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MBS and ABS: Duration and Recession Considerations

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What have you seen thus far in 2023 within the mortgage-backed securities (MBS) and asset backed securities (ABS) markets?

With mortgage-backed securities, one of the things that we've talked about is the duration extension that we saw in 2022. As rates go higher, your propensity to want to refinance goes down. For example, if you have a 3% mortgage and current mortgage rates are at 6%, it doesn't make any sense to refinance. What does that mean? Well, that life of that mortgage gets longer, and the duration extends. As rates go higher and duration extends, that exacerbates the impact on a fixed income portfolio when owning those mortgages. But the reason I say that is because we've seen duration extension somewhat stabilize in recent months.

Since the most recent jobs report (+517k jobs in January), mortgage rates have gone up a bit. And we do expect production of residential mortgages to slow as rate increases have been challenging to new home buyers. In fact, existing home sales have dropped for 11 consecutive months. In 2022, overall home sales were down roughly 18%, but pending home sales were up 3% in December. So, it appears that homeowners may be starting to adjust to the idea of rates in the 6% to 7% range, especially if they were facing a rate north of 7% last year and rates have fallen since then. So in the end, we should see production slow down but it's still out there and opportunities for new issue still exist.

One of the major concerns in the structured product market is the health and the viability of the consumer — and that really plays into the ABS market. As inflation eats into consumers' paychecks, it makes things more challenging. The savings rate has come down — it was around 9% pre-COVID but as stimulus checks hit, the savings rate skyrocketed and peaked north of 30%. Since then, it has been coming back down as consumers dip into their savings. In December 2022, the savings rate actually increased to 3.4% from 2.9% the prior month. This is well below pre-pandemic levels, but it's possible we've hit a low point because the job market remains strong, workers are getting higher wages, and inflation has started to come down.

In the ABS market, whether it's autos or consumer unsecured, we're starting to see 30-day and 60-day delinquencies in defaults creep up. But we are seeing some differences in various sub-segments of the market. Subprime auto and subprime consumer unsecured are areas that are feeling a lot more of the inflation pain in comparison to near prime or prime. These differences reinforce how important it is to understand what you own as a fixed income investor and to really dig into the details — the demographics of those securities — because we are seeing some of the subprime securities really feeling pain. But if you're able to find those diamonds in the rough or focus on higher quality, you can still find really good opportunities out there.

In summary, there is some pain for the consumer currently, but this is unlike other weak economic cycles. Again, the job market has been holding its own and if you take that into consideration with the fact that we're either in a recession or headed towards one, this is an unusual situation. But as long as the consumer continues to make those payments, we still think the ABS market offers some interesting investment opportunities — we are just approaching those opportunities with a bit more caution.

Would the confirmation of a recession negatively impact the market, or is a recession already priced into the market?

That's an interesting question. If you use the historical definition of a recession — two consecutive quarters of negative GDP growth — we've already had one. But the National Bureau of Economic Research (NBER) are the official arbiters of recessions, and they have the luxury of waiting and analyzing the data. They can come out next week, for example, and confirm that we were in a recession, that it started six months ago and that it lasted five months. If something like that were to come out, I think the market would shrug it off as it would not have been a surprise to most market participants. But if the NBER was to come out and say that we're in a recession and it started last month, there may be some knee-jerk reactions in capital markets. We think those reactions would be largely unjustified because it doesn't change the fact that unemployment is where it's at, wages are where they're at, and inflation is coming down.