suggests that the MBS market now is in uncharted territory, with today's valuations extending previously unpopulated "MBS-Cheap" regions of historical ranges.

Agency MBS Basis vs. Single-A IG Corporate Spread
Last 10 Years



Source: TCW, JP Morgan, Bloomberg

IG Corporate – Agency MBS Basis



Source: TCW, Bloomberg

The fact that agency mortgages, an asset class devoid of credit risk, have become cheaper relative to IG corporates in the midst of a global monetary tightening cycle and a slowing economy no less, reeks of a foolhardy yearning for the soft-landing narrative. A world where government-guaranteed agency mortgage spreads *surpass* that of corporate bonds can neither be the product of correct pricing of asset fundamentals nor a viable long-term steady state for bond valuations. A dislocation indeed, with the makings of a historical mean reversion story.

With the fast and furious rate rally in the fourth quarter last year, during which the current coupon agency mortgage spreads compressed by almost 50 bps in a flash, we've likely witnessed the "first leg" of the agency MBS normalization story. In a further normalization scenario – characterized by falling interest rates, a dis-inverting yield curve, and moderating interest rate volatility (all likely to spur the resumption of bank and overseas buying) – agency mortgages would be further positioned to perform well, particularly relative to credit-sensitive sectors of markets that have yet to reprice for the ramifications of tighter Fed policy and a slowing economy.

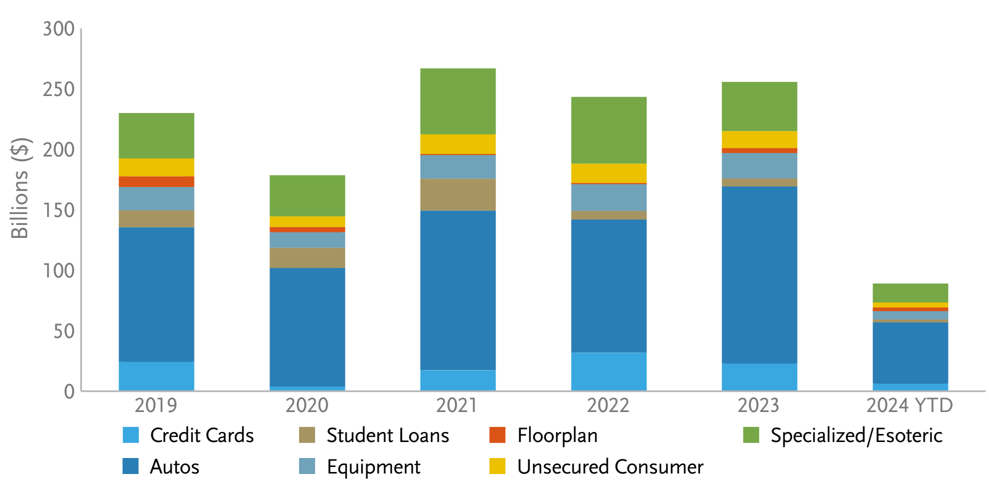
– Gordon Li, CFA

Mr. Li is an Analyst in the Fixed Income group, specializing in mortgage-backed securities. Prior to joining TCW in 2019, he was a trader at HSBC Global Banking and Markets focused on asset-backed securities.

Asset-Backed Securities (ABS): 1Q 2024 Update

The first quarter of 2024 saw the highest U.S. ABS issuance volume since 2005. Far from being daunted, investors easily absorbed the deluge of supply particularly in specialized and subordinate ABS. Offering wider spreads than traditional flow consumer ABS sectors like bank credit card and prime auto ABS, investors flocked to buy any esoteric ABS they could find. Avis kicked off the year pricing 5yr AAA rental car ABS in January at 145 bps over Treasuries and subsequently came back to ABS markets just two months later in early March with more 5yr AAA bonds 30 bps tighter at 115 bps over Treasuries. Triton priced a $450 mm container lease ABS with heavy oversubscription. This was the first container ABS since 2023 and the deal also introduced the first AA rated tranche since the Global Financial Crisis in 2008 when tranches were wrapped by a bond insurer. Data infrastructure ABS (fiber and data center) issuance from MetroNet, Stack, Switch, CyrusOne, and Ziply exploded in the first quarter with heavy oversubscriptions and bond investors feeling underwhelmed with their allocations. Finally, Bayview and Huntington Bank priced another $315 mm prime auto credit linked note transaction. As banks grapple with ways to free up capital costs, we expect to see more banks issue more of these transactions.

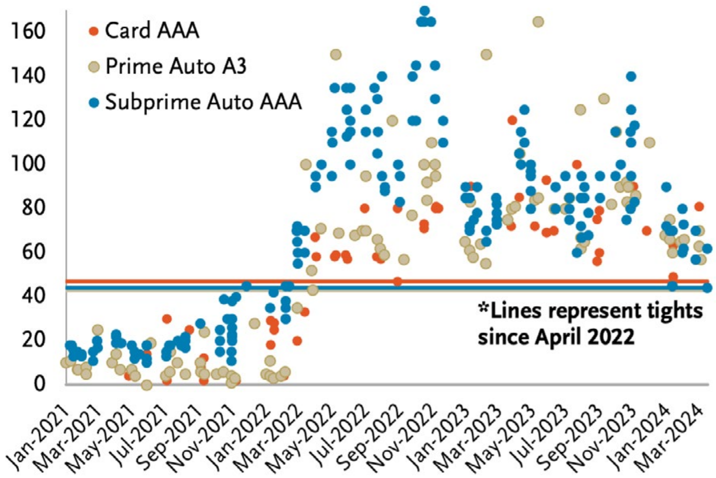
Primary ABS Supply



Source: JP Morgan Securities LLC

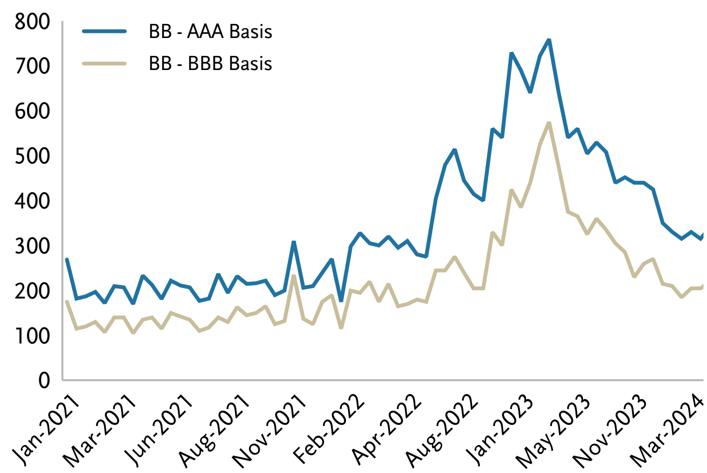
ABS sectors across the board witnessed significant spread compression over the last quarter and ended the quarter near two-year tights. Credit curves have also flattened. Using subprime autos as an example, credit curves are near the flattest they have been over the past two years. The BB-AAA basis is around 400 bps tight of the wides hit around a year ago and around 100 bps tight of the basis at the end of 2023.

ABS Spreads Are Nearing 2-Year Tights
Consumer ABS New Issue AAA Spreads (bps)



Source: Finsight, Morgan Stanley Research; Note: Only includes spreads from top 10 largest shelves by issuance volume from 2021-2024 for each product.

Capital Stacks Have Also Flattened Significantly
Subprime Auto New Issue Capital Stack Steepness (bps)



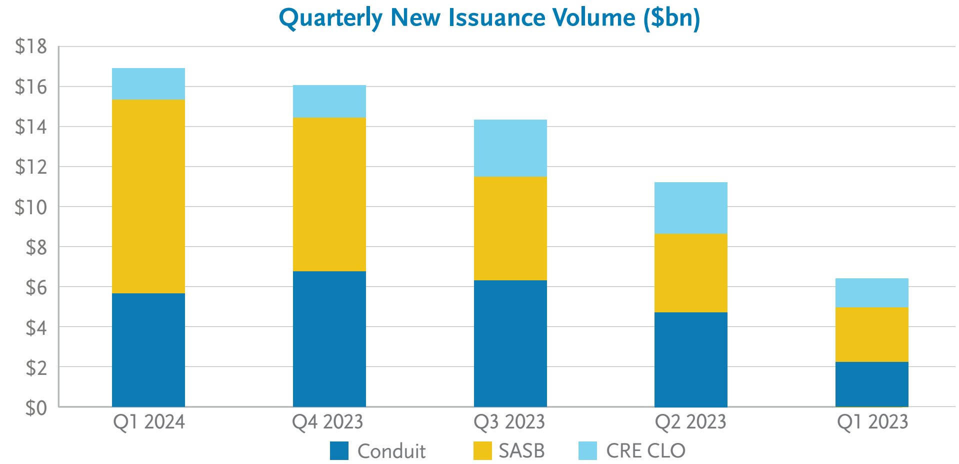
Source: Finsight, Morgan Stanley Research

– Tony Lee, CFA

Mr. Lee joined TCW in 2010 as an analyst in the Fixed Income group and is currently a trader specializing in asset-backed securities.

Commercial Mortgage-Backed Securities (CMBS): 1Q 2024 Update

With 2023 in the rearview mirror, CMBS markets broadly repeated the mantra "cautiously optimistic" while stepping into the new year. While the first quarter's prospect of interest rate cuts from the Fed brought some optimism to the market, the credit quality of the underlying assets remained a focus of the Street. The first quarter of 2024 exhibited a strong uptick in new issuance versus 2023's lighter issuance levels. Five-year conduit paper continued to churn out, similar to 2023, and the refinance of a large, Single Asset Single Borrower (SASB) industrial portfolio provided the Street with sentiment that exit is possible for sturdier, seasoned credits. On the secondary side, higher quality Tier 1 names with perceived lower exit risk or steady/increasing cash flows observed liquidity across the capital structure. More storied credits, such as seasoned conduit deals with significant office exposure and SASB backed by office properties, have begun to see more bids in secondary relative to mid-2023 levels; however, these names still significantly trade back of their Tier 1 counterparts.



Source: Trepp

On the Commercial Real Estate Collateralized Loan Obligation (CRE CLO) side, trading volumes continued to focus towards the top of the stack. CMBS loan delinquencies remained elevated throughout the quarter, with the overall delinquency rate closing at 4.67% (the all-time high on this basis was 10.34% in July 2012; the COVID-19 high was 10.32% in June 2020 according to Trepp). Delinquency rates for office loans remained elevated, closing the quarter 397 bps higher than a year ago, while over the quarter, retail loans observed the largest improvement, with delinquency rates dropping 71 bps from January to March.

Delinquency Rate by Property Type (% 30+ Days)

	Mar-2024	Feb-2024	Jan-2024	3-Month	6-Month	12-Month
Overall	4.67	4.71	4.66	4.51	4.39	3.09
Industrial	0.47	0.43	0.40	0.57	0.30	0.37
Lodging	5.45	5.45	5.46	5.40	5.27	4.41
Multifamily	1.84	1.81	1.91	2.62	1.85	1.91
Office	6.58	6.63	6.30	5.82	5.58	2.61
Retail	5.56	6.03	6.27	6.47	6.92	6.23

Source: Trepp

– Alexandra Crenshaw

Ms. Crenshaw is an Analyst in the Fixed Income group, specializing in Commercial Real Estate CLOs, single asset single borrower (SASB), and Commercial MBS credit analysis.