Securitized Credit May Be Poised to Rebound

Careful credit analysis can help uncover value in ABS, CMBS, and RMBS.

KEY INSIGHTS

- Securitized credit has lagged the rebound in other asset classes, but we believe that parts of securitized credit could outperform as the economy reopens.
- We rely on our team of experienced securitized credit analysts to help identify fundamentally strong bonds trading at dislocated prices.
- We expect to maintain measured additions to risk in the Total Return Fund until measures of implied market volatility broadly stabilize.

Securitized credit markets experienced steep declines in March, primarily as a result of the limited liquidity that seized many financial markets as the impact of the coronavirus pandemic became clearer. Securitized credit has lagged the rebound seen in other asset classes, but we believe that segments of securitized credit will recover and could eventually outperform as the economy reopens.

Although securitized credit has not received the type of direct support from the Federal Reserve’s quantitative easing purchases that other fixed income sectors have enjoyed, we anticipate that liquidity will continue to slowly return. We rely on our team of experienced securitized credit analysts to help identify fundamentally strong bonds trading at dislocated prices.

Acute Selling Pressure in March

Securitized credit instruments, which include asset-backed securities (ABS), commercial mortgage-backed securities (CMBS), mortgage-backed securities without agency credit guarantees (known as RMBS), and collateralized loan obligations (CLOs), held up better than investment-grade corporate bonds early in the pandemic-induced sell-off, as expected, given their lower-risk return profile over the long term.

However, securitized credit hit an unprecedented patch of volatility starting the week of March 16 as liquidity essentially evaporated. While credit spreads\(^1\) did not reach their widest levels from the global financial crisis (GFC) in 2008–2009, the speed of the spread widening made the March selling pressure for securitized credit even more acute than the GFC, in our opinion.

\(^1\) Credit spreads measure the additional yield that investors demand for holding a bond with credit risk over a similar-maturity, high-quality government security.
Liquidity in securitized credit became very limited as prices of virtually all risk assets plunged. Investors that use leverage, including hedge funds and some real estate investment trusts (REITs), received margin calls as prices plummeted, forcing them to sell and driving prices even lower. Dealers were unable to absorb the glut of secondary market supply, in part due to regulatory constraints, causing trading to come to a virtual halt.

While we believe the challenging liquidity conditions accounted for the majority of the spread widening, the realization that several prominent segments of securitized credit collateral, such as commercial and residential real estate and auto loans, suddenly faced an uncertain future in the face of the coronavirus pandemic also played an important role.

**Unprecedented Monetary and Fiscal Stimulus**

The Fed, the Treasury Department, and Congress have joined forces to inject an unprecedented amount of monetary and fiscal support into markets. For example, the recently enacted Coronavirus Aid, Relief, and Economic Security (CARES) Act gives the Treasury USD 450 billion of funding that the Fed can lever up by approximately 10 times to yield a massive USD 4.5 trillion war chest to support markets and lending.

However, few of the programs announced thus far have directly targeted the broad spectrum of securitized credit assets. The most important announcement so far has been the reintroduction of the GFC-era Term Asset-Backed Securities Loan Facility (TALF), which initially provided investors with non-recourse funding for purchasing a limited set of new issue AAA rated ABS before being expanded marginally to include secondary AAA rated CMBS and a small subset of CLOs. In contrast, the Fed has created two facilities for direct purchases of investment-grade corporate bonds in the primary and secondary markets.

This has created a group of “haves” receiving substantial direct Fed support (e.g., Treasuries, agency MBS, investment-grade corporates) and “have nots” (e.g., high yield debt, much of securitized credit) that have received less backing. Ultimately, if acute stress returns to markets, we think the Fed could broaden its programs to make them more helpful for securitized credit given how critical consumer and real estate lending are for the U.S. economy, but the market will likely need to deal with somewhat limited liquidity for the short term.

**Technical Weakness Likely to Slowly Reverse**

In short, a large portion of the weakness in securitized credit has been technical and, thus, should eventually revert to longer-term averages. We expect liquidity to keep slowly improving, particularly as Fed programs work their way through other fixed income segments. Encouragingly, new issuance has slowly started to resume in the ABS market and has been met with strong investor demand.

Spreads in some high-quality, liquid parts of the market have tightened considerably from their widest levels with the TALF announcement and restart of the primary market, but many other areas of securitized credit that are more directly impacted by the crisis have not participated in the rally. Spreads in these segments remain stubbornly wide due to uncertainty around the extent of losses and rating downgrades. Aside from ABS, most areas of securitized credit are likely to remain closed to new issuance for the foreseeable future.

These fundamental concerns are also legitimate, particularly at the lower end of the quality spectrum. It will take time to work out the proper price of these new risks as the economic impact of the pandemic unfolds.
Since the mid-March liquidity vacuum, we selectively added securitized credit assets to the Total Return Fund at what we believe are very attractive levels. When evaluating bonds to potentially add to the portfolio, we rely heavily on our team of credit analysts who specialize in specific segments of securitized credit.

**Opportunities in Securitized Credit Segments**

In RMBS, we have focused on some lower-rated credit risk transfer (CRT) securities, which are a type of MBS issued by Fannie Mae and Freddie Mac but with the credit risk borne by private investors. We favor CRTs with low loan-to-value ratios and significant credit enhancement, which is support from the cash flow structure of the deal. Based on our scenario analysis and stress testing, we expect specific bonds to be able to weather a long-term recession and elevated levels of late payments. Some high-quality RMBS backed by nonqualifying mortgages are also attractive. This is particularly true for those that have been outstanding long enough to experience meaningful principal paydowns, reducing their loan-to-value ratios.

CMBS have been one of the hardest-hit segments of securitized credit because of its exposure to retail and lodging businesses, and new issuance remains largely on hold. In CMBS, we prefer bonds with high-quality underlying assets and significant credit enhancement. Some CMBS backed by a single asset or single borrower instead of a pool of assets have appeared attractive. We favor deals with trophy office properties as collateral or those backed by industrial, cold storage, or biotech real estate, which we expect to be more resilient than the broad commercial real estate market.

In ABS, we think that select whole business securitizations (WBS) from high-quality issuers such as household name, quick-service restaurants are attractive. The collateral backing WBS is generally a first-priority interest in a company’s primary revenue-generating assets, often franchise fees and royalties. The issuers that we prefer are brands that have been successfully operating for more than 40 years and have survived multiple economic cycles as well as significant changes in consumer behavior. The structures of these securities are designed to handle significant shocks to cash flows from the underlying collateral.

**Cautiously Adding Risk**

We have added to risk assets, including securitized credit, at a cautious pace in the Total Return Fund because we expect additional waves of selling pressure until the extent of the economic ramifications of the pandemic are better understood. Economic data will be terrible for a while, but we will be monitoring the speed of the rebound as businesses begin to gradually reopen. We expect to maintain measured additions to risk until measures of implied market volatility broadly stabilize and we grow more comfortable that the potential for forced liquidations is low. As we have selectively added individual bonds in securitized credit and other credit sectors, we have managed overall exposure to credit risk with index credit default swaps, which are more liquid than cash bonds.

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2 Nonqualifying mortgages do not meet Fannie Mae and Freddie Mac standards for purchase, often because they exceed the maximum principal amount.

3 A credit default swap involves regular payments from the buyer to the seller in exchange for repayment of principal value to the buyer if the issuer experiences a credit event such as default.
WHAT WE’RE WATCHING NEXT

Securitized credit issuers and investors have been aggressively lobbying for the Fed to expand the TALF program into broader parts of the market, which would likely make it easier for them to tap the new issue market to raise funds. In early April, the Fed added secondary, high-quality CMBS and a small segment of CLOs to the assets covered by the TALF program, and we continue to monitor the likelihood of the central bank further expanding the facility.
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