



Perspectives on Securitised Credit

Second Quarter 2022

KEY INSIGHTS

- Weak risk appetite, interest rate volatility, and supply headwinds led to another challenging quarter for securitised credit investors.
- Improved valuations and generally strong fundamentals are balanced with an increasingly uncertain timeline for spread recovery.
- If inflation pressures abate and the Fed turns less hawkish, areas hard hit by interest rate volatility and duration extension concerns should be prime beneficiaries.

Following a dismal first quarter, conditions for securitised credit markets remained challenging over the past quarter as investors continued to face rising Treasury yields and widening credit spreads.¹ Yields rose across the Treasury curve as the market reacted to hawkish policy responses from the Federal Reserve in the face of stubborn inflation. With financial conditions tightening, credit spreads broadly widened amid mounting concerns that the Fed's efforts to tame inflation will tip the economy into recession. Lower-rated securitised tranches suffered larger price declines than higher-quality tranches in light of macroeconomic worries. And segments with longer spread durations² struggled as unrelenting inflation led to monetary policy uncertainty, fuelling interest rate volatility, which incited credit spread volatility.

A Difficult Quarter Across the Opportunity Set

As seen in the previous quarter, securitised credit sectors produced negative total returns and underperformed similar-duration Treasuries, although "safe haven" U.S. government bonds also recorded losses. After gaining traction in late March, credit spreads resumed widening in April and widened further in May before stabilising in June. Securitised markets generally lagged both sell-offs and relief rallies in the investment-grade corporate credit market, due in part to their smaller investor base and thinner liquidity.

Asset-backed securities (ABS) were among the best-performing major fixed income sectors, with total returns



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Past performance is not a reliable indicator of future performance.

¹ Credit spreads measure the additional yield that investors demand for holding a bond with credit risk over a similar-maturity, high-quality government security.

² Duration measures the sensitivity of a bond's price to changes in interest rates. Spread duration measures the sensitivity of a bond's price to changes in its credit spread over U.S. government bonds with a similar maturity.

of -0.91%, trailing duration-matched Treasuries by just 0.11%.³ Esoteric areas of the ABS market tended to experience greater spread widening than the credit card and automotive-related debt that dominate the benchmark.

With their longer duration profile, non-agency commercial mortgage-backed securities (CMBS) lost 3.19% in absolute terms, equating to excess returns of -1.08% versus comparable Treasuries.⁴ Lower-rated conduit tranches and single-asset/single-borrower (SASB) securities, which are not part of the benchmark, underperformed amid challenging liquidity and weak risk appetite. With the significant rise in interest rates, the market priced in the likelihood that maturity dates for many CMBS will be fully extended, delaying principal payments to investors.

The diverse non-agency residential mortgage-backed securities (RMBS) market broadly generated negative results for the period, hurt by interest rate volatility, constrained liquidity, and lengthening durations as mortgage rates ascended to their highest level since the global financial crisis. Higher-quality credit-risk-transfer securities (CRTs) issued by the government-sponsored housing enterprises (GSEs) lost ground but fared better than CRTs sitting lower in the capital structure. Nonqualified mortgage (non-QM) bonds—particularly the lower-rated variety—struggled amid rampant supply and concerns about duration extension and the health of the U.S. economy. Spreads for prime RMBS assets widened to a lesser degree than other mortgage credit sectors due to minimal credit concerns, but prime mortgage bonds still grappled with interest rate volatility and extension risk given their longer duration profiles.

Collateralised loan obligations (CLOs) produced negative returns across the capital structure. The broad CLO sector lost 2.37% over the quarter, with lower-rated tranches producing the deepest declines as their larger income streams were insufficient to offset price declines.⁵ Bank loans, which had been stalwart performers earlier in the year when interest rate risk was investors' main concern, experienced a reversal of fortune in May as recession concerns became more prominent, prompting outflows from loan funds across the industry. The repricing of bank loan collateral, along with generalised risk aversion and a less supportive technical backdrop, weighed on the CLO market. Performance dispersion also increased between CLO managers, benefiting well-known entities with stronger track records at the expense of lower-tier managers with weaker reputations.

Heavy Supply, Mixed Demand

New issuance remained robust despite the unwelcoming macro backdrop. Indeed, the volatile rate environment motivated issuers to expedite bringing supply to market and transfer interest rate and credit risk to investors. The heavier-than-expected supply was generally consistent with 2021, a record-setting year for securitised product issuance. With investors growing more cautious and having ample supply to choose from, demand was mixed and dependent on collateral and issuer quality, pricing levels, and other deal-specific factors.

At midyear, ABS gross issuance for 2022 totaled USD 141 billion, about 9% higher than at the same point in 2021.⁶ Issuance of automotive-related debt, the largest ABS segment, was roughly on par with last year. Credit card and esoteric ABS issuance saw meaningful year-to-date increases, while new student loan issuance abated. Higher rates, payment moratoriums, and

the potential for a student loan relief package from the Biden administration have discouraged student loan refinancing, reducing loan collateral.

Private-label CMBS issuance was up 12% year-to-date at USD 75 billion. Similar to the trends from 2021, SASB and commercial real estate CLO issuance surpassed that of the more conventional conduit segment, providing investors with more abundant supply of floating rate securities.

The pace of RMBS issuance was very heavy through April before slowing significantly as the higher rate environment suppressed mortgage origination volumes—a trend that is expected to continue in the second half of the year. Widening spreads also caused some issuers to sell loans via whole-loan deals rather than securitisations. Total year-to-date issuance reached USD 102 billion, down slightly from midyear 2021. Issuance of non-QM bonds surged, a factor that pressured spreads wider, as securitisation remained many issuers' sole funding channel. Issuance of CRTs also spiked as the GSEs packaged large volumes of home loans originated last year, and Fannie Mae made up for its absence in the market for much of 2020–2021. While agency investor issuance also boomed, other areas—such as jumbo, re-performing, and nonperforming loans—saw marked declines.

True new CLO issuance declined 13% year over year at USD 72 billion as of June 30. However, including refinancing and reset transactions, issuance stood at USD 94 billion, down 57% compared with the first half of 2021—a reflection of the starkly different rate and risk environment as well as the record level of CLO issuance that occurred last year. On the demand side, large domestic and Japanese banks pulled back from the U.S. primary market. For Japanese banks, higher hedging costs

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³ As measured by the Bloomberg ABS Index.

⁴ As measured by the Bloomberg Non-Agency Investment Grade CMBS Index.

⁵ As measured by the JP Morgan CLOIE Index.

⁶ Source for ABS, CLO, CMBS, and RMBS issuance totals: JP Morgan. All totals in U.S. dollars.

and better relative value in Europe on a currency-hedged basis were factors in the reduced participation of these large-scale CLO buyers.

A More Neutral View on Securitised Credit From a Multi-sector Perspective

During the quarter, our securitised team tempered its conviction in the asset class from favourable to neutral despite cheaper valuations and solid fundamentals. Fundamentals in the consumer sectors that predominate securitised credit markets remain strong, even as recession fears grow. The team remains encouraged by subdued delinquency rates, low loan-to-value ratios, strong underwriting standards, a still-tight labour market, and excess savings built up during the pandemic. However, improved valuations and generally strong fundamentals are balanced with an increasingly uncertain timeline for spread recovery—especially in areas with longer spread durations (e.g., RMBS and some CMBS) that are more vulnerable in a spread-widening environment. We are also mindful that the Fed is actively aiming to tighten financial conditions, and liquidity—which is usually in shorter supply in securitised markets than in corporate markets—will undoubtedly be challenged during periods of heightened risk aversion.

That said, for long-term, yield-focused investors, the current environment offers some of the highest yields and spreads since the global financial crisis. And, in some relatively new segments such as CRTs, the highest levels ever outside of early 2020 when market liquidity froze and risk premiums spiked at the onset of the global pandemic.

In a highly uncertain environment, a general theme within diversified portfolios has been to focus on shorter-duration, high-carry segments of securitised credit markets given limited catalysts for meaningful spread tightening in the near term. Our securitised team is warier of longer-spread-duration assets that are likely to experience greater volatility in a risk-off event. We anticipate turbulence

over the next few months due to myriad macro concerns and therefore favour more stable sources of yield. Positively, supply is expected to shrink in the second half of the year, providing a technical tailwind. And if inflation pressures begin to abate and the Fed turns less hawkish, areas that were hard hit by interest rate volatility and duration extension concerns should be prime beneficiaries.

Sector Highlights

- **ABS:** Consumer credit metrics for ABS borrowers remain strong, with credit card delinquency and loss rates still below pre-pandemic levels and household savings still well above 2019 levels. ABS are relatively less affected by higher rates, as the majority of the sector's outstanding bonds are fixed rate. However, some ABS subsectors could be more exposed to extension risk as the higher rate environment makes refinancing less likely at the anticipated repayment date. Auto loans across the investment-grade rating spectrum are a favoured area. These bonds offer relatively short terms, attractive absolute spread levels, and valuations that are at historically attractive levels relative to comparably rated corporate credits.
- **CLOs:** Given a historically elevated amount of loans rated B-/B3 by the major rating agencies, downgrade risk is heightened with the economy slowing and borrowing costs rising. Ultimately, however, idiosyncratic factors will likely be the primary drivers of downgrades and defaults. As such, our securitised team works closely with our high yield team to analyse the fundamental strength of underlying bank loan collateral. We have been favouring more senior CLO tranches (AAA/AA rated), which offer attractive valuations relative to comparable areas of the securitised credit and corporate markets. Lower-rated tranches still have room for spreads to widen if an economic contraction transpires and are likely to face higher spread volatility over the course of the year.
- **CMBS:** Certain lodging and office sectors face heightened risks from a recession scenario, and we are cautious on conduit bonds with larger concentrations in retail and conference-based lodging loans. Conduit deals tend to hold lower-quality underwritten loans relative to the loans backing SASB deals. SASB bonds also allow us to be more selective in commercial real estate exposures in an uncertain macro environment. Our team continues to view multifamily properties favourably despite expectations for rent growth normalisation and expense increases, and we believe that the long-term fundamental tailwinds for industrial properties remain intact. We continue to evaluate office deals on a case-by-case basis, with a preference for higher-quality assets in secondary growth markets as well as assets that have experienced significant price and/or rental rate appreciation since origination. Likewise, the team is focused on strong hotels that may be less affected by a cyclical downturn.
- **RMBS:** We remain broadly constructive on most areas within the sector, including single-family rentals (SFRs) and CRTs, as mortgage credit fundamentals remain solid despite an expected deceleration in home price appreciation. SFRs offer attractive yields and tend to be more insulated from interest rate-driven extension risk. SFRs should also benefit from strong demand for rental housing, with home purchases becoming less affordable. CRT valuations look quite attractive, though we prefer the top of the capital structure in new issue transactions given potential volatility. Though they are longer in duration, we believe certain prime jumbo and agency investor bonds from strong issuers offer attractive value. Although new issue valuations are compelling, we have become less convicted on the non-QM space due to liquidity concerns and issuer-specific factors.

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