Market Outlook for Alternative Fixed Income

BY JOLANDA DE GROOT

Financial Investigator asked John Vibert, Co-Head of Structured Product at PGIM Fixed Income, a few questions about alternative fixed income. Where are the next big opportunities in today's market?

In the immediate aftermath of the financial crisis, the promise of unlevered double digit returns precipitated an influx of crossover investors to the legacy non-agency RMBS sector. Over the past seven years, non-agency RMBS have delivered standout performance, but as spreads have tightened, investors have increasingly questioned whether value remains in this asset class.

WHAT IS YOUR VIEW ON THIS?

'In terms of 'legacy RMBS', we are specifically referring to securities backed by mortgage loans originated prior to 2008. While this opportunity has evolved since the depths of the financial crisis, the legacy RMBS market remains a $625 billion repository of spread and portfolio diversification in an increasingly barren investment landscape. Despite tighter spreads in recent years, the sector remains compelling from a sharpe ratio perspective as volatility has fallen significantly. Importantly for this thesis, we view the decline in volatility as secular rather than cyclical, stemming from a significant improvement in technical imbalances, declining public policy risks associated with the sector, greater certainty about borrower performance and a meaningful turn in macro fundamentals.

That said, in recent years we have found particularly interesting opportunities in financing legacy RMBS via re-securitization, rather than owning the underlying asset outright. We believe the stability of the senior re-securitization is mispriced by alternative money managers who have no choice but to pursue structural leverage due to the regulatory constraints on traditional repo leverage.'

WHAT ARE THE DRIVERS OF THE FAVORABLE FUNDAMENTAL AND TECHNICAL UNDERPINNINGS FOR THE LEGACY RMBS ASSET CLASS?

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and the broader economy. According to the S&P Case Shiller indices, U.S. home prices have recovered 31% from the trough in 2012 and we expect another 3-4% appreciation this year as mortgage rates stay at historically attractive levels, employment remains robust, household formation rebounds and credit expansion continues. From a technical perspective, we have seen improvement in both the supply and demand dynamics. From a supply perspective, a lack of new issuance combined with prepayments and defaults on outstanding securitizations translate to an annual 10-15% decline in outstanding supply. This stands in stark contrast to record issuance in the corporate bond markets.

From a demand perspective, our clients and their regulators are increasingly less ratings sensitive, which is important as the asset class is largely non-investment grade. For example, in 2009 the NAIC changed their risk-based capital approach for RMBS and CMBS from one that looked at NRSRO ratings to one that focused on expected bond loss and carrying value.[1] As a result, demand for legacy RMBS has improved despite the poor ratings that initially precipitated much of the forced selling during the financial crisis.'

WHAT IS THE OUTLOOK FOR CLOS AND CMBS?

'In the more senior tranches of the capital structure, we are finding outstanding values in both CLOs and CMBS, and believe that the key fundamental risks for each sector—energy/metals and mining exposure for CLOs, and poor loan quality for CMBS—are unlikely to result in material impairments. In the mezzanine parts of the capital structure, we perceive the risks of CLOs and CMBS as materially different, despite the simplistic similarity that both sectors are notoriously crowded hedge fund trades. In the CMBS market, we view the bottom quartile of collateral as quite vulnerable to default, yet believe such defaults will likely be back-loaded maturity defaults rather than term defaults, as debt service coverage ratios remain high by historical standards and underwritten Net Operating Incomes (NOI) appear contextual with trailing historical NOI. In contrast, for secondary mezzanine CLOs, the near-term default risk is higher as the fallout in energy/metals and mining is more imminent.

The fundamental headwinds for CLOs are more tangible in our opinion and the question for investors is whether prices have fallen enough to indemnify one for the incipient default risk and, for those contemplating new investments in existing funds, whether the assets are marked appropriately. On the positive side, technicals have improved modestly due to slower new issue activity, as spread volatility makes pricing new liabilities challenging. Industry expectations for issuance have declined 20-30% since the start of the year, which has helped put a floor under recent spread widening.'

John Vibert

WHAT INVESTMENTS IN THE ALTERNATIVE FIXED INCOME SPACE OFFER CURRENTLY SUPERIOR RISK/RETURN PERSPECTIVES?

'It remains our top-down thesis that the U.S. is likely to lead developed market growth, and consumers will particularly benefit from a recovering job market and the boost to disposable incomes from lower energy prices. Against this backdrop, we remain positive on U.S. housing, which should continue to benefit from the factors mentioned earlier. Somewhat predictably, we therefore favor investments in legacy non-agency RMBS and investments in credit risk transfer securities issued by Fannie Mae and Freddie Mac. Additionally, we favor investments backed by unsecured consumer loans originated by issuers with long-standing origination history and deep regulatory and credit expertise.

While CLO and CMBS mezzanines look increasingly enticing, we believe better risk-adjusted returns are still found in more senior tranches of those asset classes, as poor fundamentals are perhaps not fully reflected in current prices. Lastly, in Europe, we feel CLOs are amongst the cheapest securitized assets as the sector benefits from comparatively less energy exposure.' «

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This information contained herein represents the views and opinions of the author as of March 21, 2016.
Source of data: PGIM Fixed Income. Past performance is not a guarantee or a reliable indicator of future results.

1 NAIC (National Association of Insurance Commissioners); NRSRO (Nationally Recognized Statistical Ratings Organizations).