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
- why mortgage-backed securities now present opportunities for favourable risk-adjusted returns
- the UK government's climate risk focus and emerging legislation in the buy-to-let mortgage market

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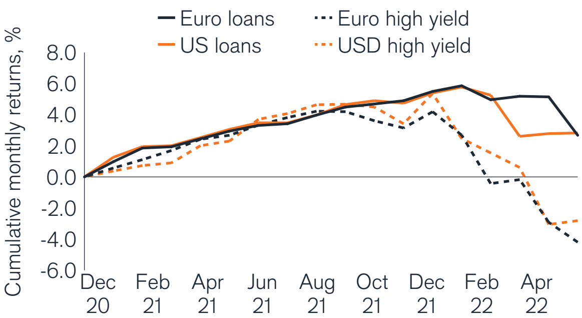
Market snapshot

Global repricing of interest rate expectations dominated all asset classes in Q2. As inflation soared, bond prices were hit simultaneously with rising interest rates and widening credit spreads. The trifecta of upward inflationary pressures, less accommodative central banks and the negative impact of the Russia/Ukraine war elevated volatility in all markets.

Figure 1 – loans versus high yield corporates

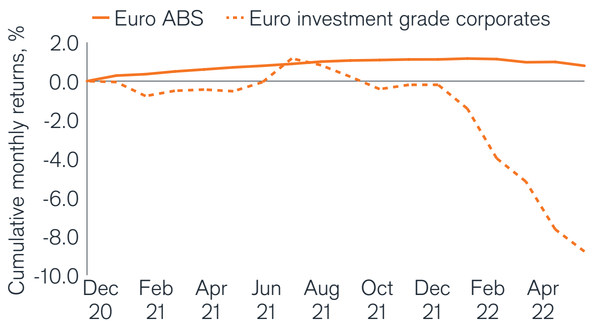
Leveraged markets generated negative returns in Q2 fearing increased recessionary risks on the current tightening path.



Source: Credit Suisse, Bloomberg. Indices: Credit Suisse leveraged loan indices and ICE BofA corporate bond indices.

Figure 2 – euro ABS versus euro IG corporates

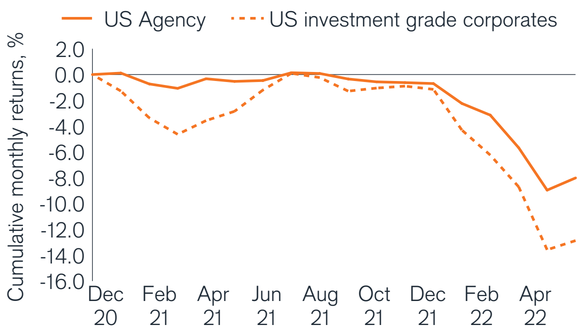
Floating rate European ABS proving defensive as inflation and rising yields continue to roil markets.



Sources: Bloomberg. Indices: Bloomberg Pan European FRN ABS Bond Index and ICE BofA Euro Corporate Bond Index. ABS: asset-backed securities.

Figure 3 – US Agency MBS versus USD IG corporates

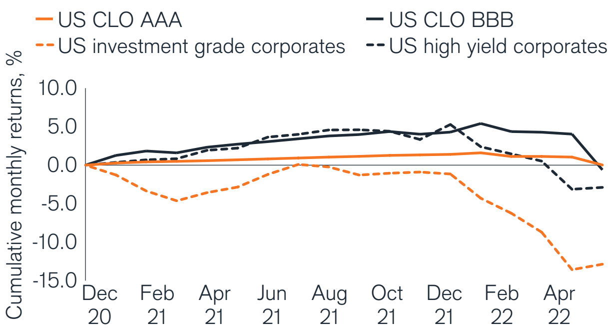
US Agency MBS returns improve as interest rate volatility turns lower.



Source: JP Morgan, Bloomberg. Indices: ICE BofA corporate bond indices. MBS: mortgage-backed securities.

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

Floating rate CLOs continue to have lower volatility than fixed rate corporate credit.



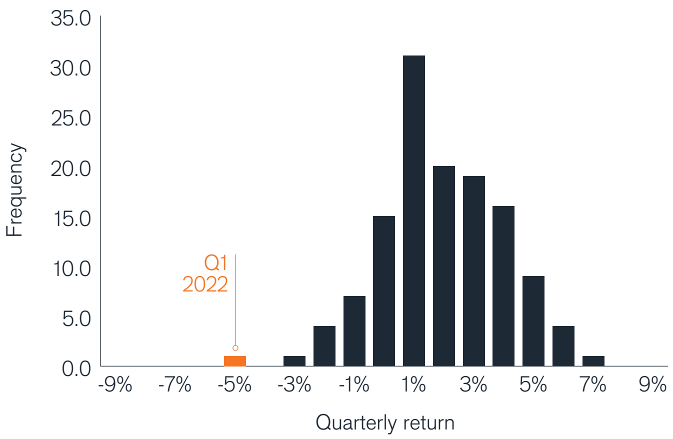
Source: JP Morgan, Bloomberg. Indices: ICE BofA corporate bond indices. CLOs: collateralised loan obligations.

Janus Henderson Investors, as at 31 May 2022. Note: returns are hedged to USD.

Mortgage-backed securities – priced for imperfection?

Fixed income investors have endured a tough start to the year. As inflation has soared, bond prices have been hit simultaneously with rising interest rates and widening credit spreads. The trifecta of upward inflationary pressure, less accommodative central banks and the negative impact of the Russia/Ukraine conflict resulted in the US Aggregate Bond Index registering its worst quarterly return in more than 30 years in Q1 of 2022 (see exhibit 1).

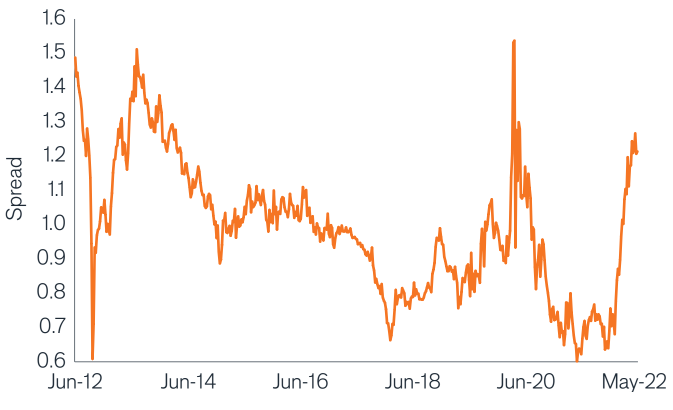
Exhibit 1: quarterly US Agg returns since June 1990



Source: Bloomberg, Janus Henderson Investors, as at 31 March 2022.

As painful as this sharp drawdown has been for investors' portfolios, in our view, a lot of bad news is now priced in. While there is potential for more bad news, we believe there are opportunities in selective areas of fixed income, particularly in mortgage-backed securities (MBS). Notably, credit spreads on MBS are presently the widest they have been since the first quarter of 2014, excluding the COVID-19 sell-off in March 2020 (see exhibit 2).

Exhibit 2: MBS credit spreads have widened dramatically



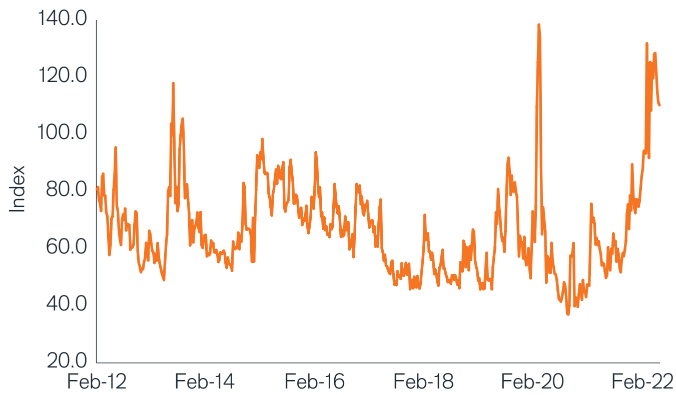
Source: Bloomberg, Janus Henderson Investors, as at 24 May 2022.

What is currently priced into mortgage-backed securities?

High levels of interest rate volatility

With so much uncertainty surrounding inflation, expected interest rate hikes, quantitative tightening (QT) and the war in Ukraine, interest rate volatility as measured by the MOVE Index has been elevated above 100 for much of 2022 (see exhibit 3).

Exhibit 3: volatility in the bond market remains at elevated levels



Source: Bloomberg, Janus Henderson Investors, as at 23 May 2022.
Note: ICE BofA MOVE Index, a measure of bond market volatility.

The MOVE Index has crossed over the 100 point mark only a handful of times in the last 10 years, and only for brief periods. During such times of high volatility, the prices of bonds with theoretical put options (like MBS) are more adversely affected than comparable non-option bonds, because the prepayment option (the ability to refinance the mortgage) held by the borrower increases in value with higher interest rate volatility.

We think that as the market gains more clarity around the trajectory of these various risks, it is likely that rate volatility will recede to more normalised levels. To the extent that MBS are penalised for their theoretical put options in a higher volatility environment, all else being equal, their optionality should provide a tailwind for price returns if we begin to move back to lower levels of volatility.

Higher Fed funds rate

As a result of the US Federal Reserve (Fed)'s recent hawkishness, the market is pricing in a year-end Fed funds rate of 3.5% (lower band). After starting the year at zero, the Fed has already raised its benchmark rate by 150 basis points, with an additional 200 basis points expected to follow. If the Fed did end up raising rates by a full 3.5% in 2022, it would register as the fastest 350 basis point start to a rate hiking cycle since 1994.

There is much debate as to whether the Fed will get to this level. Many believe that growth and inflation will slow enough in 2022 that the Fed, which in recent history has shown a propensity to err on the side of dovishness – could make a dovish pivot. Therefore, in our view, it seems possible that the Fed funds rate could close out 2022 below the 3.5% currently priced in. If that proves to be the case, MBS can benefit from the lower than anticipated rise in rates.

Fears about the Fed selling MBS

In the minutes of its May meeting, the Fed provided clarity on how and when it would begin reducing the size of its balance sheet. After a three month phase-in period following its June start date, the Fed plans to allow US$60bn in Treasuries and US$35bn in MBS to roll off its balance sheet each month.

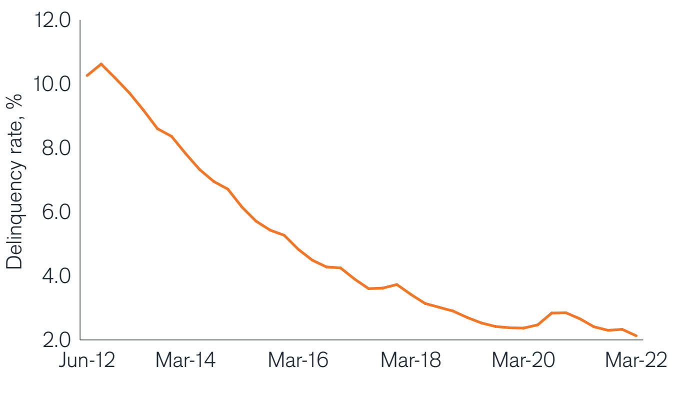
On the MBS side, to hit the monthly cap of US$35bn on prepayments alone, the Fed's US$2.7tn portfolio would require a prepayment rate of roughly 15%. There is some concern that prepayment rates may be lower than 15% following record prepayments in 2021, which begs the question: would the Fed start selling MBS in an effort to hit its monthly cap if prepayments alone do not get them there?

In our opinion, we think it is unlikely that the Fed will sell MBS anytime soon; and if they do not, the pricing of this risk into asset prices is likely to unwind.

Record low mortgage delinquency rates

A piece of the valuation puzzle that is particularly strong for MBS is record low post-Global Financial Crisis delinquency rates on single family residential mortgages, thanks in part to unprecedented stimulus in the preceding two years, high retail savings rates and a strong labour market (see exhibit 4).

Exhibit 4: delinquency rates are at record lows over the last decade



Source: Bloomberg, Janus Henderson Investors, quarterly data, as at 31 March 2022.

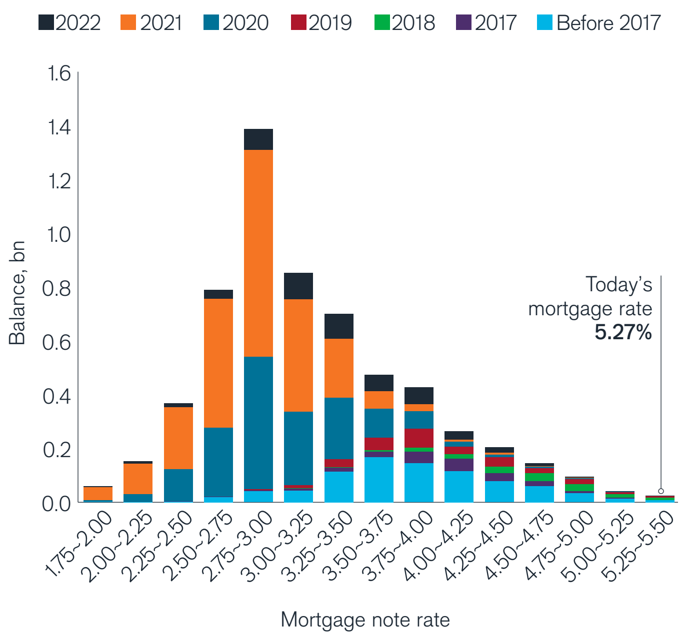
While this bodes well for the asset class, if delinquency rates do start to move higher, prices of MBS could come under pressure. But for now, consumer balance sheets remain strong and in our view it is unlikely that delinquencies would rise considerably without a deterioration in the labour market. We continue to monitor the situation closely.

Lower prepayments risk = more stable duration profile

One of variables that is most difficult to model in the valuation of MBS is prepayments risk – the risk that borrowers will refinance their existing mortgages. For bondholders, an early return of principal makes duration management challenging, while the reinvestment of prepayments poses its own set of challenges. Although, the prepayments risk landscape has changed dramatically as mortgage rates have risen above 5.0% in 2022.

When mortgage rates plummeted in 2020 and 2021, record numbers of borrowers refinanced their existing loans at historically low rates. As a result, less than 1% of outstanding government-sponsored entity (GSE) mortgages have a rate incentive to refinance, because their existing rate is below the current mortgage rate (see exhibit 5).

Exhibit 5: current mortgage rate is much higher than the rate on existing mortgages



Source: Riskspan, Janus Henderson Investors research, as at 24 May 2022. Note: Current mortgage rate, as at 27 May 2022.

As a result, prepayments risk is low, the duration profile of existing mortgages is more stable, and investors can consider using mortgages when seeking to add duration to their portfolios.

All things considered

While risks remain, we believe there are opportunities for mortgage-backed securities to provide favourable risk-adjusted returns as part of a core fixed income holding in the current environment. All MBS are not created equal and, therefore, active management, if done well, can provide better risk-adjusted returns in this asset class. As always, when managing portfolios it is important to stay nimble and keep abreast of changes in the current and expected conditions and to adjust accordingly.

UK government targets the buy-to-let market for energy efficiency

The vast majority of the UK's residential houses have poor energy efficiency. According to the government, homes across the UK contribute around one fifth of all carbon emissions in the country. In order to reach ambitious carbon neutrality goals – to reduce its net greenhouse carbon emissions to zero by 2050, the UK government is focusing on improving the energy efficiency of homes. It has identified the private rental sector (PRS) as a particular area for improvement in both social and environmental factors, focusing on increasing the energy efficiency of the lowest quality properties.

> "PRS properties are among the least energy efficient in the domestic housing stock, costing over £6bn in energy bills in 2018 and producing GHG emissions of around 11 megatonnes of carbon dioxide equivalent ($MtCO_2e$) per annum. The PRS accounts for a disproportionate number of fuel poor households (18% of PRS households are in fuel poverty under the Low Income High Cost (LIHC) measure, compared to 8% of owner-occupied households and 9% of social housing households)."

The private rental sector in England accounted for about one fifth of all households in 2021; around the same level since 2014 – having nearly doubled in size from the early 2000s. Debt financing of individual PRS properties is typically in the form of a buy-to-let (BTL) residential mortgage, which many originators securitise into buy-to-let residential mortgage-backed securities (BTL RMBS).

A UK BTL RMBS is a transaction backed by a pool of BTL mortgages originated by a bank, building society or a specialist lender. BTL lending standards differ to that in the owner-occupied mortgage space, typically requiring additional checks such as rental income covering 125% of the mortgage payment. BTL mortgages are largely interest only, in the 75-80% loan to value (LTV) range and fixed rate for 2-5 years before reverting to a variable rate.

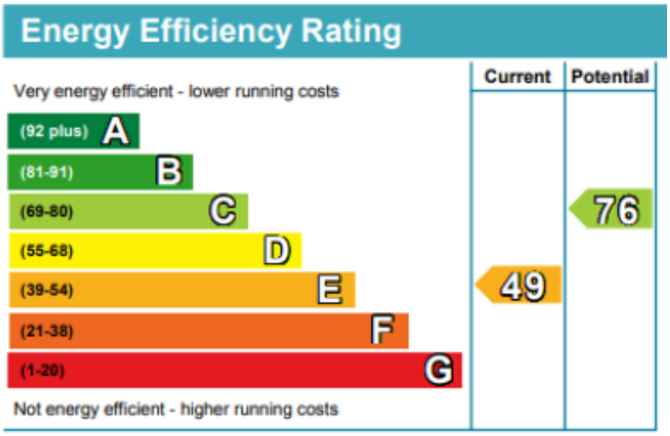
As at the end of Q1 2022, the UK BTL RMBS bond market was €27bn in size comprised mostly of 2017 and later originations from programmatic issuers. These range from long established participants such as Paragon and Paratus, to players who emerged soon after the Global Financial Crisis such as Charter Court, and the more recent non-bank entrants, Belmont Green and LendInvest.

The MEES legislation

The UK government's focus on the PRS sector is based on the view that the most energy inefficient properties impose unnecessary costs on tenants and the economy; cause poor health outcomes, which result in increased pressure on health services and contribute to avoidable greenhouse gas emissions.

As a result, the government introduced domestic Minimum Energy Efficiency Standards (MEES) in 2018, which required all PRS properties to have a minimum Energy Performance Certificate (EPC) grade of 'E' by April 2020 unless specific exemptions apply, with the cost of upgrading the properties capped at £3,500.

Exhibit 1: energy efficiency ratings bands



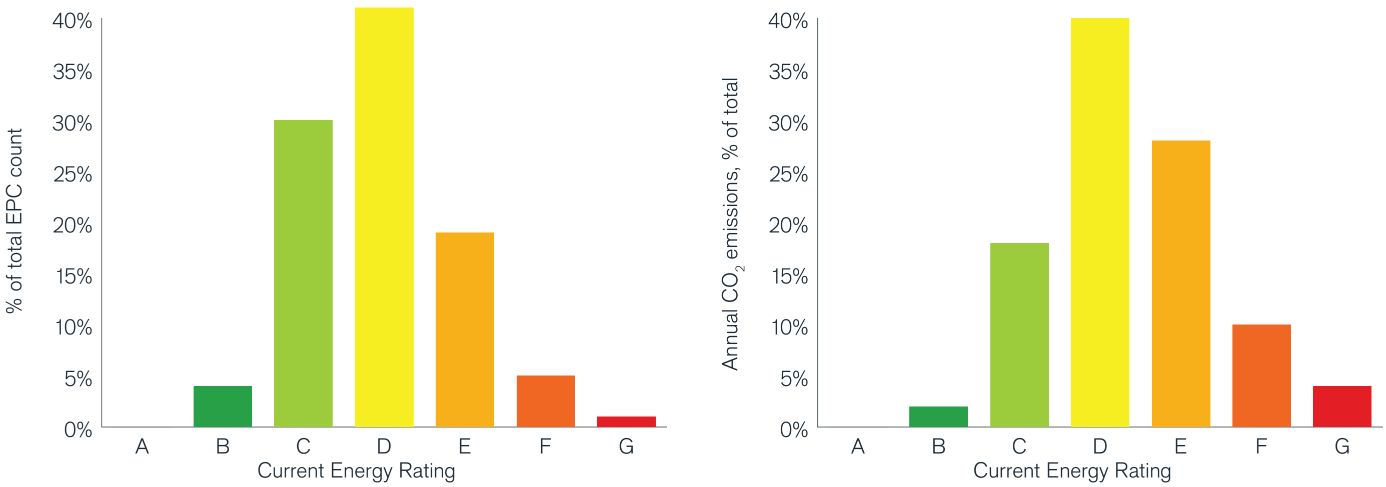
Source: UK government, Department for Business, Energy & Industrial Strategy, September 2020. Note: front page of sample energy efficiency certificate (EPC) in domestic PRS.

A subsequent consultation paper currently under review proposes an expansion of MEES for new PRS properties to a minimum EPC grade of 'C' by 2025, with all existing rental properties to reach EPC grade C by 2028. The landlord's maximum investment amount is proposed to be raised to £10,000, substantially higher than the previous threshold, while the government estimates the average cost of improving the EPC rating to band C to be £4,700.

The EPC database provides an insight on energy efficiency

The publicly available domestic EPC database contains 22.3 million individual properties, 4.6 million of which are privately rented. 13% of all CO_2 emissions from the private rental properties in the dataset are attributed to those in the lowest EPC categories of F and G, equivalent to 2.4 million tonnes CO_2e released per annum, while 68% are in ratings D and E, equivalent to 12.1 million tonnes CO_2e released per annum.

Exhibit 2: EPC ratings and emissions of the private rental sector



Source: UK EPC data base, all Domestic Private Rental Properties, current EPC ratings, as at 31 December 2021.

The UK mortgage market is evolving to meet the changing needs, with lenders not only looking at reporting the EPC ratings for their book but also launching innovative products to incentivise landlords to increase the environmental efficiency of their properties. Actions include new product ranges, offering more favourable interest rates for properties above EPC grade C, or cashback offers.

Unintended consequences of MEES

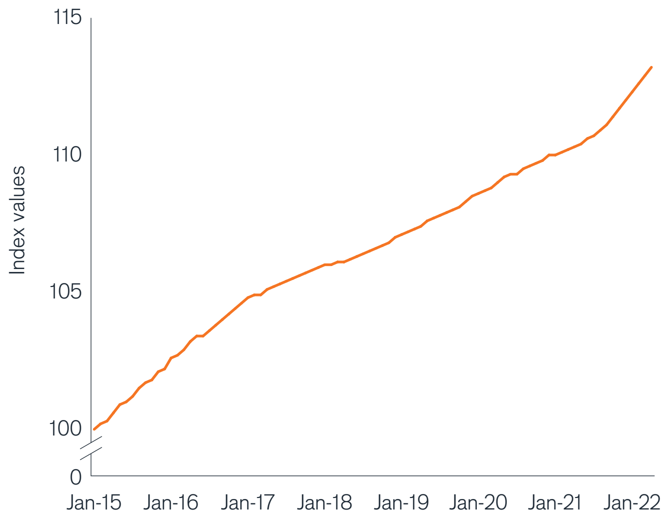
While we support the intention of the proposed MEES as admirable social and environmental goals, we are cognisant of unintended consequences that may result from its implementation. In particular, landlords may want to pass the cost of upgrading the property to the required minimum rating directly to tenants through increasing rents. They may even sell the property rather than fund the cost.

The MEES proposal is coming on top of significant changes in the buy-to-let market in the UK in recent years, driven by reductions in the mortgage interest tax relief, which have been phasing into the market since 2017. Many landlords have already raised rents to cover these costs while others are contemplating selling the property altogether. Earlier this year, a survey by the Nationwide Building Society indicated that 37% of landlords are considering selling, and 25% have already raised rents, to cover the tax burden alone.

Surveys on EPC changes for landlords are producing similar results. A survey by Shawbrook Bank indicated that only 23% would not pass on the cost to tenants while 18% expected rents to rise naturally as a result of having an improved EPC rating. In another survey of landlords with low EPC ratings, mortgage provider The Mortgage Works, reported that 52% of landlords with properties that require improvement to meet MEES regulations have considered selling their properties.

Any reduction in the supply of PRS properties would certainly exacerbate the rising rents in a market with limited supply. This issue becomes even more pressing when considering the current rate of inflation and associated cost of living crisis.

Exhibit 3: UK rental prices have increased by 13.2% since January 2015



Source: Office for National Statistics – Index of Private Housing Rental Prices, as at April 2022. Note: index value 2015 = 100.

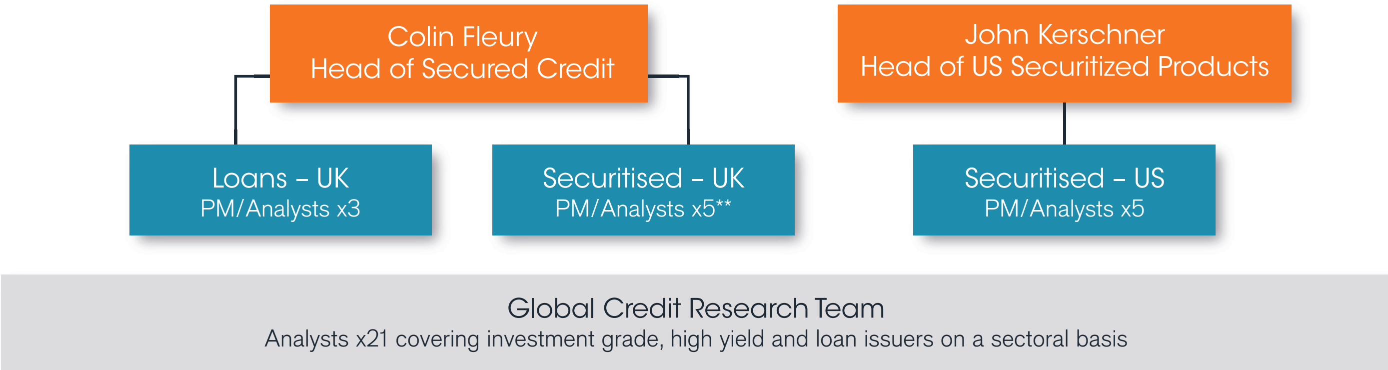
A long road ahead

There are no easy answers to how to balance these competing and pressing priorities. However, as fundamental credit investors in UK BTL RMBS we believe it is our responsibility to engage with mortgage originators not only to remain fully abreast of developments, but to encourage the evolution of the market and also ensure that lenders continue to view this area as a key priority, which should help efforts to reach environmental targets without creating an excessive social cost.

Team overview

The Janus Henderson Global Structured Debt Team applies global, asset class wide expertise to offer actively managed solutions to help clients meet their investment objectives. The team, led by Colin Fleury, Head of Secured Credit, and John Kerschner, Head of US Securitized Products, is UK and US-based and made up of 16 investment professionals.* Team members have a range of specialisms, with average industry experience of just under 16 years and an average tenure with Janus Henderson of just under eight years.* Overall structured debt assets under management at Janus Henderson exceed US$18.9bn.**

Asset class expertise includes all major securitisation markets including residential and commercial mortgage-backed securities, consumer credit and collateralised loan obligations, covered bonds and secured corporate loans and bonds. The team merges qualitative and quantitative skillsets while working closely with industry sector specialist analysts within the broader Global Credit Research Team. The Global Structured Debt Team represents an integral part of Janus Henderson's global Fixed Income platform, collaborating with experts in global investment grade, high yield and government bond markets.



* as at 4 April 2022.
** as at 31 March 2022.
** includes a portfolio analyst supporting both loan and ABS specialists.

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