

Structured credit update

Navigating the summer months

Over the summer months, global markets continued to grind higher thanks to supportive central bank policies, expanding vaccination programmes and economic reopening. This led to prices rallying for risk assets globally, including most structured credit products – with the exception of CLOs, where spreads widened. Alongside this fundamental picture, we have seen supply technicals play a significant role in driving spreads in the structured credit market, with opposing impact in the ABS versus CLO space.

Against this backdrop, and despite widening CLO spreads, our structured credit strategies generated positive returns. This was due to a combination of factors including:

- Our diversified positioning across product types
- Holdings in high-quality assets that have robust structural features and a better margin of safety to provide more resilient performance
- Active sourcing of mispriced opportunities in primary and secondary markets
- Portfolio re-positioning in anticipation of supply driven technicals.

As we navigated the summer months, there were two prominent themes that drove our re-positioning and positive performance.

With prices rallying across most markets, we viewed asset valuations as stretched in some areas.

In our view, stretched asset prices can lead to spikes in volatility. We focussed on positioning our portfolios to withstand potential volatility by increasing credit quality and diversification.

Increasing credit quality is not solely about increasing exposure to higher-rated assets, but also those with more defensive profiles and stronger structures.

For example, we took part in a UK non-conforming RMBS primary market transaction where we sourced an attractive new issue with capital appreciation potential and a defensive profile given its short-dated maturity and AAA-rating.

Elsewhere, we continued to focus on bonds with robust structures. Whilst collateral performance has generally been solid over the course of the Covid-19 pandemic, the need to focus on assets with robust structures has been imperative. In areas of weakness, such as UK SME markets, the robust structure of many of these deals led to healthy performance as transactions de-risked by diverting cash flows to senior bonds, thus providing an attractive opportunity despite weaker fundamentals.

Over the summer, US primary markets were relatively active compared to Europe, which gave us the opportunity to further increase diversification in our portfolios by adding exposure to US deals.

For example, we purchased a US data centre transaction – the first green bond in the data centre space where the issuer has been developing energy-efficient data centre technology for a decade. This new issue offers exposure to what we believe to be an exciting asset class. In addition, we purchased a mortgage insurance securitisation. This transaction not only offers exposure to the buoyant US housing market, it also increases diversification in our portfolios due to the lower correlation with other holdings.

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We believe exposure to these types of assets with defensive profiles and robust structures, alongside overall diversified portfolios, should help better insulate our structured credit strategies from volatility spikes.

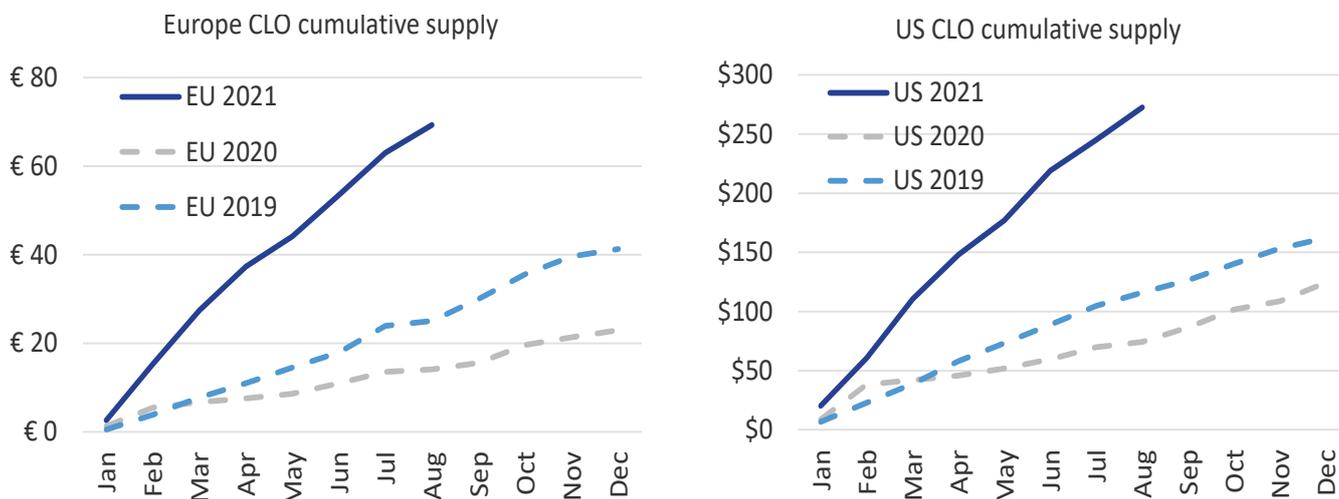
Recent spread moves in structured credit have been driven by technicals over fundamentals during the summer months and indeed through H1 in general.

In the ABS/RMBS markets, the relatively low supply (when compared with the strong demand) so far this year has kept spreads firm – this was particularly true in August as the market took a summer break. We were still able to selectively add value in primary and secondary markets when opportunities arose.

In the CLO market, the supply picture is quite different, with new issue, refinance and reset volumes significantly higher than in previous years (see chart 1). This heavy supply put pressure on spreads, most notably at the top of the capital structure (see chart 2).

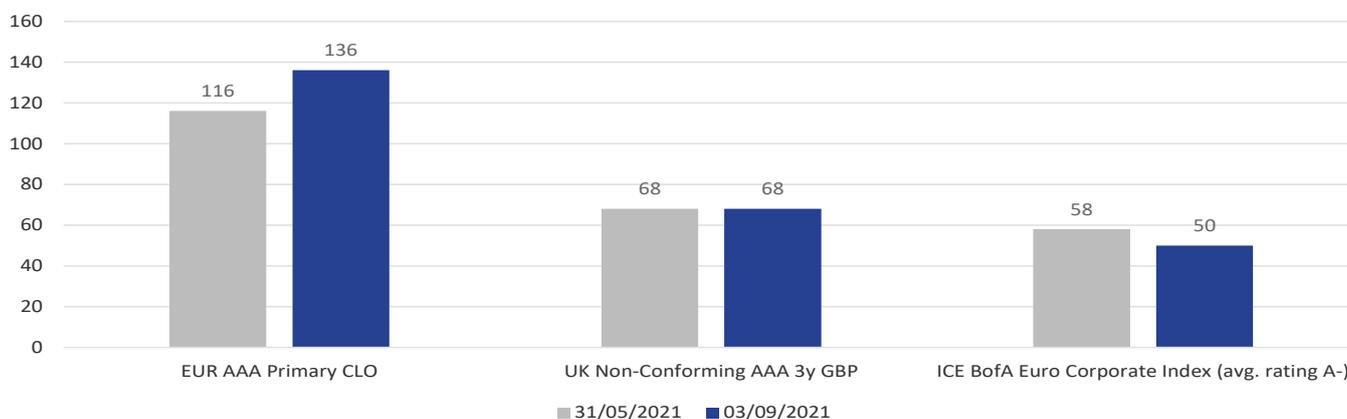
In terms of portfolio positioning, we reduced spread duration earlier this year and as higher supply led to spread widening in the new issue market, we rotated into more convex, high-grade CLO tranches whilst maintaining overall CLO exposure at the same level. This generated positive performance across portfolios and maintained our overall defensive positioning.

CHART 1: YEAR-TO-DATE SUPPLY VS. PREVIOUS YEARS



Source: LCD, as at 23 August 2021

CHART 2: HEAVY SUPPLY HAS PUT PRESSURE ON SPREADS



Source: LCD, Bloomberg, MS, Citi, BAML, as at 3 September 2021

Outlook

As we approach the final quarter of the year, we expect the existing opportunity set to continue. ABS supply is set to pick up through September, but we believe healthy demand will absorb this new issuance and spreads will remain firm in this area. CLO supply is expected to persist at high levels, as several deals issued at wide spreads in 2020 will look to refinance over the remainder of the year, and whilst we are seeing an increase in demand, this should keep primary market spreads at relatively wide and attractive levels.

Our economic outlook is constructive, although we remain cautious entering the cooler winter period as to its impact on the spread of Covid-19. This, alongside central bank asset purchases possibly slowing in both the US and Europe, could trigger market weakness. In our structured credit portfolios, we are maintaining diversified exposure across a range of collateral types and continue to focus on high-quality assets with robust structures and defensive profiles.

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