Three Securitized Debt Trends We're Watching

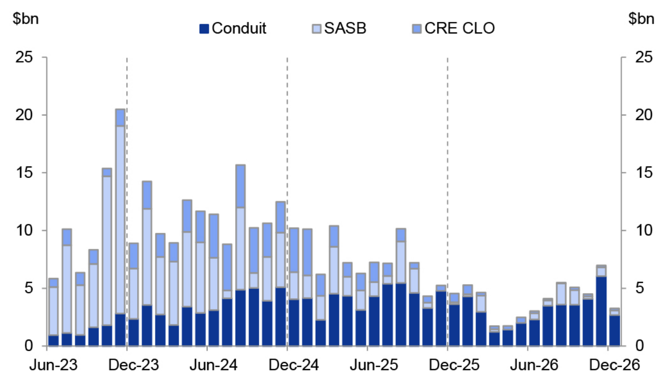
Newfleet ASSET MANAGEMENT
A Virtus Investment Partner

Securitized debt sectors have seen a lot of action this year: U.S. consumer and office property delinquencies are on the rise, while mortgage rates soared to a 22-year high as investors reconcile themselves to "higher for longer" interest rates. So, what's our outlook for securitized debt? Here are three trends we're following.

- While we think commercial mortgage-backed securities (CMBS) are still in the early innings of their credit cycle and that the troubled office space sector will likely take years to play out, we expect to see more interesting opportunities to invest in high-quality single-asset single-borrower (SASB) and conduit deals as foreclosures start to tick up.
- Delinquencies are on the rise, with subprime autos and unsecured loans being especially vulnerable, though we think most consumers will still perform well in a high 4% or even low 5% unemployment rate scenario, as U.S. consumer credit metrics revert to pre-COVID historical norms.
- Even with spiking mortgage rates, record low levels of housing inventory and low levels of mortgage delinquencies have bolstered this market. We think non-agency residential mortgage-backed securities (RMBS) demonstrate the best opportunity within housing due to their stable performance and attractive spreads.

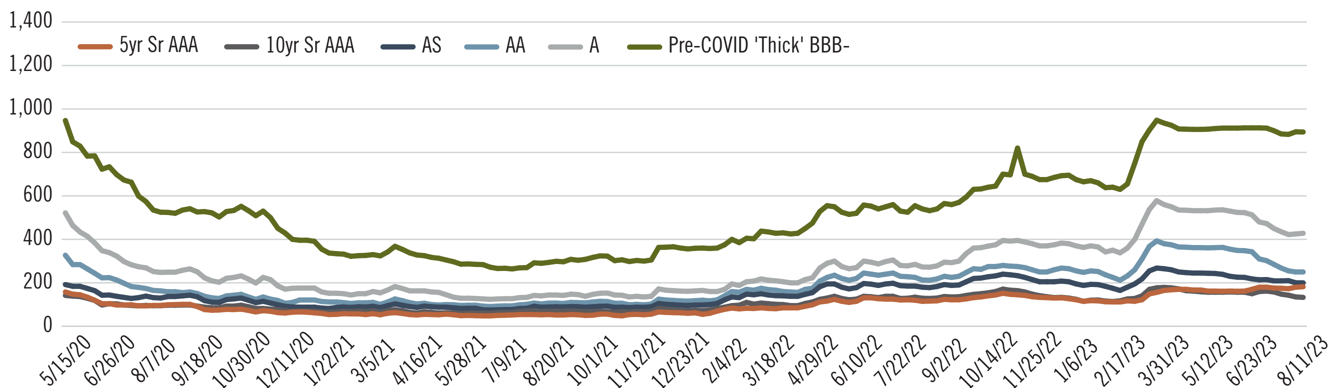
1 The troubled CMBS market faces a looming maturity wall, a plunge in new issuance, and widening spreads. As office properties continue to see elevated vacancies due to the work-from-home trend, year-to-date issuance is down nearly 70% from the same period a year ago. Meanwhile, the CMBS market is facing a wave of maturities through Q4 2023 and 2024 as spreads have widened versus U.S. Treasuries and other comparable assets. For the first time in over 13 years, AAA-rated CMBS has traded cheaper than BBB-rated corporates this year and continue to remain wide of averages.

LOAN MATURITY SCHEDULE OF CMBS SECTORS



Source: Trepp, Goldman Sachs Global Investment Research. Data as of August 9, 2023.

CMBS 2.0 SPREADS VERSUS U.S. TREASURIES



Source: JP Morgan Research CMBS Weekly Dataset; Newfleet Asset Management. Data as of August 11, 2023.

Our Outlook: Expect to see a lot of extension modifications for maturing loans due to tighter credit conditions. In addition, look for an increase in downgrades as rating agencies evaluate current negative fundamentals. Compared with investment grade corporates, senior-tranche CMBS look cheap until you peel back the cover. We would

characterize current valuations as fair. We think it is still in the early innings for problem loans as office issues will take years to play out and as 2023 and 2024 will have higher maturities to work through – look for more re-pricings lower as time marches on. We also expect to see an increase in foreclosures. We believe this will create some interesting investment opportunities within CMBS.

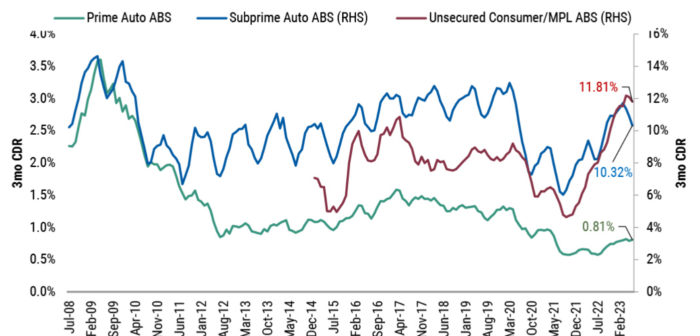
Our Strategy: Look for one-off opportunities from forced sellers to put run-off dollars to work. Selectively add exposure to seasoned conduit deals and floating rate high-quality, single-asset single-borrower positions. Floating rate coupons are extremely attractive in this high-rate environment.

2 Emerging stress in consumer loans underlying asset-backed securities (ABS) is still offset by overall resilience among U.S. consumers.

Emerging stress in consumer loans underlying asset-backed securities (ABS) is still offset by overall resilience among U.S. consumers. U.S. consumer credit performance is now reverting to pre-COVID levels after pandemic-related distortions in the economy left the U.S. consumer flush with excess savings. Delinquency levels are near historic highs for both subprime auto and unsecured consumer loans.

Though delinquencies are worsening for all types of borrowers, the increase is more pronounced for lower-scoring FICO borrowers who are more likely to sustain direct impact from the rising costs of essentials. That said, unemployment is still historically low at 3.8%.

HISTORICAL WEIGHTED-AVERAGE DEFAULT RATES BY PRODUCT



Source: Intex, Morgan Stanley Research. Data as of February 28, 2023.

Our Outlook: We're seeing a return to more normal credit metrics. Street forecasts for unemployment are now in the low-to-high 4% range for the first quarter of 2024, though we believe consumer credit should still perform well in a high 4% or even low 5% unemployment rate scenario. It's also helpful to remember that in times of stress, consumers typically cut discretionary spending first and focus on essentials, such as mortgage and auto payments.

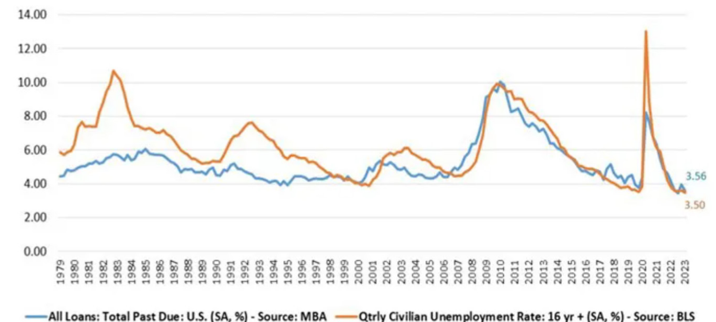
Our Strategy: Favor the more conservative parts of the capital structure within ABS that will be accretive to performance as consumer performance worsens for the rest of the year. Selectively move down the capital stack if there's an opportunity to find better pricing and a better deal structure.

3 Housing is holding strong.

Housing is holding strong. Despite affordability headwinds from higher rates, mortgage credit fundamentals still look solid, in our view. Though mortgage rates spiked from generational lows last year, threatening to dampen last year's hot housing market, the fallout has been relatively mild due to the ongoing housing supply shortage, which remains historically low and creates a floor for any potential price declines. Additionally, most homeowners were able to lock in rates over the last two years, creating low mortgage debt service levels.

Meanwhile, mortgage delinquency rates are staying low. Homeowner equity levels have ballooned to nearly $30 trillion, and stringent underwriting has helped bolster performance. That, coupled with expected low levels of supply, makes RMBS valuations look attractive as a result.

MORTGAGE DELINQUENCY RATE AND UNEMPLOYMENT RATE (SEASONALLY ADJUSTED, PERCENT)



Source: Mortgage Bankers Association's National Delinquency Survey; Bureau of Labor Statistics. Data as of May 12, 2023.

Our Outlook: Higher mortgage rates and a subsequent fall in housing activity bode well for fundamentals and technicals for this sector. Credit quality remains healthy, while the non-qualified-mortgage market is issuing enough paper to remain stable. Overall, RMBS issuance is expected to be down roughly 60% year-over-year. RMBS spreads should track agency mortgage-backed securities with carry, allowing for outperformance.

Our Strategy: Maintain our overweight to the housing sector. Favor non-agency residential exposure as credit performance remains stable, prepayments stay muted, and credit spreads are still wide of averages.

About Newfleet Asset Management

Newfleet Asset Management, distinguished by its longstanding multisector approach, dynamic structural integration, experience, and culture of collaboration, has a proven track record of successfully navigating the fixed income markets to consistently generate excess returns over full market cycles.

To learn more about Newfleet Asset Management, please contact us at 877-332-8172 or visit newfleet.com.

To learn more about Virtus's products, please contact us at 800-243-4361 or visit virtus.com.

DEFINITIONS

The **Bloomberg U.S. MBS Index** covers agency mortgage-backed pass-through securities (both fixed-rate and hybrid ARM) issued by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC). The **Bloomberg U.S. ABS Index** measures ABS with the following collateral type: credit and charge card, auto, and utility loans. The **Bloomberg U.S. CMBS Index** measures the market of conduit and fusion CMBS deals with a minimum current deal size of $300M. **Collateralized Loan Obligations** are securities backed by a pool of assets, often low-rated corporate loans.

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 industry or market sector in which the portfolio focuses its investments may cause the value of the portfolio to decrease. **Market Volatility:** The value of the securities in the portfolio may go up or down in response to the prospects of individual companies and/or general economic conditions. Local, regional, or global events such as war or military conflict, terrorism, pandemic, or recession could impact the portfolio, including hampering the ability of the portfolio's manager(s) to invest its assets as intended.

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