Janus Henderson INVESTORS

GLOBAL STRUCTURED DEBT INSIGHT

In the latest edition of the Global Structured Debt Insight, Colin Fleury, John Kerschner and team explore:

- recent trends in the securitised markets
- ways to optimise portfolio returns in a rising rates environment
- why we believe secured loans could enhance portfolio returns in 2022.

Colin Fleury
Head of Secured Credit

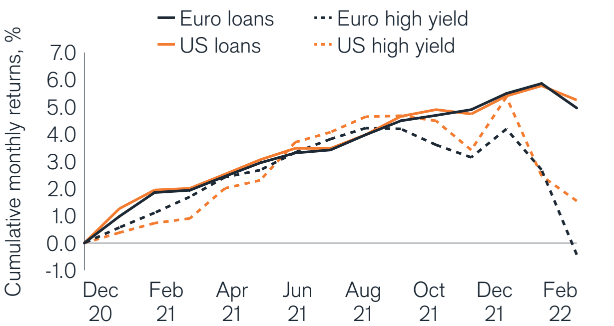
John Kerschner
Head of US Securitized Products

Market snapshot

The performance charts below paint a good picture of the developments in structured debt markets. Fixed income asset classes began the year facing the prospects of interest rate hikes and quantitative tightening, followed by a sharp deterioration in risk appetite towards the end of February on the escalation of the conflict in Ukraine.

Figure 1 – loans versus high yield corporates

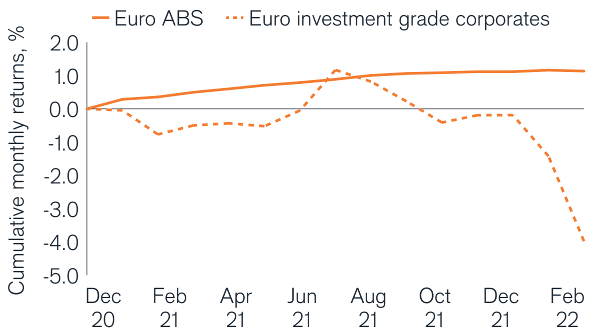
Given the lack of sensitivity to interest rates, loan markets proved resilient to the prospect of rate hikes, which induced a significant sell-off in high yield.



Source: Credit Suisse, Bloomberg, Janus Henderson Investors, as at 28 February 2022. Note: returns are hedged to USD. Indices: Credit Suisse leveraged loan indices and ICE BofA corporate bond indices.

Figure 2 – euro ABS versus euro IG corporates

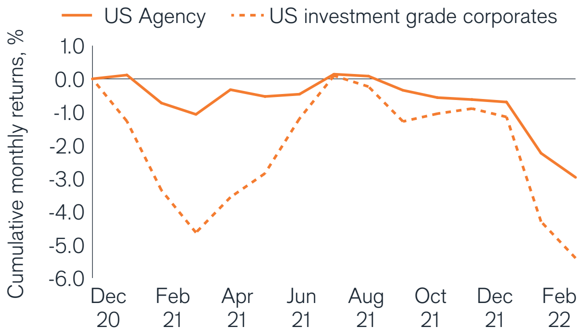
Floating rate European ABS has also proved resilient to the hawkish central bank shift and the sharp deterioration in risk appetite on the escalation of conflict in Ukraine.



Sources: Bloomberg, Janus Henderson Investors, as at 28 February 2022. Note: returns are hedged to USD. Indices: Bloomberg Pan European FRN ABS Bond Index and ICE BofA Euro Corporate Bond Index.

Figure 3 – US Agency MBS versus US IG corporates

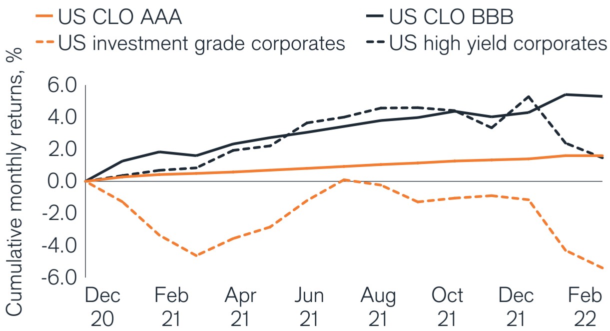
Expected to underperform coming into 2022, given Federal Reserve quantitative tightening, mortgages currently offer better risk-adjusted relative value versus US IG corporates, especially when pricing in the volatility in global markets.



Source: JP Morgan, Bloomberg, Janus Henderson Investors, as at 28 February 2022. Note: returns are hedged to USD. Indices: ICE BofA corporate bond indices. MBS: mortgage-backed securities.

Figure 4 – AAA and BBB CLOs versus US IG and high yield corporates

US CLOs continue to outperform other spread sectors given the demand for floating rate assets and the relatively high credit quality they offer compared to other floating rate sectors.



Source: JP Morgan, Bloomberg, Janus Henderson Investors, as at 28 February 2022. Note: returns are hedged to USD. Indices: ICE BofA corporate bond indices. CLOs: collateralised loan obligations.

Portfolio optimisation in rising rate environments

While substantial gains were made in equities and credit markets last year, 2022 promises to be a challenging environment for all asset classes. Periods of rising interest rates have always been volatile. It is no surprise then that investors are now facing the dilemma of searching for reasonable returns while looking for ways to shield their portfolios from the impact of rising interest rates.

What options are there for the bond investor?

Rotating investments in the portfolio towards those assets that may offer lower returns, yet have less chance of generating negative returns, could be a pragmatic choice. In particular, sectors and securities that are less likely to be impacted by volatility in interest rates and have the fundamental strength to tolerate any greater-than-expected weakness in the economy. The question then is, where to go? Floating rate securities, lower duration asset classes or securities with higher yields are all viable options, and there are a variety of established markets that can provide some or all of these characteristics.

Given that the relatively low yields currently available on longer maturity bonds do not offer much cushion to mitigate any short-term volatility, favouring lower duration securities could be beneficial. For example, it may be prudent to consider including securitised assets in the portfolio, which as well as paying floating rate coupons, often have amortising structures (principal is paid at intervals through time), resulting in a much shorter weighted average life and duration.

The appeal of securitised products

We believe the inclusion of securitised products in a portfolio can provide greater diversity in its risk factors, and hence in the expected return per unit of risk. Why? All securitised products are built around the same core idea – creating a portfolio of individual assets (diversifying individual risk), such as mortgages or car loans, and creating a single entity with greater risk-adjusted returns than its counterparts.

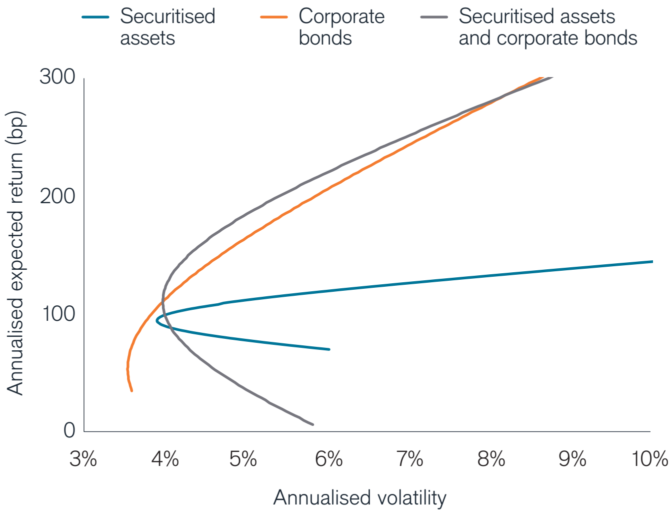
With each sector of the securitised market, new opportunities for diversification of risk factors are added to the toolbox of an active portfolio manager. Further, the benefits provided by these markets are not only due to their relatively low correlations to other major asset classes (eg, equities, government and corporate bonds), but also between different securitised products.

Building optimum portfolios to weather the volatility

Building portfolios that can deliver the best risk-adjusted returns, and help balance the risk tolerance and income needs of investors, generally requires diversification of risk exposures. We believe that given the expanse of the universe of securitised products, they can help improve the overall efficiency of a portfolio and increase the potential for incremental returns. Thus, fine-tuning the credit exposure to add securitised assets may prove prudent. In particular, in today's environment, where yields remain generally low, inflation is high and interest rates are on the rise, the assets' floating rate and lower duration nature could be beneficial.

To illustrate, exhibit 1 shows the benefits of including securitised sectors in a traditional corporate bond portfolio where the area beneath the grey line and above the orange, represents the additional value that can be captured through an allocation to securitised assets.

Exhibit 1: efficient frontier analysis – adding securitised assets to a corporate bond portfolio



Source: Bloomberg, ICE BofA, Janus Henderson Investors, as at 31 December 2021. For illustrative purposes only. Not representing the returns of any particular investment. **Past performance does not predict future returns.**
Note: ICE BofA investment grade and high yield corporate indices and AA-BBB asset-backed and commercial mortgage-backed securities indices.

Other means of accessing floating rates

The rapid growth of the floating rate bank loan market in both the US and Europe, which have grown substantially over the last decade, makes them a good destination for investors facing the headwinds of rate hikes and seeking floating rate exposure. In the US, at around US$1.4 billion[1], the floating rate bank loan market was nipping at the heels of the fixed rate US high yield market, which is marginally larger at approximately US$1.5 billion[2]. The loan market could be ideal for investors who are comfortable with high yielding sub-investment grade credit risk – in the US, around 55% of loans are rated B, and a further 6% rated CCC[1].

However, for those investors with a lower risk tolerance and a preference to stay within investment grade, collateralised loan obligations (CLOs) that own diverse portfolios of loans could

[1.] Credit Suisse Leveraged Loan Index, as at 28 February 2022.
[2.] ICE BofA US High Yield Index, at 28 February 2022.

be of interest, whether as a standalone investment strategy or as part of a meaningful allocation within a broad portfolio of securitised investments. In fact, we believe the addition of CLOs to a portfolio can bring it closer to the efficient frontier for risk-adjusted returns. CLOs' advantages are not only in their floating rates, low interest rate sensitivity and diversification elements, but also in the ability to dial credit risk up or down (eg, AAA or BBB) within a portfolio and provide yield diversification, depending on where you invest in their capital structure.

The appeal of CLOs

As the bank loan market has grown, so has the US CLO market (nearly tripling in the last decade to US$875 billion as at the end of 2021, according to JP Morgan), given that CLOs are, in essence, portfolios of bank loans with added layers of credit protection. They are also actively managed by a CLO manager, who pools together different loans to create a portfolio in an attempt to produce a more diverse and more secure offering. Nevertheless, BBB rated CLOs offer yields closer to the bank loan and high yield corporate bond markets – despite carrying an investment grade rating. The relative attractiveness of investment grade CLO yields is maintained as you move up the rating spectrum. Over the last five years, AAA rated CLOs have offered two times the spread over US Treasuries than similarly rated corporate bonds, and in the single A rating category, they have paid nearly three times the spread of their equivalents (as at 23 February 2022).

It is also worth noting that the previous lows in CLO spreads (ie, higher prices) were achieved during a time when the US Federal Reserve (Fed) was raising policy rates – as they are expected to this year. While positive capital appreciation during times of rising interest rates may seem counter-intuitive, such is the nature of floating rate securities.

Between December 2017 and the end of November 2018, when the Fed raised interest rates 1.25%, the Bloomberg US Aggregate Bond Index lost 1.62%, the shorter-duration Bloomberg 1–3-year US Government/Credit Index gained 0.82%, and the JP Morgan AAA CLO index rose 2.55%. Over the course of the longer tightening cycle, from December 2015 through to November 2018, the Fed raised rates 2.25% and the AAA CLO index rose 8.63%, more than three times the return of the 1-3-year US Government/Credit Index.

In summary...

Most investors instinctively feel that rising interest rates are bad for bonds – the opposite is often true for floating rate bonds. High inflation and expectations for rising policy rates have created demand for floating rate securities, including CLOs. We expect this will persist as long as markets expect central banks to raise interest rates, or if the outlook for inflation remains uncertain.

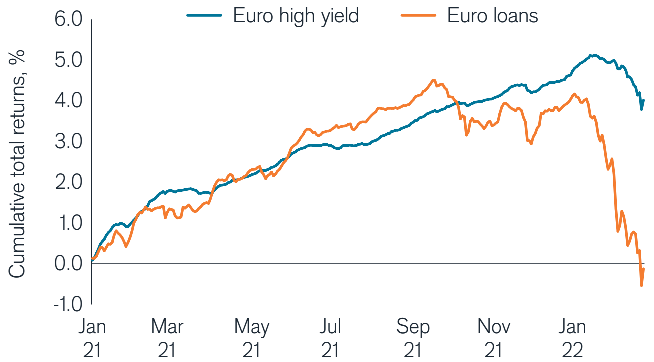
Central banks have woken up to the prospect of stickier than envisaged inflation and are scrambling to catch up. In doing so, they are prone to policy errors by putting the brakes on too hard and severely slowing growth down the road, which could hurt the prospects for credit. The current geopolitical risks also do not bode well for any asset class. In such an environment, we believe the diverse universe of securitised products could offer a solution to investors looking for positive returns amid increasing volatility.

Springtime for loans?

It has been a tumultuous start to 2022 for all risk assets, prompted by concerns around interest rate rises, reducing liquidity from central banks and more recently, the military conflict in Ukraine. While loans have not been completely immune to this volatility, the asset class has delivered a modest negative return since the start of the year. Through to the end of February, the US loan market was down 0.25%[1] and European loans were slightly more negative with a return of -0.62%[2] (both in local currency terms). This is in comparison to high yield, which over the same time horizon is down 4.71%[3], with many developed market equity indices also down at high single digits levels.

Exhibit 1 compares the cumulative returns for European loans and high yield markets since the start of 2021.

Exhibit 1: stark contrast between the returns of loans and high yield markets in Europe



Source: Credit Suisse, Janus Henderson Investors, as at 28 February 2022.

1. Credit Suisse Leveraged Loan Index, as at 28 February 2022.
2. CS Western European Leveraged Loan Index, as at 28 February 2022.
3. ICE BofA Euro High Yield Index, as at 28 February 2022.

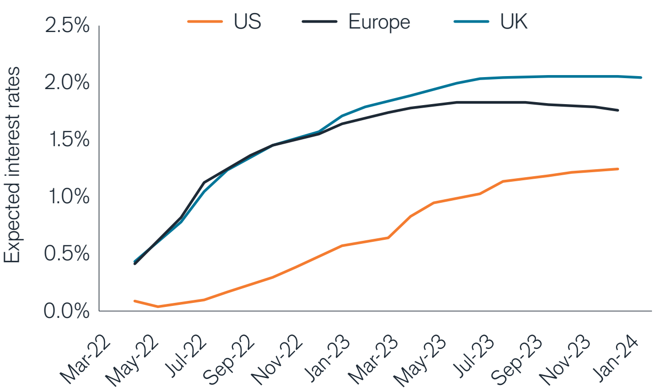
It is worth highlighting that the European loan and high yield markets are broadly similar in size with the latter at €460bn versus €382bn for loans. The two markets share many issuers and as at the end of February offered investors comparable returns; 4.29% for European high yield[1] (yield to worst) and 3.94% for loans (current yield)[2]. However, there are two big differences between the asset classes, namely the nature of the interest coupons paid by the issuers (predominantly fixed rate for high yield versus floating rates in loans) and the investor mix (open-ended for high yield with more retail investors versus more quasi-permanent capital for loans, given CLO investors account for more than 50% of the market in Europe).

Why have loans proved so resilient in the face of broader weakness?

Rising interest rates

To begin with, we are now in a phase where short-term interest rates are expected to rise – heavily signalled in both the US and UK, with the European Central Bank (ECB) also indicating that rates could move up. This is generally beneficial for floating rate assets such as loans, as it will drive overall returns higher. Market expectations for the path of interest rates are shown in exhibit 2.

Exhibit 2: current expectations for higher rates

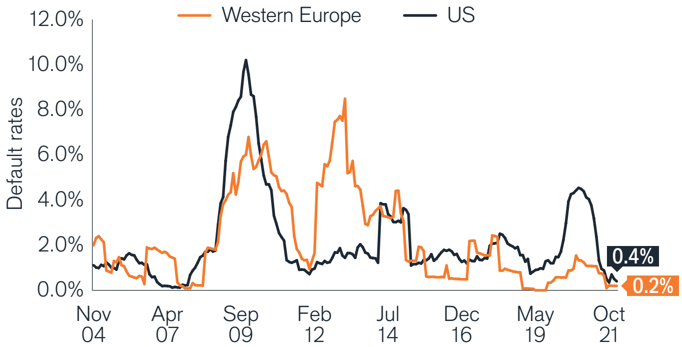


Source: Morgan Stanley, Janus Henderson Investors, as at 14 February 2022.

Defaults

We are also in a period where default rates sit at close to historical lows (exhibit 3), reflecting the cheap liquidity provided by central banks since the start of the COVID-19 pandemic. This liquidity has allowed the majority of borrowers to extend the maturity of their debt and refinance with lower funding costs. We therefore expect market losses from defaults in the year ahead to be minimal.

Exhibit 3: trailing 12-month loan default rates

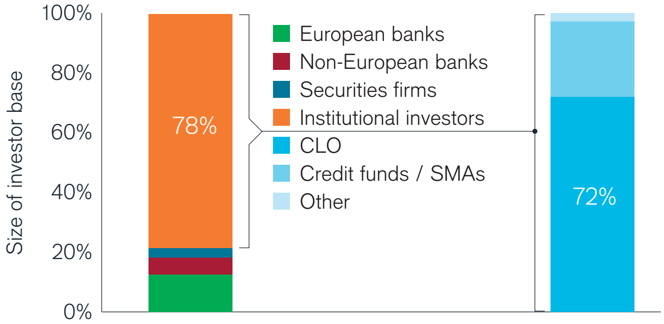


Source: Credit Suisse, Janus Henderson Investors, at 31 January 2022.

CLO support

Finally, given that the biggest investors in secured loans are collateralised loan obligations (CLOs) vehicles (see exhibit 4), the secured loan markets, in both Europe and the US, should continue to benefit from the strong technical support of a strong CLO market.

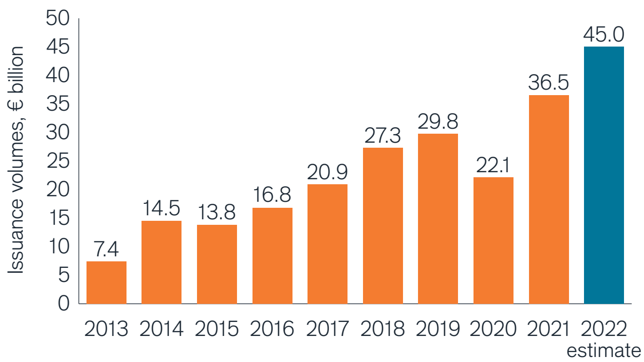
Exhibit 4: CLOs are the biggest investors in secured loans



Source: Morgan Stanley Research, S&P LCD, Janus Henderson Investors, as at 31 December 2021.

Thus, strong CLO issuance should drive new primary loan issuance as well as provide support to the secondary price levels. Exhibit 5 shows the growth in CLO issuance volumes over the last few years, with markets expecting another record year in 2022.

Exhibit 5: last year's record CLO issuance projected to continue in 2022



Source: Credit Suisse, LCD, Janus Henderson Investors, as at 10 January 2022.

1. ICE BofA Euro High Yield Index, at 28 February 2022.
2. CS Western European Leveraged Loan Index, at 28 February 2022.

An additional beneficial factor comes in the form of the CLO arbitrage. In the October issue of the Global Structured Debt Insight, we provided a brief primer on CLO equity arbitrage. The arbitrage is the difference between the spread that a pool of secured loans would generate and the cost of funding in a CLO vehicle (commonly referred to as the 'excess spread'). It is a measure of what returns CLO equity investments may produce, which in turn will influence the likelihood of CLO issuance. We see the current arbitrage between loan spreads and CLO funding costs sitting at levels that support continued CLO issuance.

A final point worth highlighting, is the senior secured structure of the vast majority of the loan market in Europe, which does offer significant downside protection were credit conditions to worsen. According to research from Deutsche Bank (January 2022), the average purchase multiple paid for European leveraged buyouts (a significant source of both loan and high yield issuance in Europe) has been steadily increasing in recent years – from 10.0x in 2016 to 12.7x in 2021, yet the leverage multiple in these transactions has been relatively static. This implies the equity cushion for senior secured creditors has been steadily increasing over this period.

Why springtime for loans?

For all of the above reasons, we view secured loans as one of the more attractive credit asset classes, which while not completely immune to wider credit market weakness, their floating rate nature should reduce the impact of likely increasing rates volatility and help to provide an attractive source of income. To illustrate the latter, the running yield on the CS Western European Leverage Loan Index as at 28 February was 3.94%.

Contact us

Email: institutionalsalessupport@janushenderson.com
Website: janushenderson.com/institutional

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