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ALM FIRST

MONTHLY MARKET COMMENTARY

JUNE 2021

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- **The April CPI report showed the biggest monthly gain in core prices since 1981, driven by large increases in prices for used cars, airfare, and lodging**
- **The "transitory vs. sustained" inflation debate persists in the economist community; wage inflation and consumer inflation expectations are worth monitoring for signs of sustained inflation pressures**

The second quarter has been relatively tranquil for financial markets thus far versus what was experienced in the first three months of 2021, apart from ever-volatile crypto-currencies. Treasury yields have settled in a tighter range, perhaps desensitized by a Fed steadfast in its commitment to current policies and adamant that inflation is not a concern. The U.S. economic recovery has been robust, and the phrase "supply-chain bottlenecks" has become popular jargon to characterize obstacles amid the reopening effort. On the fiscal front, the White House and Congressional leaders continue to negotiate the Biden administration's infrastructure spending plan, including both the scale and funding source (tax hikes), and late last week, President Biden's ambitious budget proposal was released, calling for $6 trillion of federal spending in 2022. The White House budget proposal is closely aligned with the current push for spending on infrastructure, public health, and education. It also calls for increased taxes on corporations and wealthy individuals. Critics of the current spending initiatives worry that it further fuels inflation risks given already-strong economic fundamentals and Fed support. Fiscal budgets are still controlled by Congress, and with slim Democrat majorities in both the House and Senate, the tax proposals are already meeting resistance from both Republicans and moderate Democrats, the latter of which are worried about the potential impact on 2022 midterm elections according to media reports.

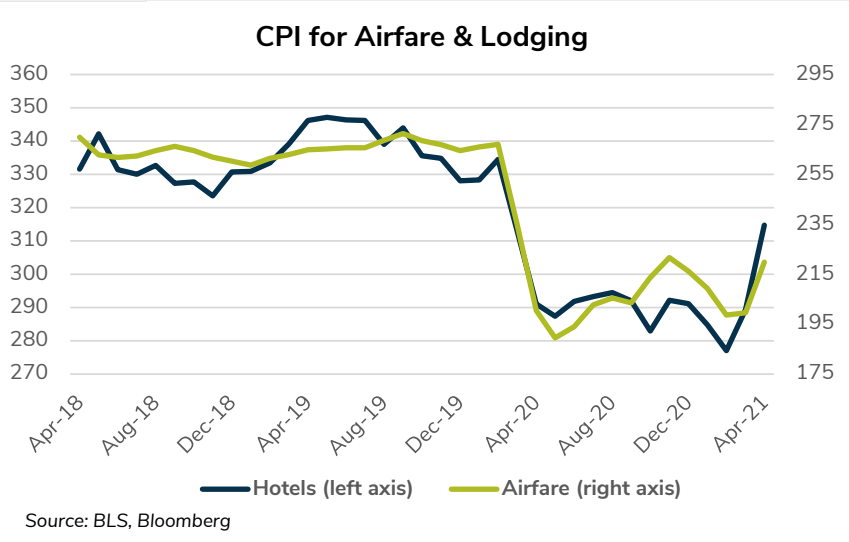
The Inflation Debate Continues

An inflation debate has captured the economist community for much of 2021, and the April CPI report provided additional fodder for both sides of the argument. The Fed remains firmly entrenched in the "inflation will be transitory" camp, suggesting that any 2021 price increases will be driven by temporary supply bottlenecks as the global economy reopens from the pandemic, but critics contend that the price increases will be stickier than Fed leaders and other inflation doves currently expect.

Core CPI surged 0.9% m/m in April versus expectations of a 0.3% gain. This was the biggest monthly increase in core prices since 1981 and triple the long-run historical average. April was expected to show price increases, but more of the focus was on year-over-year comparisons to the low point a year ago (base effect). Core CPI rose 3% y/y in April, 70 basis points (bps) more than expected, but to be clear, the huge month-over-month figure had nothing to do with the base effect. That said, the monthly price increases did exhibit signs of transitory factors. Roughly half of the April increase in core CPI was attributable to price gains for used vehicles, airfares, and lodging. Vehicle prices have been heavily impacted by supply chain disruptions, and airfares and lodging prices soared 10.2% and 7.6%,

respectively. The latter is undoubtedly a metric of increased travel behaviors as Covid moves more toward the rear-view mirror; however, Exhibit 1 provides added context to the larger inflation debate. Despite the big monthly gains, both categories remain well below pre-Covid levels.

Exhibit 1

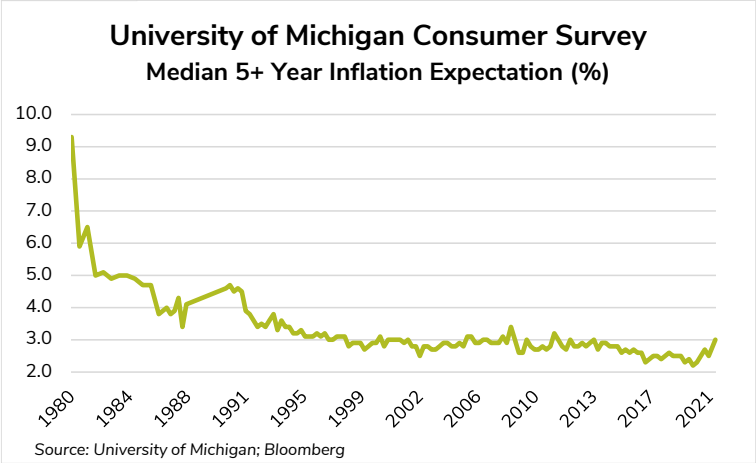


Source: BLS, Bloomberg

The market has largely faded the initial inflation worries following the release of the April CPI report on May 12. Long-end Treasury yields fell 8-13 bps over the remainder of the month, and both 5-year and 10-year TIPS breakeven yields moved lower as well. The transitory argument essentially contends that supply chain disruptions will eventually be resolved, and the initial rebound surge in travel, leisure, and other sectors more heavily impacted by Covid will eventually level off. Robust consumer spending in recent months has been fueled by a glut of fiscal stimulus and direct payments. Once that spigot is turned off, future consumption growth will be fueled by more typical sources such as income growth and sustained above-average wage growth would more likely lead to stickier price gains in aggregate. In a recent interview with the Financial Times, St. Louis Fed President Jim Bullard suggested that labor markets are tighter than they appear, pointing to anecdotal reports of worker shortages in some sectors requiring wage hikes to fill positions. If wage inflation becomes more prevalent, the camp of inflation hawks will undoubtedly expand.

Another aspect of this debate worth monitoring is consumer inflation expectations, something Fed leaders watch closely. The University of Michigan consumer survey tracks one-year ahead and 5+ year inflation expectations, and the median figures for both came in above expectations in May and are now at the high-end of the historical range over the last few decades, although still well below early 1980s levels (see Exhibit 2). Fed leaders have made it clear that they're willing to allow inflation run hot in the near-term, particularly more transitory components, but a persistent rise in consumer expectations for future price increases could alter their plans.

Exhibit 2



Source: University of Michigan; Bloomberg

II. CURRENT MARKET THEMES

Rates, Volatility, and Spreads

- **Treasury yields continued to trade in a relatively tight range in May despite the big April CPI print**
- **Demand for the Fed's reverse repo facility has been historically high in Q2 as heavy liquidity from monetary and fiscal policy finds its way to money markets**
- **Multiple Fed leaders suggested QE tapering may need to be discussed at coming meetings, and in the prior QE episode, fixed income spreads didn't widen until balance sheet normalization began**

Interest-rate volatility, both realized and implied, has been relatively subdued through the first two months of Q2, and despite the highest monthly growth rate for core CPI since the early 1980s, Treasury yields ended the month slightly lower across much of the curve (Exhibit 3). The 10-year Treasury yield is effectively back to pre-Covid levels, but breakeven yields in the TIPS market are more than 80 bps higher over the same timeframe. In other words, real yields are more than 80 bps lower versus pre-Covid levels, thanks in large part to the flood of liquidity from global central banks.

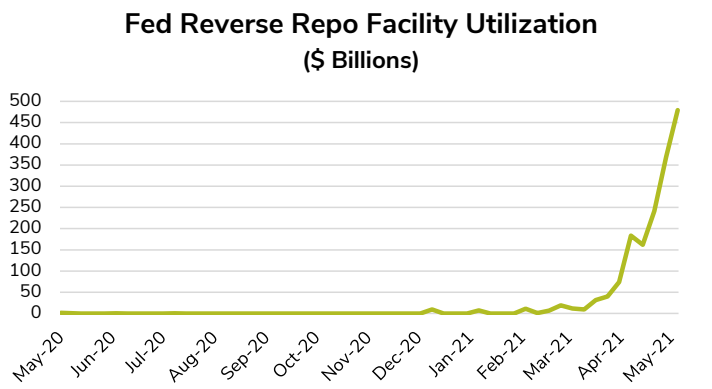
Exhibit 3

Treasury Curve			
Tenor	5/31/2021 (%)	4/30/2021 (%)	Change (bps)
1-Month	-0.01	0.00	-0.01
3-Month	0.00	0.00	0.00
6-Month	0.02	0.02	0.00
1-Year	0.03	0.05	-0.02
2-Year	0.14	0.16	-0.02
5-Year	0.80	0.85	-0.05
10-Year	1.59	1.63	-0.03
20-Year	2.20	2.17	0.02
30-Year	2.28	2.30	-0.02
Curves			
3mo-10yr	1.59	1.62	-0.03
2yr-5yr	0.66	0.69	-0.03
2yr-10yr	1.45	1.47	-0.01
2yr-30yr	2.14	2.14	0.00
5yr-10yr	0.79	0.78	0.01

Source: Bloomberg

A large share of liquidity from both monetary and fiscal stimulus continues to find its way to the money markets, which is fueling record demand for the Fed's reverse repo facility (Exhibit 4). This would suggest that loan demand and/or risk appetite is still somewhat subdued, leaving excess liquidity to be invested at the Fed's repo facility earning 0%. The good news is that the facility has so far been successful at absorbing those funds and keeping short-term rates from going negative, but at the same time, it might suggest to Fed leaders that the current levels of QE are no longer beneficial. On that note, Vice Chair Clarida and Vice Chair Quarles both suggested in recent speeches that it may be time to at least begin discussing QE tapering at upcoming meetings. In typical Fed timing, it would still likely be late 2021 or early 2022 before tapering would begin. At that point, the Fed's balance sheet would still be expanding, just at a slower pace. During

Exhibit 4



Source: Federal Reserve; Bloomberg

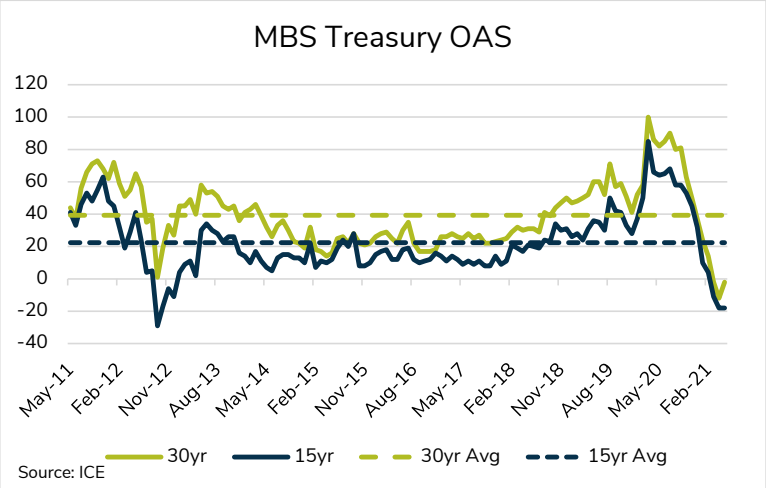
the last QE cycle, tapering began in late 2013 and lasted for 10 months. During that time period, MBS and corporate bond spreads continued to grind tighter. Balance sheet normalization, where portfolio principal was allowed to roll off, did not begin until October 2017. Once normalization began, fixed income spreads began to widen as Fed demand waned. This is certainly not to say that the same schedule will be followed in the current cycle, but it does provide added context as it relates to the impact of Fed policies on fixed income markets.

Agency MBS/CMBS

- **MBS underperformed in May as spreads widened. Most of the widening occurred in the first half of the month and was more concentrated in higher coupons**
- **Comments from Fed officials have tapering in the spotlight, but market expectations have not changed**
- **Questions around LIBOR transition and legacy hybrid ARMs remain, but GSEs and ARRC are expected to announce plan soon. SOFR ARM issuance has been slow out of the gates**
- **The Bloomberg Barclays US Agency CMBS Senior Index outpaced duration matched Treasuries by 0.37% as spreads tightened primarily on the front-end**

Mortgage spreads widened in May (see Exhibit 5) leading to underperformance versus Treasuries; the ICE BofA 30-year index lagged duration-matched Treasuries by 44 bps and the 15-year index by 5 bps. But despite this widening, the sector remains historically rich and spread moves are likely to remain muted as long as the Fed continues to cast its shadow over the space.

Exhibit 5



The bulk of the widening occurred through the first half of the month and was more concentrated in higher coupons which suffered due to continued fast speeds and the corresponding model recalibrations. Higher coupons have looked cheap relative to production coupons due to model projected slowdowns, but as speeds remained elevated in the face of this year's steepening, investor confidence in model projections weakened further.

Tapering has been a topic on investors' minds since last year, but chatter has started to pick up as of late with Fed officials publicly discussing the topic. Given current spread levels and well-functioning housing market, many investors have wondered why the Fed remains involved with the MBS market. Boston Fed President Rosengren recently responded to that question stating that in his view "the mortgage market probably doesn't need as much support now. And in fact, one of my financial

stability concerns would be if the housing market gets too over-heated." Despite this comment and those made by Vice Chairs Clarida and Quarles, the market continues to expect that tapering will start at the end of this year or early next.

Hybrid ARM LIBOR Transition

One of the remaining sticking points for the transition away from LIBOR is what will happen to legacy Hybrid ARMs. Unlike floating-rate CMOs where the underlying loans are fixed, the borrowers in a pool of hybrid ARMs have direct exposure to LIBOR, complicating matters. As it currently stands, there is not a definitive answer regarding the final form of the new index, as both the averaging period and spread adjustment remain unknown. The GSEs are expected to announce the successor rate soon, which will set the averaging period. If the plan is to replicate the structure of the newly issued ARMs, the index will be averaged over 30 days and resets will occur every six months. Additionally, the ARRC is expected to announce the spread adjustment in the coming months.

The GSEs began buying SOFR ARMs back in August of last year and stopped buying LIBOR ARMs in December, but since then issuance of the newly indexed product has been light. Some of this is due to originators needing to switch over their systems, in discussions we have had with ARM trading desks there is an expectation that supply will pick up in the future. Currently, a little over $1bn in SOFR ARMs has been issued YTD, the average pool has had an original balance of around $11 million and 30 loans. The 7/6 (7-year teaser/6-month reset) has been the most common type issued at 54%. Exhibit 6 summarizes 2021 SOFR ARM issuance.

Exhibit 6

ARM Type	% of Origination	Avg. Orig. Balance	Avg. Cpn	Avg. Loan Count	Avg. Net Margin	Avg. Loan Margin
5/6	11	6,640,102	1.79	20	2.23	2.87
7/6	54	15,184,355	1.89	38	2.11	2.74
10/6	34	10,625,654	1.99	27	2.08	2.77
Total	100	11,747,997	1.91	30	2.12	2.78

Source: Bloomberg

In terms of valuations, the sector is trading tight, like the rest of the mortgage universe. SOFR ARMs are trading with OAS in the negative single digits which puts them in the same ballpark as 15-year production coupons. After factoring in model risk and reduced liquidity, the sector doesn't look compelling relative to 15-year.

In the mortgage space, we remain most constructive on new production 15-year due to solid carry and to keep spread duration and negative convexity low in the portfolio. For those investors that can roll, we would recommend rolling these coupons to generate additional income.

Agency CMBS

Despite consistent fixed-rate Agency CMBS issuance, sector spreads remained well bid and continued to compress throughout May. In the absence of traditional 10-year Freddie K paper, the agency brought

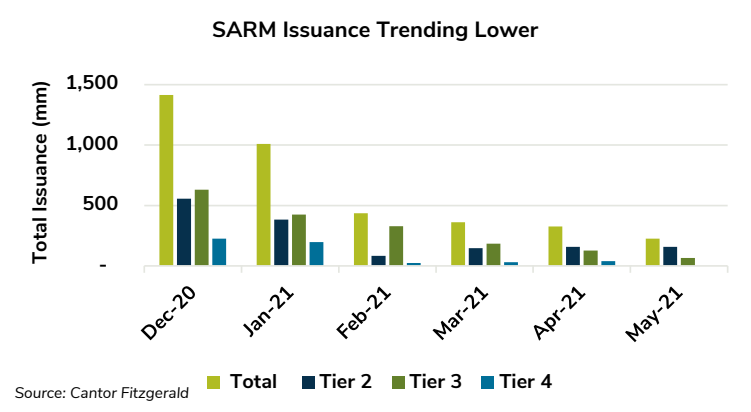
to market both a 7-year and a "lease-up" deal which finances newly constructed properties that are not fully stabilized. The 7-year deal, K-742, priced the front sequential A1 tranche at swaps+2 and the A2 at swaps+6 bps. Farther out the curve, 10/9.5 DUS spreads were unchanged in their current mid-teens range over swaps. However, relative to US Treasuries, the product tightened 3 bps due to the change in swap spreads. At the sector level, valuations in the Bloomberg Barclays US Agency CMBS Senior index tightened 7 bps m/m and generated 0.37% in excess returns over Treasuries. Spread movement was more pronounced on the front-end and belly of the curve with the 6-8.5yr segment outperforming Treasuries by 0.48%.

Floating-Rate Securities

- **Floater demand remained strong through most of May, meeting the robust supply of new issue CMBS deals. Higher cap CMOs remained thinly traded in the secondary market.**
- **SARM spreads remain tight to new issue 10-year CMBS deals, as the market has seen decreased SARM issuance over the last few months.**

Investor demand for agency-backed floating-rate securities outpaced supply in May. Demand from banks remains particularly strong, with those institutions still generally biased toward short-duration assets, and reduced Treasury bill issuance has exacerbated supply issues on that front.

Exhibit 7

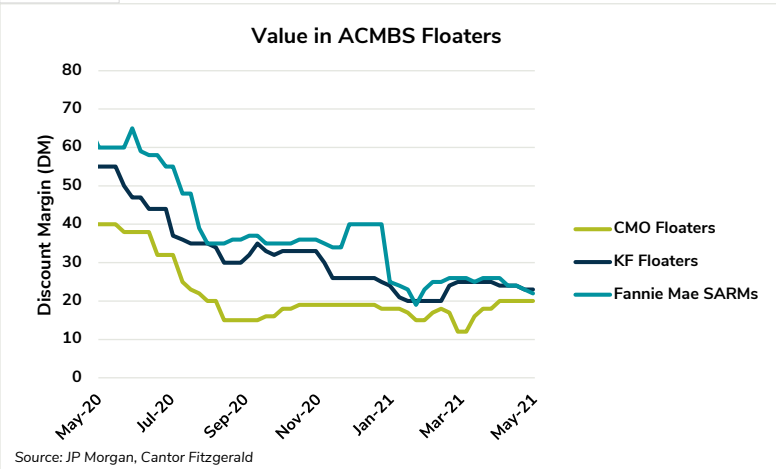


Source: Cantor Fitzgerald

The ACMBS floater market experienced mild tightening over the month. The last deal in April (K-F109) was ~1.7x subscribed and priced at SOFR+24. The K-F112 deal (last deal in May) priced at SOFR+23 and was 1.8x subscribed.

New issue KF supply will be lower in June, with only two scheduled deals on the calendar (first and third weeks of June). This comes as a contrast to prior months, which have seen new issue KF deals announce nearly every week. As issuance remains relatively light (Exhibit 7), SARMs have followed the tightening trend of their KF cousins. When looking at the entire universe of SARMs, the asset class historically trades 4-5 bps wide of new issue 10-year ACMBS. Currently, SARMs are trading right on top of KF spreads (see Exhibit 8), with higher-quality collateral SARMs (Tier 3 and 4) trading 1bp tighter

Exhibit 8



Source: JP Morgan, Cantor Fitzgerald

than KFs. When comparing the two asset classes, KFs have a better liquidity profile and more diversification in the underlying collateral. As such, we would prefer to add KF floaters on the margin rather than SARMs.

Conventional 6.5 cap Agency CMO floaters (which remain thinly traded in the secondary market) traded in the low teens from a discount margin (DM) perspective throughout the month. Investor demand for lower cap structures remained strong. These securities are being shown at a wider spread, but that spread comes at the expense of greater interest-rate risk, particularly depository institutions shocking the price and duration in an ALM framework.

HECM issuance was down 2.4% (1.04billion May issuance) from the prior month, and demand outpaced supply. The closer to par priced (non-premium) HECM floater spreads hovered in the mid 20s DM with premium HECMs trading in the high 20s / low 30s.

Non-Agency RMBS

- **Supply holds spreads roughly flat on the month, remain constructive on prime jumbo**
- **Deeper dive into resecuritized non-QM reveals slightly elevated risk layering**
- **Ample credit support, fast prepays, and substantial borrower equity should still contain credit losses**
- **AAA prime jumbo front cashflows preferred trade close to 2 pts back of UMBS**

Supply remains the topic du jour for mortgage credit as we roll into June. Now on pace to surpass both 2018 and 2019 gross issuance ($115bn & $125bn, respectively) investors have struggled to digest a seemingly never-ending new issue pipeline. The fallout? Spreads at the top of the stack continue to be compelling, in our view, for a variety of securitized credit products. Particularly in prime jumbo (prime 2.0), where spreads held roughly flat over the month for AAA pass-throughs and front sequentials, 2 points back of UMBS appears to be an attractive entry point.

Fundamental Update

Despite supply chain disruptions and construction backlogs reaching 10-year highs, home builder confidence held steady over May, near all-time highs. While a pullback in both single family starts and permits (down 13.4% & 3.8%, respectively), as well as purchase applications (down 10.2% m/m) intuitively signal weakening demand, all 3 remain at or above pre-pandemic levels. Given constrained supply, we view the imbalance as more influential to support home prices into the heavy-turnover summer months.

Searching for Tails in Resecuritized Non-QM

As discussed at length in this piece, the reissued or resecuritized non-QM market remains on a torrid pace through the first 5 months of 2021. With heavy call activity since the fall of last year (which is likely to continue), sponsors have unsurprisingly been itching to collapse deals ASAP and reduce their cost of funds. That's taken the form of nearly $3.5bn of resecuritized collateral across 14 deals already. A

common concern for these deals is often the potential for the pool to be adversely selected, with greater amounts of risk layering or fatter "tails" – but is that true? We take a look.

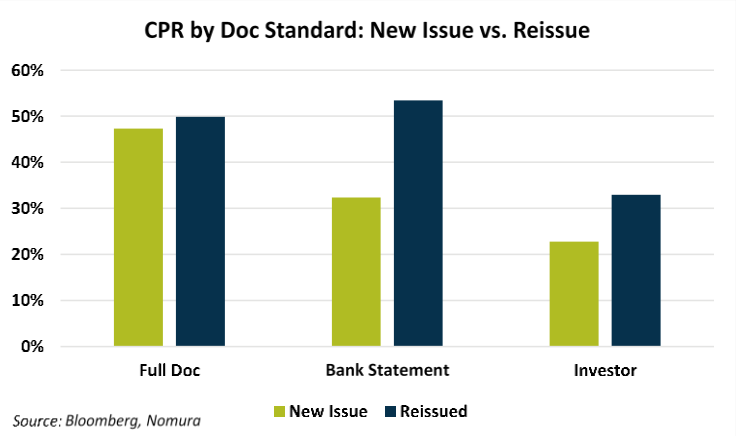
Exhibit 9 highlights a few key characteristics between 2020 and 2021 new issue vs. resecuritized deals thus far. Not surprisingly, GWACs have been considerably higher for reissued deals, which on average are roughly 32 WALA. Generally, credit boxes don't drift very far from new issue deals, but it is clear risk layering is slightly elevated in reissue vs. new issue, specifically when looking at <660 FICOs and >80% CLTVs. That said, considerable borrower equity still exists, with roughly 60% amortized CLTVs on average. Further, credit support has been consistent and considerable on reissue deals vs. their new issue counterparts, hovering in the high-20% range. When we look at prepay performance, seen in Exhibit 10, we can see resecuritized deals also tend to delever faster, as 32 months seasoning on average means the collateral pool will have already hit it's prepay ramp. Moreover, liquidated loans and loss severity continue to be ostensibly low. Only 20 loans have been liquidated with a loss, on average roughly 16%. In total, loss severities are still sub-1% for the non-QM universe.

Exhibit 9

	2020	2021	Reissued
Avg. Loan Bal	429k	410k	415k
GWAC	6.1%	5.8%	6.5%
Current CLTV	67%	64%	60%
WALA	8	11	32
WA FICO	717	733	715
<660 FICO (%)	17%	10%	15%
>80 CLTV (%)	26%	18%	29%
>43 DTI (%)	15%	3%	3%

Source: Bloomberg, Nomura

Exhibit 10



Putting it all together, what can we conclude? In reissue, credit boxes are mildly worse, and risk layering slightly elevated. Will AAA bonds still be money good (not experience principal writedown)? We believe so. Ample credit support, fast prepays to deleverage deals, and considerable borrower equity should contain credit losses to the support bonds.

Relative Value & Recommendations

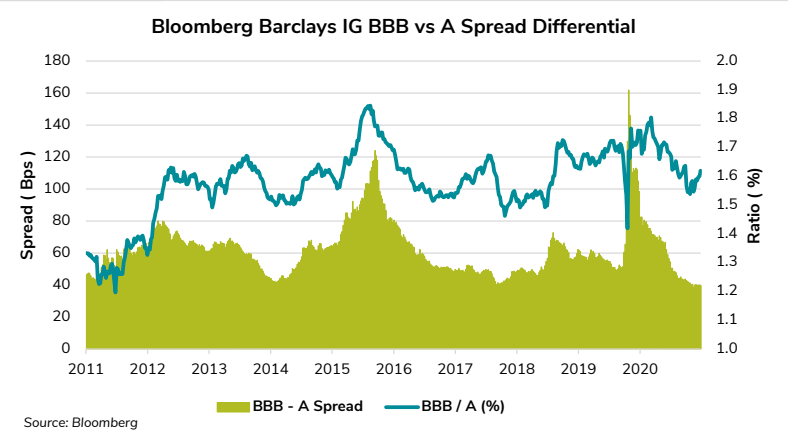
AAA prime jumbo front cashflows (FCF) are currently our preferred trade. At roughly 2 points back of 15-year 2.5%, the carry advantage relative to other short duration alternatives (namely, non-QM) is compelling in our view for taking the additional convexity risk. AAA non-QM spreads backed up a bit in May and are now holding in the +70 to swaps area. As we've noted, we recommend running new issue and/or reissue non-QM bonds to maturity (no call) but expect speeds to remain elevated for this subsector. Still, what has typically been a ~2-year asset is likely to become closer to a 3 to 4-year bond if we are to trust forward rates. Convexity protection in rated RPL still can't be found, with speeds elevated into the high teens, low-20% area. For added call protection, we recommend 100% investor non-QM (which has hard prepay penalties) or investor 2.0. The latter most recently priced approximately 1-24 back of UMBS for the AAA FCFs. That's roughly 3 points concession to where you can buy the same collateral in the agency market.

Investment Grade Credit

- **The Bloomberg Barclays Investment Grade Corporate Index outperformed Treasuries by 0.13% in May as credit spreads tested all-time lows**
- **Year-to-date 9% of BBB1 debt has been downgraded as the cost to hold a lower credit rating becomes marginalized**

Investment grade credit spreads tested the all-time lows in May from a spread perspective as robust earnings pointed to a faster than expected recovery and supported current valuations. The Bloomberg Barclays US Investment Grade Corporate Index ended the month at +83 OAS, or 5 bps tighter m/m, and generated 0.47% in excess returns relative to duration-matched Treasuries. When it comes to factor exposures, overall spread changes for lower rated BBB names were consistent with higher A-rated credits. However, the persistent outperformance in 2020 and early 2021 has reduced compensation for high leveraged names (Exhibit 11). Across tenors, the change in spreads were similar but longer spread duration maturities provided superior returns over comparable rate benchmarks. On a sector level, there was more variance as Energy posted 1.14% in excess returns over Treasuries due to the relief of higher commodity and oil prices that bolster earnings.

Exhibit 11



While total investment grade issuance is down 28% year-to-date at $755 billion, the current pace is on track to be the second busiest year on record behind only 2020's record-setting issuance levels. Companies have started to take a more opportunistic approach with a larger share of proceed uses earmarked for general corporate purposes and acquisitions. The general corporate purpose tag is relatively vague and can include a variety of uses from share buyback programs, capital expenditures,

Exhibit 12

US IG YTD Ratings Transition Matrix (%)

Start	AAA	AA1	AA2	AA3	A1	A2	A3	BBB1	BBB2	BBB3	BB1
AAA	100%										
AA1		100%									
AA2			67%	33%							
AA3				95%	5%						
A1					99%	1%					
A2					0.11%	98%	2%	0%			
A3						7%	86%	7%			
BBB1							0.14%	91%	9%		
BBB2					0.02%			1%	98%	1%	
BBB3									1%	99%	0.20%

Source: CreditSights, ICE of BofAML Indices

future acquisitions, or fund regular operations. So far, corporations with A3 and BBB1 ratings have started to take an increased share of gross issuance. Since the spread or cost of debt between A and BBB rated names continues to compress, the incentive for holding a higher rating becomes marginalized. In addition, the Federal Reserve made no distinction in support between ratings bands and only required an investment grade rating. Exhibit 12 details the year-to-date credit rating transitions for the investment grade index. Outside of the $53 billion in debt downgraded in the AA2 bucket that is attributable to the energy giants Exxon and Chevron, most transitions are concentrated in the A3/BBB1 area. While the A3 rating group has an equal percentage of upgrades and downgrades, BBB1 names have predominately been downgraded. However, one downgraded name in the BBB1 segment to highlight is AT&T which recently reached a credit positive deal with Discover to spin off Time Warner Cable and pull-forward its de-leveraging plan following the expensive C-Band auctions. We will continue to monitor the trend on whether corporations defend their credit rating or continue to be content with recent downgrades.

III. FIXED INCOME PERFORMANCE UPDATE

- **Broad fixed income had another solid month in May amid mild rate volatility and firmer spreads**
- **Spread sectors outperformed rates on the month with the exception of MBS, which was weighed down by underperformance of higher coupons following faster than expected April prepays**
- **All three ALM First model portfolios outperformed their respective benchmarks in May, boosted by the aforementioned strength of spread sectors over the month**

Broad fixed income had another solid month in May amid reduced rate volatility and firmer spreads. As illustrated in Exhibit 13, several sectors posted double-digit excess returns relative to Treasuries for the month, including 37 bps for the represented ACMBS index. The latter experienced 8 bps of spread tightening as the demand for high credit-quality securities remains high. Investment-grade corporate debt (IG credit) had another strong month as well, with the front-end index generating 21 bps of excess return relative to Treasuries.

Exhibit 13

Sector Returns								
	May-21		Year To Date					Average
	TROR	Excess *	TROR	Excess *	2020	2019	2018	Annual
Cash[1]	0.01	-	0.02	-	0.54	2.21	1.83	1.53
Treasury[2]	0.16	0.02	-0.21	0.06	4.25	4.20	1.52	3.31
Agy Bullet & Callable[3]	0.17	0.05	-0.09	0.13	3.35	3.78	1.71	2.94
15 Year MBS[4]	0.11	-0.05	-0.03	0.47	4.43	5.49	1.01	3.63
30 Year MBS[5]	-0.27	-0.44	-0.89	-0.47	4.09	6.98	1.02	4.00
US Taxable Muni	0.58	0.15	-1.87	4.58	11.82	13.69	-1.10	7.93
US ACMBS[7]	0.75	0.37	-1.23	1.13	9.02	7.42	1.06	5.77
IG Credit[8]	0.37	0.21	0.28	0.59	5.71	7.15	1.00	4.59
HY Credit[9]	0.41	0.31	3.69	3.85	3.68	10.09	-0.05	4.49
S&P 500	0.70	-	12.61	-	18.39	31.48	-4.39	14.17
KBW Bank Index	5.15	-	37.80	-	-10.31	36.13	-17.71	0.16

Sources:

1 ICE Treasury Bills 0-3 mo
2 ICE US Treasuries 1-5yr
3 ICE AAA US Agy 1-5yr
4 ICE BoA FNMA 15yr MBS
5 ICE BofA FNMA 30yr MBS
6 ICE US Taxable Municipal
7 Bloomberg/Barclays Agency CMBS
8 ICE US Corp 1-5yr
9 ICE US HY 1-5yr Constrained

** Excess vs. duration-matched Treasuries*

An exception to the general strength in May was MBS, particularly 30-year tenors. The 30-year MBS index underperformed Treasuries by 44 bps for the month attributable to index OAS widening by 10 bps. As discussed in more detail in the Agency MBS/CMBS section, the poor performance was more concentrated in higher coupons, which experienced faster than expected prepays in April. The 30-year current coupon MBS index, which excludes the aforementioned high coupon pools, only underperformed Treasuries by 4 bps in May.

While higher-coupon MBS struggled in May, most other spread sectors thrived relative to rates, and all three ALM First model portfolios were able to outperform their respective benchmarks for the month (Exhibit 14). The Core Spread Portfolio (CSP) generated a total return of 0.24% in May, 7 bps better than the portfolio's benchmark. Despite 28 bps of excess return over the last two months, the CSP has still underperformed by 20 bps on the year thanks to a rough Q1, but the 1-year excess return of 0.93% is more than double the portfolio's longer-run average annual returns.

The Enhanced Liquidity Portfolio (ELP) generated a 0.13% return in May, 12 bps better than its 9-month Treasury Bill benchmark. The ELP has been able to maintain a positive return versus the benchmark on a YTD basis of 0.18% through May, and over the last 12 months, the portfolio has generated 95 bps of excess return.

The IG Credit Portfolio (IGCP) posted another solid return of 0.33% in May, 16 bps above the benchmark. The portfolio was less impacted than the CSP by the Q1 curve steepening, with both topline (0.31%) and excess (0.46%) returns positive on a YTD basis. Over the last 12 months, the portfolio generated 426 bps of excess return, more than double the longer-run averages.

Exhibit 14

ALM First Model Portfolios Total Return (%) Summary								
As of May 31, 2021	1-Month	3-Month	YTD	1-Year	3-Year Avg. Annual	5-Year Avg. Annual	Inception Avg. Annual	Inception Date
Core Spread Portfolio[1]	0.24	0.19	-0.39	0.96	3.67	2.42	2.11	1/1/2011
ICE BofA 1-5yr Treasury & Agency Bullet Index	0.17	0.23	-0.19	0.03	3.33	2.01	1.70	
Excess Return	0.07	-0.04	-0.20	0.93	0.34	0.41	0.41	
Enhanced Liquidity Portfolio[2]	0.13	0.17	0.27	1.17	2.26	1.81	1.16	1/1/2011
50/50 blend of ICE BofA 6mo & 12mo T-Bill Indices	0.01	0.05	0.09	0.22	1.87	1.46	0.85	
Excess Return	0.12	0.12	0.18	0.95	0.39	0.35	0.31	
IG Credit Portfolio[3]	0.33	0.51	0.31	4.29	4.67	3.13	3.00	10/1/2011
ICE BofA 1-5yr Treasury & Agency Bullet Index	0.17	0.23	-0.15	0.03	3.33	2.01	1.54	
Excess Return	0.16	0.28	0.46	4.26	1.34	1.12	1.46	

[1] Returns are shown net of a 0.10% model fee. [2] Returns are shown net of a 0.05% model fee. [3] Returns are shown net of a 0.15% model fee.

* Actual fees will vary. Please see Model Fee disclaimer.

IV. MORTGAGE PIPELINE HEDGING UPDATE

The 10-year U.S. Treasury rate (10CMT) ended the month at 1.57%,6 basis points lower than the end of April. The 2 to 10 year spread on the treasury curve remained relatively the same during the month of May as the 2 year rate lowered 5 basis points. With the decrease in interest rates, low coupon TBA MBS prices increased while higher coupon TBA MBS prices decreased. FNCL 1.5, FNCL 2 and FNCL 2.5 experienced an increase of 0.29, 0.14 and 0.04 points, respectively. **Figure 1** shows the change in TBA MBS pricing, which can be compared to **Figure 2** showing the change in Fannie Mae loan pricing.

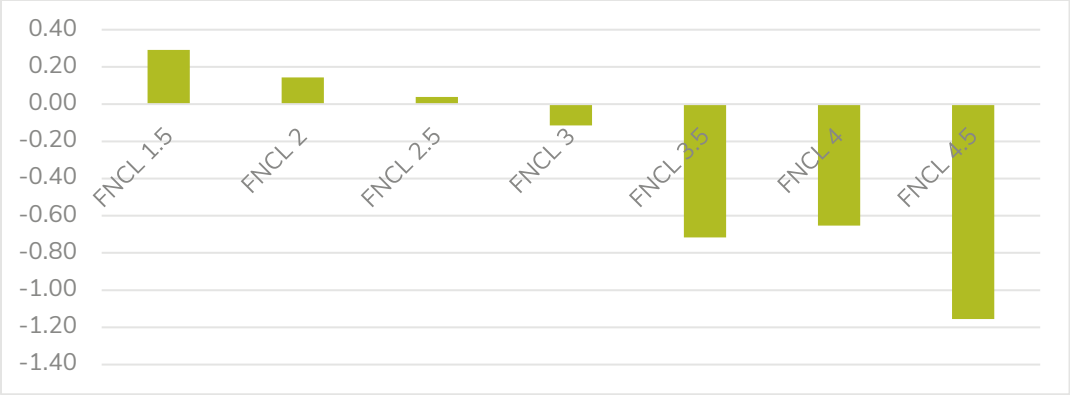
The primary/secondary (P/S) mortgage spread tightened 1 basis point since the end of April. The 30-Year primary mortgage rate, according to BankRate, is 3.08%, a decrease of 3 basis points over the month. The par yield on 30-year MBS is 1.82%, down 3 basis points from the end of April. The P/S spread is a general barometer of mortgage profitability, with the primary rate serving as the rate earned and the par yield serving as the cost of carry on the hedge. **Figure 3** shows the P/S spread since the beginning of 2020. It has continued to tighten, although mortgage rates have increased, due to rising bond yields. Despite a knee jerk reaction mid-month that saw the 10-year US Treasury rate reach 1.69% when the Fed mentioned they should start talking about "adjusting the pace" of their asset purchases, mortgage origination volume remains very strong. The five-day origination average is $6.37bln.

Fannie Mae and Freddie Mac have implemented restrictions on the amount of loans backed by investment properties and second homes they will purchase due to the cap set by FHFA. The GSEs may only acquire 7% of their volume for both products combined by year end. Effective June 1, all investment loans delivered to FNMA's cash window must be delivered against only a 30-year or 15-year investment property commitment. These loans can no longer take advantage of the low loan balance specified pay-ups. Both agencies are managing the volume of these products allowed for delivery on a lender-by-lender basis.

Loan price movements were similar in comparison to TBA MBS price movements. Lower coupon loans experienced an increase of about 25 basis points, while higher coupons experienced a decrease of 40 basis points. Over the month of May specified pay-ups on low loan balances have declined contributing to increased hedge costs.

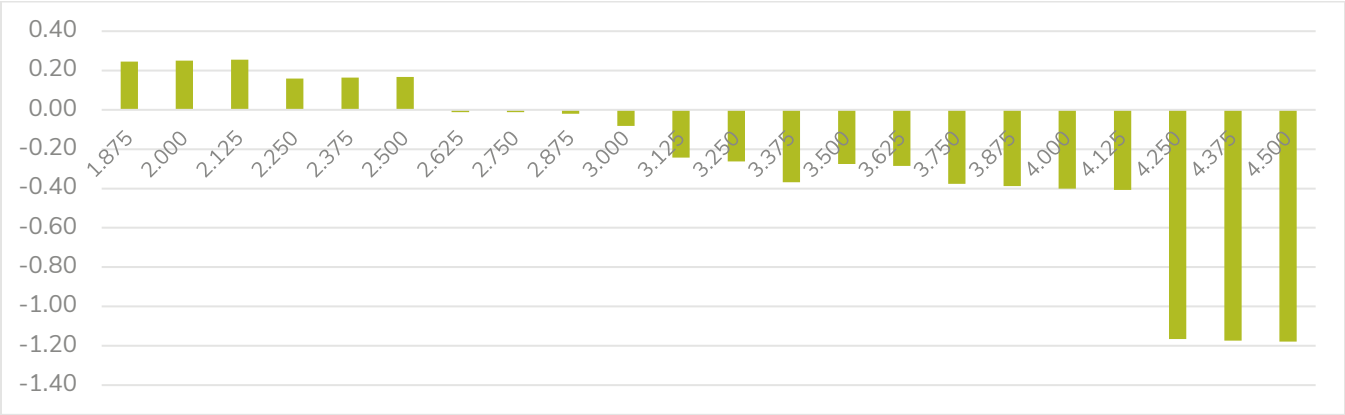
The net change in price (hedged cost) is negative 27 basis points, with an R-squared of 99.0% for the month in aggregate. The hedged cost is a net change in value for lenders hedging Fannie Mae and Freddie Mac (FMs) execution using TBA MBS contracts. Year to date hedge cost is negative 128 basis points, a roughly 26 basis point monthly average. Total hedge cost over the last twelve months is negative 204 basis points representing an average 17 basis points monthly.

Figure 1: Monthly Change in TBA MBS Pricing



Source: Bloomberg

Figure 2: Monthly Change in Fannie Mae Cash Window Loan Pricing



Source: Bloomberg

Figure 3: Primary/Secondary Mortgage Spread

Source: Bloomberg

V. CONTACT INFORMATION

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