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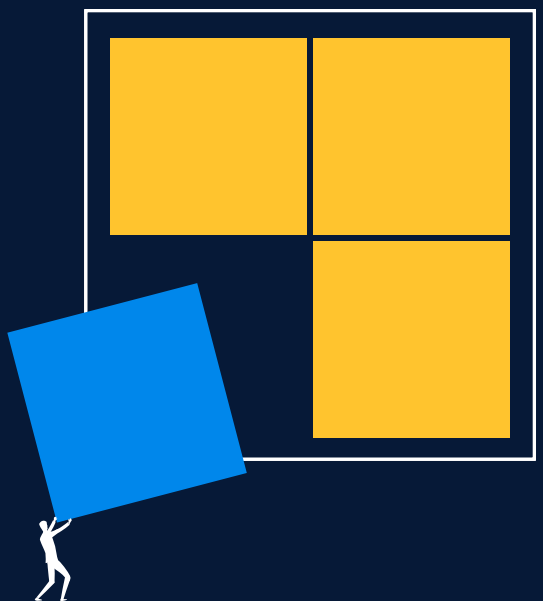
Perspectives on securitized credit



From the Field
Q1 2024

Key Insights

- The rally in securitized credit markets that began in late 2023 accelerated in early 2024 despite expectations for fewer Federal Reserve rate cuts.
- Technicals remain positive and fundamentals are largely neutral, but valuations have become less enticing.
- We see the most value in asset-backed securities, have a neutral view of commercial mortgage-backed securities, while seeing less value in collateralized loan obligations and non-agency mortgage bonds.

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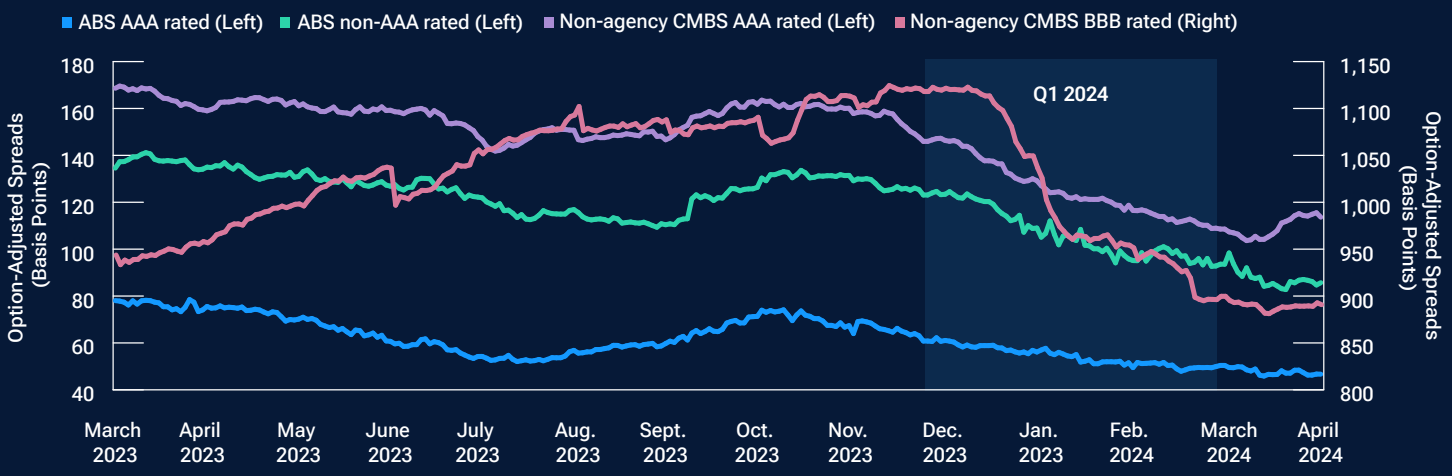
The rally in securitized credit markets that began in late 2023 accelerated in early 2024 even as the Federal Reserve pushed back on the market's high expectations for rate cuts. While the Fed's firm policy stance pressured certain rate-sensitive assets like U.S. Treasuries and agency mortgage-backed securities, securitized credit sectors were far more resilient to the market's changing expectations. After lagging the strong performance of corporate credit in the final quarter of 2023, securitized credit played catch-up in the first quarter (Q1) of 2024, and credit spreads broadly tightened—in some cases significantly.[1]

Rich corporate bond valuations appeared to drive investors who normally focus on corporate credit to turn to less expensive securitized credit. U.S. bond funds also received sizable inflows following the previous quarter's performance rebound, and asset managers had ample cash to invest. Heavy securitized credit issuance created opportunities to put that cash to work. Insurers were also reportedly more active buyers, enticed by yields that broadly remained near their highest levels

[1] Credit spreads measure the additional yield that investors demand for holding a bond with credit risk over a similar-maturity, high-quality government bond. Option-adjusted spreads are adjusted for any early repayment options that issuers may have.

A downhill ride for securitized credit spreads in Q1 2024

(Fig. 1) Strong investor demand has reduced the valuation appeal



March 31, 2023, through April 30, 2024. **Past performance is not a reliable indicator of future performance.**
Source: Bloomberg Index Services Limited. Please see Additional Disclosures page for additional information.
Indexes shown are different credit quality tranches of the Bloomberg Non-Agency Investment-Grade CMBS Index and the Bloomberg ABS Index.
A basis point equals one hundredth of one percentage point, or 0.01%.
Index data is for illustrative purposes only and is not indicative of any specific investment. Investors cannot invest directly in an index.

since the late 2000s. As Treasury yields rose, credit spreads tightened across securitized credit markets, taking valuations to less attractive levels (Figure 1).

Strong risk asset performance despite a higher-for-longer mantra

Market expectations at the start of the year pointed to as many as six rate cuts by the Fed in 2024, starting as early as March. But stronger-than-expected employment and inflation data altered that outlook, and Fed policymakers made it clear that they were in no hurry to start cutting rates until they had more confidence that inflation is under control. By late April, fed funds futures markets implied only one cut this year, likely not occurring until December. Nonetheless, risk sentiment remained strong as economic data remained buoyant, making a soft economic landing an increasingly consensus view. Credit sectors broadly produced strong excess returns versus similar-duration Treasuries, with lower-quality assets leading.[2]

Securitized credit sectors produced positive total and excess returns almost across the board in Q1. Although performance for non-agency commercial mortgage-backed securities (CMBS) varied widely as the sector faces sundry idiosyncratic risks, it was still one of the better-performing sectors overall. Non-agency CMBS returned almost 2.0% on a total return basis in Q1, which translated to an excess return of 2.4% as Treasuries sold off. BBB rated non-agency CMBS,[3] which suffered dismal performance in 2023, attracted a bid and produced an impressive excess return of 11.8% as wide spreads compressed.[4]

Similarly, in the asset-backed securities (ABS) market, non-AAA rated bonds were generally the best performers, producing 1.5% of total return and 1.2% of excess return compared with 0.7% and 0.5%, respectively, for the AAA tier of the sector.[5] Esoteric areas of the ABS market that are not included in the Bloomberg ABS Index, such as whole-business securitizations and student loans, produced even better results.

A higher-for-longer rate outlook supported demand for collateralized loan obligations (CLOs),[6] whose coupons float with the secured overnight financing rate. AAA rated CLOs, which make up the majority of the market, returned a respectable 1.8% in Q1.

[2] Duration measures the sensitivity of a bond's price to changes in interest rates. Bonds with longer duration have higher sensitivity to changes in interest rates.
[3] Credit ratings for securities are typically provided by Moody's, Standard & Poor's, and/or Fitch and are referenced here using the Standard & Poor's nomenclature. A rating of AAA represents the highest-rated securities, and a rating of D represents the lowest-rated securities. If a rating is not available, the security is classified as Not Rated. In addition to the ratings from the major rating agencies, T. Rowe Price maintains its own proprietary credit rating methodology for all securities held in portfolios.
[4] Source: Bloomberg Non-Agency CMBS Agg Eligible Index.
[5] Source: Bloomberg US Agg ABS Index.
[6] CLOs are securitized portfolios of bank loans structured into slices, or tranches, of varying credit risk. An outside firm manages the portfolio of loans.

At the lower end of the rating scale, BB rated CLOs returned 6.4% for the quarter and were up nearly 28% over the trailing 12-month period, almost keeping pace with the S&P 500 Stock Index.[7]

Although performance varied across the subsectors of the diverse non-agency residential mortgage-backed securities (RMBS) market, which lacks a comprehensive benchmark, returns were generally positive and, in many cases, quite strong. Similar to other sectors, subordinate segments of the markets generally outperformed. Spreads tightened significantly for credit risk transfer securities (CRTs),[8] nonqualified mortgages (non-QM), single-family rental bonds, and re-performing loans. By contrast, jumbo mortgage bonds, which typically have a longer duration profile than other subsectors, generated more muted returns with Treasury yields rising and rate volatility remaining elevated.

Heavy issuance across sectors in early 2024

Issuers took advantage of strong demand to sell relatively large quantities of bonds, exceeding expectations and putting markets on pace to surpass 2023's totals. ABS saw the heaviest new issuance, coming in at USD 92 billion.[9] If that pace is maintained, the market would see its largest annual gross issuance since at least 2007. Although deals were met with strong demand, the glut of supply helped keep spreads in some areas at relatively attractive levels.

A brisk pace of CLO issuance put the sector on track for a record year. True new issuance totaled USD 50 billion. The market also saw a rise in refinancings and resets of previous deals, which totaled about USD 39 billion, higher than the annual totals of the previous two years. A return of U.S. bank demand and active buying from Japanese institutions helped digest the supply. While the frenetic pace of CLO issuance is likely to slow, it is expected to remain brisk in the near term. Meanwhile, unless there is a meaningful decline in risk appetite, we expect demand to generally keep pace.

A steady stream of RMBS supply in Q1 was also met with good demand. At nearly USD 32 billion, the market is set to far exceed last year's USD 79 billion total but fall short of the lofty levels seen in 2021–2022, which were the most active since 2007. Like last year, issuance was most robust in the non-QM subsector, up 23% versus Q1 2023. Issuance of bonds backed by jumbo mortgage loans; CRTs; agency investor bonds, which are backed by investment property loans; and nonperforming loans was lighter than non-QM but still considerably higher than last year's pace.

While agency CMBS issuance was lower than the same period last year, private-label CMBS issuance perked up by 169% compared with the low volumes seen in early 2023, totaling USD 19.7 billion at quarter-end. Single-asset/single-borrower (SASB) bonds accounted for most of the total at USD 12.6 billion as demand for floating rate bonds was solid. Conduit issuance increased but was less robust than SASB bonds. Issuance of commercial real estate CLOs, an area we have been avoiding due to the lower quality of its collateral, remained at low levels. We expect non-agency CMBS issuance to rise this year over last but come in well below volumes in 2019–2022, when the rate environment was much more conducive for issuers.

[7] Source: JP Morgan CLOIE Post-Crisis Index.
[8] CRT securities are a type of RMBS issued by Fannie Mae and Freddie Mac but with credit risk borne by private investors. They can incur losses if enough homeowners in a pool of mortgages default on their loans.
[9] Source for ABS, CLO, CMBS, and RMBS issuance totals: JP Morgan. All totals in U.S. dollars as of April 5, 2024.

Competition between valuations and technicals continues

As we discussed last quarter, the battle between sector valuations and market technicals is ongoing, with technicals generally winning to date. On a spread basis, valuations have broadly become less attractive, and demand for some recent deals has softened somewhat. But technical conditions remain very strong due to interest from money managers and institutional investors seeking diversified sources of yield. Unless the risk environment suddenly deteriorates, we expect demand to hold up in the near term.

Ranking sectors based on relative value

- **ABS:** This is where we see the best opportunities, although ABS in aggregate have moved much closer to fair value. Within the sector, senior prime auto, equipment, and rental car ABS are some of the cheaper-looking assets, while timeshare-backed ABS have migrated to the more expensive side of fair.

  We continued to favor seasoned, discount-priced whole business securitizations. We also have a favorable view of synthetic prime auto debt (also known as credit-linked notes). Banks have increasingly used these instruments to transfer risk to investors and reduce their capital requirements without having to sell the underlying loans. In general, we have looked to rotate out of less liquid bonds in areas like equipment where spreads have compressed and move into better liquidity profiles.

- **CMBS:** With spreads tightening significantly, there is less low-hanging fruit in the sector, and we have a generally neutral view on valuations. We are also mindful that in many cases where there is value, this is due to the risk of loan defaults or extensions, which makes security and collateral analysis key.

  Within CMBS, we prefer new-issue conduit bonds over seasoned conduits. Underwriting standards on new issues have strengthened, and there is less office exposure in many recent deals. By contrast, seasoned conduits possess weaker collateral and have more credit rating downgrade risk. We maintained a negative view on the office sector, where bonds are trading at a dramatically wide range of prices, liquidity remains challenged, and negative headlines are most acute. Our view of retail bonds also leans negative, though we prefer smaller, open-air shopping centers over enclosed malls and stores like grocers who sell consumer staples rather than discretionary goods. Multifamily SASB bonds also look less favorable due to generally tight spreads.

  We slightly upgraded our conviction on industrial properties recently. We feel that it is a more defensive property type with supportive long-term fundamentals. We also like shorter-dated lodging-related bonds and prefer seasoned deals that have seen good cash flow growth. Indeed, cash flows in the lodging sector are an area we are closely watching. Net cash flows have been declining in some areas as people cut back on leisure travel, and business travel remains challenged.

- **CLOs:** Valuations are less compelling, though rising rates and/or continued rate volatility could cause demand for floating rate debt to persist, which could keep spreads from materially widening. On the other hand, a resurgence in refinancings and resets could limit much further spread tightening.

  AAA rated CLOs screen rich compared with investment-grade corporate bonds, though we expect higher-quality CLO spreads to hold in relatively well in the near term given the expectation of higher-for-longer rates. BBB rated CLOs are also positioned to perform well in a prolonged higher rate environment given limited impairment risk and the ability to withstand loan downgrades. By contrast, valuations for the weaker BB rated tranche could be more impacted by loan rating downgrades, defaults, and liability management exercises by loan issuers, which have risen recently.

  In the secondary market, shorter-maturity CLOs that are outside of their reinvestment period and have already been refinanced are an area that we like. Demand for such issues has been strong, and we believe CLOs with this shorter profile should be relatively resilient if we experience a spread-widening event.

- **RMBS:** Valuations look the weakest among securitized sectors following several months of strong performance. The sector rallied on hopes for rate cuts, and the prospect of fewer—or possibly no—rate cuts this year could weigh on sector spreads. This environment could also slow prepayment speeds and make early calls of discounted bonds less likely, reducing near-term profit potential. RMBS issuance has also picked up, which could eventually outweigh demand given the sector's less attractive valuations.

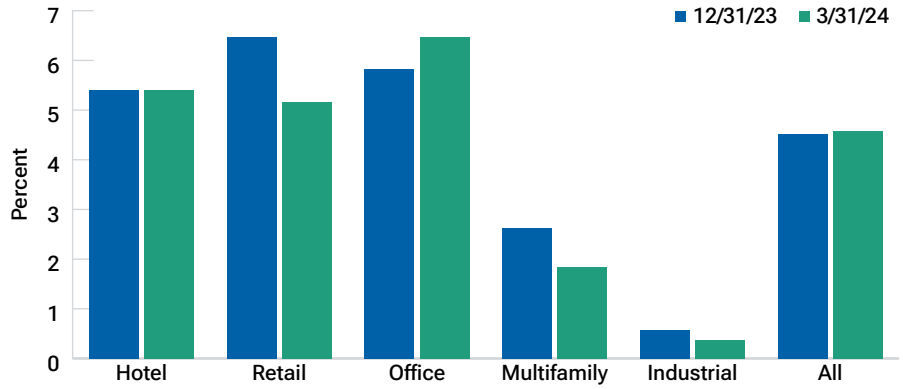
  RMBS subsectors that we like include seasoned single-family rental bonds across the quality spectrum; hybrid adjustable-rate mortgage senior bonds; and seasoned floating rate bonds backed by jumbo prime collateral and issued after the global financial crisis (GFC), when underwriting standards vastly improved.

Fundamentals not concerning but deteriorating at the margin

Fundamentals are mostly neutral outside of the CMBS sector, where the issues have been well publicized, particularly in the office sector. CMBS delinquencies have risen, with 30+-day delinquencies recently hitting 4.6% (Figure 2). Delinquencies have been most prominent in the office sector but are also high in the hotel and retail segments. Multifamily and industrial delinquencies remain low and have declined recently. As noted, the high idiosyncratic risk in the sector means that investors need to fully understand how deals are structured and perform

Delinquencies more pronounced in offices, lodging, and retail

(Fig. 2) Delinquency rate by CMBS property type (30+ days)



Source: JP Morgan. See Additional Disclosures.

careful cash flow and property analysis to avoid losses.

Fundamentals for ABS have weakened, as seen with rising delinquencies for auto loans. However, delinquencies on prime auto loans remain in line with the pre-pandemic period, and subprime is where they are a greater concern. Recovery rates on defaulted auto loan bonds have come down from their pandemic highs as car prices have moderated. According to data from the Federal Reserve, delinquency rates on credit cards are also on the rise, reaching 3.1% in Q4 2023, up from a low of 1.5% in 2021. The household savings rate has also been steadily declining, although rising home and equity prices provide many consumers with a cushion.

Downgrades continue to exceed upgrades in the bank loan market that supplies collateral for CLOs, a trend we expect to persist. Interest coverage ratios remain high from a historical perspective but have fallen since the Fed began raising rates, which will likely continue as issuers refinance loans at higher rates. Loan defaults (including distressed exchanges) have also increased from their post-pandemic lows but recently ticked lower to 2.9% at the end of April according to data from JP Morgan. When defaults occur, recovery values have been well below historical levels. However, we believe that the top of the CLO capital structure remains well insulated from fundamental deterioration and see the most risk in the BB rated mezzanine tranche.

Fundamentals are probably strongest in the RMBS sector. Delinquencies on prime loans and CRTs remain quite low, though the non-QM subsector has seen a gradual rise with the labor market cooling. Prepayment speeds remain very low in a higher rate environment, meaning that it will take longer to realize the value in discounted bonds. Continued home price growth due to low housing supply is supportive of sector fundamentals, though affordability has declined to its lowest level since the GFC, which could be problematic over the longer term for the sector and the broader U.S. economy. While we have few fundamental concerns about RMBS, valuations are uninspiring outside of a few pockets, causing our view of the sector to skew negative.

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