



Perspectives on Securitized Credit

Second Quarter 2023

KEY INSIGHTS

- Securitized markets maintained the positive momentum that transpired following March's banking system distress.
- Supply technicals remained highly supportive, but fundamentals are gradually worsening, and valuations have become more fair than cheap.
- We saw the best opportunities in high-quality ABS and CLOs, had a balanced opinion of RMBS, and remained cautious on CMBS.

Securitized credit markets maintained positive momentum in the second quarter that began in early April following March's banking system distress. Concerns about banking system health gradually faded as no additional major institutions failed, and emergency liquidity measures introduced by the Federal Reserve (Fed) had their desired calming effects. Investor confidence was also boosted by a last-minute resolution to the debt ceiling standoff in Congress, thereby avoiding a U.S. government default; slowly declining inflation data; and surprisingly resilient growth, even in the face of sharply higher interest rates. The improved sentiment supported demand for risk assets broadly, benefiting securitized assets.

The Fed hiked the fed funds rate in May; paused rate hikes in June following 10 consecutive increases, as policymakers hinted they would; and then tightened once more in late July.

The July move raised the policy rate to a range of 5.25% to 5.5%, its highest level since early 2001. Fed Chair Jerome Powell was elusive with forward guidance, emphasizing that future policy actions will be data-dependent with inflation still elevated but gradually progressing toward the Fed's comfort zone.

After dropping in March, Treasury yields subsequently rebounded across the curve, led by the more policy-sensitive front end, keeping key sections of the term structure deeply inverted. Treasury market volatility remained quite high when viewed from a longer-term perspective but declined significantly from its pinnacle in mid-March, when bank failures threw markets into a frenzy. The moderation in rate volatility and signs that the Fed was at or near the end of its tightening cycle were positive factors for more interest rate-sensitive areas such as non-agency residential mortgage-backed securities (RMBS).



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RMBS Led Other Sectors in Q2

The diverse and difficult-to-benchmark RMBS sector generally produced the strongest total returns of major securitized credit sectors. Returns for RMBS were broadly robust—a welcome respite following significant rate-driven challenges last year. Credit risk transfer (CRT) securities and nonqualified mortgage (non-QM) bonds, particularly lower-rated tranches, generated some of the strongest returns, aided by supportive macro and technical backdrops.

Collateralized loan obligations (CLOs) also generated solid total returns despite the move higher in Treasury yields, aided by their near-zero duration¹ profile. Indeed, the prospects for yet another rate hike before year-end helped revive demand for floating rate assets, which had begun to fade earlier in the year when investors anticipated that rate cuts could soon be necessary if banking system stress worsened. Similar to the RMBS sector, lower-quality slices of CLO deals bested the performance of higher-quality tranches, though performance in the sector was broadly positive. Overall, the CLO index rose 2.43% for the quarter, adding to year-to-date gains.

Commercial mortgage-backed securities (CMBS) produced mixed results as the sector continued to face a flurry of negative headlines highlighting growing stress in the commercial real estate (CRE) market. Office buildings attracted the most negative attention, and negative developments for specific properties led to increased dispersion in performance and idiosyncratic risk, making careful security selection more critical. Non-agency CMBS in the Bloomberg U.S. Aggregate Bond Index, which consists of only fixed rate debt, produced negative total returns (-0.50%) with Treasury rates rising. But the CMBS

index recorded positive excess returns, driven by AAA rated bonds, which outperformed similar-duration Treasuries by 0.86%. By contrast, BBB rated CMBS underperformed Treasury counterparts by 1.44% as investors remained wary of areas offering less structural defenses against losses on underlying loan collateral.

Asset-backed securities (ABS) ended the quarter with modest absolute losses of -0.12% as their lower duration made them more inoculated from rate increases. But excess returns for ABS were positive, surpassing duration-matched Treasuries by 0.58%. In contrast with the CMBS market, performance for ABS was relatively balanced across the ratings spectrum. Investors saw fundamentals slowly deteriorating but not to a degree that would threaten the fortitude of ABS structures. Student loan debt experienced meaningful credit spread tightening in Q2. Auto loans—both prime and subprime—also tightened, as did credit card and high-quality equipment deals. Rental cars and container-backed bonds were among the weaker performers.

Issuance Increased but Still Light

As concerns about banks eased, new issuance picked up following a sluggish start to the year. CMBS experienced the most notable increase, with year-to-date gross new supply reaching USD 73 billion in early July compared with just USD 18 billion at the end of March. Still, that put the sector on pace to fall well short of 2021's USD 241 billion supply mountain, which, along with fundamental concerns, weighed on sector performance.

RMBS saw a more modest increase in new supply in Q2, putting the midyear total at USD 39 billion. That pace fell well below that seen in 2021 and 2022,

the two most active years for issuance since 2007 before the onset of the great financial crisis (GFC).

By contrast, ABS issuance increased in Q2 and was the only sector trending near the pace of 2022, which was one of the heaviest years for the sector ever. Abundant supply, totaling USD 129 billion at midyear, was a factor that helped keep ABS valuations at less elevated levels in some spots.

CLOs were the only sector to see a quarter-on-quarter issuance decline in Q2, putting the midyear total at USD 57 billion compared with USD 130 billion for full-year 2022. Notably, almost all of this year's issuance consisted of true new issuance rather than refinancings, resets, or reissues of older deals—a consequence of materially higher financing costs. However, these types of transactions, which have repercussions for CLO investors, have recently started to show signs of life.

Valuations Moved Closer to Fair

As often occurs, spreads² for securitized credit sectors began tightening after corporate credit sectors had already begun to rally in late March. As corporates richened, the tightening trend in securitized credit accelerated in June and into July. Bearing the most fundamental risks, non-agency CMBS spreads tightened—at least for higher-quality issues—but remained at the wider end of their range since 2016. There were also pockets of cheapness to be found in the ABS sector. With the recent rally, valuations for CLOs and RMBS were closer to the midpoint of their range since 2016, which includes the massive spike in spreads in March 2020 when the global pandemic caused credit markets to seize up. The securitized credit universe has recovered substantially since then—particularly ABS and RMBS.

Past performance is not a reliable indicator of future performance.

¹ 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.

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.

Overall Neutral Conviction Level

Toward the end of Q2, our securitized credit team considered raising their broad conviction level on the asset class, which serves as an allocation recommendation for our multi-sector fixed income strategies. That upside bias was predicated on valuations screening well in comparison with corporate bonds and being in line with fundamentals, which were deteriorating but not overly concerning. While fundamentals saw little change—and may have even improved with U.S. economic data surprising positively recently—the valuation gap versus corporates narrowed as the securitized rally extended into July. This tightening kept our conviction rating at neutral.

Favoring ABS

As of this writing, within the securitized credit asset class, we saw the best opportunities in ABS. As noted, there are pockets of cheapness, due in large part to a healthy supply pipeline. We saw the most value in certain equipment, auto dealer floorplan, subordinate prime auto loans and leases, and mobile phone deals. Our analysts also saw potential upside stemming from early redemptions for select ABS backed by timeshare collateral.

In addition to valuation appeal, ABS have historically held up relatively well when the market environment turns more volatile. Although market conditions have been surprisingly calm since March, we believe that the economy has yet to feel the full impact of large-scale monetary tightening. We are also concerned that market liquidity could deteriorate in the second half of the year if bank reserves continue to shrink with banks facing deposit withdrawals. Meanwhile, heavy U.S. Treasury issuance could pull cash from the banking system and constrain primary dealer balance sheets. In a risk-off scenario, we believe that ABS, which offer good liquidity, are the most attractive option in securitized credit.

The U.S. consumer, which is closely linked to ABS collateral performance, is slowing, but from a position of strength. Unlike the period leading up to the GFC, when consumers were overleveraged relative to their assets, total and liquid assets as a share of U.S. households' liabilities are high. In other words, debt burdens are relatively low (Figure 1). Despite the rise in rates, debt servicing costs remain low from a historical perspective, and consumer checking account balances are still above their 2019 levels, according to Bank of America. However, consumer

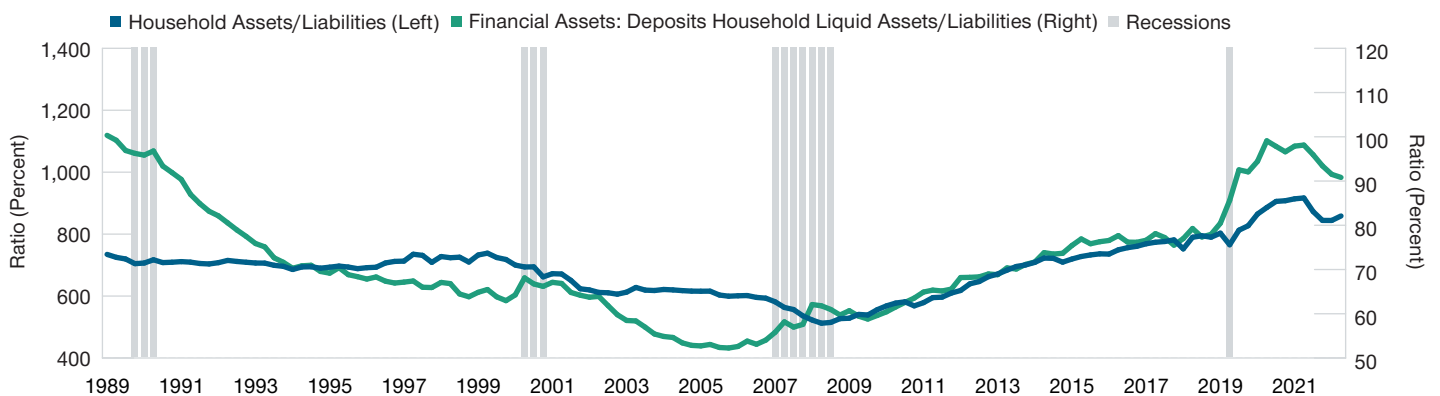
loan delinquencies have risen recently, and the resumption of student loan payments in the fall will likely drive a further increase in delinquencies as excess savings are depleted.

Opportunities in High-Quality CLOs

Valuations for CLOs are more fair than cheap. But, like ABS, higher-quality CLOs offer decent trading liquidity compared with lower-quality CLOs and the CMBS and RMBS markets. Fundamentals for CLOs are trending negatively, due to expectations for a higher bank loan default rate as leveraged issuers grapple with higher capital costs. Credit rating downgrades of bank loans have also exceeded upgrades recently. That said, our bank loan team believes the default rate will remain manageable as it drifts toward its longer-term average. If defaults do rise, CLOs sitting higher in the capital structure are less exposed to losses. Indeed, AAA rated CLOs endured volatility but did not suffer any permanent losses during either the pandemic economic shutdown in 2020 or the GFC in 2007–2008. We expect the CLO credit curve to steepen, with lower-rated bonds underperforming, if a recession becomes more of an imminent threat. At present, we saw the best value in AA rated bonds that

Strong Household Balance Sheets Supportive of Consumer Spending and Asset-Backed Securities

(Fig. 1) Total and liquid assets as a share of U.S. households' liabilities are high relative to history



December 31, 1989, through March 31, 2023.
Source: Federal Reserve Board.

benefit from sitting higher in the capital structure but offer attractive spread pickup relative to AAA rated issues.

A Neutral View of RMBS

We held a more neutral opinion of RMBS following their strong Q2 performance. Valuations are now on the tighter side, and liquidity in the sector can be challenging outside of the CRT subsector. On the positive side, technicals are very supportive given the significant decline in issuance this year—a situation that could be exacerbated by Fannie Mae's and Freddie Mac's plans to reduce CRT issuance in the second half of the year. And the fundamental picture has improved with national house prices stabilizing in the face of high mortgage rates, supported by limited supply. Moreover, easing inflation should make the Fed less aggressive in tightening policy, which could help suppress high interest rate volatility that has whipsawed mortgage bond prices. On the downside, a higher-for-longer interest rate environment means that discounted bonds may take longer to move back to par value. And new issues that are priced near par have convexity risks if rates move sharply in either direction. We have been focused on opportunities in the secondary market priced at a discount and offering better convexity.

Great Promise for CMBS—Eventually

CMBS clearly offered the most attractive valuations, and relatively light issuance should work in the sector's favor from a technical standpoint. Yet they remain our least-favored sector at present.

Fundamentals remain on a deteriorating trend, with delinquency rates increasing. This has been most apparent in the office segment, which has also seen a rise in loans in special servicing, but also recently in the lodging space. Negative press coverage continues to weigh on sentiment, and we expect to see more negative headlines as a large wall of maturing CRE loans, estimated by the Mortgage Bankers Association to total USD 1.4 trillion, hits over 2023–2024. News of loan extensions and selective defaults will likely persist as real estate cycles take a long time to play out. An increase in property sales—some out of necessity—and downwardly revised appraisals may also reveal where property valuations really stand. This may lead to some sensational headlines but should also improve price discovery and provide more clarity for investors.

We believe that CMBS will eventually present a great buying opportunity. But for now, we remain cautious. With uncertainty around the sector so high, we continue to rely on our credit analysts to highlight positions that we should exit along with mispriced buying opportunities as the idiosyncratic, illiquid sector gets painted with a broad valuation brush. Within the sector, we believe it is prudent to stay defensive except in unique situations where our analysts believe the market is misperceiving risks. Areas that we favor today include junior AAA rated conduit bonds, particularly shorter-term issues that offer more yield due to the inverted yield curve. In the floating rate single-asset single-borrower space,

we like some lodging-related credits. Lodging issues offer the highest yields outside of the office space—an area where we remain bearish. We like hotels generating strong cash flow growth, as they have potential to refinance early, in which case their discounted prices will pull back toward par value.

High Yields Should Mitigate Interest Rate Risk

All said, the picture for securitized credit is balanced. Technicals remain highly supportive. Liquidity has been good lately, but we are mindful that it can be transient—a reason why these smaller sectors often offer a generous risk premium versus corporate credit. Fundamentals are deteriorating generally but are not overly concerning outside of CMBS. And while spread valuations are relatively fair (or cheap for a reason in certain cases), yields offer broadly attractive value for long-term-oriented investors. The yield to worst for the high-quality, lower-volatility ABS sector, for instance, sat near 5.5% in late July, the highest since 2009. With a duration of about 2.7 years for the index, the sector offers a substantial cushion should interest rates rise further. Indeed, yields for the sector would need to rise more than two percentage points for price declines to fully negate annual coupon income. With the Fed clearly wanting to declare victory in its inflation battle, making substantial additional rate hikes unlikely, we view that as an enticing proposition for long-term, yield-focused investors.

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Source for ABS, CLO, CMBS, and RMBS issuance totals: J.P. Morgan.

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