Will 2020 Be the Year of Securitized Credit?

The outlook for the sector is looking up.

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Corporate credit has had a very good year. Record-low interest rates have encouraged firms to issue huge amounts of debt, which has been eagerly snapped up by yield-thirsty investors. At the end of November, the Bloomberg Barclays US Corporate Bond Index had returned 14.8%, an impressive recovery from its 2018 loss of 2.5%. However, about two-thirds of the strong returns were driven by the significant decline in government bond yields, leaving corporates vulnerable if government yields reverse part of their fall. Additionally, investment-grade corporates are not cheap: With spreads[1] around the 20th percentile of their historical range, there are fears that the sector could be hit if there are any jitters over the global economy.

In our funds, we recently diversified some of our corporate exposure into securitized debt instruments, which pool together contractual debt such as residential mortgages, commercial mortgages, car loans, student loans, and credit card debt. The securitized debt sector has benefited over the past 10 years from consumer deleveraging and more robust structuring and currently has generally higher credit ratings than corporate debt. It also offers attractive spreads and short duration profiles, which should provide some protection against a rise in government yields. What's more, the securitized debt sector has historically displayed a moderate correlation to corporate debt and other risky assets, making it an attractive avenue for diversification and potentially reducing overall portfolio volatility.

Non-agency residential mortgage-backed securities (RMBS) look particularly interesting. The correction in the U.S. housing market in 2006–2007 was one of the major causes of the global financial crisis; but since then, U.S. households have undergone a tremendous amount of debt reduction. The rebuilding of the RMBS sector is still in its infancy, but the combination of relatively low leverage, beefed-up

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[1] Credit spreads measure the additional yield that investors demand to hold a bond with credit risk relative to a comparable-maturity Treasury security.

protections, and high expected compensation per unit of credit risk will likely gradually attract more investors seeking to diversify away from corporate debt. Overall, we prefer non-agency RMBS to agency RMBS (which are government-guaranteed securities, meaning there is no credit risk) because they have lower convexity risk, meaning their prices tend to fluctuate less when interest rates change.

In the commercial mortgage-backed securities (CMBS) sector, single asset single borrower (SASB) loans are interesting. SASB transactions involve the securitization of a single loan, which is typically collateralized by one very large, exclusive property or a small pool of properties. These loans tend to have very low leverage and are generally high in quality and offer some very solid deals, even at lower credit-quality levels.

Collateralized loan obligations (CLOs)—portfolios of leveraged loans that are securitized and managed as funds—have been in the news a lot recently. In recent months, yields on BBB and BB rated CLOs have rocketed, while those on similarly rated corporate bonds have dropped, creating the widest spread between the two asset classes since 2016. We cautiously added some exposure, but we are double- and triple-checking our fundamental analysis. Leveraged loan defaults are expected to rise next year, so lower-rated CLOs may be more vulnerable than their credit ratings would suggest. Higher-rated (e.g., AAA) CLOs, which should be safe from the leveraged loan storm, are also interesting, though they come with worse liquidity than a typical corporate bond.

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