Inflation Worries Put Securitized Debt into Focus

Securitized debt may be an attractive solution for investors looking to diversify away from fixed income assets susceptible to inflation risk.

Key Takeaways

- Securitized debt offers higher relative value than many corporate bonds of similar quality and duration.
- Surging prices on homes, autos, and other goods may even boost performance for certain securitized assets.
- Because much of the securitized market is tied to the strength of the U.S. consumer, it benefits from strong tailwinds driven by rising wages and low levels of personal debt.
- Securitized debt offers a way to diversify beyond corporate credit risk with relatively attractive yield and short duration.

There are many ways to hedge inflation risk as prices continue to soar – loans and high yield are two well-publicized solutions – but there's another overlooked option for investors that may offer an opportunity for yield: securitized debt.

It's no secret that investors see inflation as the biggest roadblock for markets in 2022. CIOs and portfolio managers surveyed in a recent CNBC poll flagged inflation as their biggest worry as U.S. inflation soared to 7% in December – the fastest pace since 1982.

Conventional wisdom dictates that investing passively in a traditional mix of bonds and equities has helped protect against movements in yields, but high enough levels of acute inflation would hurt performance across the board, particularly if investors are mainly using traditional core bonds as a hedge.

So, what to do in an inflation-elevated environment?

Securitized debt can work with price increases, not against them

First, a primer: securitized credit is debt secured by pools of assets from many individual borrowers – examples include auto loans, credit card receivables, or mortgages. The securitized credit universe is a wide opportunity set that provides diversification from traditional fixed income. Much of securitized credit, such as esoteric asset-backed securities (ABS), is not represented in traditional bond indexes, and includes financing across a wide range of sectors that don't always receive attention from investors.

From a credit perspective, securitized debt is a compelling inflation hedge because much of the debt in that sector is backed against assets. Investing in securities backed by pools of "real" physical assets, such as real estate and autos, can be a way to reduce inflation risk as prices on those assets continue to rise.

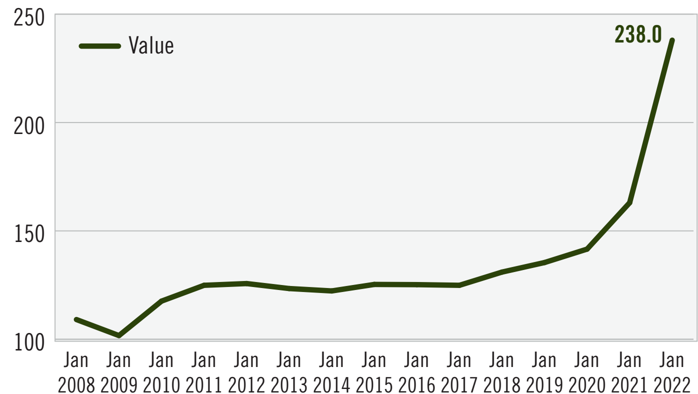
Autos and homes are two of the most notable examples: prices on both are surging to record highs, driven by supply chain disruptions and pandemic-fueled consumer demand. Their price gains bode well for the loans they back in ABS. High valuations mean higher loan recoveries – a positive for investors looking for a greater degree of protection against risk of default.

The Manheim Used Vehicle index (shown to the right) shows the extent of the surge in the auto market. Though used-car prices may finally show some signs of cooling down this year, the persistence of supply chain snarls slowing new car building indicates ongoing resilience in valuations for the time being.

Supply chain disruptions coupled with demand have also boosted home prices, which are up 20% year-over-year (shown below). This benefits performance for residential mortgage-backed securities (RMBS), which have seen strong demand from investors over the last year.

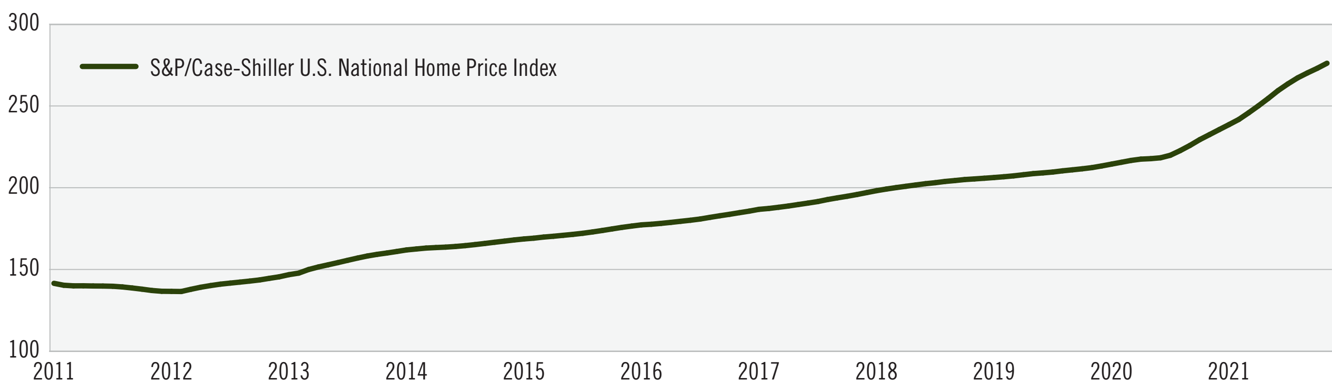
USED CAR SALE VALUATIONS

Manheim Used Vehicle Value Index – Mid-January 2022



Source: Manheim Index and Cox Automotive, as of January 1, 2022.

NATIONAL HOME PRICE VALUATIONS



As of November 1, 2021. Source: S&P Dow Jones Indices LLC.

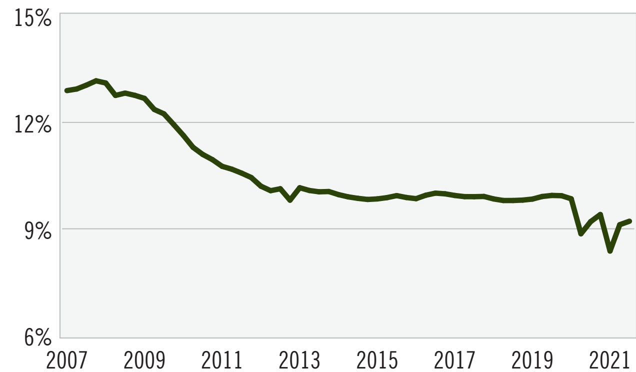
The U.S. consumer offers diversification from investment grade corporate debt

The inflation surge and its impact to companies have been cited by corporate leaders as a major potential risk for 2022. In a recent survey of 900 global CEOs by the Conference Board, over half the respondents expect elevated pricing pressures to last until mid-2023 or beyond. Though companies have maintained earnings strength thus far by raising prices on finished goods, economists cite concerns that consumers will eventually resist higher prices and cut spending.

While this may potentially affect corporate bond and equity performance, many securitized products rely on strength from the U.S. consumer to perform – and luckily, the average consumer is in good shape, post pandemic.

Unemployment hit a post-pandemic low of 3.9% as of December, while the average household debt service ratio (i.e., ratio of total required household debt payments to total disposable income) remains lower than it was pre-pandemic, and significantly lower than it was in 2007 pre-global financial crisis, when it hit a historical peak.

AVERAGE HOUSEHOLD DEBT SERVICE RATIO



As of July 1, 2021. Source: Board of Governors of the Federal reserve System (U.S.).

Meanwhile, wages shot up 4.8% in November from a year earlier. Higher wages – though a burden for companies trying to lower costs – can boost the performance of consumer-backed debt including auto and student loans, credit cards, residential mortgage credit, and other consumer-loan-backed securities. S&P Global's Structured Market Outlook for 2022 expects both U.S. credit card ABS and personal loan ABS performance to remain stable, citing the strengthening economy and favorable loan performance during 2021.

Additionally, the very supply chain challenges and price surges that eat into corporate gains may also benefit valuation of assets that underly certain securitized debt, including financing for shipping containers and railcars, trucking equipment, and agricultural machinery. Overall, S&P forecasts positive performance in these sectors due to higher-than-normal asset recovery values and high demand for shipping and transport.

Securitized offers short duration at attractive yields

Rising interest rates typically come hand in hand with inflation – and the shorter duration of securitized debt helps mitigate the negative price impact caused by rising rates. Additionally, portions of the securitized universe are made up of floating rate assets, in which coupons rise as rates increase, potentially acting like a hedge against inflation.

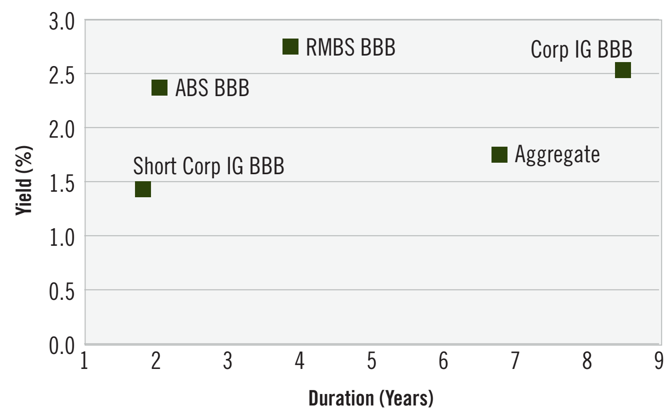
Over the past several years, roughly 70% of single-asset single-borrower commercial mortgage-backed securities (CMBS) consisted of floating rate assets. For ABS and non-agency RMBS, that percentage has ranged in the high single digits to mid-teens.

Furthermore, securitized credit offers attractive relative value compared with corporate bonds of similar duration and quality. The yield premium is not related to the quality of the underlying credit or the likelihood of return on payment of principal.

One reason for the yield premium is that securitized credit requires a greater investment of resources for investors in specialized technology and data. Another reason has to do with liquidity, as most broad market indexes do not include structured credit securities, and the securities are primarily traded over the counter and not through electronic exchanges.

In other words, the reason for the extra yield mostly has to do with technical issues in the space, not riskier or low-quality assets – meaning investors in this sector may benefit with relatively attractive returns without a significant risk of loss.

SECURITIZED SECTORS SHOW ATTRACTIVE YIELD COMPARED WITH CORPORATE BONDS OF SIMILAR DURATION



Past performance is not indicative of future results. As of December 31, 2021. Corporate data: Bloomberg Aggregate Bond Index and ICE BofA 1-3 Year A-BBB U.S. Corporate Index. ABS and RMBS data: based on firmwide exposures across Newfleet Asset Management.

Post-2008 securitized debt: more investor protections and higher credit quality

Securitized credit made headlines for the wrong reasons in 2007-2008 when one of its subsegments backed by subprime mortgages played a key role in the Global Financial Crisis. The good news is that the industry has since undergone significant reforms. This includes stricter lending and underwriting standards, greater structural protections for investors, and regulatory oversight to ensure credit ratings more accurately represent the quality of the security.

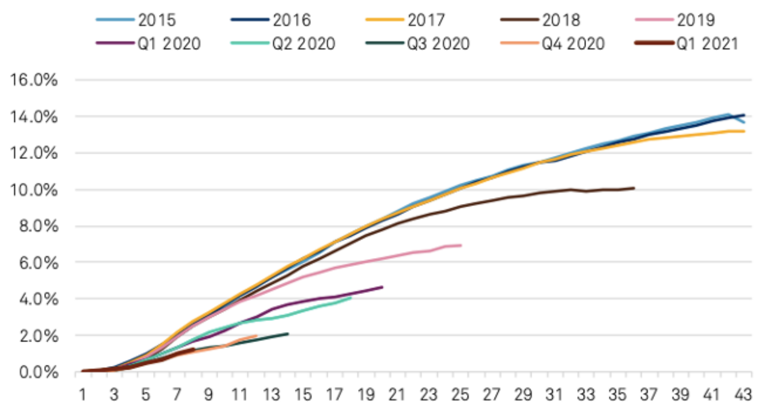
Furthermore, there is reason to believe much of securitized debt may not see meaningful degradation in quality in the near term. For example, the auto loans space still shows resilience, even with loan amounts and monthly payments on the rise. 60-day auto loan delinquency rates as of Q3 2021 stayed flat at 0.55% year-over-year, according to a report by Experian.

S&P's Structured Market Outlook for 2022 also forecasts stable ratings performance and strong credit quality this year for both prime and subprime auto pools given their better-than-expected collateral performance and favorable economic outlook for the coming year. New issuance in the space is expected to increase to 8% due to higher new vehicle sales, vehicle price appreciation, and greater vehicle financing. Net losses by car year (see right) show that Q1 2021 subprime net losses have already trended significantly below 2020.

Meanwhile, S&P's report anticipates solid issuance activity this coming year for non-agency RMBS despite the likelihood that U.S. home price appreciation will soften from 2021. Strong housing demand, limited supply, and relatively low fixed mortgage rates are cited as the main drivers, with those fundamentals precluding a drastic correction in home prices.

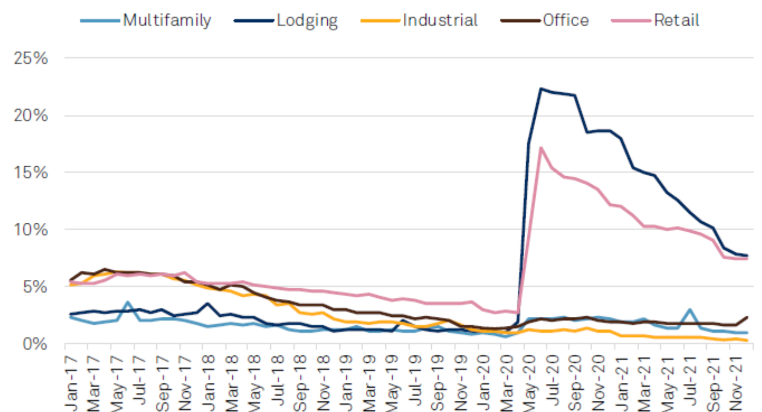
In the CMBS space, issuance for the year was at its greatest since the Global Financial Crisis, with overall CMBS delinquency and forbearance rates falling in 2021.

SUBPRIME AUTO CUMULATIVE NET LOSSES BY VINTAGE



Source: S&P Global Ratings.

DELINQUENCY RATE BY PROPERTY TYPE



Source: S&P Global Ratings.

Due to its complexity, investing in securitized credit requires deep expertise

This asset class poses an opportunity for investors looking for a short-duration hedge with an attractive return profile that also provides diversified exposure to the U.S. consumer.

However, securitized instruments are more complex and less liquid compared with traditional fixed income bonds. Evaluating securitized debt requires investors to take a close look at the deal structure, the value of the underlying collateral, the characteristics of the debt tranche, covenants, and stress scenarios.

An experienced specialist familiar with the full breadth of opportunities, risks, and pitfalls within these sectors can select securities that offer compelling return potential while striving to hedge against rates, inflation, and credit risk.

To learn more about Virtus' range of investment solutions for investors concerned about rising rates and higher inflation, please contact us at 800-243-4361 or visit virtus.com

INDEX DEFINITIONS

The **Bloomberg U.S. Aggregate Bond Index** is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, and CMBS. The **ICE BofA 1-3 Year A-BBB US Corporate Index** measures performance of U.S. corporate bond issues rated A through BBB, inclusive (based on an average of Moody's, S&P and Fitch), with a remaining term to final maturity less than 3 years. The index is calculated on a total return basis. The indexes are unmanaged, their returns do not reflect any fees, expenses, or sales charges, and they are not available for direct investment.

Credit Ratings noted herein are calculated based on S&P, Moody's and Fitch ratings. Generally, ratings range from AAA, the highest quality rating, to D, the lowest, with BBB and above being called investment grade securities. BB and below are considered below investment grade securities. If the ratings from all three agencies are available, securities will be assigned the median rating based on the numerical equivalents. If the ratings are available from only two of the agencies, the more conservative of the ratings will be assigned to the security. If the rating is available from only one agency, then that rating will be used. Default Rate is most commonly referred to as the percentage of loans that have been charged off after a prolonged period of missed payments. Defaulted loans are typically written off from an issuer's financial statements and transferred to a collection agency. In some cases a default rate may also be a higher interest rate charged to a borrower after a specified number of missed payments occur.

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IMPORTANT RISK CONSIDERATIONS

ABS/MBS: Changes in interest rates can cause both extension and prepayment risks for asset- and mortgage-backed securities. These securities are also subject to risks associated with the non-repayment of underlying collateral, including losses to the portfolio. **Credit & Interest:** Debt instruments are subject to various risks, including credit and interest rate risk. The issuer of a debt security may fail to make interest and/or principal payments. Values of debt instruments may rise or fall in response to changes in interest rates, and this risk may be enhanced with longer-term maturities. **Sector Focused Investing:** Events negatively affecting a particular market sector in which the portfolio focuses its investments may cause the value of the portfolio to decrease. **Market Volatility:** Local, regional, or global events such as war, acts of terrorism, the spread of infectious illness or other public health issues, recessions, or other events could have a significant impact on the portfolio and its investments, including hampering the ability of the portfolio manager(s) to invest the portfolio's assets as intended.

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