RBC BlueBay
Asset Management

Credit matters again

RBC BlueBay Securitized Credit team

Alongside mince pies, ambitious New Year resolutions and reinstated gym memberships 'tis the "Season of Outlooks." The business of making bold short- and medium-term predictions is fraught with danger at the best of times, let alone in more recent years, which if nothing else have been unpredictable. With the sense that we are reaching peak rates, uncertainty has been shifting from rates to the growth outlook. As a result, we will likely see a shift in focus from top-down to bottom-up analysis. Credit matters again. One of the best strengths of the Securitized Credit market is the strong protection investors receive against defaults. Against this backdrop one thing is for certain: valuations are more attractive than they were a year ago.

In this report, rather than focus on making bold predictions, we would like to explore how an allocation to Securitized Credit in 2023 can protect against uncertain downside while still capturing the upside of attractive valuations across risk assets.

Preservation of capital

Across geographies we expect consumers and corporates alike to be pressured by continued high rates and a slowdown in growth in 2023. This will likely result in an increase in (often unpredictable) idiosyncratic defaults. Preservation of capital is critical in this environment, and Securitized Credit structures are capable of absorbing significant defaults well in excess of even some of the most draconian expectations.

To help understand the level of protection against defaults let's consider three of the sectors we invest in: U.S. and European RMBS, U.S. CMBS and U.S. and European CLOs.

U.S. and European Residential Mortgage-Backed Securities (RMBS)

Higher mortgage rates and inflation are pressuring borrower finances, which in turn is applying downward pressure on demand for housing and home prices. However, mortgage markets in general are a high-quality investment and in a strong position compared to the previous cycle:

- **First loss taken by the borrower** – loan-to-value (LTV) ratios are lower than they have been historically and have benefited from recent house price appreciation. This has resulted in increasing homeowner equity and a larger buffer from loss for the mortgage owner.
- **Homeowners are generally more affluent**, and this cohort is less pressured by a rise in the cost-of-living.
- **Mortgage underwriting has been high quality** since the 2008 recession, with lower LTVs, more stringent income checks and considerably less proliferation of interest-only and other weaker product features.
- For buy-to-let and investor mortgages specifically, you also benefit from the income stream from the tenant if the landlord runs into difficulty.

In the event that there are defaults with losses on the mortgages, the more junior bonds in the securitization structure absorb losses first. Due to conservatively structured transactions with lower leverage than in the past, the tranches we invest in can absorb large amounts of losses.

Looking at specific examples in the U.S. – seasoned Agency Mortgage Credit Risk Transfer (CRT) and non-Qualified Mortgage (QM) are both sectors we are active in. The former transfers the credit risk on agency-owned mortgages and the latter is private-label origination for borrowers that fall through the strict lending criteria imposed by the agencies, but are still high quality e.g. investors, self-employed, foreign national.

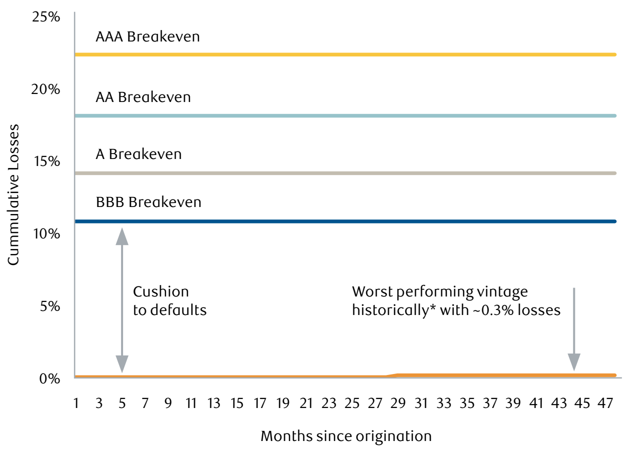
Asset Class	CRT	Non-QM
BBB tranche LTV	52.1%	32.6%
BB tranche LTV	52.4%	36.0%
Original pool LTV	72.2%	63.8%
Current pool LTV	52.9%	41.7%
WALA at issuance	6 months	20 months
WALA today	23 months	47 months
FICO	763	712

Source: Bloomberg, BlueBay.

We have a preference for seasoned profiles in both these sectors (see table above), all the above bullet points apply but in addition the acceleration in home prices in the last two years combined with the conservative LTVs on the mortgages at the underwriting stage leaves us with low leverage at the BBB and BB tranche level, while spreads to hold this risk remains compelling and dislocated for various technical reasons – oversupply, macro backdrop.

In Europe we can look at a Dutch Prime Buy-to-Let RMBS example. Chart 1 shows that the level of losses that each tranche can absorb without impairment (the breakeven level) is much, much higher than historical levels of losses seen in prime Dutch mortgages. Even UK Non-Conforming losses, one of the worst performing European mortgage market through the GFC, only reached about 4% in 2007 originated mortgages. Finally, the Dutch market is in a better position than some of its peers, with greater undersupply of housing and fewer variable rate mortgages.

Chart 1: Dutch Prime BTL RMBS breakeven versus historical losses



Source: Moody's, Intex, BlueBay.
*Using Moody's data starting in 1997.

U.S. Commercial Mortgage-Backed Securities (CMBS)

Along with residential, the commercial real estate market is dealing with higher mortgage rates as we enter 2023. Capitalization rates (the ratio between the annual income on the property and the current market value) are expected to adjust higher as Treasury rates climb, putting downward pressure on valuations. No property type will be immune to this as rental growth slows in multifamily residential and industrial, while recession fears could dampen retail demand. Hotels, hit significantly during the Covid crisis have rebounded but recession fears could lessen this demand if unemployment picks up. Office continues to go through a transition as working from home continues post Covid and financing in the sector has dried up.

With that said, opportunities exist in the CMBS market as the market has repriced throughout 2022 and delinquencies remain low, around 3% overall. While we expect delinquencies to rise from here, particularly in weaker sectors such as office, leverage in the CMBS market is relatively contained and the market broadly should be able to withstand a deterioration of property values.

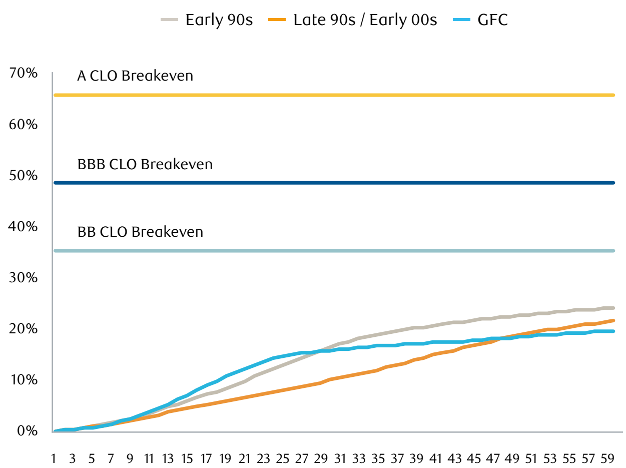
However, picking the right assets in stronger markets remains paramount. We believe the multifamily residential market should slow, but with affordability in housing an issue and the lack of shelter supply, we do not expect major dislocations. Industrial should continue to perform as the landscape of the digital economy and the movement of goods across the country should continue to be favourable to the industrial warehouse segment of the market. Hotels will feed off the broader economy and could be affected by a slowdown. However, travel remains robust, and operators have been able to adjust to inflation faster than other property types due to the nature of the asset type. Office remains an issue and the future of office use remains to be seen. We believe trophy assets with longer term leases should withstand the disruption, but we remain concerned that Class B offices with tenant rollover will have considerable issues going forward.

Remaining higher in the capital structure and exposed to assets that continue to show positive net operating income (NOI) growth remains our core focus. These assets are well protected with robust protection from more junior bonds and borrower equity. Large institutional borrowers with strong capital and commitment to the sector will be able to withstand valuation declines particularly if NOI continues to grow and the long-term outlook remains constructive. Ultimately the low leverage in the mortgages and CMBS structure will protect the CMBS bonds from losses. Using a multifamily residential property deal as an example. A single asset and a single borrower with credit enhancement (bonds junior in the structure) of over 30%, along with significant borrower equity and as a result an LTV on the CMBS bond below 50%, remain attractive with yields over 8% for short duration paper with prepayment optionality upside. These markets remain strong with occupancies over 97% in a supply constrained market.

U.S. and European CLOs

Collateralized loan obligations (CLOs) are securitizations backed primarily by broadly syndicated senior-secured corporate loans. The capital structures here are very robust and to demonstrate this we can compare historical cumulative default rates versus the breakeven level of cumulative defaults required to impair the various bonds, both investment grade and sub-investment grade. You can see from Chart 2 that to impair these tranches, defaults would need to be significantly higher than in prior cycles. We think this is unlikely given the current outlook, thus providing a very comfortable cushion against the rise in defaults that we expect to see. Further, as you move up the capital structure into higher rated and high-grade bonds, the protection is even more significant.

Chart 2: U.S. CLO breakeven defaults versus historical cumulative defaults in prior cycles



Source: Moody's, Intex, BlueBay.

Our view is that while annual defaults will rise from their current low levels, we are unlikely to see cumulative defaults surpass historical cycles. The loan maturity wall is relatively benign (~8% of loans mature in 2023 or 2024) and the market is larger and more mature with better liquidity available than in those prior periods. The important message here, however, is that we do not need to make a specific prediction on defaults to be comfortable with the cushion to defaults on CLO bonds – we have a large margin of safety. CLO structures can certainly withstand onerous default projections, and CLO returns are less correlated to defaults than are single name corporates (given the diversification element and structural protections of a CLO).

Return outlook – what's being priced in?

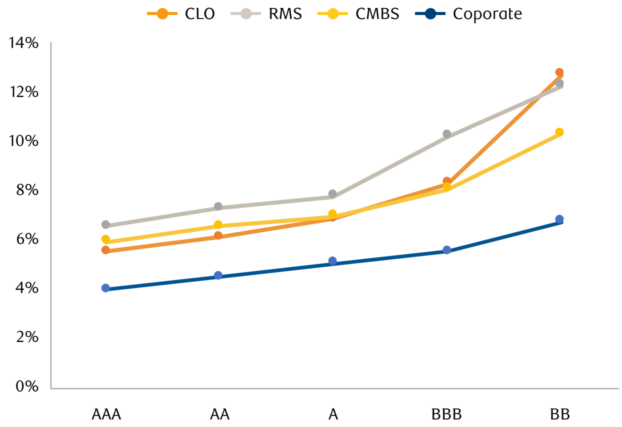
So where does that leave us? Fundamentals are weaker, yes, but the combination of collateral and bond structure is very strong – in general the quality of the bonds in our universe is very high. Importantly, bond prices are also lower, so the next question is what is being priced in at current levels? In our view a very severe downside scenario – prices have dislocated from fundamentals.

Where are yields currently?

With the increase in both base interest rates and credit spreads, all-in-yields across fixed income have become very attractive – you can now achieve 10% yield-to-maturity for investment grade credit risk. Further, credit spreads in the Securitized space have dislocated more from fundamentals than in corporate credit and have lagged the recent credit rally.

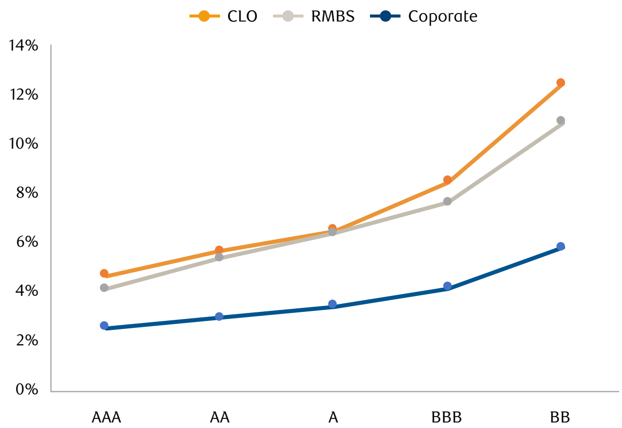
Yields are higher in Securitized versus corporate credit of the same rating – Chart 3 & 4 – and this relative attractiveness has increased recently and is not far from Covid wides – Chart 5.

Chart 3: U.S. Yields: Securitized v Corporate by Rating



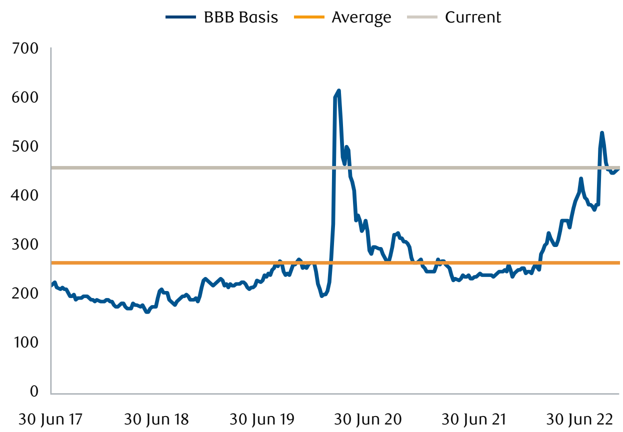
Source: Bloomberg, BlueBay.

Chart 4: European Yields: Securitized v Corporate by Rating



Source: Bloomberg, BlueBay.

Chart 5: BBB CLO versus BBB Corporate Spreads



Source: Bloomberg, Wells Fargo Securities, BlueBay.

What is the return potential from here?

Any normalisation in credit spread from here, accompanied with high carry creates a compelling 1- or 2-year return outlook – table 1. Potential IRRs range from 7 to 30%. This compares favourably to corporate credit – see table 2.

Table 1: Indicative return potential available in Securitized Credit using CLOs as an example

Geography	Rating	Current yield (USD)	Current Spread (local, bps)	January 2022 spread (local, bps)	1Y IRR in USD (Sell at Jan-22)	2Y IRR in USD (Sell at Jan-22)
U.S.	AAA	5.5%	195	105	10%	8%
	AA	6.2%	265	150	13%	10%
	A	7.0%	345	200	16%	11%
	BBB	8.3%	475	300	19%	14%
	BB	12.7%	900	630	28%	20%
Europe	AAA	6.0%	200	100	11%	8%
	AA	7.0%	300	175	14%	10%
	A	7.9%	380	215	18%	12%
	BBB	10.2%	600	315	27%	18%
	BB	14.3%	1000	600	36%	25%

Source: Bloomberg, BlueBay.

Table 2: Indicative return potential available in U.S. Corporate Credit

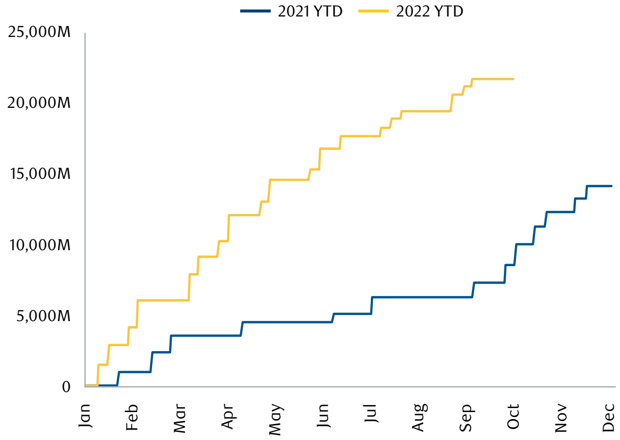
Rating	Current yield (USD)	Current Spread (local, bps)	January 2022 spread (local, bps)	1Y IRR (Sell at Jan-22)	2Y IRR (Sell at Jan-22)
BBB	5.6%	200	125	8%	6%
BB	6.9%	305	224	9%	7%

Source: Bloomberg, BlueBay.

Why are yields higher in Securitized Credit?

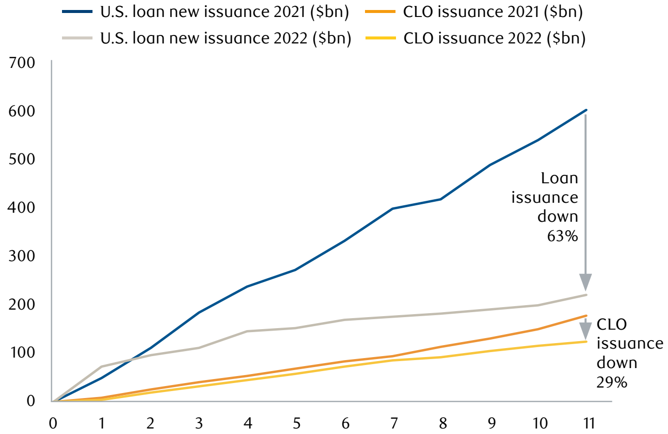
Oversupply in Securitized Credit, on top of already volatile markets, has been one of the differentiating factors for our market in 2022 and one of the main reasons for the dislocation in spreads from other fixed income asset classes. This is a technical factor, and one we expect to subside somewhat in 2023 as we have seen much less mortgage origination in recent months and loan warehouses are being worked out. Chart 6 shows the oversupply in Agency Mortgage CRT in new issue, while Chart 7 shows the decline in issuance for corporate loans (as you would expect in this environment with higher borrowing rates) versus CLO issuance which has declined far less. In fact, loan issuance is down around 63% whereas CLO issuance has only declined 29%. On the secondary supply side, there was a big dislocation in European markets following liquidation on behalf of UK pension schemes in October. The effects of which are still being felt today – YTD supply in secondary is now over 50% higher than 2021 – see Chart 8.

Chart 6: Primary market issuance in U.S. Agency Mortgage Credit Risk Transfer (CRT)



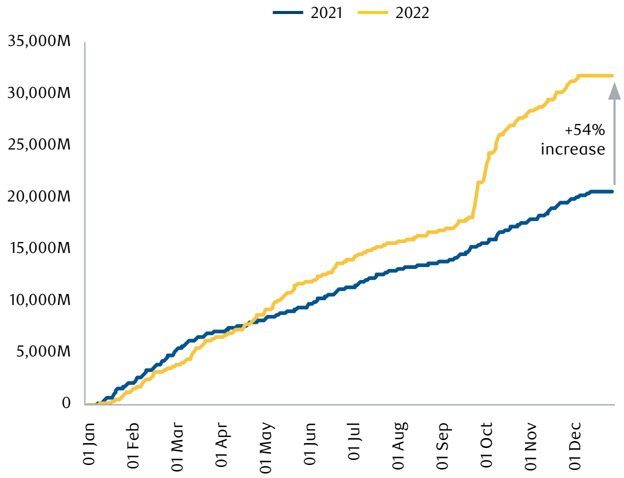
Source: BofA, BlueBay.

Chart 7: Primary market issuance in U.S. CLOs is elevated this year relative to corporate loans (YTD)



Source: BofA, BlueBay.

Chart 8: Secondary auction supply in European ABS



Source: Morgan Stanley, BlueBay.

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