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Structured credit – opportunity knocks

investing in the 'Real Economy' during COVID-19

July 2020

Background

After a sharp market sell-off in the wake of COVID-19, the lower level of dedicated real-money investors supporting structured credit has slowed its recovery and left housing risk, in particular, as an attractive investment opportunity. With corporations and governments further levering themselves and rates ultra-low, now is the time to consider whether an opportunistic allocation to structured credit could be a fit for your portfolio. Such an allocation could be a stepping-stone to building a more robust, diversified fixed income portfolio for the future.

Introduction

Structured credit[1] was a popular topic heading into 2020, with many fixed income investors extolling the virtues of consumer over corporate balance sheets. Nevertheless, the sector was hit hard by the COVID-19 sell-off. Although the Federal Reserve has provided substantial support to financial markets, it has mainly backstopped corporate credit (an opportunity we have covered in previous papers[2]) and equities, leaving structured credit slower to recover.

Despite these headwinds, we remain supportive of the sector. The increased leverage and tightening spreads in corporate and sovereign credit make structured credit, as an alternative source of spread, more relevant than ever. This realization has led us to create the playbook on the following page for investing in structured credit in the wake of COVID-19. In this paper, we provide background on:

(1) **Why structured credit** was favored heading into COVID-19
(2) **What happened** during the sell-off
(3) **Where are opportunities** in the immediate future

What is structured credit?

Structured credit is a fixed income investment that can be either floating or fixed rate. Underlying credit risk can come from sectors such as residential RE, commercial RE, consumer credit and corporate credit. What distinguishes it from other segments of fixed income is the structuring of cash flows into tranches based mainly on prioritization of principal repayment. Structured credit can be either a defensive or a growth investment depending on a tranche's location in the capital structure and quality of the underlying collateral. The majority of the universe exists outside of standard benchmarks such as the Bloomberg Barclays Aggregate.

[1] Structured credit covers a wide variety of assets that generally share a few characteristics:
1) Issuance from a bankruptcy remote special purpose vehicle
2) Dedicated, income-generating assets (residential mortgages, commercial mortgages, credit card receivables, student loans, auto loans, equipment leases, etc.) that are themselves often backed by physical collateral (homes, office buildings, cars, etc.)
3) Tranching of the security into different risk categories featuring a payment waterfall

[2] Please see *Time to Buy: High-Yield Debt* | *Braving the Unknown: US High-Yield Debt* | *Opportunities in Dislocated Credit Markets*

COVID-19 Structured Credit Playbook

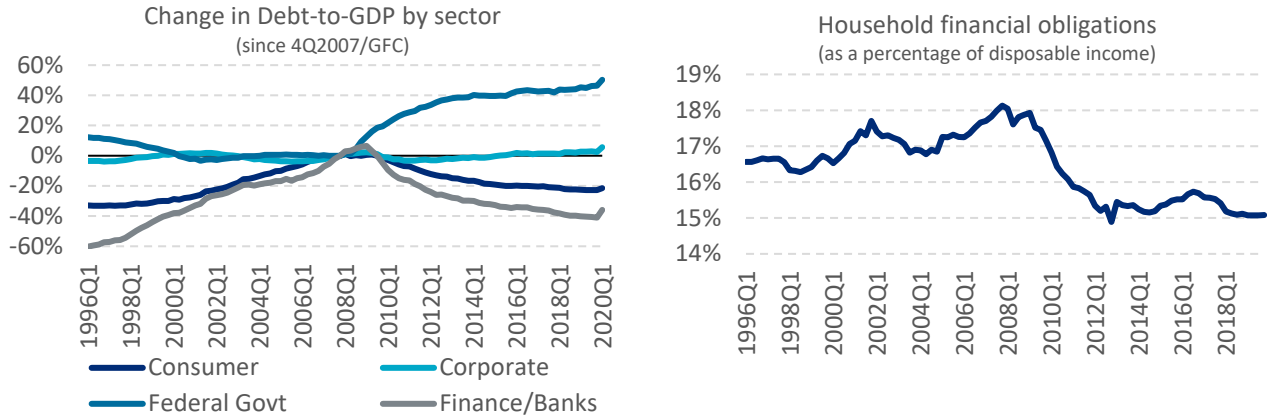
We believe there are three main stages to investing in structured credit post-crisis:

Source: Mercer

Why was Structured Credit Favored?

The superiority of consumer over corporate balance sheets was a popular theme in fixed income heading into 2020, and, indeed, the case for structured credit looked compelling. A combination of declining leverage post-global financial crisis (Figure 1), better underwriting standards (Figure 2), enhanced subordination (Figure 3) and cheaper valuations (Figure 4) made structured credit appear to offer relative value versus corporate credit, especially late in the credit cycle. The natural conclusion was to grow structured credit allocations within multi-sector mandates or as new single-sector allocations, as was reflected in Mercer's own Dynamic Asset Allocation recommendations.

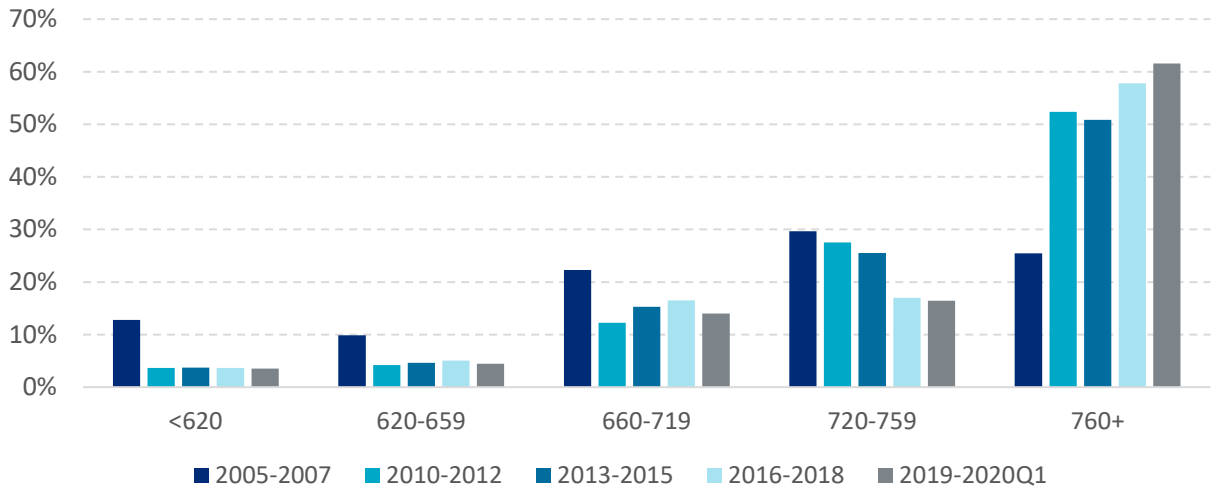
Figure 1. Consumer leverage had declined post-GFC



Source: Federal Reserve.

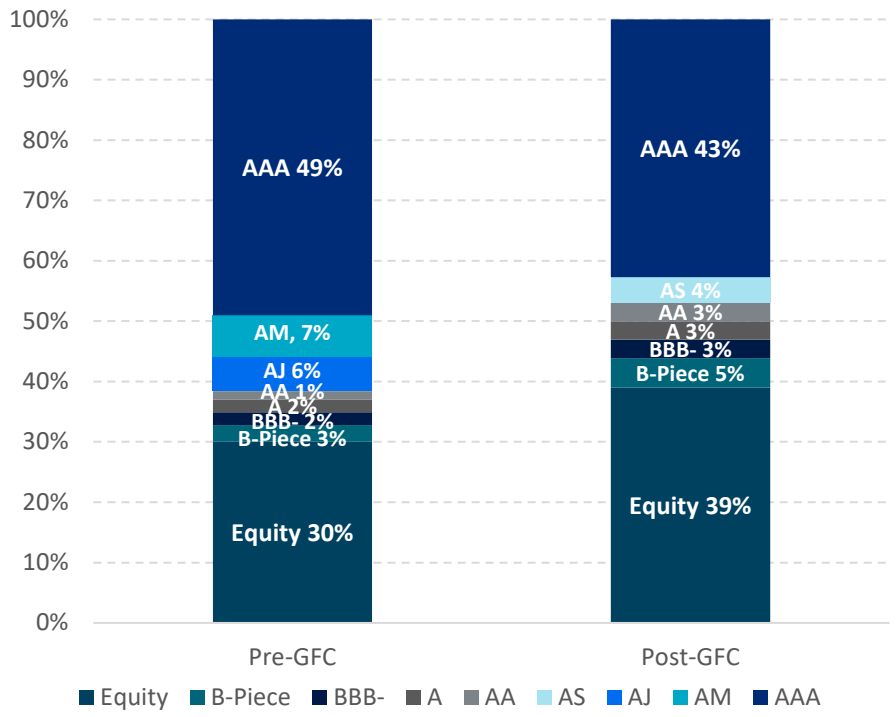
[3] Please see *Term Asset-Backed Securities Loan Facility*

Figure 2. FICO distribution of new mortgage loans



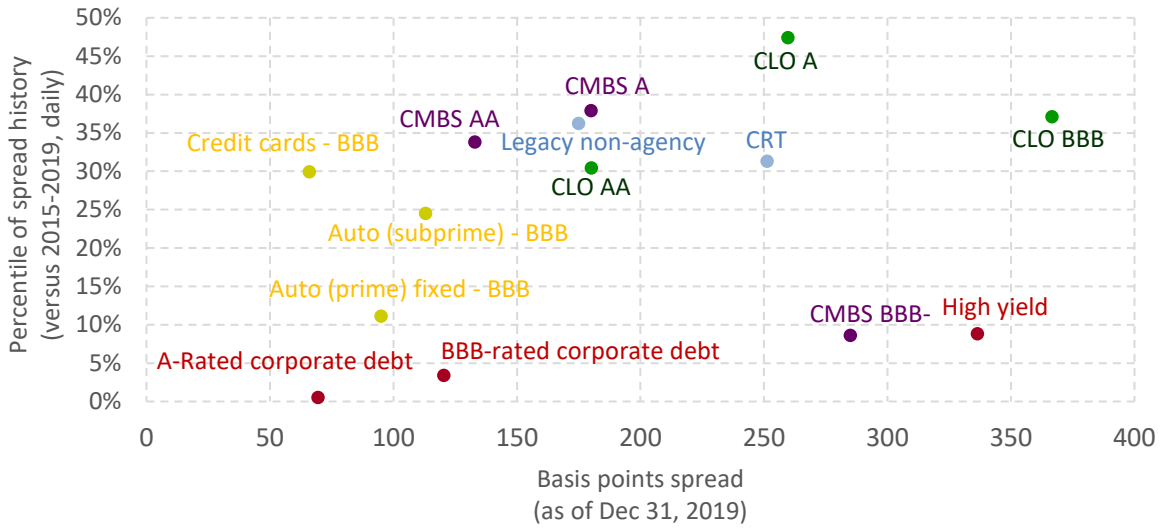
Source: Federal Reserve Ban of New York, Equifax.

Figure 3. Illustrative CMBS capital structure



Source: Marathon.

Figure 4. Corporate credit was tight heading into 2020

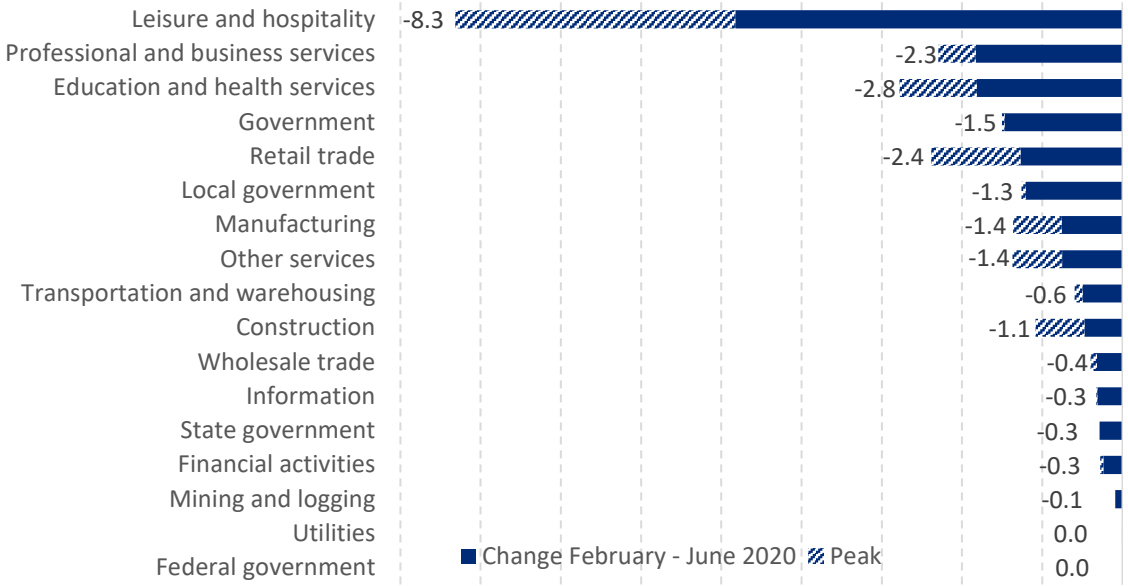


Source: JP Morgan

What happened?

What we could not have foreseen at the start of 2020 was that the long-anticipated recession would be due to a communicable disease rather than corporate leverage excesses. Indeed, the sectors most affected by the disease and the subsequent lockdowns (Figure 5) were consumer- and real-estate related. Beyond the unanticipated source, what also stands out is the sharpness and depth of the recession. Unemployment in the US went from around 4% to double digits in a month, new jobless claims topped 40 million cumulative in just 11 weeks and Q1 GDP, not even the heart of the economic damage, came in at −5.0%.

Figure 5. Change in employment by industry (peak and current job losses from February, millions)



Source: BLS.

As would be expected, risk-on assets of all forms saw steep price declines. However, while the economy is still reeling, many segments of financial markets have now seen significant recoveries owing to the quick deployment of unprecedented amounts of monetary and fiscal stimulus. Structured credit, however, has lagged other forms of risk due to less direct support from policy measures, a more direct link to the real economy and market structure/investor base differences versus other spread assets. Examining these factors, we see the following:

- Although the **policy response** in the aftermath of COVID-19 has been robust, much of the Federal Reserve's strongest and most direct efforts support corporations. In corporate credit, the Federal Reserve opened a secondary market purchase facility for investment grade issuers, supported falling angels and backstopped ETFs. For structured credit, the main valve of support has been TALF, which focuses on a narrow subset of AAA-rated tranches of mainly new issue bonds/collateral. Along with other factors, this critical difference has supported more than $1.5 trillion in corporate issuance so far in 2020, including the three largest months on record in the investment grade space. This support equates to billions of dollars of subsidies to corporations and their existing debt and equity investors. Structured credit issuance, by contrast, has been a paltry $200 billion and is running well below 2019's pace. That structured credit is only on the periphery of the Federal Reserve's largesse is also apparent in credit spreads:

Figure 6. Credit spreads

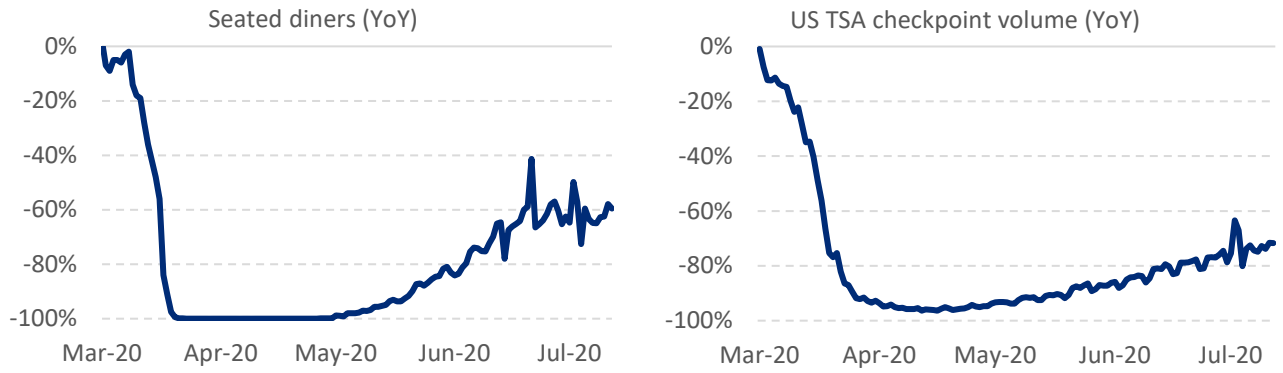
Sector		A	BBB
Corporates	**Current**	**111**	**196**
	March-wide	331	488
	Pre-COVID	80	135
Collateralized loan obligations (CLOs)	**Current**	**325**	**475**
	March-wide	800	1,100
	Pre-COVID	250	350
CMBS: conduit	**Current**	**300**	**600**
	March-wide	800	1,200
	Pre-COVID	200	300
CMBS: single asset, single borrower	**Current**	**300**	**425**
	March-wide	650	750
	Pre-COVID	175	200
Agency CRT (low LTV)	**Current**	**200**	**300**
	March-wide	500	700
	Pre-COVID	80	160
Agency CRT (high LTV)	**Current**	**275**	**450**
	March-wide	600	800
	Pre-COVID	100	200
Non-QM	**Current**	**275**	**325**
	March-wide	800	900
	Pre-COVID	225	250
Single-family rental	**Current**	**275**	**350**
	March-wide	700	750
	Pre-COVID	175	200

Source: Bloomberg, Bank of America Merrill Lynch via Manulife.
Note: Current spreads are as of July 13, 2020. Pre-COVID spreads are as of February 21, 2020.

- Although "don't fight the Fed" can certainly be seen from the above spread chart, it is important to acknowledge that some segments of structured credit have also seen a meaningful increase in the risk of principal loss due to **tighter links to the real economy** and lockdown hit sectors. Segments particularly affected by COVID-19 related restrictions (Figure 7), such as CMBS with concentrations in

malls and hotels, aircraft leasing ABS, rental car ABS and CLOs, could see losses (versus par), especially in lower-rated tranches with less subordination. Given the high degree of uncertainty in the recovery from COVID-19 and the lack of a backstop from the Federal Reserve, trying to call recovery values in these segments is difficult. However, these distressed sectors may provide attractive opportunities down the line for investors to capitalize on deeply discounted dollar prices as economic outcomes become clearer.

Figure 7. Impact of COVID-19 restrictions



Source: OpenTable; TSA; data as of July 10, 2020.

- What is most interesting at this point in the cycle are segments of the market that suffered from the **forced unwind of large levered investors** and lack dedicated sponsorship to drive a recovery. Many of these segments are less directly affected by COVID-19 but are exposed to the consumer more generically. In areas like non-agency RMBS and credit risk transfers (CRTs), forced selling to cover margin calls (Figure 8) by mortgage REITs and structured product hedge funds pushed prices down sharply. Prices fell well below fundamentals given the state of homeowner equity and the nature of jobs lost to this point in the cycle, as we explore further in the following section.

Figure 8. Year-to-date change in FTSE mortgage REIT index market cap

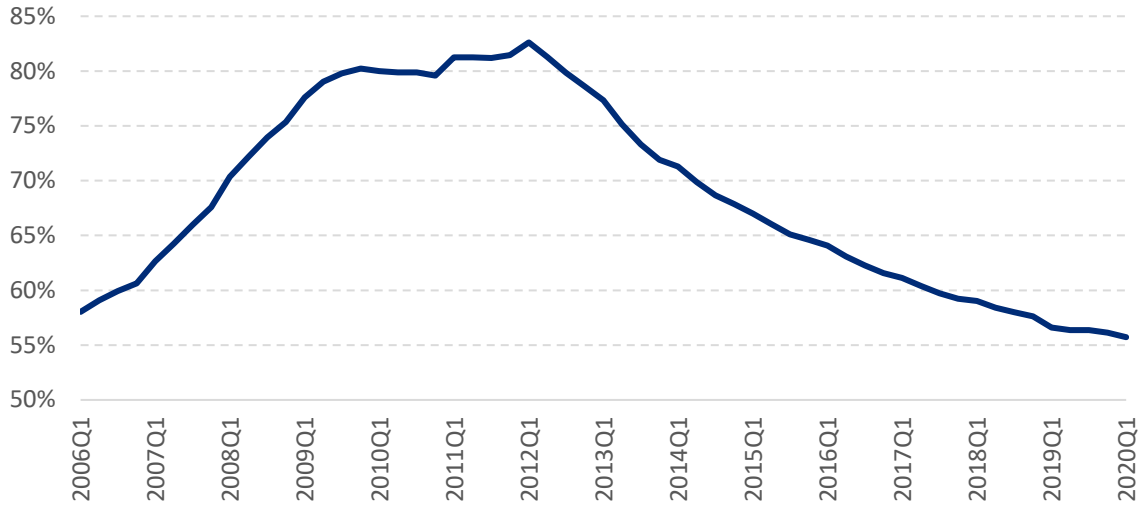
Source: FTSE; data as of July 10, 2020.

Where are the opportunities?

Although the velocity of the sell-off experienced across structured credit markets was unprecedented, we believe its indiscriminate nature ultimately has provided investors with a compelling opportunity. In particular, we find housing risk attractive given its smaller impact from COVID-19 and its position at the epicenter of the liquidity crisis in Q1 2020. The strong fundamental characteristics that ultimately underpin our conviction in housing risk include high homeowner equity, constructive forbearance policies and the nature of jobs lost at this point in the cycle.

- **Homeowners started on solid footing:** With the average borrower's loan-to-value (LTV) having fallen to post-crisis lows (Figure 9), households have significant equity stakes in their homes. This equity component is significant as delinquency rates and cure rates are highly correlated with a borrower's incentive to remain in the house. In this sense, today's backdrop varies dramatically from the 2008 experience, when many loans had little to no equity cushion and quickly came to be "underwater." In addition, tighter underwriting standards have led to a high-quality borrower base on average. With a lower likelihood of default as the starting point, the potential for contagion due to foreclosures leading to falling home prices is diminished.

Figure 9. Mortgaged home LTV



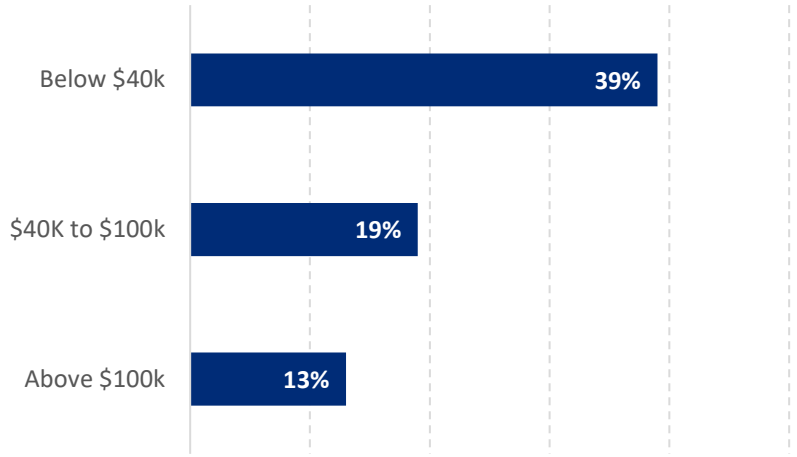
Source: Federal Reserve, US Census Bureau

- **Forbearance policies protecting those with a temporary loss of income:** The Federal government has been adamant about its desire to keep borrowers in their homes despite any temporary financial hardship they may face. We expect the forbearance provisions that have been put in place to soften the blow stemming from the rapid rise in unemployment for both agency and non-agency borrowers. Forbearance is one of the primary tools mortgage servicers utilize during crises and natural disasters to help borrowers avoid foreclosure when they are temporarily unable to make their required

mortgage payments.[4] These special agreements with lenders have the positive impact of delaying payments while keeping potential borrower defaults lower than they otherwise would be. Given the unknown duration of the current economic shutdown, the government is offering up to 12 months of forbearance for agency-backed loans. Although not explicitly covered, non-agency RMBS servicers generally follow the lead of their agency counterparts, meaning most of the non-agency mortgage market will follow suit. With many servicers offering hardship relief, cure rates should be higher and ultimate default rates lower than what we would normally expect during an economic disruption of this magnitude.[5]

- **The loss of income and jobs has been concentrated in renters:** Although the toll on the US labor market has been severe, the job losses thus far have been skewed toward lower-income workers (Figure 10), who are less likely to be homeowners.[6] Homeowners are more likely to be salaried professionals, who have encountered less income disruption due to the transition to working remotely. We still expect high levels of unemployment to put downward pressure on home prices over the medium term, but, ultimately, we believe that downside tail risk in home prices stemming from labor market pressures is less than that priced into the market.

Figure 10. Households experiencing a job loss in March (by household income)



Source: Federal Reserve

[4] It is important to note that forbearance does not stop bond cash flows from being paid. Mortgage servicers are responsible for advancing payments to investors during the forbearance period. So one of the largest risk factors for housing during the sell-off in March was the solvency risk of mortgage servicers, as it was not clear if they would have enough capital to make good on their legal obligations. The government made it known that they were clearly aware of the potential strain on servicers and provided a backstop after four months for agency loans.

[5] As of April 2020, according to Black Knight, 8.8% of mortgage loans in the US were in forbearance, and nearly half of those still made their April payment. Additionally, the daily volume of net additional forbearance plans dropped substantially in May, signaling that, at this point, a majority of loans likely to move into forbearance have already made the transition. More than 70% of portfolio/non-agency RMBS loans in forbearance had a combined LTV of less than 70%. Separately, according to the Mortgage Bankers Association, 10% of private-label loans were in forbearance as of the last week of May.

[6] According to a survey by Avail of 2,775 property owners and 7,379 tenants, 53.5% of renters reported that they had lost their job due to COVID-19 related restrictions.

Paths for investment

Investors can access housing risk through a variety of different instruments (Figure 11) and investment strategies. To help demonstrate our thesis for housing, we provide a deeper dive in the Appendix on legacy non-agency RMBS and CRTs, two segments particularly hard hit by the forced de-levering in March.

Figure 11. Sample instruments for investing in housing risk

Instrument	Description
Legacy RMBS	Securities holding non-GSE, non-Ginnie Mae loans made pre-GFC
Credit risk transfer (CRT)	First-loss credit risk on pools of loans from the GSEs (and others)
Re-performing loans (RPL)	Packages of loans from an MBS that have cured after a delinquency
Non-performing loans (NPL)	Packages of still delinquent loans bought out of MBS
Non-QM	New issue loans that fail to meet the requirements of QM
Jumbo 2.0	New issue loans that are above the GSE loan limit thresholds

For interested clients, there are several Mercer-rated, mortgage or structured credit-oriented strategies available. We break these into four main categories (Figure 12): core/core plus strategies with a structured credit tilt, structured credit replacements for core/core plus allocations, opportunistic structured credit allocations and private/less liquid alternatives funds focusing on structured credit. The focus on housing credit risk will vary by category and manager implementation. Given the relative cheapness of structured credit compared to corporate credit and the ability of managers in broader mandates to pivot to value as we progress through the cycle, even broader, more multi-sector structured credit mandates should prove attractive for boosting portfolio diversification and yield. Which category and level of focus on housing risk is most appropriate will depend on a client's individual circumstances and funding source.

Figure 12. Implementation options for structured credit

Implementation	Pros	Cons
Core/Core+ with structured credit tilt	One-stop solution for higher-quality diversification	Least impact on a portfolio with other credit strategies
Structured credit Core/Core+ replacements	Diversifies other high-quality fixed income allocations	Less diversification of non-IG credit, growth FI allocations
Opportunistic securitized allocations	Attractive valuations; diversifies non-IG credit	More liquidity risk; higher fees; more retail-oriented
Less liquid, alternative products	Unique primary market and esoteric opportunities	Often performance fees; lack of liquidity; leverage

Home is where the Heart is (and more than ever, your office)

In our increasingly work-from-home society, the "can't live without" item of the current recession is likely to be people's homes, just as it was cars or cell phones in the past. The sharp market sell-off in March and slower subsequent recovery in structured credit have also conspired to make housing risk, in particular, an attractive investment opportunity. With corporations and governments further levering themselves and rates ultra-low, now is the time to consider whether an opportunistic allocation to structured credit could be a fit for your portfolio, and potentially, a stepping-stone to building a more robust, diversified fixed income portfolio for the future.

Appendix: Example housing subsectors

Example: Legacy non-agency RMBS

We believe the legacy (pre-GFC) non-agency RMBS market is well-positioned to generate strong risk-adjusted returns across a wide range of potential economic outcomes. The extreme seasoning of the underlying loans and home price appreciation post-GFC makes this sector less sensitive to changes in home prices and thus less levered to the uncertainty surrounding the current economic environment. The average loan-to-value (LTV) within a legacy non-agency RMBS deal is below 60%, meaning investors have, on average, a 40% cushion versus current home prices. Additionally, borrowers remaining in these loan pools have demonstrated an ability to weather economic headwinds in the past, including the global financial crisis. Although the market has experienced a price rebound from the March lows, spreads remain well wide of where they were entered the year. At current valuations, it would take a housing market downturn worse than what was experienced in 2008 to impair an initial investment at these discounted dollar prices.

Example: CRTs

Credit risk transfer (CRT) is another subsector that we believe offers compelling value at current distressed prices. CRTs are generally issued by the government-sponsored housing enterprises, Fannie Mae and Freddie Mac, as a way to offload some of the credit risk in their residential guarantor business. Homeowners within CRT pools feature solid, prime credit metrics, as they are the same borrowers included in the agency mortgage-backed pass-throughs. The majority of the borrowers in CRT pools have FICO scores (a measure of borrower credit history) above 750. What makes CRTs worthy of credit spread is structural leverage. The tranches issued into the market are thin and at the very bottom of the capital structure. This makes them highly susceptible to bouts of volatility when loan default expectations change. As a result, CRTs experienced significant drawdowns in March as 1) investors feared a spike in mortgage delinquencies and defaults would cause permanent impairment, 2) there was uncertainty, since resolved, around treatment during forbearance and 3) mortgage REITs were forced to sell down large positions due to margin calls. This combination of factors has created an opportunity to gain exposure to higher-quality CRT tranches at discounted dollar prices, ultimately reducing the negative asymmetric proposition of these securities when priced at par.

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