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EAGLE EYE
SPECIAL REPORT
BY EAGLE COMPLIANCE, LLC

At the start of each week the Fiscal Agent provides a commentary covering recent developments in the markets, rate trends, and information related to the sale and funding of the 504 debenture pools. Eagle Compliance encourages everyone to take advantage of the information provided in the weekly postings.

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Weekly Market Commentary for the week of February 22, 2022

The February 2022 SBA 504 debenture offering was conducted during tough capital market conditions that featured a notable rise in Treasury yields. The benchmark Treasury 10-year note yield at pricing on February 10 was 1.99%, 26 bps above the level from January. In addition, heavy competing supply and notably wider spreads over Treasuries across all bond market sectors required an additional 12 bps on the two debenture rates versus January to place the debenture pools with investors.

There are a number of indicators that we look at to get a feel for the market environment as we approach each sale, and then as we experience the sale. Here's a list of the most important indicators below, and what the changes from the January sale meant for the February sale – bullish or bearish.

- *Treasury Yields*: Bullish, as noted above, yields were notably higher so a higher coupon resulted for investors.

- *Yield Curve Slope*: Bearish, sharply flatter. In fact, the 7-year Treasury yield equaled the 10-year Treasury yield. This is an esoteric but important phenomenon that applied pressure to widen spreads to Treasury for the 504 debenture pools (DCPCs). New DCPC's expected average lives are always shorter than the Treasury pricing benchmark maturity. For example, in February the new 25-year DCPC pool was expected to paydown over an average of 8 to 9 years, but the pool was to be priced off the 10-year Treasury benchmark.

  When the curve flattens, therefore, if the spread of a DCPC pool over the 10-year pricing benchmark is not widened, the resulting DCPC coupon over the shorter average life point on the Treasury yield curve will contract. So most often, when the yield curve flattens a lot, the DCPC spread to 10-year pricing benchmark must widen to compensate investors. Esoteric it may be, but we must track and measure this relationship all the time.

- *Wider Spreads Away*: Bearish, in addition to higher Treasury yields, spreads over Treasuries were wider m/m in government agency current coupon MBS (+30 bps), new issue agency CMBS

(+12 bps) and the main investment-grade corporate bond credit index (+15 bps). These sectors provide the main competition for DCPCs. To compete, spreads to Treasuries on the DCPCs had to widen 12 bps m/m.

- *Supply*: Bearish, very heavy new issue in agency CMBS and private label CMBS, so there was lots of competition for investors' eyes.
- *504 Prepayments*: Bullish, 504 debenture pool prepays remained high in a rising rate environment. This gave existing DCPC investors opportunity to reinvest the paid-down cash at a higher coupon.
- *Rate Volatility and Market Psychology*: Bearish, investors were skittish as the Fed prepared for rate hikes and portfolio runoff. Expected 30-day volatility in Treasury yields was at the highest level since the March 2020 pandemic market shock.
- *Macro Backdrop*: Bearish. 7-plus percent US consumer y/y inflation rate and close to war with Russia.

The 504 Debenture Rate Change. In terms of the m/m change in the coupon for investors and, therefore, the interest rate for the borrowers, the 38 bps monthly increase was one of the largest in some time. The last time there was a larger monthly increase was June 2009 (52 bps). There were ballpark increases in March 2021 (29 bps), November 2016 (36 bps), and January 2010 (33 bps). As large as that 38 bps increase was, it was not quite one standard deviation (43 bps) of the monthly change when measured since the beginning of 1999.

Understanding the Backdrop Is Key. The Fed is preparing to exit from a couple of years of massive quantitative easing and near-zero policy rates, at a time of the highest inflation rates since the beginning of the '80s. *We've never experienced this combination of events before in the markets.*

There was a predictably strong reaction in the fixed income market, and key interest rates quickly increased. For example, the Freddie Mac 30-year mortgage rate is now near 4% (3.92% for the February 17 survey, that does not include an assumed 0.8 pt. in upfront fees). That rate is up 81 bps since the end of 2021. By comparison, the 504 25-year debenture rate increased by 57 bps since the December offering.

Thus far, however, it has been a *very orderly* market move there has been no experience of a destructive *taper tantrum* as we saw the first time the Fed tried to exit from quantitative easing on the other side of the global financial crisis.

Calendar. This week here are the major economic releases on schedule:

Thursday February 24 2022			Actual	Previous	Consensus	Forecast
08:30 AM	US	GDP Growth Rate QoQ 2nd Est Q4		2.3%	7%	
Friday February 25 2022			**Actual**	**Previous**	**Consensus**	**Forecast**
08:30 AM	US	Personal Income MoM JAN		0.3%	-0.3%	0.3%
08:30 AM	US	Personal Spending MoM JAN		-0.6%	0.6%	
08:30 AM	US	Durable Goods Orders MoM JAN		-0.9%	0.5%	-0.1%