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Perspectives on Securitized Credit

Third Quarter 2022

KEY INSIGHTS

- Despite an encouraging start, securitized credit markets experienced a fourth straight quarter of losses driven by rising Treasury rates.
- Issuance is expected to taper off into year-end, but liquidity is likely to remain challenging.
- With credit fundamentals gradually deteriorating across securitized sectors, we have grown more cautious in commercial mortgage-backed securities while seeing dislocated opportunities in high-quality collateralized loan obligations.

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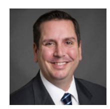

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The third quarter began with a firmer tone for securitized credit markets. Interest rate pressures, which have driven spread volatility, briefly eased as U.S. Treasuries rallied on hopes that the Federal Reserve could soon dial back monetary policy tightening, leaving the door open for a soft economic landing. However, the decline in Treasury yields and related rebound in sentiment was not lasting, and most areas of securitized credit ended the period with a fourth straight quarter of losses. But in contrast with the preceding three quarters, the negative total returns were due more to a continued ascent in underlying Treasury yields rather than due to increasing risk premiums. After widening substantially through June, credit spreads[1] were relatively stable or tightened in lower-volatility segments of securitized credit while continuing to widen in some riskier segments.

Investors were encouraged early on that the Federal Reserve was making progress in subduing inflation with the fed funds rate climbing into restrictive territory and economic data indicating that tighter monetary policy was having the desired restraining effect. But an upturn in core inflation and hawkish rhetoric from Fed policymakers—who reinforced that the central bank was prioritizing price stability, even at the expense of economic growth—dashed hopes for a dovish policy pivot. Treasury yields resumed climbing across the curve in August. Shorter maturities recorded the largest yield increases, leading to inversions of key sections

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[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.

of the curve—historically a prescient leading indicator for recessions. With risk appetite fading, securitized spreads widened again to varying degrees to end the quarter, following the lead of corporate credit and equity markets with a noticeable lag.

ABS and High-Quality CLOs Fared Best

With their lower duration[2] profile and less credit spread sensitivity, asset-backed securities (ABS) held up relatively well in a broadly challenging environment for fixed income assets. ABS recorded total returns of -1.34% but outperformed similar-duration Treasuries by 30 basis points (bps).[3] Despite risk-off sentiment, lower-rated ABS performed better than the AAA rated tranches[4] that dominate the market, benefiting from tighter spreads and their higher income streams.

Collateralized loan obligations (CLOs) likewise performed relatively well with total returns of -0.11%,[5] benefiting from their floating rate characteristics with the Fed raising short-term policy rates by another 150 bps during the quarter. In contrast with ABS, CLO performance was led by AAA rated issues and deteriorated progressively for lower-rated tranches. After tightening through mid-August, CLO spreads resumed widening in late August after Fed Chair Jerome Powell delivered a terse, hawkish speech at the Jackson Hole Economic Symposium. The widening accelerated in late September, fueled by forced liquidations from UK pension funds. These levered investors with highly rate-sensitive portfolios faced margin calls amid turmoil in the gilt market caused by the short-lived British government's ill-advised tax and spending plan. This ongoing deleveraging has led to mispriced opportunities in high-quality CLOs, in our team's view.

With longer durations, conduit commercial mortgage-backed securities (CMBS) experienced larger price declines with Treasury yields rapidly escalating. Non-agency CMBS produced total returns of -3.17% but outperformed duration-matched Treasuries by 6 bps as spreads traced a V-shaped pattern and ended the quarter little changed at the index level.[6] Spreads on BBB rated conduit CMBS widened more significantly amid growing recession concerns. Subordinate single-asset/single-borrower (SASB) commercial mortgage bonds also struggled, hurt by general risk aversion, relatively heavy SASB supply, and concerns that the spike in short-term rates will create refinancing challenges and put pressure on issuers' debt-service-coverage ratios.

Non-agency residential mortgage-backed securities (RMBS) experienced another difficult quarter amid risk-off sentiment, elevated interest rate volatility, and signs that an expected correction in the housing market is underway. Credit-risk-transfer securities (CRTs)[7] issued by Fannie Mae and Freddie Mac outperformed most other RMBS sectors. Nonqualified mortgage (non-QM) bonds were the worst performers, driven by wider spreads, elevated supply, and extending durations. Prime mortgage subsectors generally underperformed as well due to extension risk (unexpected lengthening of time to receive principal payments,) with the average 30-year mortgage rate rising above 7% for the first time since late 2000.[8]

Issuance Should Slow Into Year-End

Primary market supply slowed in the third quarter following an overwhelming start to the year, but supply exceeded demand in some subsectors, such as non-QM RMBS and SASB CMBS. Issuance is expected to continue to taper off as we close the book on a so-far ugly year, providing a little more technical support from the supply side. Issuance was front-loaded in the first half of 2022 as issuers looked to offload loan inventories and lock in funding costs before rates rose further. A high-volatility environment could also discourage issuance, as it has in recent weeks. More deals struggled to find a clearing level that investors were willing to accept, pressuring spreads wider and putting some deals on hold.

In line with its relatively stronger performance, the ABS market experienced smoother supply and demand dynamics during the past quarter than other sectors. At just shy of USD 200 billion[9] through the end of September, new issuance in the ABS market was roughly in line with its level at a similar point last year, which was the most active year for issuance since before the 2008 global financial crisis (GFC). Demand for new ABS issues

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[2] Duration measures the sensitivity of a bond's price to changes in interest rates. Bonds with longer duration have higher sensitivity to changes in interest rates.

[3] As measured by the Bloomberg ABS Index. 1 basis point equals 0.01%.

[4] Credit ratings for securities are typically provided by Moody's, Standard & Poor's, and/or Fitch and are referenced here in Standard & Poor's nomenclature. A rating of AAA represents the highest-rated securities, and a rating of D represents the lowest-rated securities. If a rating is not available, the security is classified as Not Rated (NR). In addition to the ratings from the major rating agencies, T. Rowe Price maintains its own proprietary credit rating methodology for all securities held in portfolios.

[5] As measured by the JP Morgan Collateralized Loan Obligation Index (CLOIE). 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.

[6] Based on the Bloomberg Non-Agency Investment Grade CMBS: Eligible for U.S. Aggregate Index.

[7] 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. They can incur losses if enough homeowners in a pool of mortgages default on their loans.

[8] Sources: Bloomberg Finance, L.P., and Bankrate.com.

[9] Source for ABS, CLO, CMBS, and RMBS issuance totals: JP Morgan. All totals in U.S. dollars as of September 30, 2022.

was relatively strong as investors looked to replace paid-down bonds and were attracted by spreads that had climbed to their widest levels since early in the pandemic.

By contrast, CLO issuance has run well below the pace of a record-setting 2021. With the significant rise in rates, CLO refinancing and reset transactions were a fraction of the monumental volumes witnessed last year. True new issuance reached USD 105 billion at quarter-end, on pace to exceed 2019's pre-pandemic levels but fall well short of 2021's total of USD 184 billion.

RMBS issuance has slowed this year, but the supply picture has varied across the numerous subsectors that comprise the market. Jumbo prime loan issuance meaningfully declined with higher mortgage rates reducing origination. In contrast, CRTs and non-QM deals saw significant increases over last year. CRTs could benefit from positive technicals with only a handful of additional transactions scheduled before year-end. Meanwhile, non-QM deals have not let up despite struggling to find buyers. Given that securitizations are many non-QM originators' only financing option, deals have needed to reprice at cheaper levels to get executed. Despite tepid demand, non-QM issuance is expected to remain high through year-end as issuers look to clear inventories of older loans issued when rates were lower and adapt to the new, less hospitable lending environment.

Finally, private-label CMBS issuance, at USD 91 billion at quarter-end, was down about 7% from 2021's pace. Similar to the trends from last year, floating rate issuance has exceeded fixed rate issuance by a more than two-to-one ratio. SASB deals, which are typically floating structures, have continued to see the highest volumes and have experienced less of a slowdown than the conduit market, a technical factor that has weighed on SASB performance.

Liquidity to Remain Challenged

Market liquidity is typically scarcer for securitized credit than for competing spread products like corporate bonds and agency MBS—a feature that, while not ideal from a trading perspective, should translate into a nice liquidity premium (i.e., the additional excess return investors expect to earn above a high-quality government security to compensate for the additional risk) for longer-term investors. Liquidity has become more challenged with the Fed engaged in an aggressive quantitative tightening campaign that is rapidly shrinking bank reserves. Elevated rate and spread volatility are also not conducive for liquidity.

With volatility likely to remain high and bank balance sheets constrained, our traders see little chance of liquidity meaningfully improving into year-end. Dealers rebuilt depleted trading inventories in the third quarter as investors retreated, compelling dealers to step in with bids—albeit at a cost for those looking to sell. This has left dealers with less capacity to add more risk at a time of year when they are usually more reluctant to act as liquidity providers due to regulatory and seasonal factors.

Fundamentals Gradually Deteriorating From Strong Levels

The path of fundamental credit performance for securitized collateral is eroding, but the deterioration has been gradual and mostly in line with our expectations. Consumers emerged from the pandemic in very strong shape thanks to built-up savings aided by government largesse. However, inflation and higher borrowing costs have begun to take a toll on household balance sheets. Consumer loan delinquencies have risen at the margin, though largely confined to less creditworthy borrowers. Delinquency rates remain below pre-pandemic levels, and a strong labor market remains fundamentally supportive.

The housing market is feeling the effects of higher rates and decreased affordability. Residential prices peaked at midyear and have turned lower, and we expect home prices to fall by about 5% to 10% in 2023. The commercial real estate market is likely to see somewhat greater price declines. As noted, the floating rate SASB segment has been a burgeoning area of the CMBS market. Issuers in that space will likely face additional stress on their ability to cover debt payments as rates rise, causing extension and downgrade risk. CLOs will likely see more credit rating downgrades than upgrades for their loan collateral as recession risks rise—among the reasons why we have generally favored the top of the CLO capital structure.

While a recession is never a welcome development, encouragingly, signs have so far pointed to an early 2000s-like downturn rather than a more calamitous GFC-like event, with more manageable levels of delinquencies and losses. At this uncertain stage of the cycle, with a variety of outcomes still possible, we believe active management backed by a strong research platform is even more critical in securitized markets to position appropriately from a sector/subsector perspective and to separate the wheat from the chaff in terms of individual credit selection.

Being Defensive in CMBS, and Seeing Dislocations in CLOs

Trying to time an entry point in any market to take advantage of cheaper valuations has been challenging this year, and securitized markets have been no exception. Credit spreads have room to widen further, as they remain far below March 2020 peaks. But yields have risen to compelling levels, particularly for long-term investors who are less concerned with mark-to-market asset price fluctuations. Moreover, valuations in some shorter-duration segments are at levels that offer a cushion against further price declines if rates and/or risk premiums continue to rise. However, we are not overly bullish due to macro hurdles and liquidity and technical headwinds, which are of more concern to us than sector fundamentals.

We continue to like areas of the markets that are shorter duration and offer higher levels of coupon income to help dampen price volatility. We have become increasingly selective across sectors but, perhaps, most so in CMBS, a sector whose fundamental headwinds were exacerbated by post-pandemic behavioral changes (e.g., reduced business travel and a hesitant return to offices). Investing defensively, we have favored seasoned junior-AAA conduit bonds. In the SASB lodging space, we have focused on higher-tier properties and prefer leisure-oriented hotels over those dependent on business travel. Our analysts have become less constructive on office properties, which are generally seen as having more downside risk than upside potential. That said, we still see promise in select office deals.

In the ABS market, we believe that automotive- and equipment-related subordinate bonds offer a compelling combination of liquidity and volatility-adjusted spread pickup versus Treasuries. In the RMBS market, we like re-performing loans (RPLs) and single-family rentals (SFRs). RPLs have exhibited less spread volatility than other RMBS subsectors this year, aided by limited issuance and less sensitivity to interest rates and extension risk than areas like non-QM bonds. Similarly, SFRs have been a more defensive mortgage segment. While the housing market is clearly weakening, overall fundamentals in the rental market remain solid. Indeed, affordability pressures in the home purchase market could bolster rental demand and contribute to higher operating margins for landlords.

Finally, we have seen attractive opportunities and pricing dislocations in high-quality CLOs stemming from ongoing deleveraging by UK pension funds. While spreads on CLOs could widen further if a global recession strikes and bank loan defaults increase, CLOs at the top of the capital structure have a solid track record in past economic downturns despite the sector's naysayers. We are confident that the sturdy credit enhancement levels offered by senior CLOs should be able to endure a default scenario exceeding that of the GFC, which our high yield credit team—whom we partner with to analyze bank loan collateral—is not anticipating.

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