An APS Portfolio Strategy call

Outlook 2023: The out-of-consensus call

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AGENDA

- The economy: Stephen Stanley
- The markets: Steven Abrahams
- Agency MBS: Brian Landy
- CMBS: Mary Beth Fisher
- CLOs: Caroline Chen
- Bank strategy: Tom O'Hara
- Q&A

Source: BEA

OUT-OF-CONSENSUS ECONOMIC CALLS FOR 2023

- **No recession in 2023**
  A recession is quite possible but not as soon as the consensus expects.

- **The labor market holds up better than expected**
  Labor demand will continue to moderate, but the labor market will remain tight for much of 2023, as firms continue to add workers after suffering through a shortage of workers during the pandemic.

- **Inflation moderates more gradually than expected**
  The consensus calls for inflation to fall sharply by the spring. While I agree that the rate of inflation will decline in 2023, inflation will likely remain stubbornly high throughout 2023.

- **No easing in 2023**
  Even though Fed officials have been unusually clear that they do not expect to be able to lower rates next year, fed funds futures contracts continue to price in modest rate cuts in the second half of next year. In my view, the Fed will remain on hold until well into 2024.

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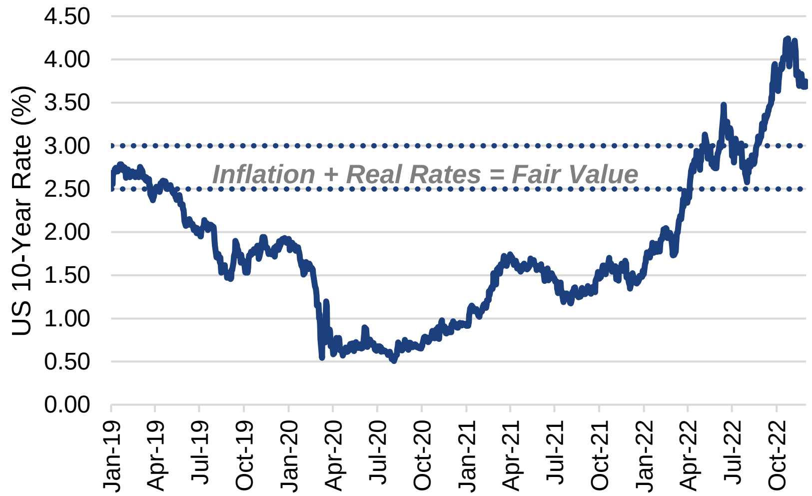
Events more likely than not to happen in 2023

- The US 10-year Treasury rate drops below 3.25%
- The US 2s10s slope approaches -100 bp
- The range for implied rate volatility drops in half
- Home price appreciation from December-to-December stays positive
- The leveraged loan and CLO markets surf a wave of downgrades
- The Fed does not sell MBS

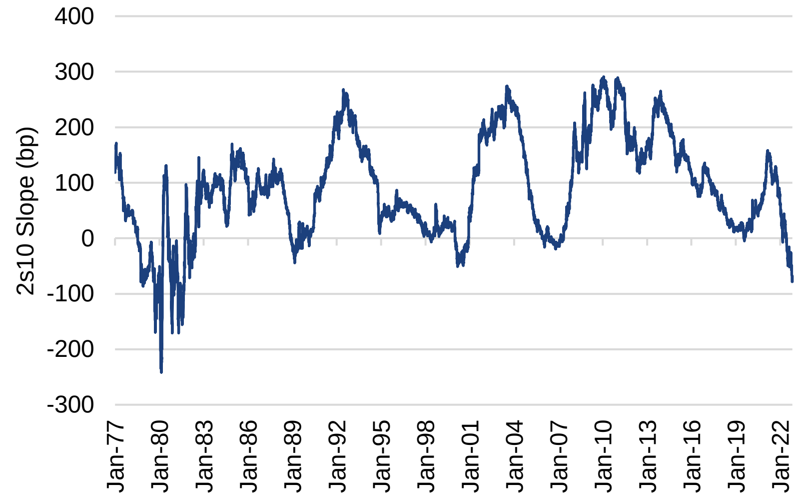
Source: NAR, Census Bureau.

THE RATES MARKET SURPRISES

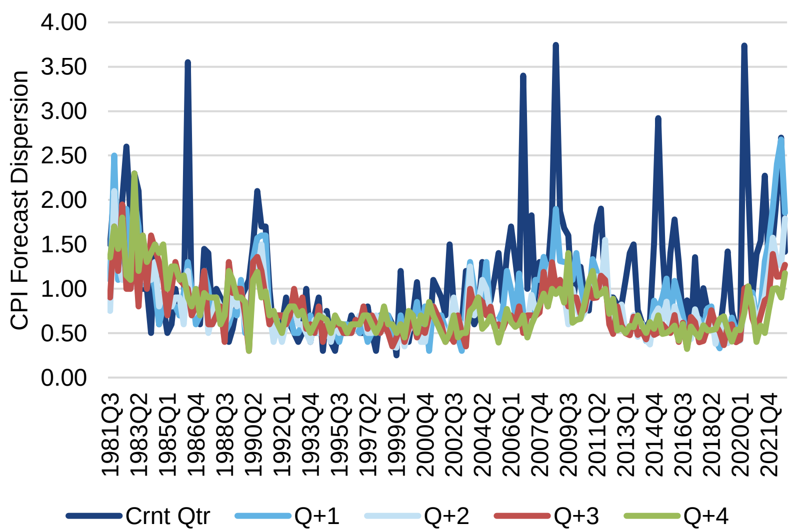
US 10Y rates drop below 3.25%



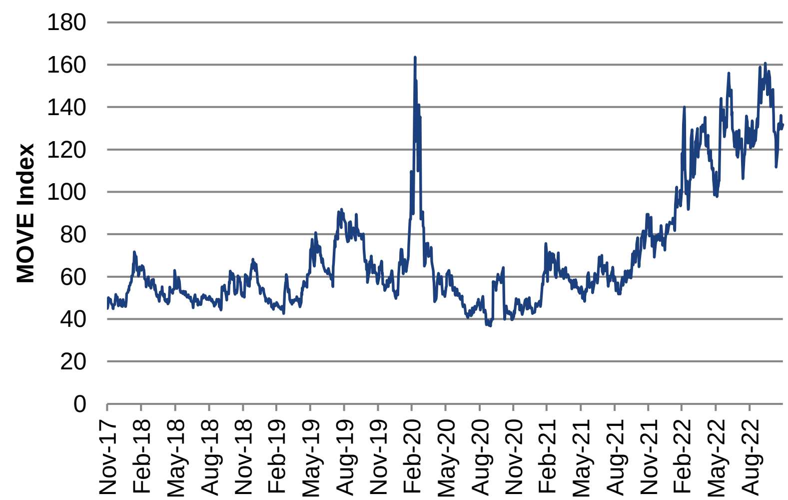
2s10s approaches -100 bp



Fundamental uncertainty falls…

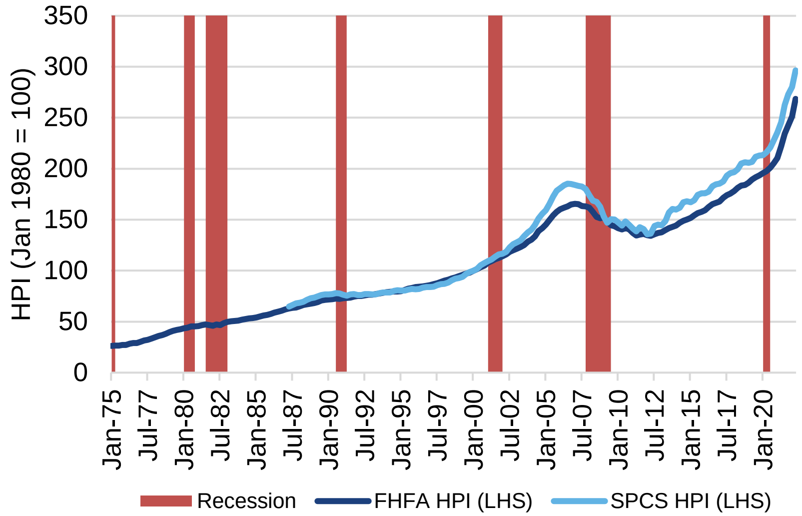


…And the vol range falls in half

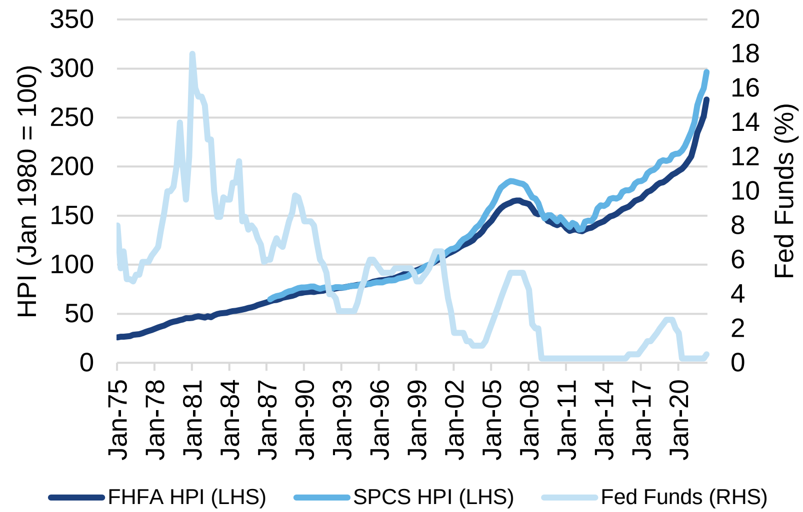


HOME PRICE APPRECIATION FROM DECEMBER-TO-DECEMBER STAYS POSITIVE

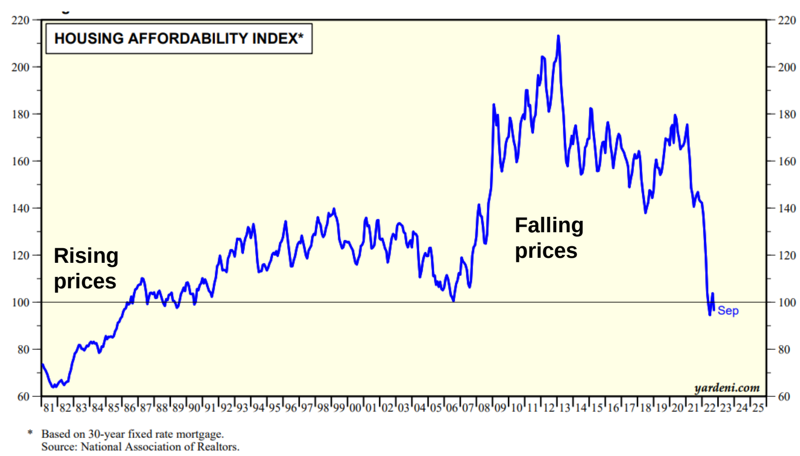
Positive HPA in 6 of 7 recessions



Positive HPA in 6 of 7 tightenings



A complex link to affordability



Explanation: price targeting

Most homes trade in a price targeting market

- Homeowners can stay, withdraw, rent
- Homeowners must be able and willing
- Case study: California, Vancouver 1975-1985

Some trade in a price clearing market

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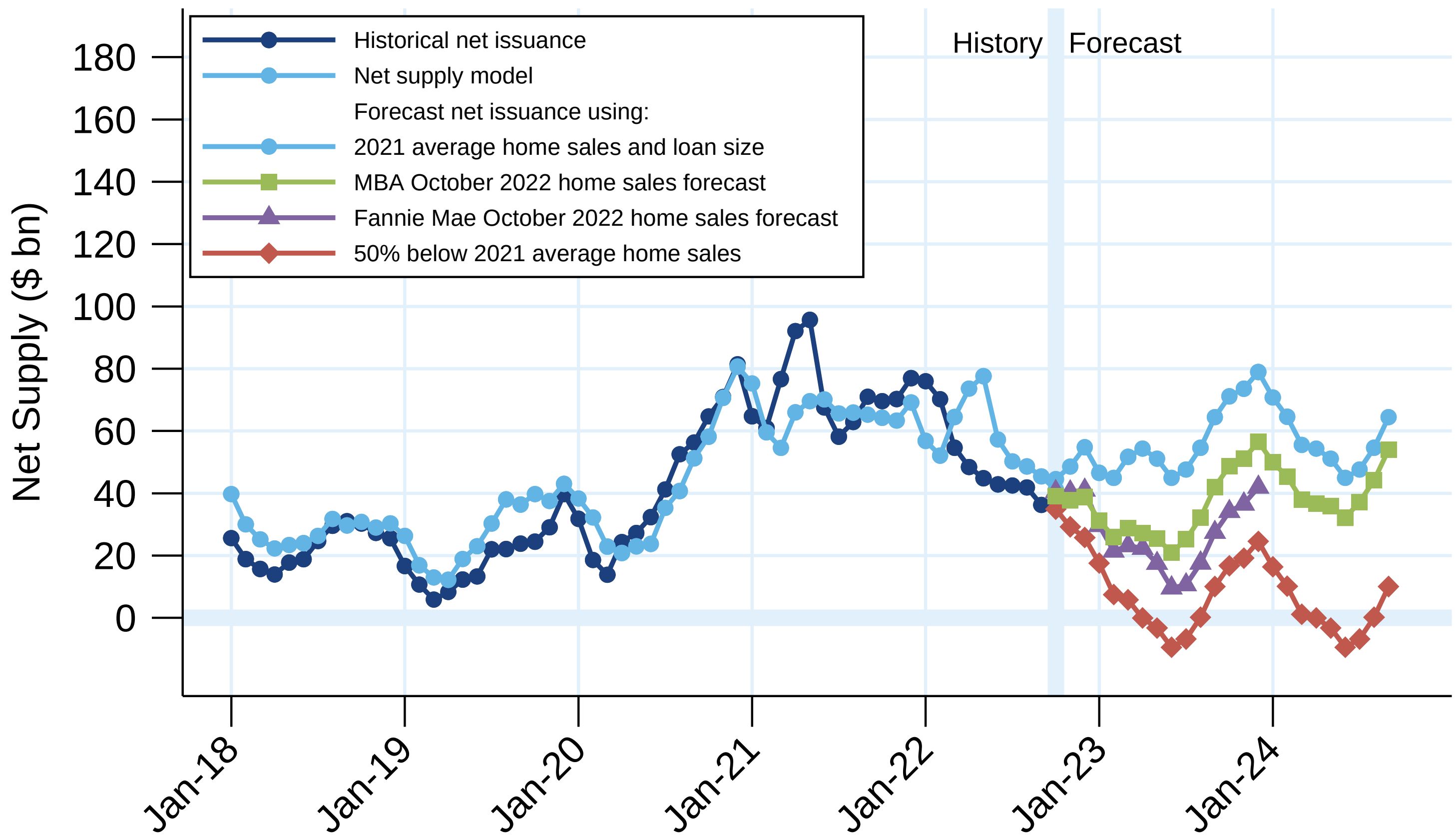
AGENCY MBS SUPPLY OUTPACES DEMAND IN 2023

- Heavy supply and light demand keeps spreads wide
- Turnover settles in at historical averages
- Specified pooling gets a boost from higher loan limits
- FHA insurance premiums likely to fall

Larger loans should keep net supply around $360 bn next year



Source: Fannie Mae, Freddie Mac, Amherst Pierpont Securities

Spreads are likely to stay wide to entice non-bank investors to add MBS

	Q4 2017	Q4 2018	Q4 2019	Q4 2020	Q4 2021	Q2 2022	Change since... Q4 2019	Change since... Q4 2021
Depositories	$ 1,896	$ 1,911	$ 2,058	$ 2,647	$ 3,385	$ 3,222	$ 1,164	$ (163)
Fed	$ 1,765	$ 1,644	$ 1,409	$ 2,066	$ 2,606	$ 2,701	$ 1,292	$ 94
Foreign	$ 909	$ 970	$ 1,100	$ 1,105	$ 1,188	$ 1,165	$ 65	$ (23)
Mutual+MMFs	$ 715	$ 860	$ 926	$ 750	$ 352	$ 446	$ (480)	$ 94
REITs	$ 252	$ 272	$ 326	$ 259	$ 154	$ 139	$ (187)	$ (15)
St+Loc Govt	$ 23	$ 24	$ 21	$ 21	$ 136	$ 130	$ 109	$ (7)
Pensions	$ 187	$ 220	$ 266	$ 208	$ 132	$ 189	$ (77)	$ 57
Life Ins	$ 152	$ 180	$ 262	$ 195	$ 111	$ 102	$ (160)	$ (9)
GSEs	$ 188	$ 173	$ 174	$ 113	$ 86	$ 51	$ (123)	$ (36)
P&C Ins	$ 21	$ 26	$ 39	$ 12	$ 43	$ 41	$ 2	$ (2)
FHLBanks	$ 127	$ 135	$ 142	$ 38	$ 26	$ 22	$ (119)	$ (4)
Brokers	$ 38	$ 58	$ 78	$ 77	$ 15	$ 57	$ (21)	$ 42
Unallocated	$ 70	$ 128	$ 111	$ 96	$ 125	$ 332	$ 221	$ 206
Total: Fed+Dep.	$ 3,661	$ 3,555	$ 3,466	$ 4,714	$ 5,991	$ 5,922	$ 2,456	$ (69)
Total: All others	$ 2,612	$ 2,918	$ 3,334	$ 2,777	$ 2,244	$ 2,342	$ (992)	$ 98
Total	$ 6,342	$ 6,601	$ 6,911	$ 7,587	$ 8,360	$ 8,596	$ 1,685	$ 236

Source: Fannie Mae, Freddie Mac, Amherst Pierpont Securities

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CMBS: TURNING THE CORNER ON SPREADS

PRICES

- Commercial real estate prices are likely to fall 10% to 15% in most property sectors in 2023. Cap rates should rise 1.00% to 1.50%.
- The price correction will be due to the rise in interest rates, not a significant deterioration in fundamentals, as the economy is expected to remain relatively stable through most of the year.

SPREADS

- CMBS and CRE CLO spreads are close to their wides and low issuance over the next several months will provide support.
- Spreads are already beginning to tighten in secondary trading.

TRADES

- Begin overweighting AA through BBB exposures while the credit curve is still very steep. Prefer cleaner deals with yields in 9% to 10.5% range.
- Stay concentrated in floaters, but begin extending in duration no later 1Q 2023.
- Position in 2016-2019 Ginnie Mae project loans which should have prepay speeds 4 to 9 CPR.

CAUTION

- Office is on its own trajectory and continues to deteriorate.

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CLO 2023 Outlook

- CLO looks vulnerable to a wave of loan downgrades that few CLOs may be able to escape. Spreads may stay wide for the bonds with low overcollateralization test cushion.

- Primary market conditions may stay challenging. A handful of managers tapped the market with static CLOs this year, and the share of static deals may continue to rise next year. Static CLO may offer good relative value.

- Loans transit from LIBOR to SOFR without credit spread adjustment may add headwinds to equity investors.

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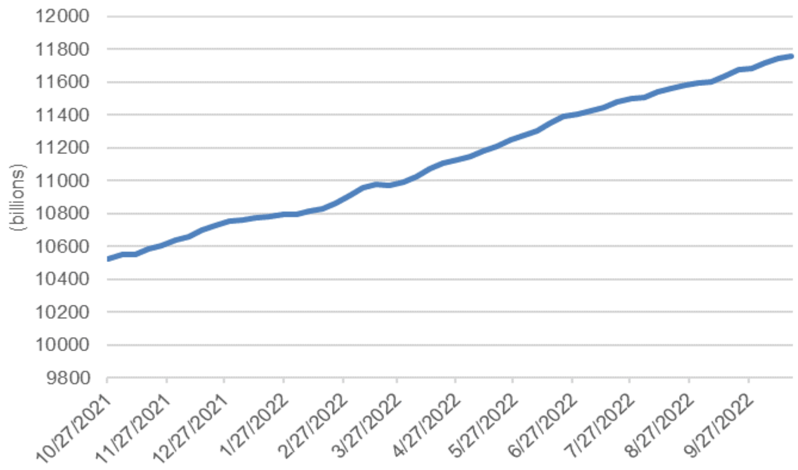
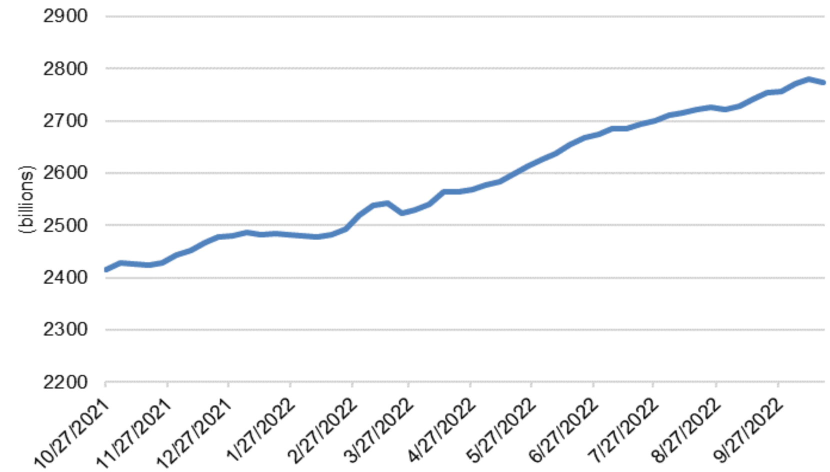
LOAN GROWTH CONTINUES

Loans to continue their upward trend of the past 12 months



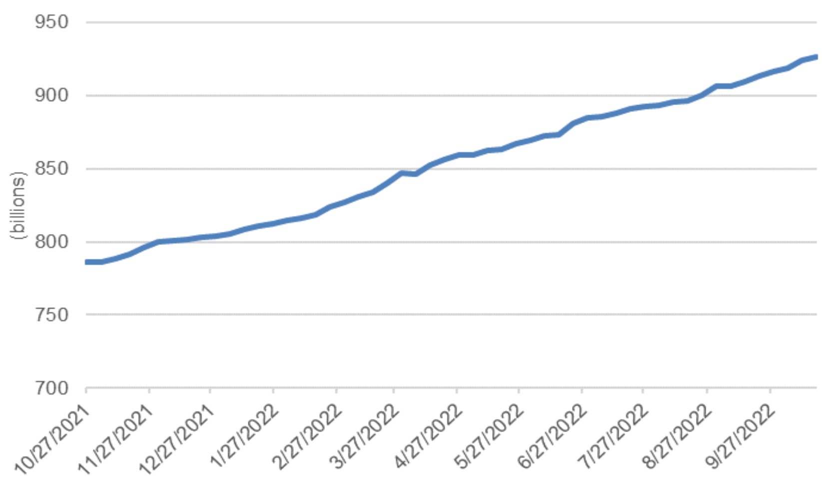
Source: Federal Reserve H.8, Amherst Pierpont Securities, Loans and leases in bank credit, all commercial banks, s.a.

Post-pandemic demand for C&I loans continues to grow



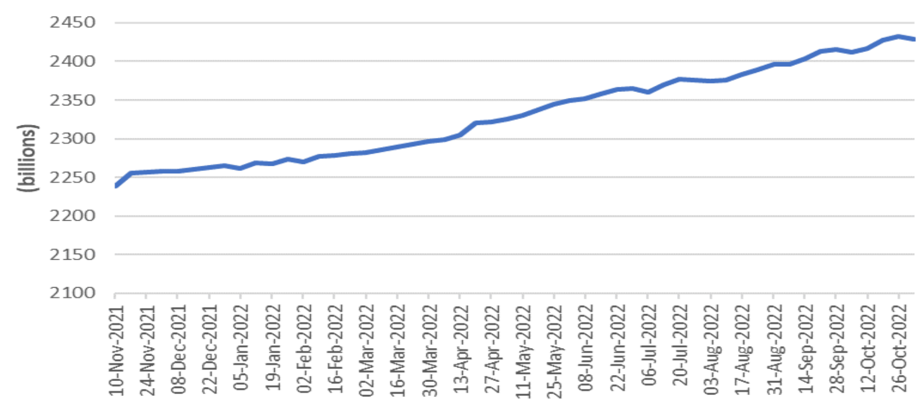
Source: Federal Reserve H.8, Amherst Pierpont Securities, Commercial and industrial loans, all commercial banks, s.a.

Inflation and economic pressure will drain consumer liquidity and credit card balances will continue to grow



Source: Federal Reserve H.8, Amherst Pierpont Securities, Consumer loans: credit cards and other revolving plans, all commercial banks, s.a.

Residential mortgage production stalling out



Source: Federal Reserve H.8, Amherst Pierpont Securities, Residential real estate loans, all commercial banks, s.a.

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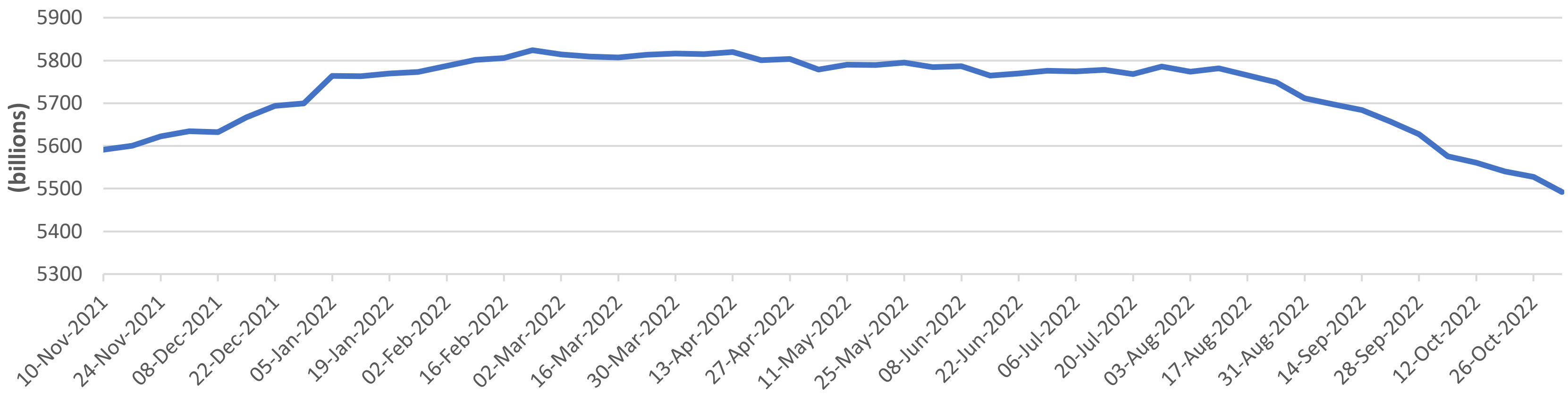
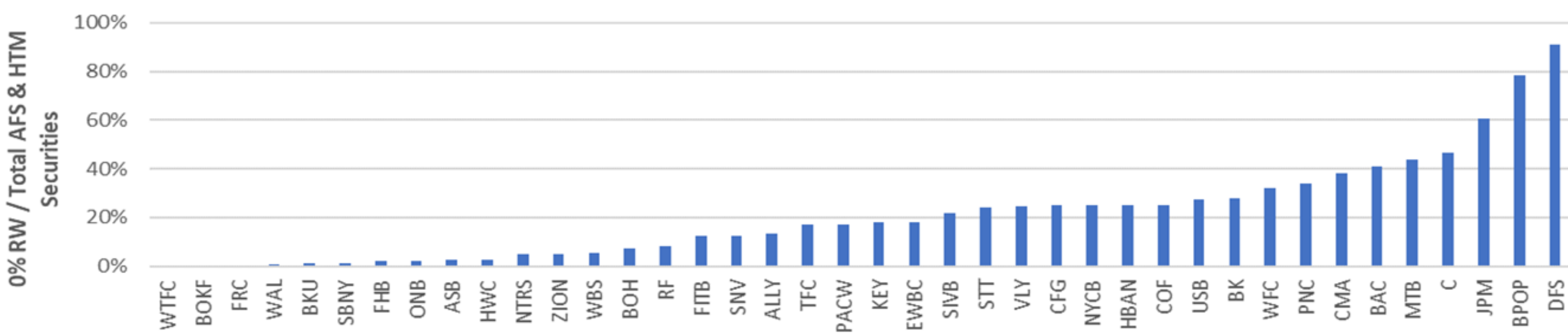
SECURITIES PORTFOLIOS CONTINUE TO SHRINK

Balance sheets will continue to need to make space for new loans



Source: Federal Reserve H.8, Amherst Pierpont Securities, Securities in bank credit, all commercial banks, s.a.

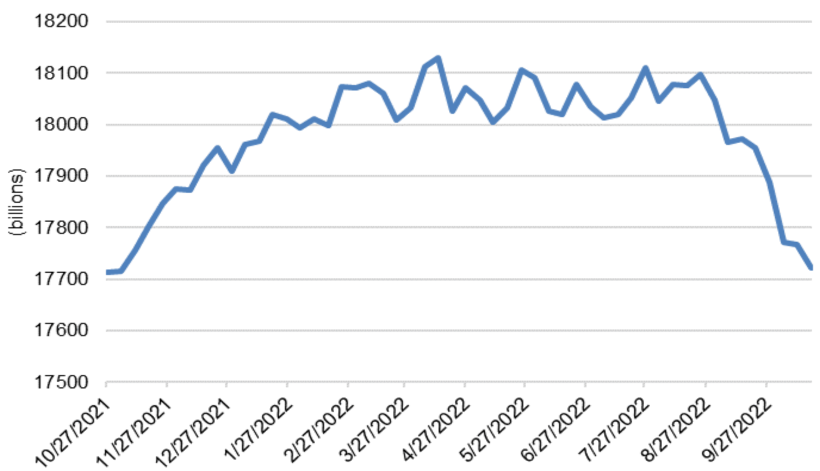
0% risk-weight securities continue to increase as a percentage of securities portfolios, up 1 percentage point in 22Q3 to 18%



Source: S&P Global, APS

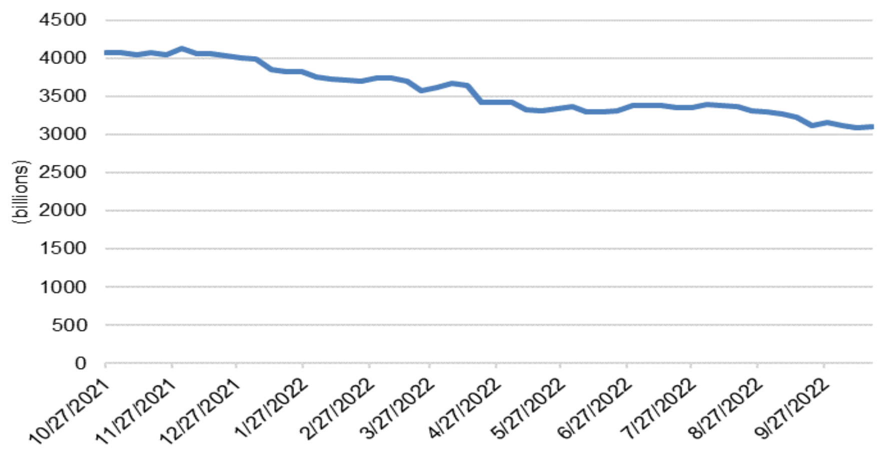
DEPOSITS CONTINUE TO DECLINE

Rising rates make deposits more difficult to retain



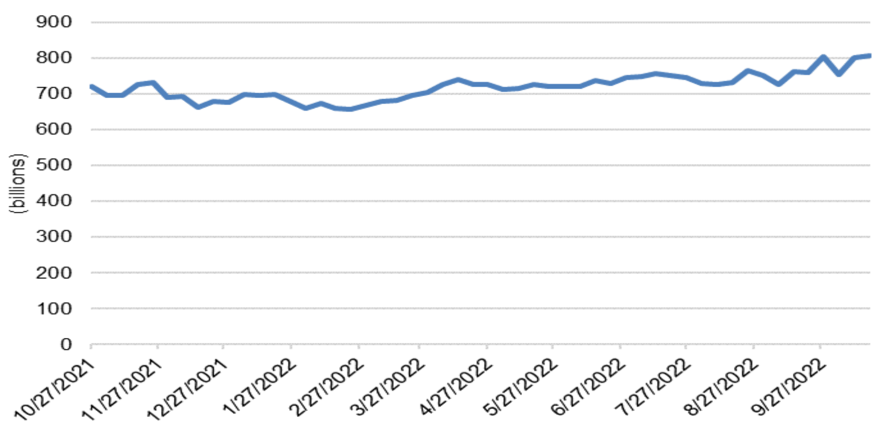
Source: Federal Reserve H.8, Amherst Pierpont Securities, Deposits, all commercial banks, s.a.

Further cash balance declines will need to be limited



Source: Federal Reserve H.8, Amherst Pierpont Securities, Cash assets, all commercial banks, s.a

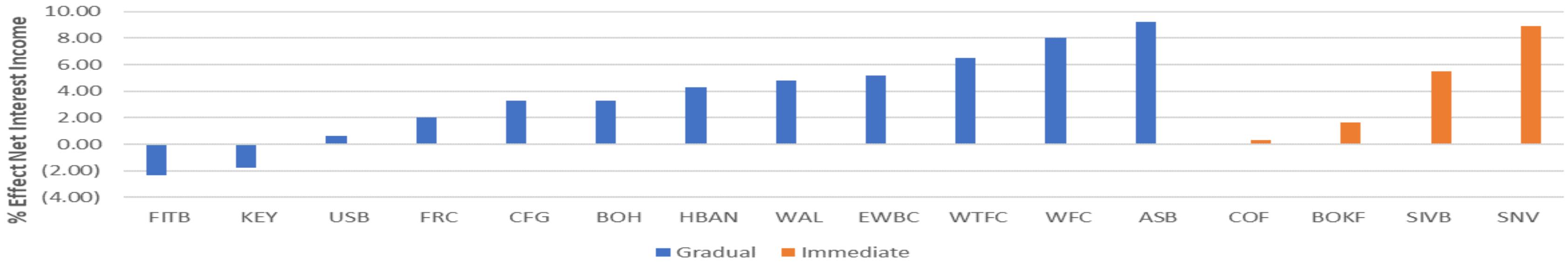
Wholesale funding will need to replace a larger percentage of deposit run-off in 2023



Source: Federal Reserve H.8, Amherst Pierpont Securities, Other liabilities, all commercial banks, s.a.

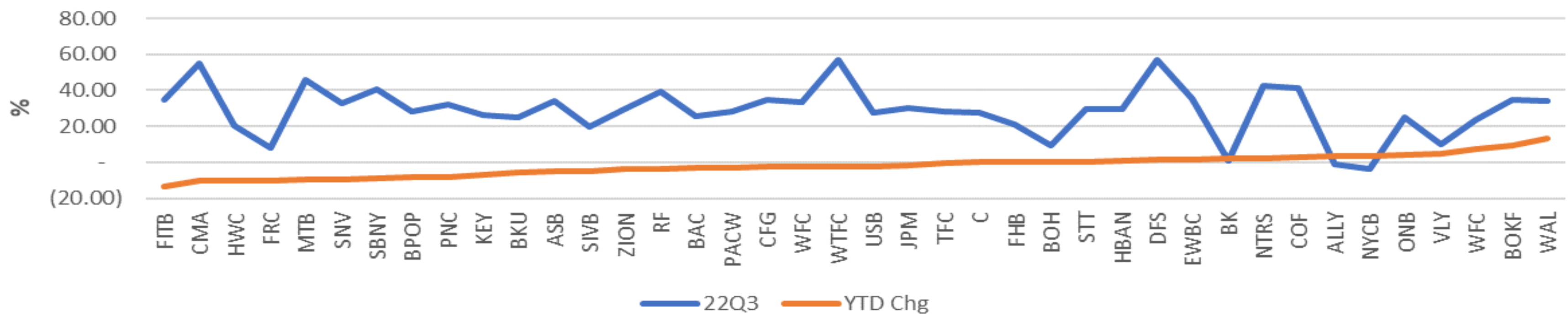
Bank steps to reduce asset sensitivity will be moderate

Impact of 200 bps rate increase on net interest income



Source: S&P Global, APS

1-year gap / total assets



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