NOV
17
2022

Structured Credit, a Cheaper but Safer Alternative

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In a year of nowhere-to-hide amid interest rate shocks, the global fixed income market has cheapened significantly. However, with recession risks looming in 2023, investors must tread carefully to avoid credit landmines. We currently see several attractive opportunities with cheaper valuations and minimal credit risks in high-quality agency residential mortgage-backed securities (RMBS), agency commercial mortgage-backed securities (CMBS), and AAA non-agency CMBS.

1. Agency Mortgage-Backed Securities (MBS)

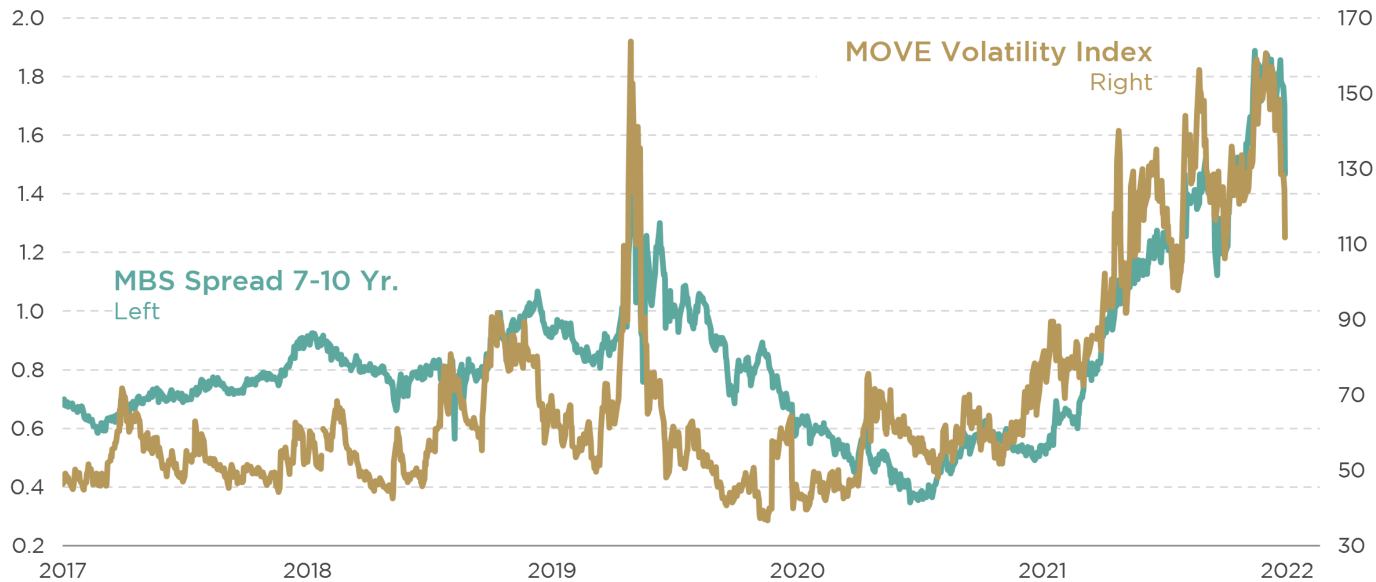
Mortgage rates have topped 7%, the highest since 2000, eliminating the opportunity for most existing loans to refinance. At the same time, housing affordability has deteriorated sharply. The housing market will slow down drastically. However, the tail risk in housing is much less than the Global Financial Crisis (GFC). The current levels of the housing market should remain supported by the lack of supply, healthy household balance sheets, and the lack of distressed sales—a notable contrast to the GFC.

An MBS investment comes with an embedded short on prepayment options, hence its spread to Treasury bonds has a positive correlation with interest volatility (see Figure 1). Driven by rate volatility and exit of the largest buyer, the Federal Reserve (Fed), mortgage spreads are once again at the widest of the post-GFC period, and MBS valuations are very attractive. We believe the heightened interest rate volatility should peak, which should bode well for MBS. Furthermore, convexity is near the best levels due to the out-of-money status. MBS are notorious for their negative convexity, but now given the high interest rate, the convexity is the least negative.

1

MBS Spread to 7 to 10-Year Treasury vs. MOVE Volatility Index

% (Left), Index (Right), As of 11/10/2022



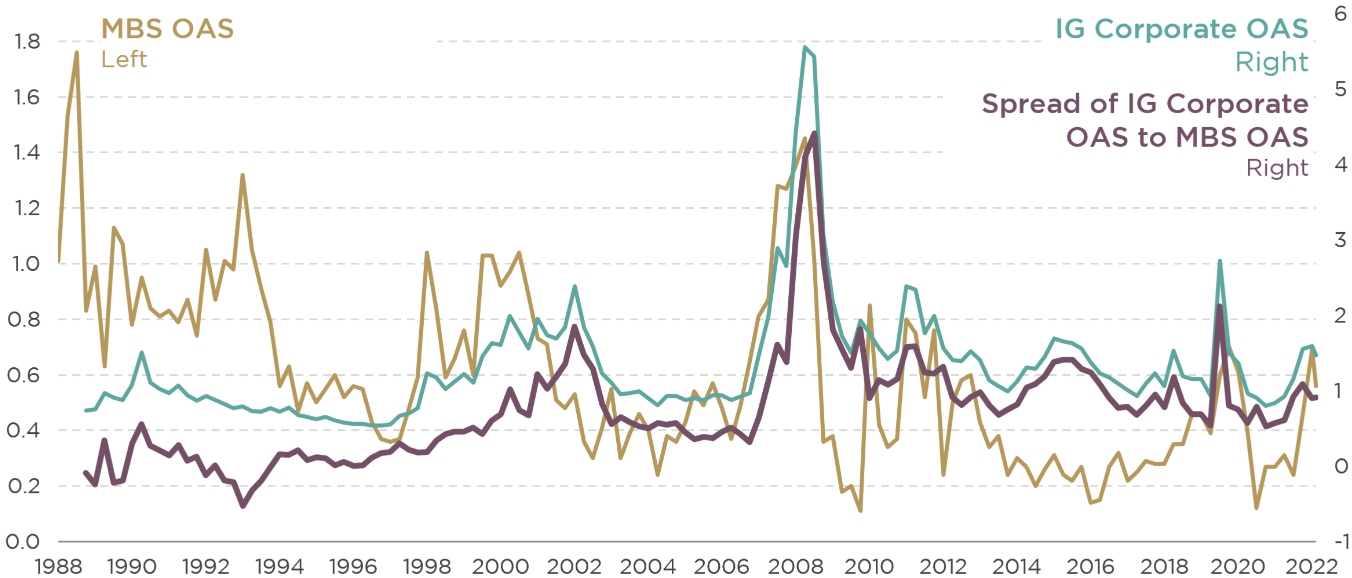
Source: Bloomberg (© 2022, Bloomberg Finance LP)

The widening in mortgage spreads has significantly outpaced the widening in investment grade (IG) corporate spreads this year. As a result, IG corporates' pickup in spread relative to MBS (purple line) is close to the post-GFC tight, compared to the IG corporate option-adjusted spread (OAS) (teal line) and MBS OAS (gold line) (see Figure 2).

2

MBS Option-Adjusted Spread vs. Investment Grade Corporate OAS Index

%, As of 11/10/2022

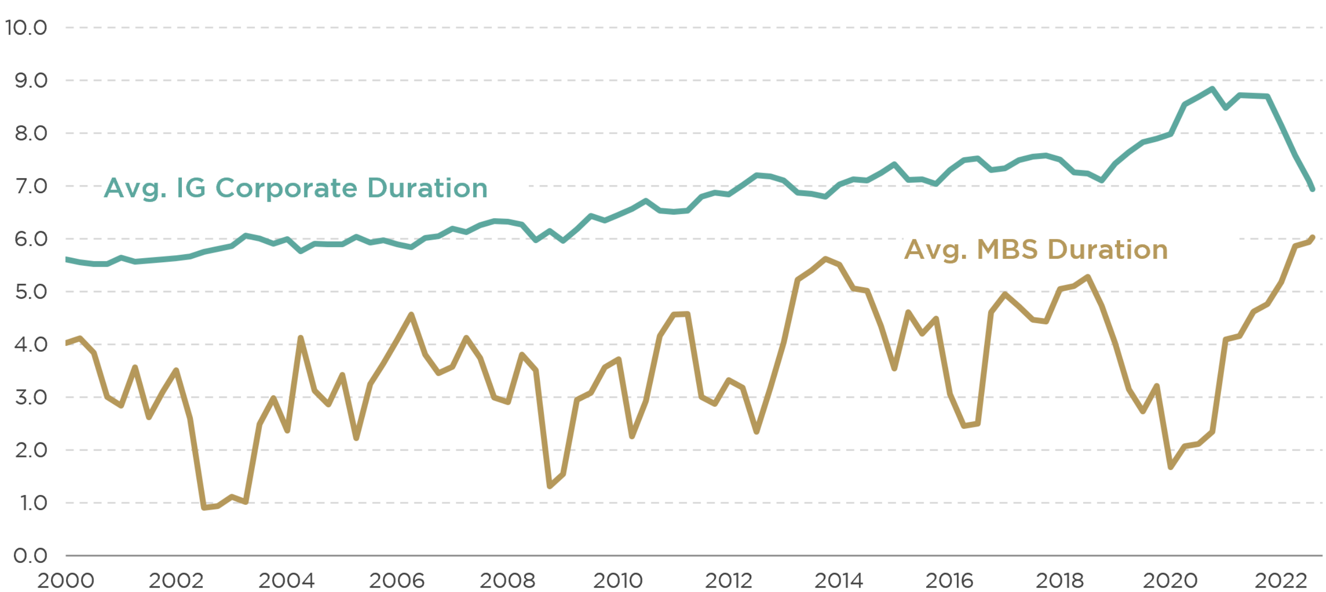


Source: Bloomberg (© 2022, Bloomberg Finance LP)

Fundamentally, high mortgage rates put roughly 99% of borrowers out of money to refinance, extending the MBS duration to its historical high of over 6 years (gold line) (see Figure 3). At the same time, the duration for IG corporate bonds fell below 7 years (teal line). Therefore, if we wanted to capture the spread tightening move, MBS is at less of a disadvantage versus IG corporates from the duration perspective.

3 Average MBS and Investment Grade Duration

Years, As of 10/25/2022



Source: Bloomberg (© 2022, Bloomberg Finance LP)

Lastly, we have increasingly observed a more favorable market technical. Challenging housing affordability inevitably reduces housing activity and mortgage origination, hence less MBS supply. At the same time, attractive valuation meets with the first signs of inflows into MBS funds. With this said, there is still some uncertainty in demand from the Fed, banks, foreign buyers, money managers, REITS, and government-sponsored enterprises (GSE), like Freddie Mac and Fannie Mae.

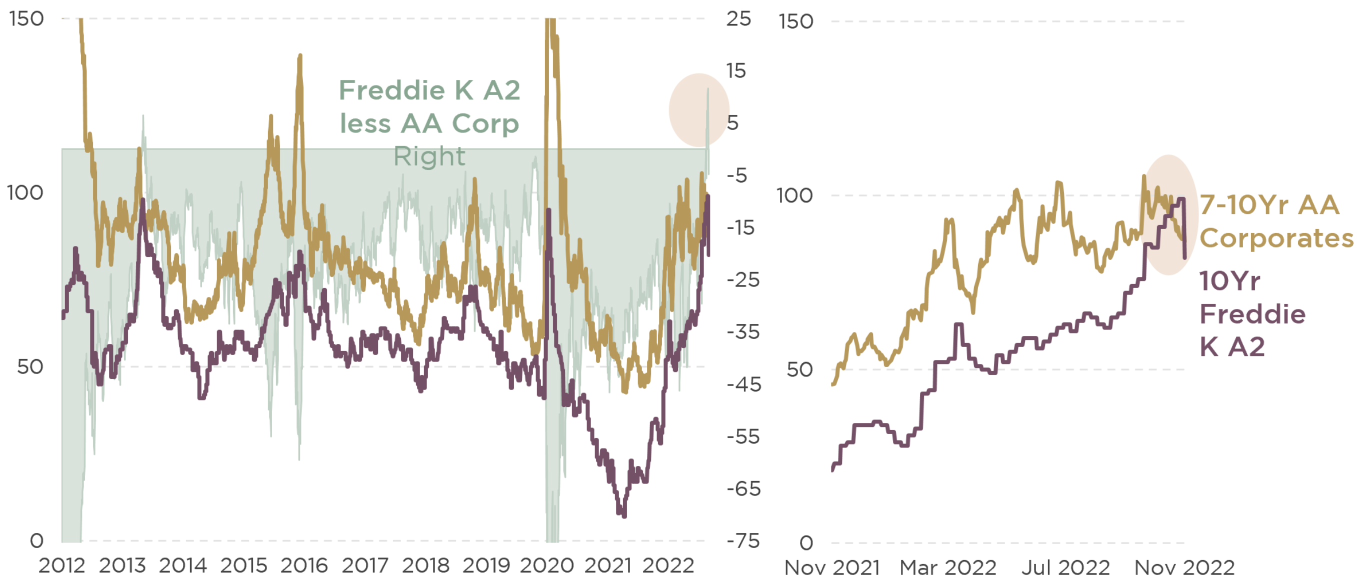
2. Agency Commercial Mortgage-Backed Securities (CMBS)

Government guaranteed agency CMBS with call protection are now cheaper than 7 to 10-year AA corporate bonds, a rare case in history (See Figure 4).

4

Agency CMBS Spreads vs. 7-10Year AA Corporate Spreads

Basis Points, As of 11/10/2022



Source: J.P. Morgan

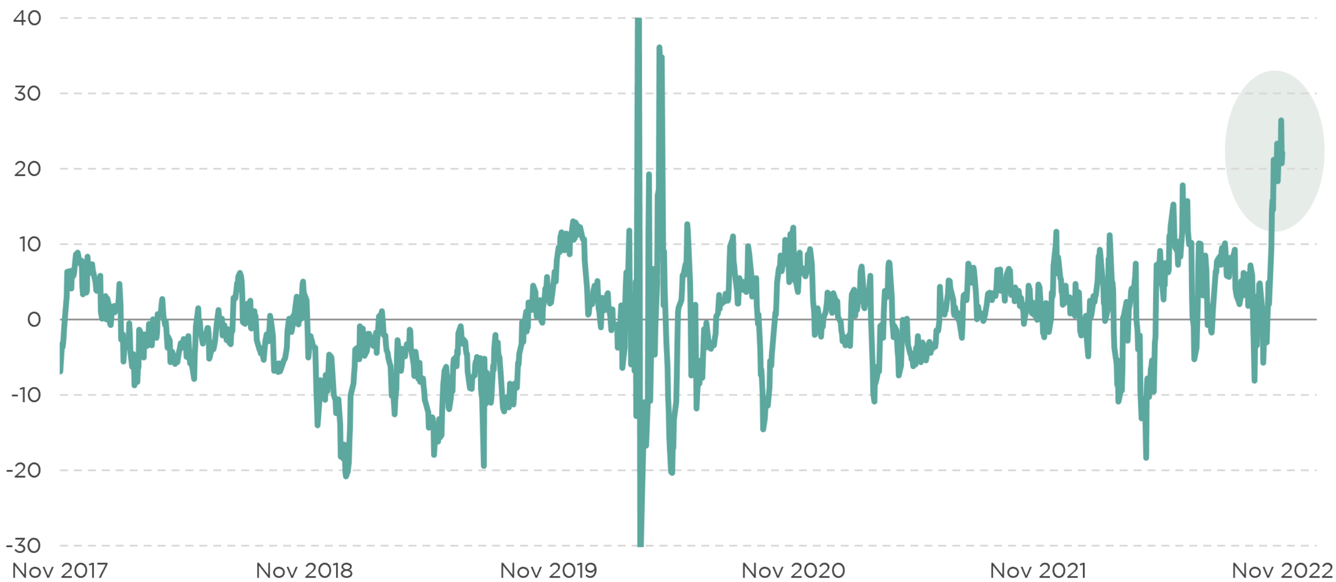
3. Non-agency CMBS

Currently, AAA-rated conduit CMBS look cheaper than similar duration single-A corporate bonds (See Figure 5).

5

Spread of AAA 10-Year CMBS to 7 to 10-Year A Corporate Bonds

Residuals from a linear regression of 10yr conduit CMBS LCF Treasury spreads to 7-10yr A corporate Treasury spreads, daily spreads over last 5 years; As of 11/10/2022



Source: J.P. Morgan

There are also attractive opportunities in other AAA-rated sectors like AAA collateralized loan obligations (CLO), AAA non-qualified mortgage securities, AAA subprime auto asset-backed securities (ABS), IG-rated credit risk transfers (CRT), etc. Investors with larger risk appetites also can find opportunities in BBB or equivalent CLO, CMBS, or CRT, which offer double-digit yields that help compensate for the credit risks.

It is nearly impossible to time the market bottoms exactly, and the above assets can still get cheaper if the Fed overtightens and Treasury rates climb significantly higher from here. However, we think these structured credit investments should pay off over the medium to long term.

Conclusion

With high-quality structured credit having cheapened so much, we do not need to take excessive credit risk to achieve decent returns. As recession risk looms in 2023, we believe these structured credit sectors should outperform during an economic downturn with minimal credit risks. Historically wide spreads compensate for many risks. We believe investors should consider taking advantage of these opportunities and the potential for attractive long-term returns.

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