All the Credit® Episode 35

Transcript

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Female Voice: You're listening to All the Credit, a monthly podcast series brought to you by PGIM Fixed Income an active global fixed income investment manager. And now your host senior portfolio manager, Mike Collins.

Mike Collins, CFA, Host and Senior Portfolio Manager, Multi-sector Strategies: Hello, welcome to Episode 35 of All the Credit, PGIM Fixed Income's monthly podcast. I'm Mike Collins, your host of All the Credit. The residential real estate market, that is the market for your homes and apartment buildings is suddenly in a downturn, and not just in the United States. It's becoming more of a global phenomenon. And what an abrupt turn it's been. I mean just a few months ago, in the Spring and Summer of 2022 housing was red hot. Prices and rents were soaring. Construction, especially for apartment buildings was booming, and aggressive bidding wars were back en vogue ala the mid-2000s. And then suddenly, mortgage rates jumped. Economic growth started to slow. Stock and bond prices tumbled, and sure enough, home prices reached historically unaffordable levels. To be sure, today's housing market and the mortgage market are nowhere near that calamitous precious that they were on just prior to the great financial crisis of 2008, but we should probably all be prepared for lower house prices, lower rents, a decline in home construction and existing home sales and increasing delinquencies and defaults, especially on lower quality mortgages. Albeit, all of these measures are coming from fairly healthy levels. And housing is such an important topic, not just because we all need a place to live. As my old colleague used to say, we're all born short a house but also because of the importance of home prices and construction activity on economic growth, on wealth, and of course, critically, on inflation. Also, of course, fixed income investors, like ourselves, and many of our clients typically invest in all kinds of residential mortgage-backed securities. In this episodes of All the Credit, we'll review the current state of the housing market, including the recent history of home price appreciation and changes in rental rates. We'll discuss affordability issues and our expectations for the looming decline in home prices and rents. Importantly, we'll explore the likely impact of these trends on economic activity and inflation. Finally, we'll highlight our positioning and fundamental analysis with regard to housing and mortgage-related fixed income securities. And our guest for this timely discussion is the head of mortgage credit research at PGIM Fixed Income, and one of our newer colleagues, Kaustub Samant. Prior to joining PGIM Fixed Income last year, Mr. Samant was the head of U.S. Mortgage Credit Research at J.P. Morgan, where he was responsible for forecasting home prices and forming views on all the key residential mortgage-backed securities or RMBS sectors. Kaustub has been routinely quoted in major media outlets, has presented at dozens of industry conferences, and was consistently recognized as the leading analyst in the Institutional Investor and Greenwich Surveys. While at J.P. Morgan, Mr. Samant had also covered nonmortgage asset-backed securities, he received a degree in applied mathematics from Columbia University. Kaustub and I are here to give you all the credit. Kaustub, welcome to your inaugural appearance on All the Credit. We and our clients are really fortunate to have someone with your talent and experience as part of our team. Thank you for joining us.

Kaustub Samant, Head of Mortgage Credit Research: Thank you for having me, Mike. Great to be here.

Mike: Yeah, I mean you're a relative newcomer to PGIM Fixed Income. We've had the luxury of bringing a lot of really talented folks, some from the south side, over the years, and what's already been a really impressive career. Why don't you just spend a minute explaining for our listeners what brought you here and what's some of your initial impressions on so far.

Kaustub: Yeah, sure. So I was on the south side, as you said, for many years, and PGIM was my client. It was actually my first ever client meeting was with PGIM with my current colleagues in our old gateway building. So the relationships goes way back, and my impression of the outside were that mainly PGIM is a place that has very smart, thoughtful people that are also very easy to work with, which you may be surprised is sort of a rare combination within Wall Street, and that's proven to be true when I've joined the place as well. And the second thing is that there is a deep commitment to structured products. So, if you look at not just myself but just my other colleagues and bench trends across the organization, a lot of people have a lot of expertise in this asset class, and that was also very important to me, because it sort of dictates what kind of traits you can do, what sort of position you can put on, and what kind of exposure you get to various asset classes. And so far, it's been a great seven months.

Mike: Yeah, well, thank you. It's been great getting to know you, and we sure do own a big positions across a lot of different securitized or structured products, and maybe at the end I'll just kind of highlight some of those, especially with regard to the housing-related sector. So let's dive in to one of today's hottest topics, of course, is housing. And why don't you just review some of the recent trends. Like since COVID kicked off, you know, the last couple, few years, it's been one of these crazy, red-hot markets. I mean I have so many friends, and young people, young colleagues who have been trying to buy places, and they just keep getting outbid, and it was such a brutal market, and I know the advice I was giving them was just wait, wait, wait, it's got to become more of a buyer's market. What's been the recent path?

Kaustub: Yeah, so as you said, COVID was hugely positive for housing, right, when you make people kind of work from home, you had to kind of stay in your house for much of the day, they end up wanting to buy more house, and that's exactly what sort of happened, right. So, pre-COVID home prices were growing at a steady three, to kind of 5%, and post-COVID, that jumped up to like a 10 plus percent year over year change. So a big change. A lot of that was driven by sort of true organic demand for housing. And at the same time, the other thing that happened was mortgage rates dropped, right. So at the end of 2020, mortgage rates were kind of below 3%, so you could lock in a 30-year fixed rate mortgage for in the high twos. Compare that to where we are today, mortgages rates as of this morning were around 6, 6.3%, right. So nearly 400 base points higher. So guys got sort of the deal of a lifetime. The end result of all of that was that home prices were up about 40% since COVID. So it was a huge move within a relatively short period of time, particularly for sort of a major, major asset class, and that's, I think, sort of not news to anyone that's listening. The other thing that happened, though, was the combination of sort of very strong purchase demand as well as strong refinance demand meant that like mortgage origination shot up. Right. So, if you think about pre-COVID mortgage originations were in like the low $2 trillion, right, every year. In 2020 and 2021, that number hit sort of 4 to 4.5 trillion, right. So a major jump, right. So what that led to was a lot of these non-bank originators going public. They started sponsoring sporting stadiums, and overall, at the end of 2021, it looked like nothing could go wrong. Obviously, sort of the higher rate environment has changed all of that. I think it has put a dampener on HPA and has put a lot of question marks on sort of the strength of some of these nonbank originators and sort of what happened to the originating model going forward.

Mike: Yeah, and HPA is home price appreciation, right?

Kaustub: Yes.

Mike: You know, this is inside baseball stuff, but you know, there is a lot of young folks who listen to these podcasts, Kaustub, and they're always trying to figure out, hey, should I buy or should I rent? Rent rates have also skyrocketed. They kind of lagged during COVID. You couldn't give away an apartment in New York City, and now those rents have kind of doubled back to where they were. I mean what's the better deal right now, and if you had to advise somebody say in their 30s, should they buy or rent, do you have a sense of the affordability? They're both unaffordable in my mind.

Kaustub: Yeah. So J.P. Morgan has a great index on this, and pre-COVID they sort of track where it makes sense to rent versus buy at the MSA level. So that's sort of regional level. And pre-COVID, it made sense to sort of buy in about 30-ish percent of the areas in the country. That number has gone to basically zero. It's like, you know, 5% or something, but basically zero. So it doesn't make sense to buy anywhere, which it shouldn't be a surprise to anybody, right. Home prices shot up 40%. Mortgage rates have now doubled. Yes, home prices are sort of declining, but that decline hasn't been nearly enough to bring back affordability back to where it was pre-COVID. So you're at a stage where buying is very unaffordable, even if you incorporate what you just talked about, which is that when prices have gone up a lot. So it frankly doesn't make sense to buy. I think what rental operators will do in this environment is point to that discrepancy and say that because there is this big gap between rent versus buying, there's a lot more room for us to push rents up, and I think that's the big question for this year. Home prices have already started declining. Is it the case that this locked-out home buyer is willing to pay more in rent, or is the renter also kind of capped out from an affordability standpoint and there's only so much room for rents to go up. I think that's sort of an unanswered question, and there are lots of views on that. But I think that'll be an interesting trend to sort of focus on as we head into 2023.

Mike: And for what it's worth, I think rents have become unaffordable for a lot younger people as well. It's kind of crazy. I spent a fair amount of time in Florida, and they are building multi-family apartments as fast as they can at really high, expensive rental rates, and my sense is, hey, in a year or two from now, we'll have some empty apartment buildings and/or rents will have to come down. But then you see some cities, and I have a daughter who is moving to inner city Seattle, and it looks pretty affordable there. I think some of the real inner cities have kind of been gutted, and maybe that's an exception because of the tech exposure there and the weakness that's gone through. But it's very regional as well. So let's look forward. So we talked about house price was already down a little bit from the peak. That's not surprising. What is your forecast? What's our forecast for home prices over the next year or two? How bad can it get?

Kaustub: Yeah, so everyone now when they talk about home prices, talk about sort of a peak to trough. In other words, like how much will home prices fall from where they were in the peak, which is June of last year, rather now, to kind of the trough, right. And we think that peak to trough decline will be around 15%, which I would say is roughly around consensus, right. We don't think this is a supply driven trough. In other words, it's not like there are a lot of homes coming online. You said there were a lot of apartment buildings coming online. That's not the case for single-family homes. There's not a lot of construction that's coming online anytime soon. So it's not like supply is going up. It's really just that demand has fallen off a cliff. Demand, if you measure it just by existing home sales. So, in other words, number of homes that are sold in any given month are now down to where they were in the middle of the lockdown. So, in other words, when we were all stuck in our houses, just like not sure about whether we can go outside and sales came in at whatever level they came in, that's basically where we are today, just because rates are up a lot. So that demands are structured, and housing has been real, and it's sort of unclear when that sort of goes back up again. We think for that to really resume or to get to a more stable path, you really need housing to be affordable again. I think you've sort of alluded to this affordability crisis, and that's really where we are in single family housing. There's an affordability crisis. So, the way we think about it is simply, you know, incomes grow at sort of what people are projecting, and rates stay relatively flat. So, 6-7%, we're not saying like they go up higher than that, but it's in this sort of range prime level, then home prices are declining by about 15% for that affordability to sort of come in line. Obviously, many sort of wild cards to that, right. There's like if rates go down a lot, the rates rally a lot, suddenly the affordability picture looks much better. Rates growth is much stronger, right. The labor market has been relatively sticky, right. So, the wage growth is very high, then that also sort of solves the affordability crisis. So I think there are lots of wild cards to this, but I think this is a purely demand-driven drop in sort of housing, that we think will happen over the next couple of years.

Mike: And 15% sounds pretty brutal, especially if you bought your house last June, and you're going to be marked down 15%, but what does that really mean for the whole housing stock? I mean prices went up a lot, like you said, I don't know if they went up 30, 40% over the last three years. So where would that leave us, let's say, kind of more on a trend or versus three, four, five years ago?

Kaustub: So that forecast of kind of down 15 will probably bring housing back to where it was in sort of Q1 of 2021. You know, we've already seen, just for context, from its peak in June, we already seen home prices drop 3%. So, we think there's another sort of 10% or so decline in sort of home prices to go before that affordability comes in line. In terms of what it means facing housing stock, it doesn't mean that much for the existing homeowner, right. Like the existing homeowner, for the most part, bought their house during COVID. Yes, they may be flat to where they bought it. So like all the HPA that they realized on paper has sort of gone back to where it was before, but the reality is, they've locked in a really great mortgage. Their mortgage rate is going kind of 3% less than that. Rents are going up. The current mortgage rate is much higher than what it what they've locked in the bank than right now. So I think the challenges that existing homeowners have just nowhere to go. Even if they want to move, it's hard for them to move, half of them to rent, half of them to sell. So you're entering into a situation in housing right now where demand has really come down, but it's not that listings are going up. So new listings are running down 20% year over year. Existing homeowners are simply not putting their homes on the market because they are in these like golden handcuffs if you will.

Mike: Yeah, a little bit of gridlock, right. Like you said, anybody who bought a house in the last three, four, five years is in the money on the home price and on the mortgage rates. I think that's part of what's happening, for sure. What other big trends are you seeing or expecting in terms of like generational, you know, household formation from millennials, everybody talks about, and it seems like there was this kind of bubble coming through where you have a lot of millennials who were in those key household formation years. Or the trends, we've seen big trends through COVID, everybody moving to the kind of sunbelt, and certainly we see that, you know, to some extent, Florida, and away from the big cities, but how would you kind of characterize some of those key trends?

Kaustub: Yeah, so I think the latest data we have on that is from the census around 2021, and that's exactly what you see, right, which is there's this great migration away from some of the major metros, be it New York City, LA, San Francisco, and people are moving to kind of the smaller metros, and those smaller metros, as you say, tend to be concentrated in the sunbelt. I think that trend was also happening pre-COVID, and COVID, like it did for many things, simply accelerated that trend, right. So more people just did it in a very short period of time that created this sort of great migration, right. Now, the question is, did that really continue in 2022, and we don't still have official data yet, but there have been some studies done using kind of postal service data, using adverse changes, and things like that, and it seems like some of the major metros have rebounded, right. So I live in New York City. New York City is pretty safe to say isn't quite as dead as it was in 2021, right. New York City is somewhat back, and that's also what the data shows, that people have started to move back into the city, and that wave of sort of migration outwards has at least slowed a little bit. So I think that's one. You alluded to the millennial wave, and I think that's a really very important trend for housing. Housal formation is still running at like a positive sort of 1.3% over kind of a three-year period. So housal formation is still up. The challenge for the housing market is that that increase in housal formation simply hasn't been matched with housing supply, particularly in the single-family side of the market. Since the financial crisis of 2008, home builders in response to that simply underbuilt homes. That continued for many, many years and still sort of continues. So we think we're net short around 6 million single-family homes in the United States, and so there's this structural shortage of homes while at the same time there is a huge wave of buyers that's going to come online for home buying. That is a great sort of tailwind in the long run for housing. The challenge, though, is that's a long-run tailwind, but in the near term, the housing market has to grapple with higher rates. That makes us feel very good about housing after affordability comes in check. That means that if there are buying opportunities, and I will talk about securities a little bit later, the buying opportunities, we feel good about buying them in the long run, but in the near term, from a housing market perspective, the sort of structural demand doesn't necessarily help because these same millennials simply can't afford to buy homes right now.

Mike: Yeah, it's really fascinating how this whole volatility around COVID with the shutdown, the reopening, the inflation, the price increases on everything from rents to food and cars and commodities. And now, it's all reversing and kind of trying to find a normal equilibrium level, and housing is certainly in the crux of that. So maybe once we get through this two-, three-year period, and hopefully that at some point normalizes interest rates from five down to a lower, more sustainable level, you get a better equilibrium. Like you said, and the equilibrium is not that bad for housing. It's a kind of a sustainably decent market.

Kaustub: I think the question, when you look at a lot of these COVID trends, right, is are they a blip? Are they just simply like it's a one-time thing, people got scared of COVID and moved out of the major metros, as we just talked about, was that just a blip? Or is that going to continue? I think if you ask home builders, multifamily builder, they'll tell you that a migration to sunbelt will continue because that's where they're building. So that is a bet that people are making, and it's unclear whether that continues or not. And the second question is that if it's not a blip, is that just a pull forward of demands? In other words, even though there was this organic demand for home buying during COVID, was that just people that were already on the fence about buying, right? They would have bought over the next five years, next six years, and they simply made those purchase decisions during COVID because that's what they were forced to do, and if that's the case then even if rates come down, so rates are no longer at 7%, 6%. They come down to kind of 5 or 4 in terms of mortgage rates here, 4 or 5%, it's possible that like home demand doesn't really rebound, right. It's not like there's this massive rebound in sort of home demand simply because all the people that kind of wanted to buy in the near term already did during COVID, and you now sort of need the next wave of home buyers, those guys that are going from renters to buying to come back online. So I think there are very interesting questions about housing in the next few years that is somewhat being hidden by higher rates, right.

So rates are very high. Demand is falling. And you're not getting a chance to sort of analyze these sort of broader COVID trends as much.

Mike: All right. So, let's turn to the big picture. I know you're a bottom-up analyst, and you're analyzing a lot of mortgage debt portfolios, but the big picture on the economy, I know a lot of the listeners are interested. If house prices are down and if housing activity, like I said, construction and existing home sales are way down, what does that mean for GDP? What does that mean for growth this year? I know we've already seen a decline in construction activity last year, and it hit GDP last year by close to a percent, right. So, we only grew at like just above zero last year, and it would have been 1.5 or 2 maybe if housing held up, and what's the expectation for this year?

Kaustub: All right. This is where I'm going to pretend to be an economist, because that's not kind of my background, but this is what an economist tells us, and there are assumptions around home prices, on rents, you know, they say that they expect a drag on real GDP of around, you know, one and a quarter percentage points, and they expect most of that to come directly from, as you said, residential investment. Of course, housing is a big part of the economy, and so if home prices drop, housing activity slows, that'll effect GDP, and just sort of coming back to sort of what we talked about, I think just touching on housing activity for a second, the other challenge, I think from a policy standpoint, from a housing policy standpoint is that as rates have moved up, right, as you said, investment in housing has gone down. So the one thing that we're seeing is that single family housing starts, have started to decline. In other words, like future supply of housing, which was looking kind of decent during COVID because rates were really low and people were building homes, that started to come offline as well. In other words, fewer people are building, fewer homes are being built. So going forward the structural shortage of housing will become more, will just increase. So that it's a challenge from a housing policy perspective. It's great for home prices and great if you're investing in homes, but I just wanted to touch on that before we sort of continue in the broader macro story.

Mike: Yeah. So, in the near term, it hit GDP by about a percent last year. It will hit GDP potentially by about a percent this year, and I know our internal forecast for GDP this year in the U.S., kind of like just a little bit above zero-ish, and that includes the housing deceleration. So if it's worse, maybe it goes to zero. If it's a little bit better, maybe it goes to 1 or 1.5, but either way, we're kind of stuck, and then how about the inflation? I know we just recently got some inflation numbers, and there was a lot of debate about the shelter component to CPI or to inflation, and if you look at that component, it just keeps going up and up and up, but you're telling us home price is already falling, and rents, on a month-over-month basis, in many places are falling, and that's not captured. I know all the economists are trying to come up with these new alternate measures. We looked at one today. It was, you know, core, services, inflation, x shelter. We're only starting to strip things out, and that is actually running with a one handle right now, x shelter on kind of a three-month annualized basis. So that is pretty wild, right. So what is your view on a shelter component with regard to inflation and what's forward looking?

Kaustub: There does tend to be a lag between sort of rents and that shelter component tends to be kind of a six-month lag or so. As you said, rents have started to come down. So now that drop in rents has been more muted than the drop in home prices. You know, home prices, like I said, have gone about 3% peak to trough already. Rents are maybe at close, down maybe 0 to 1%, right, depending on what sort of index you kind of look at. And there's a lot more debate. I think there's a consensus on the single-family housing side that this drop in home prices is a turn of a cycle and that home prices are going to continue dropping, right. That's sort of the consensus view. I think when you look at rents, there is less consensus along those lines. There is a lot of debate that what you're seeing in the moderation in rents is simply seasonality. In other words, it's like winter is when we get most of the data. People simply don't rent in this time. People rent in the summer and spring, and that's when we're going to see rents go back up again. And so, consensus for rental is not that rent is going to keep on going up at 10% or so. Rents are going to go up by about 2 to 3%, right. So that's the consensus view. That is the view of our multi-family analysts, and I think one part of that sector, which may be more challenged is sort of the higher rent property. So exactly what you kind of talked about at the start, which a lot of construction that's happening is happening in those sort of class A properties, those higher-end, higher margin properties, and maybe that is too much construction then kind of rents come down in that specific segment, but overall, people remain fairly bullish on kind of rent growth, but it's definitely going go come down, so that should translate into kind of lower shelter inflation over time.

Mike: That's great. Yeah, I'm sort of, like maybe I'm a little axed or bias, but I feel like rents on average will be lower, you know, in six or 12 months from now than they are today on average, and that's not consensus, like you're saying. So, it is a big variable, an uncertain variable that could have a big impact on inflation and confidence and demand and all that. So, we'll see how that plays out. Maybe we'll do a follow-up later in the year on that. So, for now let's get into your day job cost. You know, you are a senior analyst effectively following, and you have been for decades, mortgage related, securities, mortgage debt, mortgage loans. I just spoke with a lot of the senior folks, executives of our company, and they're asking me, oh, are we going to start seeing defaults and delinquencies among some of these residential mortgages? And is this going to be another OA or is it nothing near that, and is there a problem? Are there some looming vulnerabilities in the mortgage market, and how do you see the underwriting on these securities in general? Where do you see some of the vulnerabilities? How would you compare this to the brutal problems we had 15 years ago?

Kaustub: So the good news for the mortgage market is the presence of the U.S. government, and depending on who you are, some people will say that's not a good thing. Some people will say it's a good thing. But the reason why I say it's a good thing for us in terms of where we stand today is that the labor market, as it deteriorates, should it deteriorate, would likely result in higher DQs, in higher delinquencies, right. More people go delinquent on their mortgage if they are losing their job. It's pretty straightforward. Now, the good news for mortgage credit is like if you look at where that risk is housed for the most part it's housed in the U.S. government. So, if you look, if you think about that subprime borrower that created that 08' crisis, or that led to that 08' crisis, those loans really originated in private-label securitizations that were bought by the street by investors all over the world. This time around, most of that risk, I would say all of that risk, really is sitting with GMA and FHA at the U.S. government. What we're left with, in terms of what we can invest in a day-to-day basis is either the super prime borrower that's sitting on bank portfolios, in other words like J.P. Morgan and Wells Fargo, all of those big bank originators that originate mortgage on a daily basis, they traditionally look at their own clients, the originate with them. They originate in the highest quality bar possible. So that's a very, very low default risk. And then the second place that you could invest in is in the GSC. So, Fanny May and Freddie Mac, they have sort of near prime-ish borrowers, right. So not quite high prime but still very, very high-quality borrowers, and you can sort of get exposure to credit risk that way. But for the most part, in terms of the mortgage-backed security space, you simply don't have exposure to the borrower that's most vulnerable, and at a high level, I think that's a positive thing. If you look at the system as a whole also, there's just simply less leverage in the system, right, so the borrower is less levered. The end investor, who is allowed to put a lot of leverage either through the structure, in other words, the structure, the structure, the security itself, or they were just doing a lot of repo, there's less leverage that way as well. So the system is less leveraged. And then, obviously, I think you sort of talked about this, but underwriting standards are very high, right. So, the sort of simple fact is if you go today and try and get a mortgage, you will, I think, A, be surprised at how much you're asked for in terms of just data. And I think the second thing you'd be surprised by is just how much of that data is simply automatically pulled from either your checking account, from your employer, from online portals, right. So, there's simply less ability for there to be that same level of sort of broad or, you know, manual errors that were created in a way because of sort manual underwriting. In other words, a loan officer simply putting something, writing something in the form. Well, that is just not happening as much anymore, right. So, the systemic improvements that you've seen in underwriting plus all these other things that I've talked about, I mean that there's far less risk in the system today than there was in 2008. And there are many other things that we can kind of talk about, but I don't want to bore your audience with all of the details. I think for the most part, we feel much better about mortgage credit today than we did in 2008.

Mike: I totally concur with that. So, we're a big global shop. A lot the listeners are outside the U.S. right now. Are there any hot points, you know, I know places like Sweden and the Netherlands, even the UK, Canada, Australia, all these places are undergoing these giant rate increases like we've seen here, and they all have unaffordable, probably overvalued housing stock, and they're starting to see some deceleration and draw downs in home prices there. You know, what is your view on kind of the global context, any hot spots you're worried about?

Kaustub: Yeah, look, I think the U.S. homeowner is in a great spot. The current homeowner is in an awesome spot. They've locked in a 30-year fixed-rate mortgage at 3%. That's a deal of a lifetime. It may prove to be a deal of a lifetime. I think the challenge in the rest of the world is in many countries the way the mortgage market is structured is there is a fixed rate period of typically two to five years, and then the mortgage rate resets higher based on where rates are today. In other words, a borrower in the UK may have locked in the mortgage at 2% five years ago, and their rate may be up for reset today, and because rates are significantly higher, right, their mortgage rate overnight is going to jump, and that borrower essentially in most parts of the world, in many parts of the world is going to have a payment shock. And the question is, when you combine that payment shock with a cost-of-living crisis, in other words as inflation and everything prices are going up, that is not a good recipe for the housing market in many of those countries, right. So, it's -- a lot of those countries have the same sort of home price increase that we did in the U.S., like you said home prices are coming off the boil over the last several months in those countries as well, but I think the added challenge is simply that as home prices start to go down and rates stay elevated, do you get existing homeowners selling, simply because they can't afford their house? And that exacerbates the problem. And I think that's less of a risk in the U.S., but we think that's more of a risk in other parts of the world, and that sort of gets us concerned when we look at mortgage credit exposures outside the United States. It's just the structure of that mortgage market.

Mike: And that's certainly been one of the big risks that we've been highlighting is, you know, the longer these central banks stay really hawkish and keep rates really high, the more it will start weighing on different components, different borrowers, different asset classes, you know, homeowners.

Kaustub: Yep.

Mike: Subprime borrowers, consumer loans, and you're starting to see even some deterioration among consumer loans, auto loans, credit card loans already, so I think there is a little more pain to come around the world. So that's really interesting. Now that kind of wrap up with our positioning within the mortgage book, if you will, that you kind of help analyze, have we made any shifts in terms of, within the capital structure, trying to get maybe more defensive with this view that housing might be on a little bit of a downturn.

Kaustub: Yeah, so I think our goal always, right, is to connect sort of the macro view ultimately to positions and to bonds. And so, the starting kind of second half of last year, the thing that we started to do was simply become more defensive as you said. Well, there are two ways you can do that in mortgage credit. One of them is you can move up the capital structure. In other words, within the same transaction by high-rated bonds that have more credit protection, so even if delinquencies do rise, you're less likely to take that right down. So that's one. And the second is, we also looked at more or sort of rotated into more sort of seasoned positions. So, in other words, looked at securities, which originated earlier in this cycles, where the borrowers have more embedded sort of equity. So the home prices have gone up a lot. They've locked in this 3% mortgage. Even if the labor market deteriorates, they're going to try their hardest to ensure that they don't default, right. Because these are alternatives aren't that great. Those are the two changes that were made, again, linking up our macro view to kind of securities and sort of how we position ourselves.

Mike: You know, we have over 100 billion in multisector portfolios. We don't have a lot of nongovernment guarantee, and all this stuff Kaustub does is kind of this nongovernment guaranteed stock, whether it's private label or issued by Fanny and Freddie, but they're credit risk transfer bonds that are kind of subordinated. And we don't have a lot of it, and we have gotten more defensive there. Interestingly, on the agency mortgage-backed securities the government guaranteed, you know, Fannie, Freddie, Ginnie stuff that Kaustub doesn't cover, we have a separate agency mortgage-backed securities team. We were really underrate that, really defensive, more from a relative value standpoint. They weren't offering any incremental spread over treasuries, and they got killed throughout 2022, and we bought a lot of them, kind of late last year, and have covered a big part of that underweight across a lot of different portfolios, really just from a, and it's a really high-quality, like I said, government guaranteed liquid asset class that was suddenly offering a lot of incremental spread. So, what that's worth, a little bit off the top. So, any closing remarks, Kaustub, before we sign off?

Kaustub: Yeah, look, I think it's a super interesting time for housing and for residential real estate. You know, everything, like I said, home price kind of goes down. I think it's going to create a lot of opportunities, and I think because of our place in the market in terms of our reputation, the people that we have and our team, I think we're best poised to take advantage of it. This is challenging time. I kind of look forward to what 2023 brings. So, I think it's a very exciting time for us at PGIM.

Mike: Yeah, I mean, you know, you don't just get defensive. Maybe there's opportunities to buy cheaper securities that are going to pay off, right. So hopefully we're well positioned for that. So thank you, Kaustub Samant, for all those thoughtful insights on housing and mortgage markets, and thank you for helping us and our clients navigate what's likely to be a really volatile market going forward and help ensure that we're invested in the right security. So, everybody listening, again, please check out our website, PGIMFixedIncome.com for all of our latest thought leadership. We recently posted our first quarter 2023 outlook. Please look at the bond blog, which we call the bond blog. You can easily find it. We just put out a couple really interesting pieces. One is called Yield is Destiny, bonds are back, right. And Robert Tipp wrote that, and it's really a function of, hey, yields are really high right now. This may be a generational opportunity to actually have more public fixed income in your portfolios. And then we have one that's related to today's topic, and if you want to dive more into the non-U.S. kind of European housing and real estate markets, we put out a paper a little bit ago called The House Divided, Finding Quality in European Real Estate. So that's something that's very topical. So, with that, we'll sign off. Thank you for listening.

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