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Global Asset Management

Positioning portfolios in the face of increased stagflation risks

Tom Mowl
Portfolio Manager

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With the risk of stagflation in Europe increasing, we believe that portfolios should be positioned to withstand such an eventuality and securitised credit is well positioned to provide a solution.

The appalling events being witnessed in Ukraine are further increasing the risk of significantly higher input costs across a range of raw materials, a trend that was already in full force last year. Coupled with potentially slower growth, this has increased the risk of a recession in Europe, which would likely lead to an increase in corporate defaults and credit tiering.

The strength of the central bank response in the face of spiralling inflation will be keenly watched by market participants, alongside the fiscal response from individual governments to protect companies and consumers from higher costs. There are sectors and geographies that are better positioned to face this emerging threat from input costs. For example the US, where the economy has weathered the latest Covid waves, is now re-opening and consumer balance sheets are in solid shape, having amassed excess savings in the region of USD2.5 trillion.

So how can the securitised credit market be used to help protect portfolios against these risks?

- **Stay up in credit:** within securitised credit markets you can focus on investing in higher-rated tranches that are insulated from a significant increase in defaults while maintaining an attractive carry across your portfolio.
- **Focus on stronger, less exposed sectors:** by targeting sectors that are less exposed to inflationary pressures, such as real assets (residential and commercial mortgages), as well as sectors on solid fundamental footings (such as consumer credit), it is possible to create portfolios more isolated from the emerging risk of higher input costs. Consumers are well placed to benefit from potential fiscal support, were in a strong position coming into the latest crisis and, particularly in the US, are benefiting from continued economic re-opening following the pandemic.
- **Geographical diversification:** the US securitised credit market is a c.USD3 trillion market, allowing the opportunity to invest in a variety of profiles that are further removed from issues being faced by Europe – three examples of which can be found in the table below.

Collateral	Strategy	Rating	Credit spread	Avg. life	Investment thesis	Modelled 12-month potential total return*
US agency residential mortgages	Total return	BBB	+300-400 bps	3-4 yrs	▪ Exposure to US housing market ▪ Technical factors of higher supply driving pricing, not fundamental performance	8-12+%
US commercial mortgages	Defensive, carry	BBB	+250-300 bps	~1 yr	▪ Short, very low leverage (~20% LTV) hotel with significant cash infusion due to recent acquisition ▪ Benefits from reopening of travel and leisure in the US	3-4%
US corporate loan	Carry plus total return	A	200-250 bps	4-5 yrs	▪ Almost out of reinvestment period - risk will reduce as the deal de-levers ▪ Discount to par offers total return upside if markets stabilise	5-6%

* Modelled potential 12-month total return assumes that spreads return to January 2022 levels (which were still wider than at 2021 tights) over a 12-month period.

Source: Bloomberg, Intex, BlueBay Asset Management, March 2022.

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