RBC BlueBay
Asset Management

A Q&A with Sid Chhabra, our Head of Securitized Credit & CLO Management

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Securitized Credit team

Published May 2024

With our Securitized Credit funds delivering strong positive returns across the board, it's a timely moment to ask Sid Chhabra for his views on key themes, pressure points in Securitized Credit markets, and the outlook for the rest of the year.

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Key takeaways:

- Overall, the outlook is constructive with a cautious bias, as we believe the lowest cohorts of corporates and consumers will need to restructure their overleveraged balance sheets.
- For the rest of the year, primary issuance is likely to remain elevated, leading to spreads in Securitized Credit remaining much wider than corporate credit.
- We remain positioned in the higher quality segment of the market, where carry yields in high single digits are strongly appealing, with low spread duration.

We're already about a third of the way through the year; what key themes have you been following in markets and specifically within Securitized Credit?

The narrative of immaculate disinflation and a comfortable soft landing has been challenged, as a result of persistently strong inflation data in the US, particularly in services. This is delaying the path of price cuts until later in the year, leading to an upward move in yields across the curve.

Growth data in the UK & Europe remains weak but improving from a low base, and inflation data has responded better, although rising yields in the US have also created upward moves in yields in the UK and Europe.

Unlike in October 2023, this wider move in yields hasn't caused much pressure in risk assets, where a strong technical of inflows have supported credit spreads, and ultimately investors and the market have balanced out the upward move in yields with better underlying economic data to remain supportive of higher quality risk assets.

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Spreads in corporate IG, high quality HY and leveraged loans have remained tight, and equity markets continue to show reasonable positive performance. This overall backdrop has been supportive for investors in Securitized Credit.

The positive sentiment for risk assets coming into the year has meant there has been a significant pick-up in gross supply across US and European ABS, RMBS/MBS and CLO markets but matched for the most parts by investor demand.

This has ultimately led to strong positive returns from a combination of high carry and modest spread compression. The upward move in yields hasn't been completely pain-free for broader markets, with overleveraged corporates with weak fundamentals, and especially those with nearer-term maturities seeing significant underperformance.

Given that backdrop, how has performance been in Securitized Credit?

Securitized Credit markets came into the year materially lagging the recovery in spreads we had seen in IG and HY markets. Whilst our market has seen significant issuance since the start of the year, the higher spreads on offer versus developed market corporate credit, together with the shorter interest rate duration nature of most of our asset class, has led to significant positive performance so far.

Most of our funds are close to mid-single positive percentage returns for the year, and a few of them further north of mid-single digit returns. This has been driven by a combination of both high-quality carry and some spread tightening, particularly across the mezzanine portion of the market. Securitized credit is significantly outperforming, versus other areas of fixed income market.

Let's drill down a bit on this 'higher for longer' narrative. Where do you see the pressure points, and what will be the impact on Securitized Credit markets?

Consumers and corporates have been dealing with higher rates and cost of living pressures for some time. On the consumer side we have witnessed a deterioration in collateral performance and a rise in delinquencies, though that is largely attributable to a cohort of borrowers with less savings and wealth – typically those at the lower end of the income spectrum. This is mirrored in the corporate space where those that have exhibited the weakest performance are ones with challenged fundamentals and stretched capital structures where there is a higher sensitivity to a rise in rates.

Our view through the first quarter has been consistent – i.e. we have assumed that 2024 will show a rise in weakness of lower quartile consumers and corporates and therefore have positioned in the higher quality segment where there is a strong margin of safety and where spreads and yields on offer were already very attractive to begin with. We continue to forecast pressures to remain persistent for the lower quartile of borrowers amongst consumers and corporates, but no systemic rise in stress, and as a result, haven't significantly changed our positioning over the last few weeks.

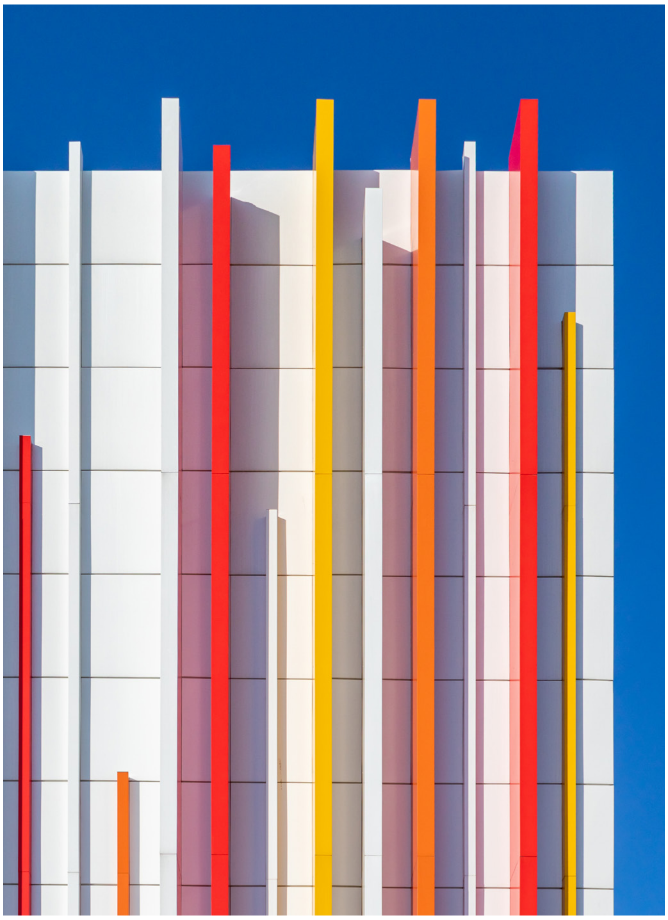
The areas most at risk in our markets are those that are most sensitive to higher rates, such as commercial real estate, and those at the very lowest parts of the capital structure where investors are most exposed to front loaded idiosyncratic events and rises in delinquencies. We have been highlighting for quite some time now the issues the CRE sector faces, which are not isolated to defunct offices, but also include excesses built on cheap funding, such as transitional multi-family residential property loans. At this stage, we see market pricing for such assets better reflect the underlying weakness in fundamentals and don't expect further material deterioration.

How do you see the remaining two thirds of this year playing out?

There is still a long way to go for the year and uncertainty will likely remain high, whether that be around inflation and rates, geopolitical risk or elections. We believe investors should keep things simple, target better quality investments, with attractive risk-adjusted returns and protection against a significant pick up in defaults – this is where we believe Securitized Credit comes in.

The benefits of an allocation to the sector have been proven over the last few years and our outlook from a fundamental and technical perspective is broadly constructive. With spreads remaining very attractive on account of elevated supply, there is a benefit of investors receiving attractive all-in yields relative to most other parts of the fixed income universe.

Many AAA rated securities in our markets are still offering current yields close to 6.5-7% as an example. Further, when there is high supply, there are opportunities for us to tilt our positioning to those segments where risk-adjusted spreads and yields are most attractive and use the primary market to deploy capital. This has worked well in the first quarter for our funds, and we expect the same for the rest of the year.



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Published May 2024

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