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The Last Credit Refuge before the Next U.S. Recession?

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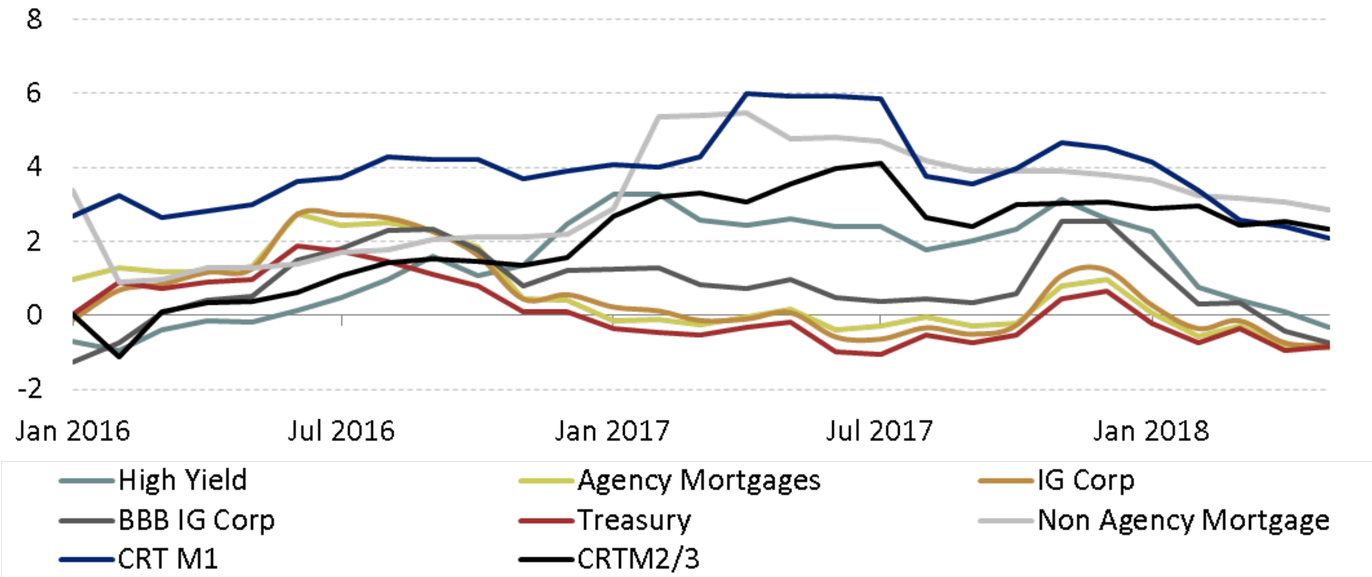
With the maturing U.S. credit cycle, the flattening yield curve, the unwinding of the Federal Reserve (Fed) quantitative easing (QE), the intensifying geopolitical risk and correspondingly intensifying trade war, we think mortgage credit could be the "last refuge" before the next recession hits. Even if the next U.S. recession could theoretically start 18-months from now, it's not too early to start thinking about return potential in a different economic environment. Mortgage credit isn't immune from macro/geopolitical risks nor is the sector insulated from common late-cycle issues like oversupply in certain regions/sectors or easing of lending standards. However, this segment may offer a better value proposition and return potential going forward for credit investors. First, let's take a look at how different segments of the credit market have performed over the last few years.

Cross-Sector Performance

Even though past performance is by no means an indicator of future performance, Citigroup did an interesting study on the relative value between mortgage credit and corporate credit and concluded that mortgage credit offers stronger relative value on a risk-adjusted basis. We all know that the U.S. credit cycle has matured over the past decade. Investment grade corporate credit performed strongly from 2015-16, but has generally underperformed recently. High yield credit has lagged over the past 12 months after outperforming during 2016-2017. Meanwhile, mortgage credit, including non-agency residential mortgage-backed securities (RMBS) and credit risk transfers (CRTs), has consistently outperformed since 2016, measured by 12-month trailing Sharpe ratio, as shown in the chart below. Mortgage credit represented by CRT M1 and CRT M2/M3 and non-agency mortgage are the top three lines of the line charts. CRT bonds are structured with sequential payment of M1, M2/M3 and B1 tranches.

Chart 1: 12-Month Trailing Sharpe Ratio

As of 5/1/2018

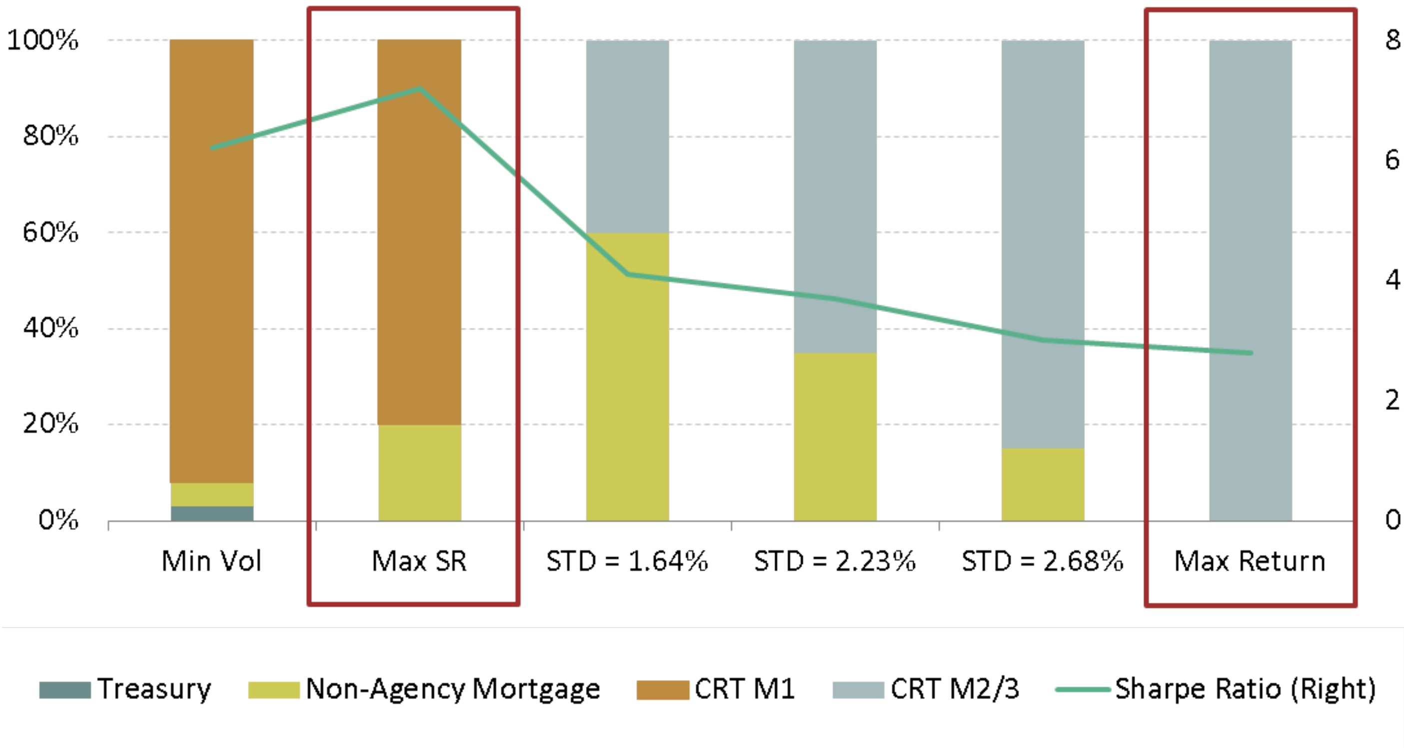


Source: Yield Book, Intex, FINRA, Citi Research

Based on covariance of both corporate credit and mortgage credit assets since 2015, Citigroup constructed various portfolios and return targets at a given level of risk. The result is shown in Chart 2 below. The optimal portfolios are exclusively mortgage credit: the optimal risk-adjusted portfolio with the highest Sharpe ratio is a 20/80 split between non-agency mortgage-backed securities (MBS) and CRT M1, while the optimal portfolio with maximum expected return is 100% CRT M2/M3.

Chart 2: Portfolio Composition for Performance Targets

As of 6/30/2018



Source: Yield Book, Intex, FINRA, Citi Research

While we won't allocate 100% of a portfolio to MBS, we nevertheless think the chart above highlights the attractive return potential. Most mortgage credit outperformed other credit sectors in the first half of 2018, and the best performers are listed in Table 1 below:

Table 1: 2018 Year-to-Date and 2017 Returns Summary – Ranked by 2018 Total Return

As of 6/30/2018

Sector	1H 2018 Total Return	1H 2018 Excess Return (vs. Swaps/Libor)	2017 Total Return	2017 Excess Return (vs. Swaps/Libor)
NDX 100	10.7%	N/A	33.0%	N/A
CAS 1B1	4.3%	3.2%	16.1%	15.1%
CLO 2.0/3.0 BB	3.0%	1.9%	16.0%	15.0%
S&P 500	2.6%	N/A	21.8%	N/A
Leverage Loans	2.2%	1.0%	4.1%	3.1%
Legacy non-agency MBS	2.1%	0.9%	9.9%	8.9%
CAS 1M2	2.0%	0.8%	11.9%	10.9%
CLO 2.0/3.0 BBB	1.7%	0.5%	8.1%	7.1%
CMBS BBB-	1.5%	3.2%	7.9%	6.8%
CLO 2.0/3.0 A	1.4%	0.2%	4.4%	3.4%
Floating ABS	1.3%	0.2%	2.9%	1.8%
CLO 2.0/3.0 Total	1.3%	0.1%	3.9%	2.9%
CAS 1M1	1.2%	0.1%	2.9%	1.9%
CLO 2.0/3.0 AA	1.2%	0.1%	3.2%	2.2%
CLO 2.0/3.0 AAA	1.1%	0.0%	2.6%	1.6%
Fixed ABS	0.4%	0.3%	2.1%	1.1%
HY Corporate	0.1%	1.1%	7.5%	6.4%
US Municipal	-0.3%	0.8%	5.4%	4.1%
Agency MBS	-0.9%	0.2%	2.4%	1.1%
CMBS	-1.1%	0.6%	3.4%	2.2%
US Treasury	-1.1%	0.7%	2.4%	1.1%
Agency CMBS	-1.2%	0.4%	3.0%	1.8%
EM Corporate	-2.5%	-1.3%	6.9%	5.8%
IG Corporate	-3.1%	-0.9%	6.5%	5.0%
EM Sovereign	-4.8%	-3.1%	9.0%	7.7%

Source: BofA Merrill Lynch Global Research, ICE Data Indices, LLC., Palmer Square CLO Indices, S&P LCD

Note: Excess returns are measured over swaps for fixed rate assets, over Libor for floating rate assets. Legacy non-agency RMBS excess returns are benchmarked to Libor, not swaps, as majority of sector is floating.

The B1 tranches of credit-risk transfers (CRTs) have been the star performers both in 2018 and 2017, despite three severe hurricanes. As shown below, the CMBX BB. 6 series printed 7% returns in 1H18, even without counting the 5% carry:

Chart 3: CMBX BB Price Trend for 1H 2018

As of 6/29/2018

Source: Bloomberg (© 2018, Bloomberg Finance LP)

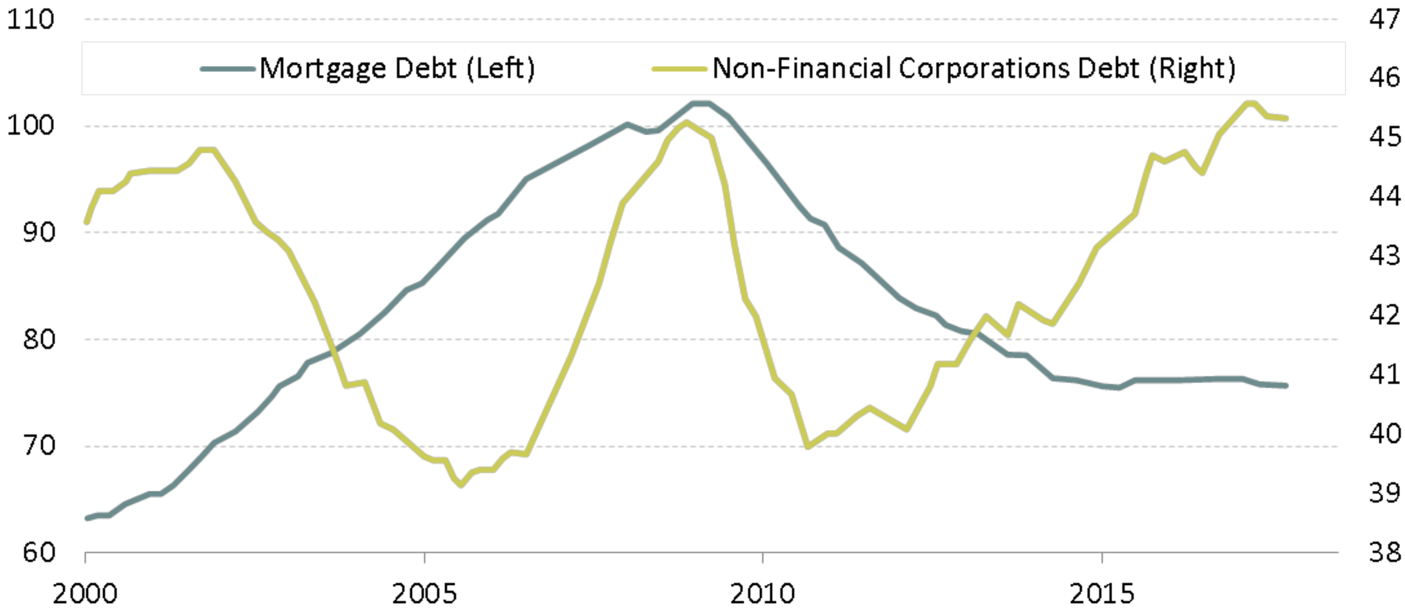
So why do we think mortgage credit will continue to outperform despite a stellar first half of 2018?

Solid Fundamentals

Housing fundamentals are solid due to the severe shortage of supply, low unemployment rates, and pent-up demand from millennials. With that being said, we think housing price appreciation may decelerate going forward due to declining housing affordability to better align with wage growth. On a relative basis, the mortgage segment of the credit market has de-levered, while corporates have increased debt levels during the post-crisis period. Secondly, the mortgage segment is in the earlier stage of the credit cycle, whereas corporates are in the later stage of the credit cycle.

Chart 4: U.S.: Mortgage Debt vs. Nonfinancial Corporations Debt (% of GDP)

Percent of GDP, As of 7/31/2018

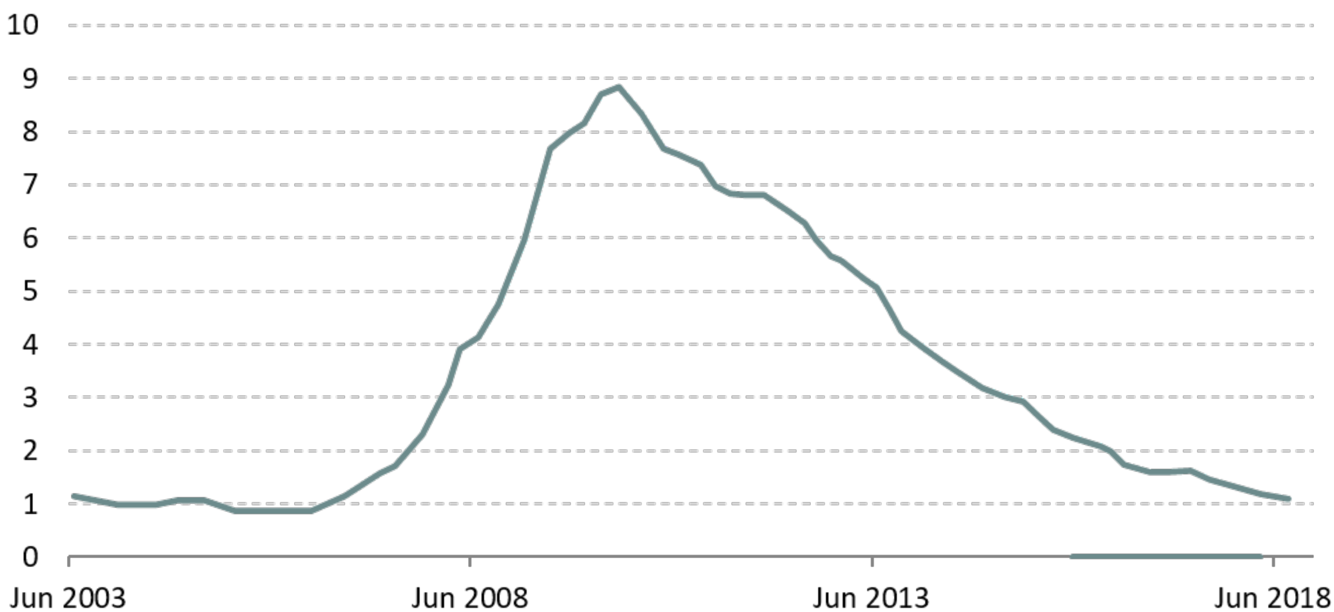


Source: Haver Analytics

The Fed mortgage 90-day delinquency rate has been trending downward:

Chart 5: Fed Mortgage 90-Day Delinquency Rate

As of 6/30/2018



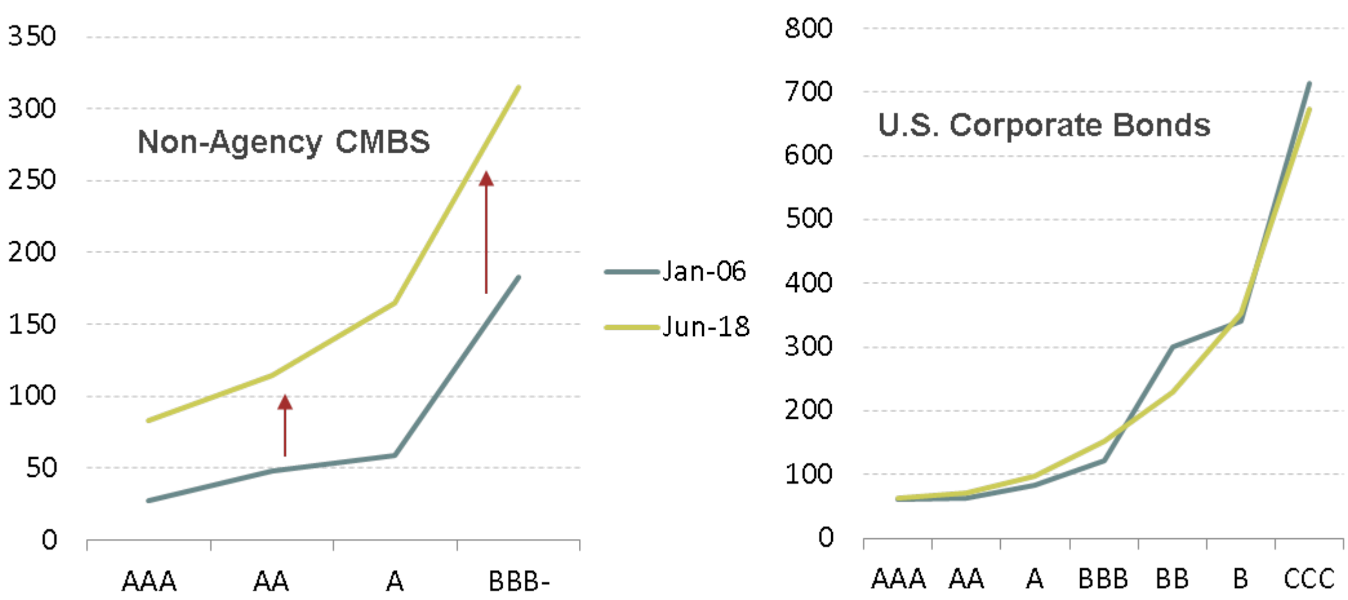
Source: Bloomberg (© 2018, Bloomberg Finance LP)

Cheaper Valuations

Structured credit spreads are still much wider versus pre-crisis levels, whereas corporate spreads are similar to pre-crisis levels. The CMBS credit curve has shifted up enormously since the last crisis, as shown in the left chart below, whereas the current corporate bond credit curve looks similar to the 2006 level, as shown in the right panel of Chart 6:

Chart 6: Credit Spread by Rating: January 2006 vs. June 2018

Basis Points per Credit Rating, As of 7/1/2018



Source: BAML, Goldman Sachs Global Investment Research

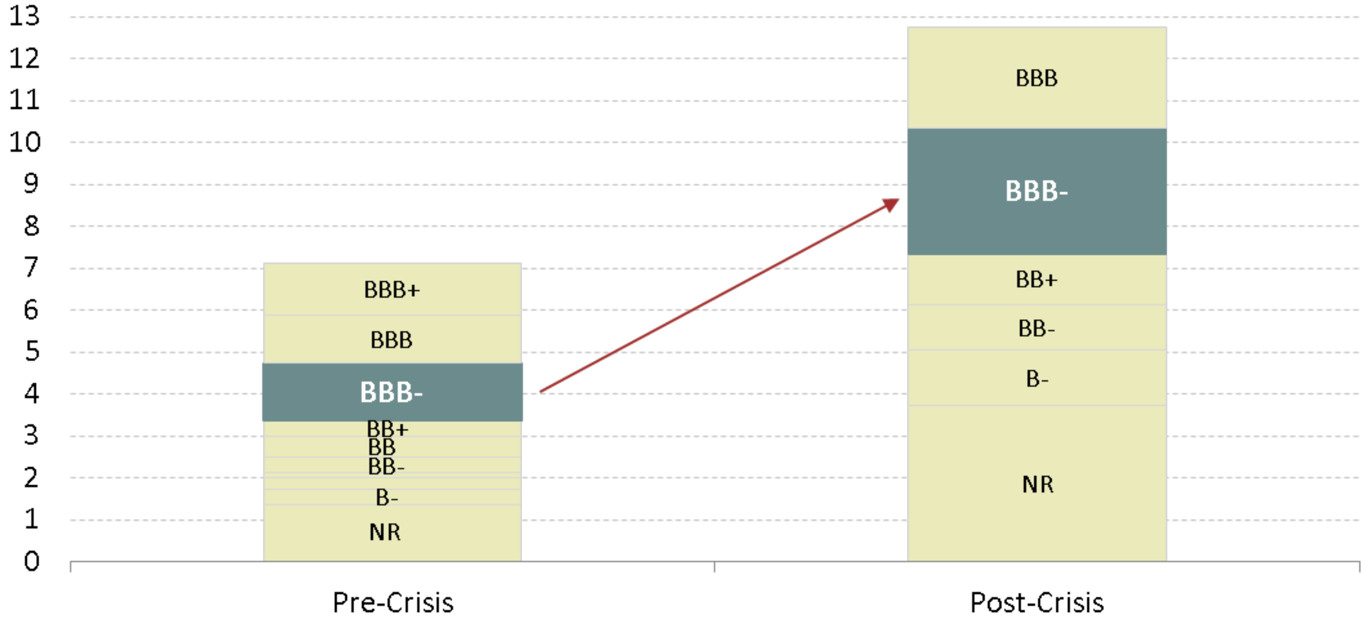
Source: BAML, Haver Analytics, Goldman Sachs Global Investment Research

Better Structures and Collateral Quality

Deal structures have become more investor friendly since the crisis; there is more credit support. Post-crisis CMBS conduit BBB- tranches have more subordination and are thicker than BBB- tranches issued pre-crisis (as shown in Chart 7).

Chart 7: Pre-Crisis and Post-Crisis Bond Size

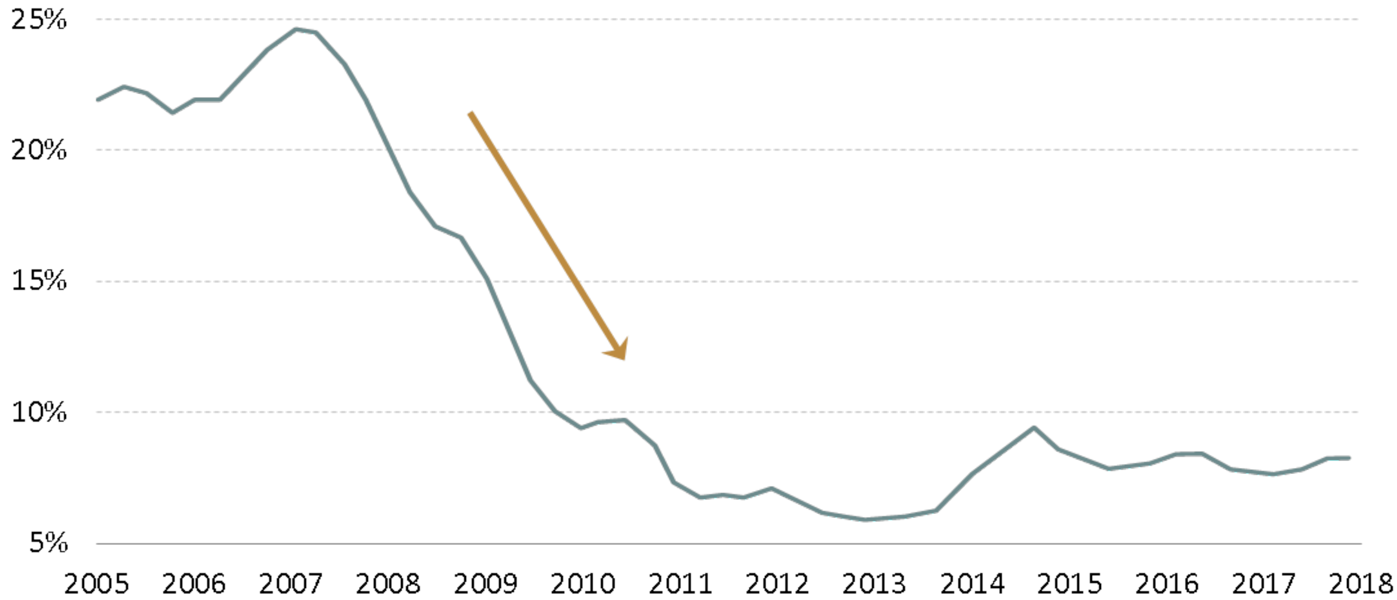
Percent, As of 12/31/2016



Source: Intex, Goldman Sachs Global Investment Research

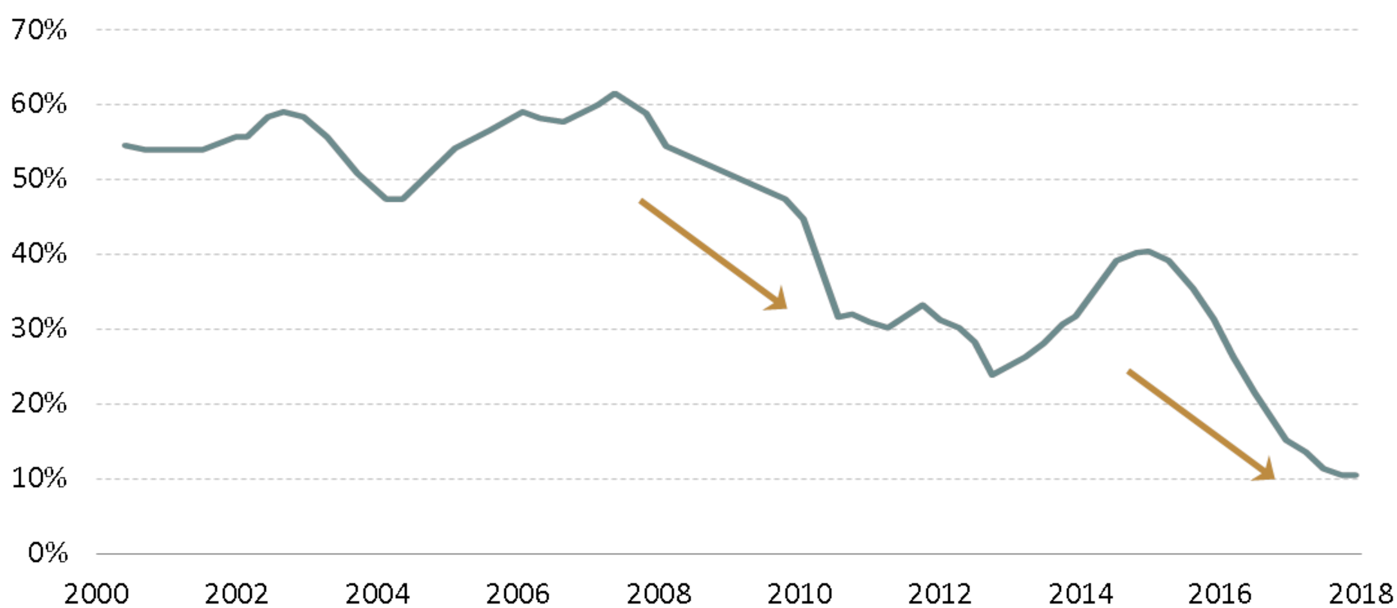
Mortgage underwriting has drastically improved post-crisis with underwriters tightening their credit box, albeit we have seen gradual easing lately. However, post-crisis underwriting still remains much more conservative than pre-crisis standards. Better and tighter underwriting standards are shown below in terms of better risk metrics such as higher FICO scores and lower loans-to-value.

Chart 8: Percentage of Mortgage Originations with Credit Score Below 660
By Origination Quarter, As of 6/30/2018



Source: Federal Reserve Bank of New York, Haver Analytics, Goldman Sachs Global Investment Research

Chart 9: Percentage of CMBS Loans with LTV Ratio At or Above 70%
By Origination Quarter, As of 6/30/2018



Source: Trepp, Goldman Sachs Global Investment Research

Conclusion

Given the uncertainty stemming from macro risks and the unwinding of the Fed QE, it could be prudent for credit investors to tactically add defensive positions. An allocation to mortgage credit may be part of a defensive credit strategy given the better collateral quality, de-leveraging, solid fundamentals, and cheaper valuations. Heading into 2019, we continue to see opportunity in the structured credit space, from private-label RMBS to non-agency and agency CMBS. For global credit investors, we believe even European RMBS still offers good value.

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