RBC BlueBay Asset Management

Resurgence in idiosyncratic risks brings Securitised Credit in focus

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Securitized Credit team

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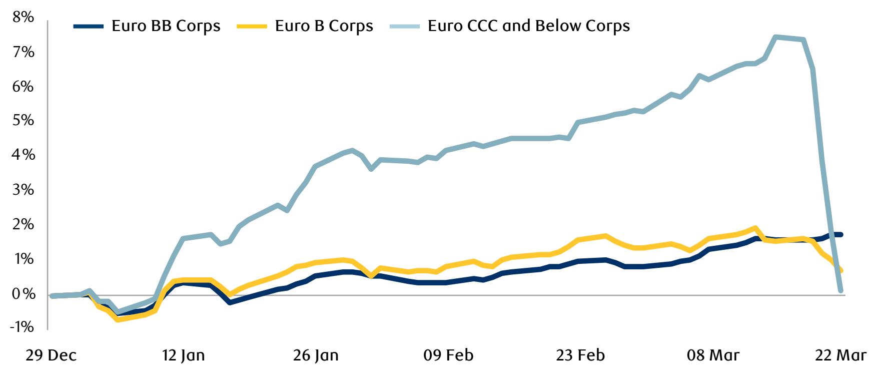
Recent idiosyncratic credit events within High Yield markets have brought back into focus the benefit of exposure to Securitized Credit. Cushion to defaults coupled with attractive yields as a result of a lag versus broader markets and elevated primary supply are providing a triple margin of safety.

A more challenging fundamental credit backdrop

We have seen a recent pick-up in idiosyncratic credit issues for European corporates, with three large, well known issuers seeing significant price drops on their bonds. These declines, occurring over a matter of days, have swiftly wiped out all 2024 YTD returns for CCC & below-rated HY corporates, which now sit flat for the year.

This provides a reminder that while markets are currently benign and largely pricing in start of rate cuts this year, idiosyncratic credit events – especially within more levered capital structures – will be prevalent in a higher for longer interest rate environment. While we don't foresee a material increase in defaults, we do think certain issues will continue to pop up for over-levered credits with weak underlying fundamentals. This highlights the risk of single name obligor exposure, particularly when it can arise for idiosyncratic rather than thematic reasons.

YTD CCC Returns Now Flat After Heightened Credit Risks



Source: Bloomberg, as at 22 March 2024.

Securitized Credit as an alternative

Securitized Credit provides exposure to a diversified pool of assets: each loan or asset in a typical portfolio represents a small portion of the entire collateral, meaning that there is no large single name obligor exposure taken by investors. Therefore, in an environment where it is increasingly likely we see some prevalence of idiosyncratic credit issues, Securitized Credit provides a significant margin of safety. While this has always been true of Securitized Credit, now is a particularly attractive time to invest in the asset class for 3 key reasons:

1. **Cushion to defaults:** While even Sub-IG tranches can withstand double digit defaults without impairment, we have focused mainly on the Mezzanine-IG part of the capital structure, where we can pick up stronger default protection while still earning attractive carry and total return opportunities.

2. **Lag versus broader markets:** Securitized Credit is noticeably lagging other credit indices, with spreads on Euro CLO BBB currently in line with those of Euro Single B Corps (historically, Euro CLO BBB have been 100 bps tighter). Within RMBS, we have seen the BBB bonds on UK BTL pricing 105bps wider than the comparative deal in 2022.

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3. **Heavy primary supply**: A flood of Securitized Credit supply has further enhanced the lag versus broader markets, causing certain arrangers experiencing tight deadlines and inundated investors to issue wider than fair value in order to place bonds to the market. This is a situation we have taken advantage of numerous already times this year and expect to continue to do more of throughout 2024.

The recent rise in idiosyncratic credit events again highlights the importance of diversified exposure, which can be achieved through investing in Securitized Credit. The asset class benefits from significant protection from defaults, attractive yields, and no concentrated single name obligor exposure. Supply dynamics should continue to generate great alpha opportunities for investors to take advantage of in the coming year.

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