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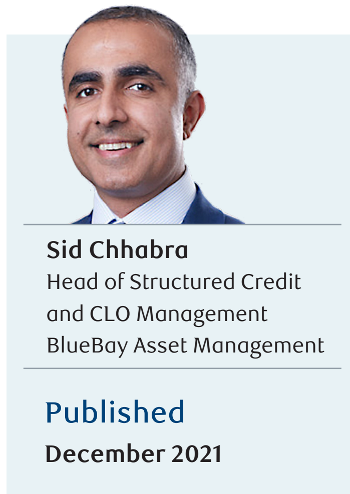
Global Asset Management

Structured credit in 2022



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2021 was a year of solid performance across structured credit markets as growth rebounded, fundamentals improved and issuance volume was buoyant.

We had bouts of volatility throughout the year, with the most significant moves seen at the end of November with the news of a new Covid-19 variant, Omicron, hitting headlines.

Looking to 2022, we consider the challenges for markets and investors.

Markets

- The backdrop of above-trend global growth, falling unemployment and strong household balance sheets are providing tailwinds.
- Headwinds include declining central bank support alongside the risks of inflation, higher rates and the continued uncertainty of the Covid-19 pandemic, which still dominates global headlines and weighs on consumer confidence.
- Our expectation is that we will see an increase in idiosyncratic defaults as the impact of inflation on costs, alongside tighter supply chains and labour shortages, increases the likelihood of idiosyncratic shocks.
- We believe structured credit assets are set to deal with these challenges quite well given the floating-rate nature of much of the asset class and structural protections embedded to insulate from defaults. In addition, the investment-grade structured credit space is much shorter spread duration versus investment-grade corporates. This lower spread duration typically means less mark-to-market volatility during periods of stress.

Investors

- In our view, one of the biggest challenges facing investors is sourcing yield without taking on too much risk. With 20% of global bond markets at a negative yield, it's difficult for investors to find attractive yielding assets.
- Structured credit provides a solution, with even the most senior tranches across most asset types offering a positive yield at higher levels than lower or similarly rated corporates.

Key themes for 2022

Fundamentals

1. Consumers are in a good position but face some challenges ahead

Consumer asset-back security (ABS) and residential mortgage-backed security (RMBS) sectors are generally quite robust and have performed well over the course of 2021. Fundamentals are solid and have improved in some areas after a slight deterioration in 2020.

In the US, the housing market is well supported, though we continue to monitor growing affordability concerns alongside the potential impact of rising interest rates. We have found the most compelling value in more seasoned collateral that has a significant amount of embedded house price appreciation and was originated at higher mortgage rates, which has led to consistently high prepayments rates and mitigates extension risk.

In Europe, payment holidays have come to an end for most mortgages and the impact on RMBS performance was muted, reflected in the arrears data, as shown in chart 1.

Housing markets are in a strong position, in our view. Looking at the UK market, house price growth appears to have peaked at its highest post-global financial crisis (GFC) level in September 2021, driven by the stamp duty extended holiday and a pent-up spike in demand post-Covid-19 lockdowns. House price growth is likely to decelerate in 2022, due to inflationary pressures and the impact of higher interest rates and taxes, but should continue to be supported by structural undersupply.

The UK rental market remained strong and buy-to-let (BTL) mortgages were in significant demand in 2021; the demand for BTL mortgages may weaken in 2022 if interest rates start to increase. We are marginally more cautious in the UK market than we were this time last year, given the headwinds of the unwind of the furlough scheme, rising inflation, higher energy prices and tax increases. As a result, we favour more senior defensive positions in UK RMBS.

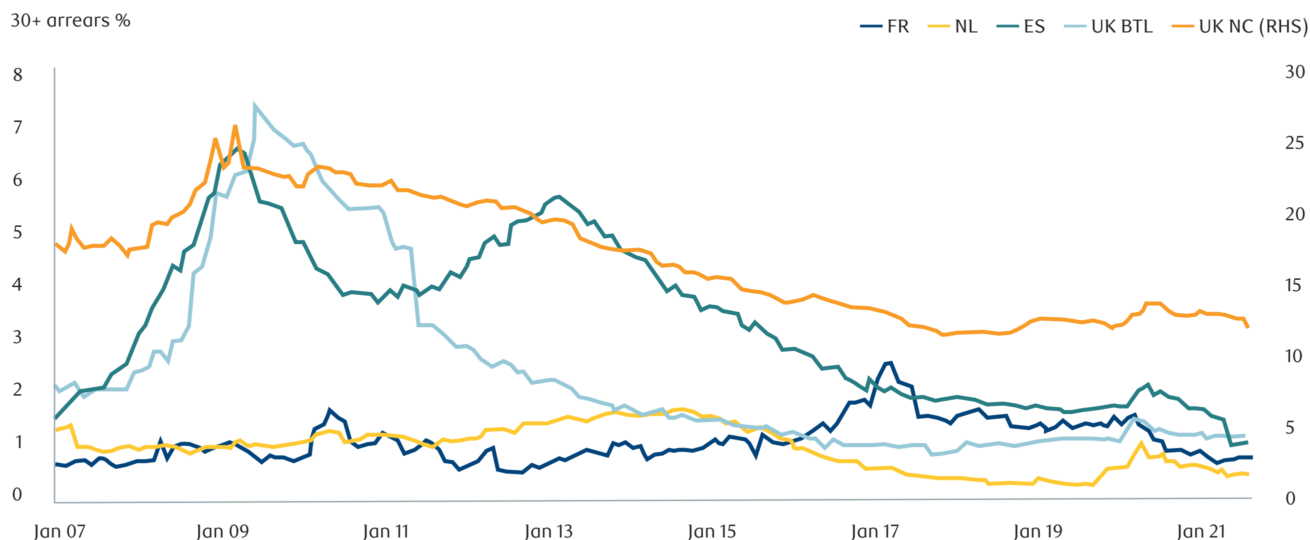
In the autos space, arrears in the UK remain slightly above pre-Covid levels from a low base, while German auto ABS remains arguably the most robust sector. We believe the auto ABS market should broadly benefit from continued strength in the used vehicle market.

The biggest risks to consumers, in our view, are inflation and rates. Although rising prices are negative for consumers, in terms of the prices of real goods such as fuel and food and the rising costs of debt given expected rate rises, these should both be mitigated somewhat by wage inflation, alongside accumulated savings. In addition, the ongoing Covid-19 pandemic continues to weigh on consumer confidence and if this trend continues, the impact could be negative for consumer spending and growth. Overall, our view on consumer ABS and RMBS is positive, though we think there are likely to be some vulnerable pockets.

2. Fundamentals for credit are broadly stable – we expect defaults to rise, albeit from low levels

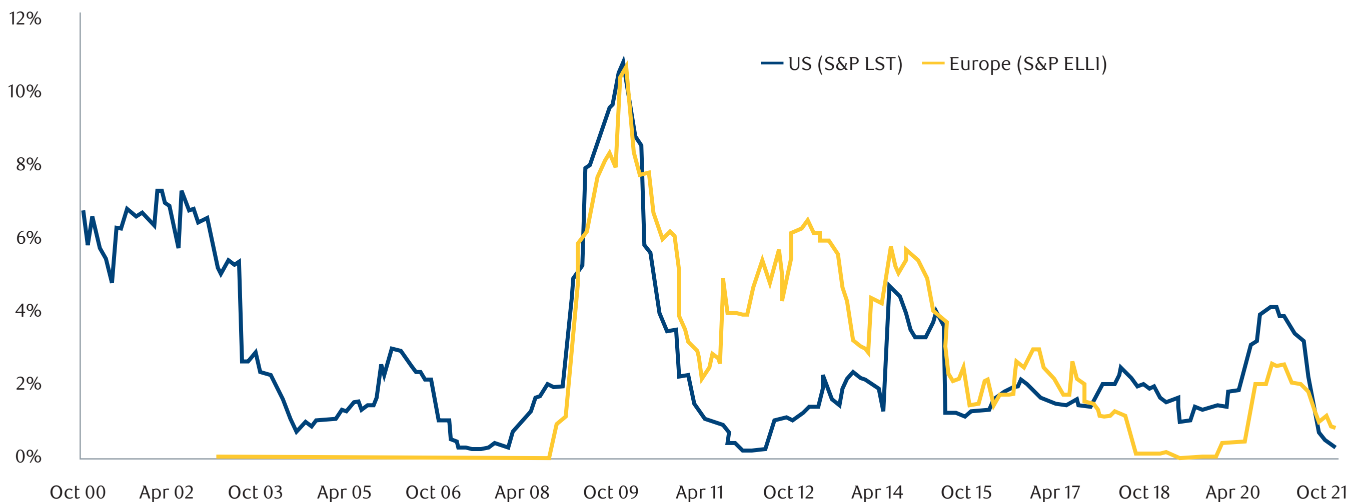
In the commercial space, the re-opening of most businesses has created a more supportive backdrop for commercial mortgage-backed security (CMBS) assets going into 2022. While the retail sector continues to be an area of concern, other property types are starting to stabilise in the post-Covid world. Office vacancy rates fell slightly through Q3 2021, but many mass transit markets remain under pressure as return-to-office momentum remains weak. The hotel recovery is well underway with

Chart 1: RMBS arrears



Source: Fitch, Morgan Stanley Research as at December 2021

Chart 2: US & European historical default rates



Source: S&P LCD as at 30 November 2021

leisure hotels continuing to see healthy demand while business travel is undergoing a structural change and has been slower to recover. Multi-family and industrial fundamentals remain solid as demand continues to outpace supply in these markets. Even with some clear vulnerabilities, we believe these sectors will improve next year as supply bottlenecks ease and businesses should fully emerge from Covid-19-driven disruptions.

In the collateralised loan obligation (CLO) space, underlying collateral quality improved during the year in both Europe and the US. The improvement in quality is reflected in CLO metrics, with CCC levels declining and loan default rates falling.

We expect CLO fundamentals to remain positive next year amidst a backdrop of above-trend growth and loan defaults expected to remain low, but likely picking up towards the second half of 2022 when we also expect to see more assets trading at stress levels (see chart 2).

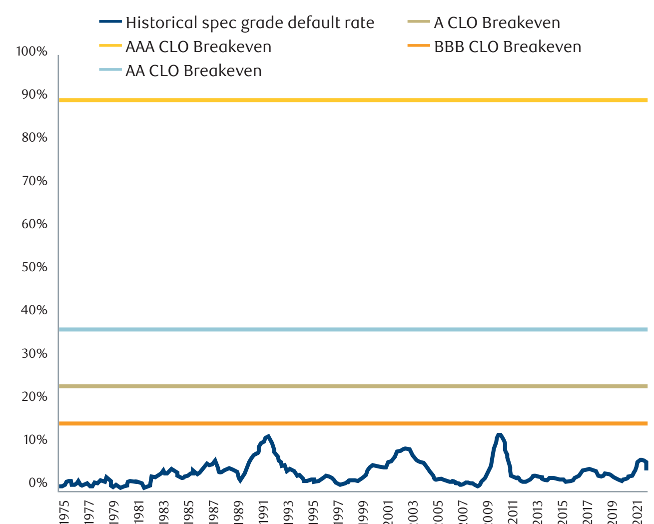
Low default rates and the potential for rising interest rates create a supportive backdrop for CLOs. We expect robust performance, notably for equity tranches. We also think there will be continued dispersion in CLO performance in 2022 as the rise in idiosyncratic risks should give some CLO managers an opportunity to outperform peers.

For debt investors, it is worth reiterating that CLO structures are well designed to insulate investors from a pick-up in defaults. Chart 3 shows the levels of cumulative defaults we would need to see before investment-grade tranches take any losses. Defaults would need to be at peak GFC levels of about 12% on a sustained basis to impair the BBB-tranches. We do not foresee this being the case and therefore are comfortable with exposure to mezzanine tranches in strategies that are permitted to hold lower-rated assets.

In the US, we anticipate the Libor transition to the secured overnight financing rate (SOFR) will be a key theme for the market in the new year – indeed, it has already been quite topical in the US over recent weeks. CLO deals that close in 2022 will be priced off SOFR, which may dampen investor appetite during the early part of the year as investors feel out the appropriate basis to LIBOR.

For CLO managers, liabilities is one side of the transition but the asset side looks likely to be more complex, given loans issued from January 2022 will be priced off SOFR, while seasoned loans will be predominantly off Libor. There will be a basis risk (the difference between Libor and SOFR) that CLO equity investors will have exposure to. Therefore, there could be some dispersion in equity performance depending on how managers navigate the transition, which could present a potential opportunity for investors.

Chart 3: CLO breakevens



Source: Moody's, Index as at 30 June 2021

Supply dynamics

Supply technicals were a big driving factor in spread moves in the structured credit market over the course of 2021. We think this dynamic will continue into next year.

Primary market supply was significant, with CLOs leading the way in both Europe and the US. At the time of writing, we've seen USD176.4bn of new issues in the US and EUR36.6bn in Europe (net supply), with both sides of the Atlantic setting records in terms of volumes. Given the fairly benign macro backdrop and attractive CLO arbitrage, we expect new issue supply to continue at a healthy pace next year, although, as noted above, we believe there will be some slowdown in the US in the first few months of 2022, driven by the Libor to SOFR transition.

Repricing activity was significant during 2021, with CLOs that were priced at wider spread levels in 2020 seeking to reset their liabilities at more favourable levels. While CLO refinancings/resets do not usually have a material impact on the outstanding size of the CLO market, they have a significant impact on technicals. This repricing volume, alongside the heavy new issuance, put pressure on primary market spreads. We expect repricing activity to remain elevated next year, though at lower than volumes seen in 2021.

In the US, supply in ABS/MBS increased across most areas, with agency CMBS the only exception as issuance declined. Non-qualified mortgage (QM) 2021 issuance was back to 2019 levels, with USD40bn at the loan level and USD25bn of this in RMBS. We expect issuance to be 50-100% higher next year, driven by lender competition and a widening in credit availability. The impact of Covid-19 was a tightening on lending, the average FICO score in non-QM from 2017-2019 was 710 – post-Covid this increased to 730. We expect this to reverse somewhat in 2022, which should increase issuance in the space.

In credit-risk transfer securities (CRT), 2021 issuance was approximately USD20bn. We forecast similar levels next year, though expect slower prepayments, meaning net issuance figures will be higher at approximately USD8bn versus USD1bn this year. The single family residence (SFR) space saw elevated issuance in 2021, with USD15bn so far. We expect issuance to remain elevated in 2022 as issuers find the low cost of funding and recent structural changes attractive. We expect the increased issuance to be well absorbed by the market across these areas with no material impact on spreads.

Elsewhere, across ABS/MBS markets supply in Europe was consistent with levels seen in 2019, after 2020 proved to be a lower year of supply. This supply backdrop kept spreads firm across most asset types. We have seen approximately EUR30bn of supply across RMBS, with a notable increase in UK non-conforming and buy-to-let transactions, which is an area we expect will continue to grow next year. Overall, we expect issuance will increase year-on-year, albeit at a gradual pace.

Relative value

Our commentaries over the course of 2021 have frequently referred to the attractive relative value in structured credit products versus fixed income – and this continues to be true today.

Table 1 compares a range of structured credit products to corporate and government indices, focusing on the investment-grade space, including details on weighted average life or spread duration, rating, spread and the breakeven level. This highlights the attractive risk-adjusted value on offer in structured credit, where a higher spread can typically be achieved with shorter spread duration and higher credit quality.

ESG

ESG has been a big theme in the structured credit market over 2021 across ABS, MBS and CLOs. We saw the first green RMBS transactions print in the UK and France, the first social RMBS in the UK, social consumer ABS in Germany and recently, a green CMBS. We expect momentum to grow in 2022 and for ESG-labelled issuance to increase, though still at very low levels compared to the broader market issuance.

Table 1:

	UK Autos	US CLO	US MI CRT	US Non-QM	European Investment Grade Corporates Index	US Investment Grade Corporates Index
Rating	A	AAA	BBB	A	A+	A-
Spread (bps)	160	140	216	125	52	95
Spread Duration	2.9	4.3	0.6	1.5	5.42	8.19

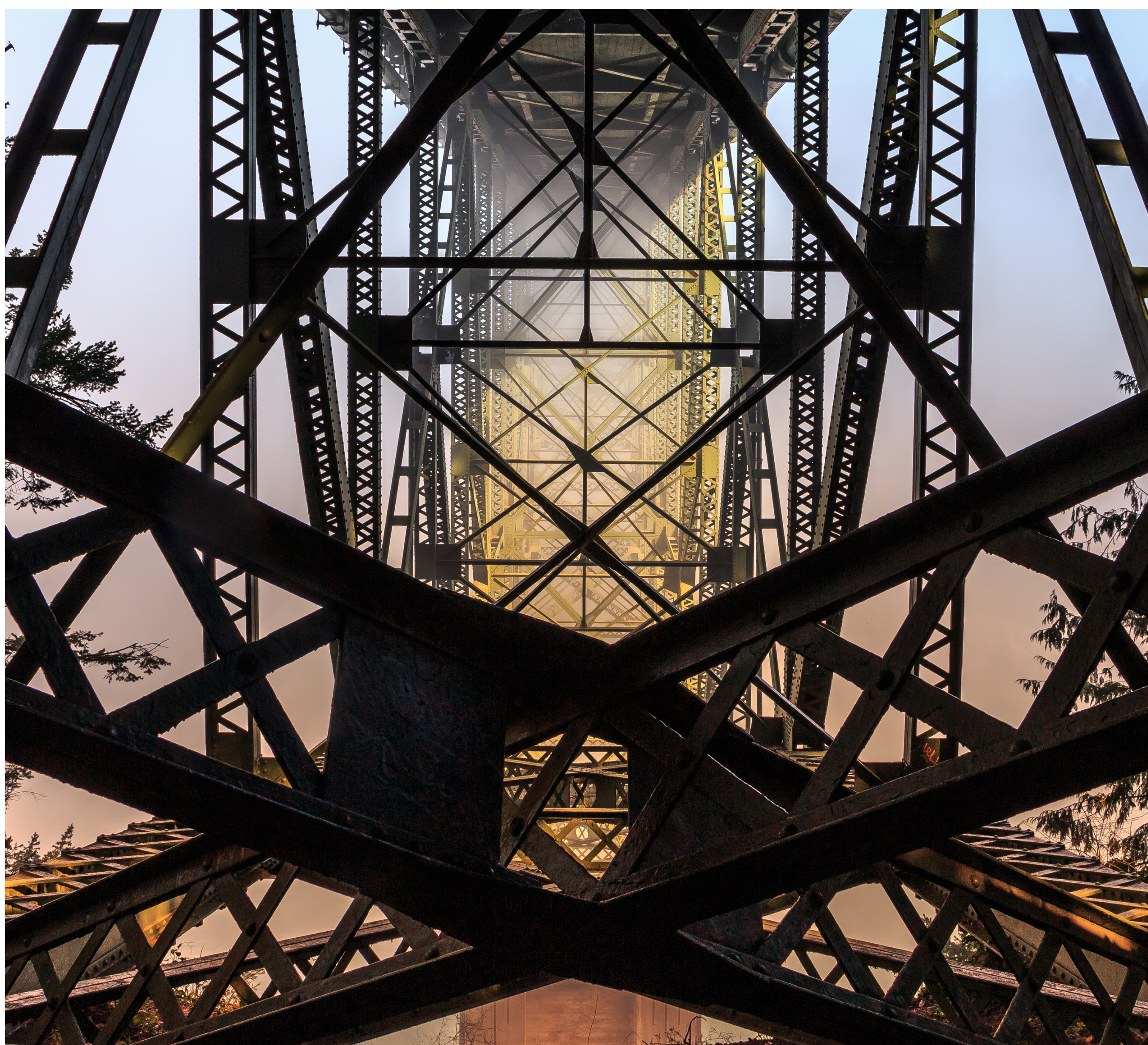
Source: OAS vs Libor spread, Bloomberg: European Investment Grade Index ER00, US Investment Grade Index C0A0, ABS and CLO sectors based on example bonds in November, as at date 10 December 2021.

In CLOs, negative screening became the market standard in Europe, with the number of screened-out industries increasing. We have also seen issuance of some European CLOs with positive screening incorporated, however, the volumes are relatively low. In the US, only about one third of new issue CLOs are incorporating negative screening.

Managers are taking different approaches in how they implement ESG analysis and we believe it is important to assess the overall quality of each CLO manager's ESG approach as part of our investment process. We expect ESG to be a big topic of conversation in the CLO and ABS universe for 2022 as investors try to formulate the most effective way to analyse ESG risks in deals.

Final view

Overall, we remain cognisant of the risks markets face in 2022. Whilst fundamentals in most areas appear robust, we expect a degree of uncertainty and pockets of volatility in some areas. We believe structured credit offers a unique opportunity for investors to get exposure to floating-rate assets with attractive yields and embedded structural protection from defaults.



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