



Pockets of Value Still Exist in Securitized Credit

Securitized sectors also provide useful diversification benefits.

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KEY INSIGHTS

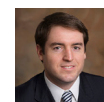
- The securitized credit sectors offer pockets of relative value, particularly in areas that have not yet fully recovered from the selling pressure in March.
- Securitized credit also provides diversification for a fixed income portfolio, including relatively low historical correlation with investment-grade corporate credit.
- We are positioning our exposure in securitized credit to potentially benefit from an expected robust economic upturn in 2021.

The securitized credit sectors offer pockets of relative value, particularly in areas that have not yet fully recovered from the selling pressure that swept financial markets at the onset of the coronavirus pandemic in March. Securitized credit, which includes commercial mortgage-backed securities (CMBS), non-agency residential mortgage-backed securities (RMBS), asset-backed securities (ABS), and collateralized loan obligations (CLOs), can also provide attractive diversification for a fixed income portfolio, including relatively low historical correlation¹ with investment-grade corporate credit. Relying on the research of our team of

credit analysts, we have been finding opportunities in all four segments of securitized credit.

Credit Spreads Still Wide in Some Areas

Unlike investment-grade corporate bonds, where credit spreads² have almost completely recovered from their dramatic widening in March, portions of securitized credit still trade at spreads that are meaningfully wider than where they started the year. For example, at the end of December 2020, five-year senior ABS backed by rental car revenue traded at 145 basis points (bp)³ over the swap rate,⁴ which was still 43 bp wider than



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¹ Correlation measures how one asset class, style, or individual group may be related to another. A perfect positive correlation means that the correlation coefficient is exactly 1. This implies that as one security moves, either up or down, the other security moves in lockstep, in the same direction.

A perfect negative correlation means that two assets move in opposite directions, while a 0 correlation implies no relationship at all.

² Credit spreads measure the additional yield that investors demand for holding a bond with credit risk over a similar-maturity, high-quality government security.

³ A basis point is 0.01 percentage points.

⁴ The swap rate is the fixed interest rate that one party in an interest rate swap demands in exchange for paying a floating rate to the other party over a set time period.

“...we are confident that the attractive longer-term diversification properties of securitized credit remain intact.”⁷

at the beginning of 2020.⁵ Lower-quality (BB/B rated) credit risk transfer (CRT)⁶ RMBS traded at spreads about 80 bp wider compared to the beginning of the year. These relatively wide spreads demonstrate that potential areas of value still exist in securitized credit. In contrast, spreads on A rated corporate bonds were only 2 bp wider than at the start of 2020, according to J.P. Morgan data.

Historically, securitized credit returns have had a relatively low correlation with investment-grade corporate credit performance, so securitized credit has provided valuable diversifying characteristics for multi-sector portfolios that typically have large allocations to corporates. Given the heavy weighting of corporate bonds in aggregate benchmarks, many multi-sector portfolios usually are dominated by corporate credit risk.

However, many low-correlation relationships between fixed income sectors broke down in March as market participants began to realize the broadly negative impact of the pandemic on economic growth. Liquidity disappeared, and leveraged market participants were forced to sell due to margin calls, leading to declines nearly across the board. Correlations between securitized credit and investment-grade corporates have decreased since then, moving back toward their historical pattern, and we are confident that the attractive longer-term diversification properties of securitized credit remain intact.⁷

Supportive Environment for Securitized Credit

We are increasingly confident in a robust economic recovery in the second half of 2021, although the next few months will likely be challenging in terms of pandemic-related restrictions weighing on growth. The Federal Reserve is likely to remain extremely accommodative

for the foreseeable future, especially under its new flexible inflation-targeting framework. This, effectively, will allow the central bank to keep rates at low levels even when inflation meaningfully increases above the 2% target. Under the Fed's old policy framework, the central bank's practice had been to raise rates in anticipation of future inflation solely due to a low unemployment rate.

In addition, while the size of a stimulus package depends on various factors, including the final composition of Congress after the November election and Georgia's January 2021 Senate run-off elections, we see a high probability of some amount of additional fiscal support coming down the pike. We believe that this macroeconomic environment could be supportive for taking advantage of selective opportunities in securitized credit. In addition, we expect a relatively low level of new securitized credit supply in 2021, which should provide technical support for the sector.

Positioning for Expected Medium-Term Upturn

In light of this outlook for limited new securitized credit issuance next year, we are positioning our exposure in the sector to potentially benefit from the expected economic upturn well in advance. In general, we prefer single-asset/single-borrower (SASB) CMBS rather than CMBS deals that are backed by a number of properties and borrowers, known as conduits. SASB bonds typically have high levels of credit enhancement—support from the cash flow structure of the deal—and are more straightforward to analyze than debt backed by large pools of loans.

In SASB deals, we favor bonds backed by high-quality leisure lodging assets because we believe that leisure travel will likely recover more quickly than

⁵ Data source: Bank of America.

⁶ Credit risk transfer (CRT) securities are a type of MBS issued by Fannie Mae and Freddie Mac but with the credit risk borne by private investors.

⁷ Diversification cannot assure a profit or protect against loss in a declining market.

business travel. We have been more cautious when investing in CMBS backed by certain types of retail properties, which we believe are likely to experience continued pressure even when the economy recovers from the pandemic.

Some High-Quality CLOs Attractive

We are also carefully analyzing high-quality (AAA rated) CLOs,⁸ which generally have held up well through 2020. The most attractive bonds in this segment have resilient structures and ample credit enhancement that should allow them to endure a prolonged slump in the economy without experiencing credit issues. These CLOs tend to have higher yields than corporate bonds with similar credit quality, and high-quality CLOs have also generally held up better than corporates in risk-off periods beginning with the global financial crisis of 2008–2009.⁹ We rely heavily on our credit analysts to examine new CLO issues and the managers of the underlying collateral and to negotiate the terms of new deals.

Value in ABS Backed by Automobile-Related Collateral

In ABS, we have been finding opportunities in bonds backed by automobile-related collateral, including subprime vehicle loans and rental car revenue. Automobile rental ABS is an interesting segment that experienced severe spread widening at the onset of the pandemic as investors aggressively sold travel-related securities but then began to recover as the used-car market boomed and some travelers rented vehicles rather than travel by air.

We also favor some whole business securitizations (WBS) from gyms and some restaurant chains that could benefit from an economic recovery. The collateral backing WBS is generally a first-priority interest in a company's primary revenue-generating assets, often franchise fees and royalties.

Selective Opportunities in RMBS

While we are not finding as many pockets of value in RMBS because the housing market has been one of the few bright spots in 2020, we have been selectively adding some lower-rated CRTs and bonds backed by nonqualified mortgages (loans that do not meet the criteria for purchase by Fannie Mae or Freddie Mac). We have also been using RMBS backed by prime jumbo loans (those that exceed the maximum principal size for purchase by Fannie Mae or Freddie Mac) and subordinated RMBS, in general, as a way to add yield potential.

Size of Fiscal Package Could Affect Recovery

The obvious risk to our positioning for a vigorous economic recovery in the second half of 2021 is that the expected contraction over the next few months is longer and deeper than expected. Delays or other problems with vaccine distribution could create this type of scenario. The fiscal relief package passed in late December 2020 should help boost the strength of the recovery later this year, and we are closely monitoring political sentiment toward additional fiscal spending as Washington, D.C., transitions to the Biden administration.

⁸ Collateralized loan obligations (CLOs) are securitized portfolios of bank loans structured into slices, or tranches, of varying credit risk. An outside firm manages the portfolio of loans.

⁹ **Past performance is not a reliable indicator of future performance.**



WHAT WE'RE WATCHING NEXT

Once COVID-19 vaccines are widely distributed, we expect travel-related industries to rebound fairly quickly, with vacationers likely to return more quickly than business travelers. This outlook informs our exposure in various segments of securitized credit, including CMBS, where we are more confident in bonds backed by collateral related to leisure travel. The rate at which companies gain comfort in sending employees to business meetings will affect our positioning in debt backed by conference centers and other assets related to corporate travel.

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