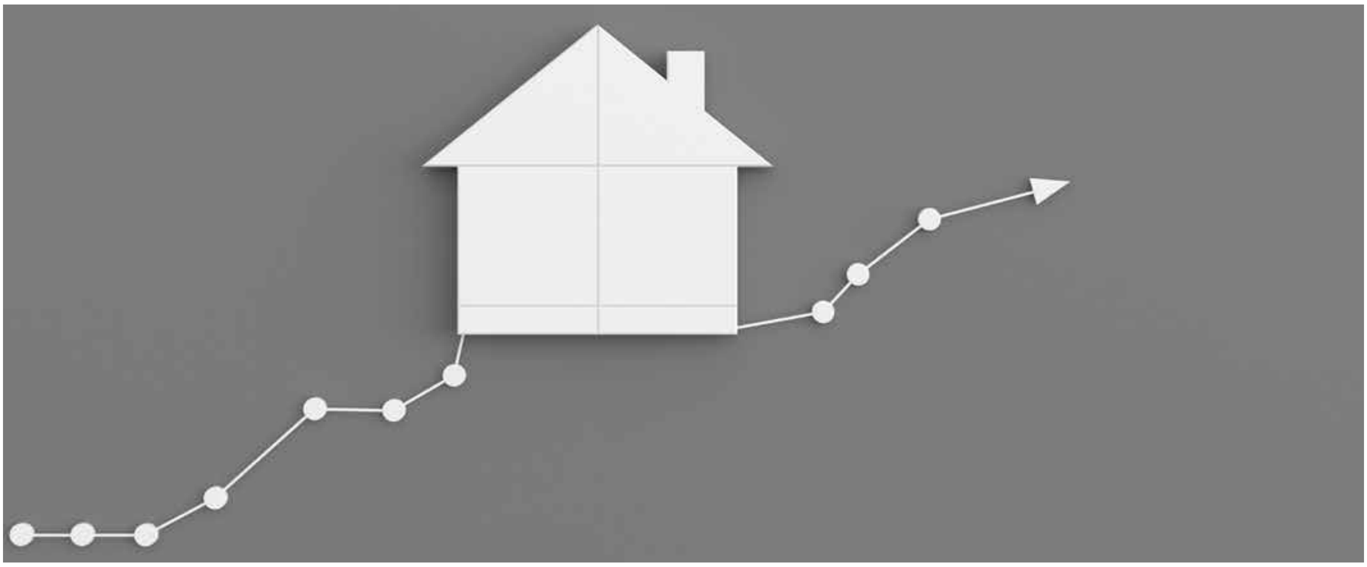


What does the inverse yield curve mean for fixed income investors?

Ashley Burtenshaw

The US interest rate yield curve recently moved into inverse territory, causing concern among some, but not all fixed income investors. This paper looks at what the inverse yield curve means for those investors who have diversified into credit to improve their investment income.

The interest rate yield curve is determined by the market as it weighs collective information to 'bet' on what central banks will do next with their policy rates.

For example, if the US Federal Reserve is forecast to raise rates to 2% in 12 months' time to counter inflation, then any fixed income investment earning less than that could be considered a poor investment. But if the US economy remains weak and the US central bank keeps rates near zero, then a 1.5% yield would obviously remain attractive.

At present, US inflation is expected to rise rather than weaken and most central banks, in particular the US Federal Reserve, are preparing to further raise interest rates - and as a result bond yields are rising. By March 2022, the US two-year bond yield had risen from 0.5% in November 2021 to 2.3%, while the 10-year rate had risen from 1.6% to 2.3%.

Editor's Note: On 4 May 2022, the US Federal Reserve lifted its benchmark interest rate by half a percentage point to a range of 0.75% to 1%, its biggest increase in 22 years.

Once the 10-year rate is less than the two-year rate this signals a flattening of the yield curve, to the point where the gap between these two rates recently moved to an inversion where the 10-year rate of return went below the two-year rate.

This yield curve inversion is often seen by the professional market as a leading indicator of recession, and it often has been accompanied by the US Federal Reserve initially raising interest rates quite aggressively, but then at some point stops and again begins to cut rates as they believe inflation is under control and that they need to prime the economy again as it is weakened somewhat from those higher interest rates; all the while creating uncertainty.

Residential mortgage-backed securities

Residential mortgage-backed securities (RMBS) are floating rate notes that produce income that moves in line with interest rates.

Yields on combined RMBS tend to follow the Reserve Bank of Australia (RBA) cash rate and can also act quite differently in times of stress - such as inverse yield curves. They are often seen as a safer haven asset and can help cushion a portfolio that may be too heavy on equities.

The reason is that RMBS are an investment similar to a bond but are made up of a bundle of home loans bought from the banks that issued them. Investors in RMBS receive periodic payments like bond coupon payments. However, the rate of return is linked to the RBA cash rate.

What does this mean for Australia fixed income investors?

Despite all this uncertainty, our analysis into the domestic mortgage landscape reveals certainty around borrower affordability and no reason can be seen for why the RMBS and asset-backed securities (ABS) sector will not continue to prosper in delivering the highest returns for the risks involved.

A key for fixed income investors today is to invest in credit that has interest-linked income, such as RMBS that have a floating rate of interest that is linked to the RBA cash rate, irrespective of what the yield curve does.

As such, it is important to invest with an established and credible credit manager.

Gryphon has recently been tactically positioning all its portfolios with a strong defensive bias. This was in anticipation of a weaker investment environment including elevated market volatility. Escalating geopolitical tensions culminating in Russia's invasion of Ukraine have compounded an already fragile market facing reduction in central bank liquidity, inflation and uncertainty regarding the pace and timing of interest rate increases. In Australia, add to all that moderating house prices and floods.

Will falling house prices impact fixed income investors?

Much has been made in the press of recent house price forecasts which indicate an expectation of slowing house price growth in Australia and even declines in house prices in 2023.

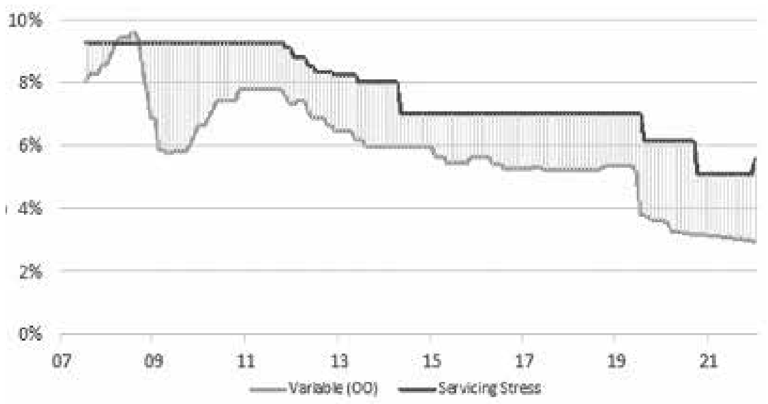
The RBA *Financial Stability Review* (FSR) released in April 2022 shows that it is very focused on the impact of rate rises on the housing market. The report notes that most borrowers are well positioned to weather rate increases having built up substantial overpayments on their loans during the pandemic, citing "strength in household balance sheets has been underpinned by high savings, the strong labour market and rising house prices".

According to the FSR, the average Australian home loan payee is 2.1 years ahead of their mortgage payments. Effectively this means that they could miss over two years of mortgage payments and still be current with their mortgage.

Gryphon's analysis also found that most borrowers are well placed to manage the expected higher mortgage rates, entirely consistent with findings by the RBA and Standard & Poor's (S&P). Gryphon found that while the current weighted average interest rate for the underlying home loans backing their RMBS portfolios was around 3.2%, it was not that long ago in October 2018, that the mortgage rates were around 2% higher at 5.18%.

Another way of thinking about this is that house prices would need to fall by more than 50% before the average borrower in this group would be in negative equity. Of note, prior RBA research has shown that the borrower needs to both be in negative equity and lose their income before they default.

Figure 1 illustrates the correlation between the level of servicing stress [bold line] and falling variable mortgage rates for owner occupied borrowers over recent times.



Source: Standard & Poor's, Firstmac

The average borrower also has substantial savings providing payment buffers against higher interest rates. On average, if the borrower continues to make the same mortgage payments as they have done over the past 12 months, then their savings are sufficient to plug the gap to meet the higher mortgage payments resulting from a 2% increase in interest rates for about 52 months.

Additionally, household incomes have been supported by strong employment growth with an unemployment rate around 4%—historically an extremely low level. Employment is a key driver of a borrower's capacity to make their mortgage payments with a high correlation between borrower arrears and unemployment. The expectation is that higher interest rates will be accompanied by wage growth and a strong employment market ensuring the incidence of financial stress remains low as borrowers are less vulnerable to a sustained fall in income.

The performance of the loans underlying Gryphon's RMBS investments, measured as the percent of borrowers more than 90 days in arrears, has been very good since May 2018. In October 2018, only 0.20% of borrowers were 90+ days past due compared to—an also very low—0.34% in March 2022.

Conclusion

Despite the global challenges and concern about house prices, Gryphon believe that RMBS are better protected now from falls in house prices than they were prior to the pandemic, with many households having saved significantly during COVID-19.

This market volatility is an external market factor unrelated to fundamental mortgage credit. RMBS issuers must pay their RMBS obligations in full prior to being able to allocate cash/profits to pay anything else such as senior unsecured bank debt, hybrids, or dividends.

As a result, RMBS are the least sensitive to inverse yield curve or house price declines. **FS**

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Ashley is co-founder and chief investment officer at Gryphon Capital Investments. He is responsible for the firm's investments, portfolio management and is a member of GCI's Investment Committee. Ashley has over 23 years' experience in financial markets that spans across a broad range of areas, including securitisation in debt capital markets, fixed income trading and funds management.