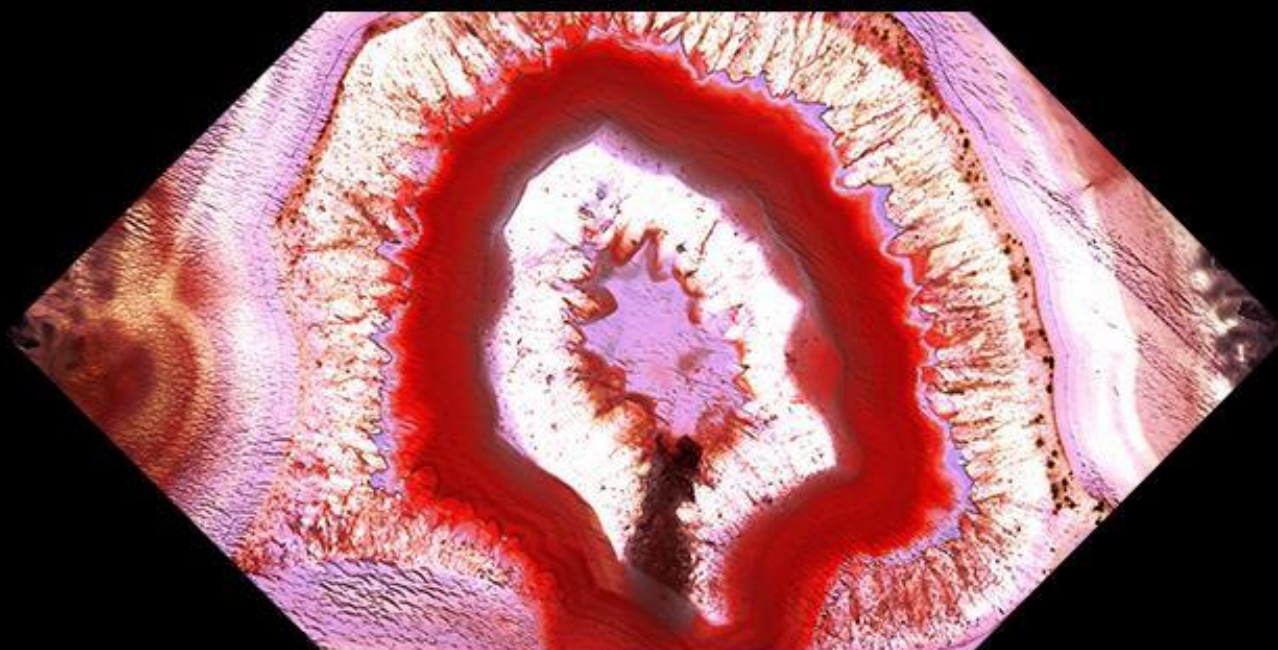


Securitised Credit Market Update

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For Professional Clients only.



Securitized Credit Market Update



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Andrew Jackson and Paul Mitchell discuss the changes in Fed rhetoric, the implications for Securitized Credit and the performance expectations of the asset class in 2024.

The Federal Reserve rhetoric has shifted from a higher for longer scenario to the market pricing in additional central bank rate cuts. How does this affect your view of Securitized Credit?

Yes, higher for longer was a perfect scenario for Securitized Credit as an asset class. Essentially, it meant that the higher base rates were going to be around for longer, so we have higher income for a longer period of time, and a lot of the returns from this asset class are driven by that current income.

But there's another element to that income. It is also spreads. Spreads remain wider than corporate fixed income for every rating category. They also haven't tightened as much as the spreads in corporate fixed income, so the gap is wider than usual.

So how do you view the market pricing?

Fixed Income and Equity Markets are currently pricing in a soft-landing/mild recession. Securitized Credit spreads are pricing in the probability of a worse recession than many economists – but that just means that there is more price appreciation potential within the Securitized Credit asset class. The combination of higher starting base rates and wide spreads means we remain in a good situation. We may end up in the scenario where the recession ends up being less deep than is currently priced into the Securitized Credit Market, and in fact, spreads start to tighten and catch up with Corporate Fixed Income.

This scenario would mean we can get higher income and benefit from tightening spreads, and therefore capital gains.

The market is pricing very aggressive rate cuts and we currently do not see a reason why rates will begin to be cut before the middle of next year and then are expected to be gradually reduced at a steady pace thereafter.

How will this affect the asset class?

This is a broadly floating-rate asset class. That means our coupons are based off SOFR, SONIA, EURIBOR and as those base rates remain high, so the coupons on our bonds remains high, which means Securitized Credit continues to generate high income levels.

We will continue to benefit from high base rates until the coupons on the bonds reset following the first interest rate cut. Base rate cuts typically take around 6 weeks to feed through to the coupons floating rate bonds pay.

Further, rates are not expected to reduce back to zero as previously occurred and are expected to settle at a more normal level.

Securitized Credit pays a higher rate of income when compared to equivalently rated Corporate Bonds, as the asset class benefits from complexity and illiquidity premiums – as this is an OTC traded marketplace, offering a higher spread level.

The value of investments and any income from them can go down as well as up and investors may not get back the amount originally invested.

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What about credit enhancement?

Most investors are predicting a soft-landing/recession, or a difficult economic situation coming in the near term. Almost all of the investments that we make benefit from what we call credit enhancement, and that offers some degree of credit protection against a deterioration in the economic situation.

So how will Securitized Credit perform against this backdrop?

Securitized Credit has outperformed the majority of the fixed rate fixed income asset classes in 2022 and 2023. It also means that we have very low correlation to the returns from those fixed-rate asset classes, and therefore we're a very good diversifier within a fixed income portfolio. We see no reason why the asset class will not continue to add value and diversification to investors' portfolios as we continue to move through the change in economic cycle benefitting from the high initial income levels and potential spread tightening later in the year.

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