BlueBay
Asset Management

Structured credit update

The resilience of ABS

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Risk assets in general have carried their positive momentum from the second half of last year into 2021 and asset-backed securities (ABS) markets have been no exception to this. Across sectors and geographies – whether that be mortgages, auto loans, credit cards or leveraged loans – performance of the underlying collateral has been generally robust, which, when coupled with the attractive spreads available, has brought new investors to the space.

The continued pace of the vaccine rollout provides a pathway towards reopening in most major economies and a return to some degree of normality in the coming months. As we quickly approach the end of the first half of 2021, it seems an opportune moment to pause for breath, take stock of where we are and consider where we go from here.

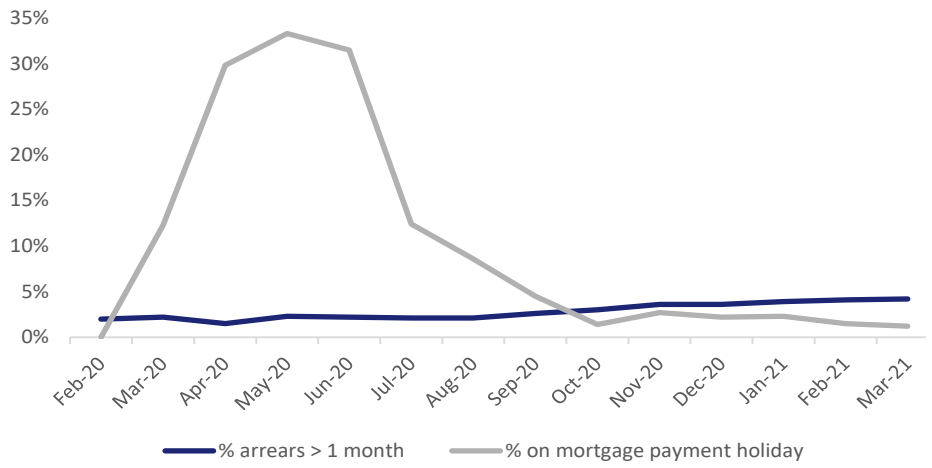
Fundamentals are robust

The fundamental fears present at the end of Q1 last year have not materialised. With the substantial support of governments, performance across collateral types has been robust. For example, let's consider UK non-conforming mortgages. Payment holidays were made readily available by UK lenders – they were very well-advertised with few to no restrictions and, as a result, uptake was high. At the peak, c.30% of UK non-conforming mortgages were on a payment holiday (15-20% for the market as a whole), which merely delays the payment of the mortgage. Fears that this trend was masking performance deterioration have since abated as holidays have largely expired with only a limited increase in arrears of less than 2%. The chart shows data for a selection of representative non-conforming transactions.

With around 12% of the workforce still on furlough, expectations are for unemployment and arrears to further increase in Q3/Q4 2021 after the scheme expires – though with less than 3% of non-conforming borrowers on payment holidays today, further increases in arrears should remain contained.

It's also important that this is put into context – the weakest vintage of non-conforming mortgages originated immediately prior to the global financial crisis (GFC), saw one month or more arrears rise to a peak of over

MORTGAGE PERFORMANCE DATA FOR A SELECTION OF UK NON-CONFORMING RMBS



Source: Kensington Mortgages, April 2021

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30% in 2009 and remain elevated for many years. Even then, losses on GFC-era RMBS bonds were very limited.

In our opinion, the asset class today is much stronger – underwriting criteria on the underlying mortgages has been much tighter with lower LTVs and ABS transactions have been structured more conservatively with more credit protections. Overall, we are positive on UK mortgage credit.

This story is not unique to UK mortgages – fundamentals have typically been strong across ABS collateral types and structures are conservative on a historical basis. US non-qualified mortgages have seen similar trends of spikes in forbearance (in this case to around 20%), followed by healthy re-tracing against a strong fundamental backdrop – forbearance rates are now below 10%. Performance is again well within the limits that the structures are designed to absorb. In other mortgage sectors such as Dutch prime and buy-to-let, payment holidays were not really a thing to begin with.

Away from the mortgage market, the patterns are similar. In CLOs, loan defaults have so far peaked well below previous cycles. We now look set to return to the low-default environment we have been in since the GFC, with speculative-grade corporate default rates looking to have peaked below 8% in both the US and Europe. Again, structures in the CLO market have been further improved since the GFC, despite having experienced lower loss rates than witnessed in corporate bond markets over the GFC – no AAA or AA-rated CLO has ever been impaired.

The performance of ABS collateral and structures through the Covid period provides yet more evidence for the resilience of the asset class to fundamental shocks. We can now add the Covid-19 pandemic to the GFC and European debt crisis as tangible evidence for the high quality of the transactions and structures.

Technicals

Supply being well absorbed – where are we heading?

Following a Covid-impacted 2020 for issuance, the start of 2021 saw very healthy volumes in primary markets that were generally well absorbed by investors as new capital flowed in. There have been pockets of weakness in certain profiles that have created opportunities, particularly in sub-investment grade tranches as the heavy supply weighed on spreads. As we move into the summer, we have seen a slowdown in issuance in ABS markets, which has limited supply in recent weeks and strengthened the technical picture. In European ABS the ECB remains a buyer, which has also supported the technical.

But what about yields?

As with other risk assets, yields have generally compressed in ABS markets. Central banks around the world have played their part in creating over USD13 trillion of negative-yielding debt – so-called 'return-free risk' – pushing up risk asset prices across asset classes, including in credit markets. However, when considering the bigger picture, spreads achievable in ABS are attractive on an absolute basis and compare favourably to corporate and government risk.

Spreads available in ABS markets include +75 bps for 3-year AAA UK non-conforming RMBS and +120 bps for 4-year AAA-rated CLOs. This is attractive compared to recent issuances in the corporate bond market, where the spread on a typical 5-year BBB-rated bond would be around +40 bps – you can achieve a higher return for lower risk and lower spread duration. If you look further down the capital structure, the pick-up in spread becomes even more significant – 5-year single-A rated and 5-year BBB-rated CLOs trade at +200 bps and +300 bps respectively, a substantial pick-up to a +40 bps BBB-rated corporate bond.

ABS may also provide added benefits of diversification and floating-rate coupons and therefore low interest-rate duration, which is topical in a world concerned about inflation and the direction of future interest rates. Thus, we think that there is a very compelling argument for investors to add ABS to their portfolios in the current environment to complement their existing holdings.

What happens next?

Our portfolios are currently positioned to take advantage of the attractive potential relative value and incremental carry on offer, but in a low-risk manner via securities that have a significant cushion to defaults or collateral deterioration. While markets are well supported today, we are seeing pockets of excess supply in certain areas that are creating opportunities to add securities at wider levels. We remain cognisant of the risks and prefer to keep duration short, ready to take advantage of any future bouts of volatility while protecting against the possibility of rising rates through floating-rate securities.

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