Janus Henderson INVESTORS

GLOBAL STRUCTURED DEBT INSIGHT

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

- recent trends in the securitised markets
- the impact of a US Federal Reserve (Fed) taper on the US mortgage-backed markets
- the concept of collateralised loan obligations (CLO) equity arbitrage.

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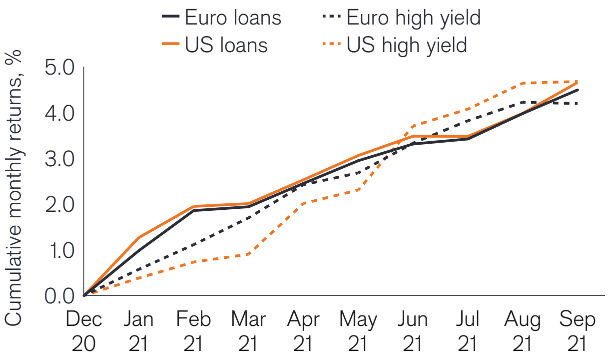
Market snapshot

We believe the following performance charts paint a good picture of the main developments in securitised markets over the last few months; steady recovery in loan and high yield markets, US Agency MBS reacting to the impending Fed taper and US CLOs continuing to be a stable source of carry.

Figure 1 – Loans versus high yield corporates

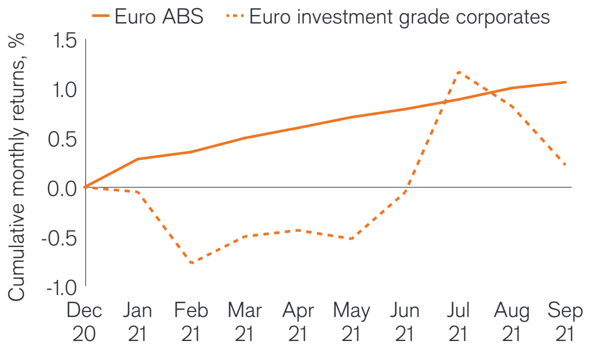
Steady recovery across loan and high yield markets as credit metrics improved YoY as the global economy re-opened.



Source: Credit Suisse, Bloomberg, Janus Henderson Investors, as at 30 September 2021. 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

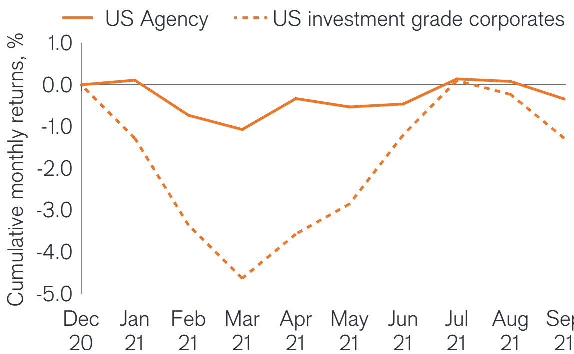
Euro ABS spreads: consistent grind tighter YTD, less impacted by rates volatility, benefited via post-Brexit boost early in the year.



Sources: Bloomberg, Janus Henderson Investors, as at 30 September 2021. 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 monthly return

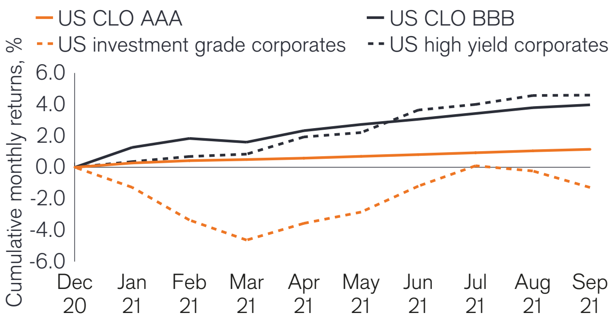
US Agency MBS have widened in comparison to US investment grade corporate credit in preparation for the Fed taper, expected to commence November 2021.



Source: JP Morgan, Bloomberg, Janus Henderson Investors, as at 30 September 2021. 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 be a stable source of carry offering wider spreads than comparable lower rated US corporate credit with the added benefit of a floating rate coupon.



Source: JP Morgan, Bloomberg, Janus Henderson Investors, as at 30 September 2021. Note: returns are hedged to USD. Indices: ICE BofA corporate bond indices. CLOs: collateralised loan obligations.

Tapering without the tantrum

Substantial fiscal and monetary support for the US economy in 2020 broke all records and, in our view, set new precedents for intervention in the financial markets by the US Federal Reserve (Fed). A lot has changed in a year. Both macro and microeconomic fundamentals have improved; corporate bond markets have rallied toward historical spread lows, and securitised products have recovered broadly, while the Fed has recently signaled it could begin tapering asset purchases from November 2021.

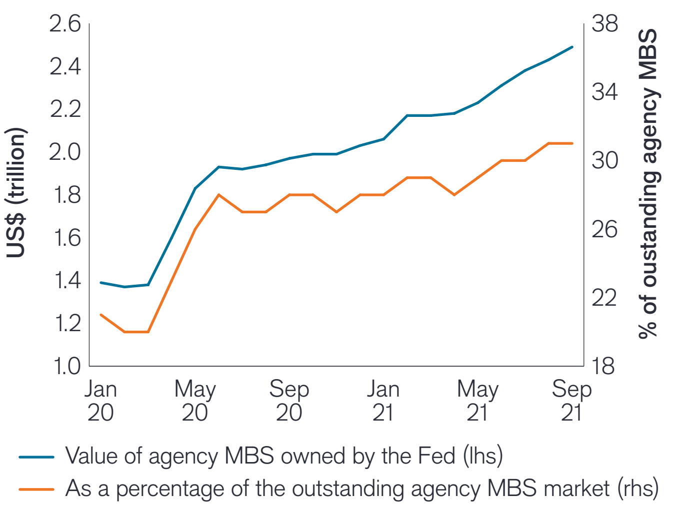
What effect will reducing the current pace of quantitative easing have on credit markets generally, and the mortgage market specifically?

The Fed was aggressive in 2020

Before COVID-19 struck, the Fed owned about 23% of outstanding agency mortgage-backed securities (MBS)[1]. As COVID spread, it started buying agency MBS and Treasuries in the open market to provide liquidity to financial institutions and to help lower mortgage rates. While the liquidity provided short-term medicine, lowering mortgage rates was a longer-term strategy to provide consumers the opportunity to refinance their mortgages at cheaper rates, thereby putting more disposable income in their pockets. The strategy worked. Mortgage rates plummeted as US Treasury yields fell, refinancing spiked[2] and the Fed aggressively bought the new mortgages.

Today, the Fed owns about 31% of the outstanding agency MBS market (see chart), or approximately US$2.5 trillion[1] – and is still buying. Estimates vary, but it seems likely it will end up owning around 40% of the market before reaching the point where the volume it is buying is lower than the rate at which the holdings mature – that is, paid off or pre-paid as homeowners refinance or move. Regardless of where that point is, it is less of a concern to the market than how the Fed plans to ultimately reduce its exposure.

Fed holdings of agency MBS



Source: Bloomberg, as at 30 September 2021.

The market remembers 2013-14

The Fed had a smaller scale MBS and Treasury purchasing programme in the Global Financial Crisis (GFC). Unfortunately, the attempt to taper those purchases was something of a debacle. When the markets caught wind that US Treasury purchases would slow, 10-year yields spiked ca. 1.0% in just a few months. The period came to be known as the “taper tantrum”, which in our view, was due to a failure in communication. In 2013, caught by surprise, the markets leapt to a worst case conclusion as the Fed failed to sufficiently communicate its intentions in advance, and give markets time to digest the plan.

We think the Fed has learnt its lesson and been much more intentional about telegraphing its thinking in advance. Since June, the Fed has been signaling that it will take the process in steps. At the September meeting, Chair Powell indicated that tapering bond purchases could begin as soon as November and could be complete by mid-2022.

Our view is that the Fed will most likely announce the date to start tapering MBS purchases after its November meeting, with a US$5 billion reduction in purchases of MBS each month. We think the central bank would like to get back to owning closer to 20% of the market, near the level held pre-COVID, but will not lower its holdings to zero; purchasing MBS has proved a useful tool for supporting the economy and moderating market volatility in times of stress.

Given the volume of bonds currently owned and being purchased, we expect the Fed’s tapering will last less than a year – but getting the size of the MBS portfolio to its target could take a few years. To be clear, we do not expect the Fed will ever sell MBS outright in the open market – which could raise supply concerns, rather, it will buy fewer bonds over time while letting the ones it holds mature or prepay.

Is the Fed likely to provide the same support, or even more, in the next crisis? History would suggest ‘yes’. We would expect the Fed to ramp up its MBS (and US Treasury) purchases as these are ideal assets for the Fed to own given their high credit quality. It may also help that the Fed does not need Congressional approval to buy US Treasuries or MBS but it is seen as more controversial for it to be using its powers under the Federal Reserve Act to buy the bonds of corporations.

Tapering, without the tantrum

The Fed deserves credit for learning from its mistakes and being willing to first "talk about talking about" plans to both raise interest rates and taper bond purchases. Today, we believe most of the potential widening in MBS spreads due to tapering has already taken place. However, withdrawing liquidity from the MBS and Treasury markets could have a greater impact on corporate bonds and other 'risk assets' broadly. If riskier assets do see spread widening as the Fed withdraws liquidity, we think investors may find MBS' approximately 0.9% yield advantage over US Treasuries (while carrying the same credit rating) attractive[3]. Conversely, if a reduction in the Fed's purchasing of Treasury securities causes Treasury yields to rise (even if orderly), this would raise mortgage rates commensurately, thereby lowering the speed at which they would prepay – another positive for MBS as an asset class.

1 Bloomberg, 30 September 2021.

2 Between 21 February and 6 March 2020, the US Refinancing Index rose more than 200%. Bloomberg, 31 August 2021.

3 Bloomberg, US MBS Index, 30 September 2021.

CLO equity arbitrage — a brief primer

Demystifying equity arbitrage in CLOs

Collateralised Loan Obligations (CLOs) are structured vehicles where a pool of primarily sub investment grade secured loans are financed by a combination of publicly issued bonds (CLO debt) and CLO equity. CLO debt is issued in tranches with varying degrees of risk attached to each bond, typically rated from AAA to BB (or single B).

New issue CLO deal formation is dependent on finding an equilibrium between the spread levels that are acceptable to CLO debt investors (commonly referred to as 'cost of funding') and the return that the CLO equity will generate.

CLO arbitrage is a measure that allows an easy and transparent estimate of what returns CLO equity investments may generate. It can be defined as the difference between the spread that a pool of secured loans would generate and the cost of funding, further adjusted for administrative costs of running the deal, as well as expected losses arising from potential future loan defaults. The resulting value is commonly referred to as the 'excess spread'. This excess spread is then amplified by the structural leverage[1] provided to the CLO equity tranche, typically ten to eleven turns of leverage, to arrive at an expected CLO equity return (see figure 1).

Figure 1: CLO arbitrage – a simple back of the envelope calculation

Leveraged loans weighted average spread (WAS) (Libor +)	3.80%	Spread that portfolio of loans generate over Libor
Total income (A)	**3.80%**	
CLO liabilities cost of funding (Libor +)	1.95%	Weighted average spread on CLO bonds (cost of funding)
Senior fees	0.10%	Senior management fees that CLO manager receives
Sub fees	0.20%	Sub-management fees that CLO manager receives
CLO running cost	0.05%	Administrative and other costs associated with running a CLO
Expected losses	0.60%	Expected losses per year estimated at 2% constant default rate (CRD) and 70% recovery rate
Total expenses (B)	**2.90%**	
Net income to CLO equity (A-B)	0.90%	Loss adjusted excess spread, represents CLO equity income
Loss adjusted return on Equity	9-11%	Equity returns are amplified by the leverage in the structure (assuming 10-11 turns of leverage)

Source: Janus Henderson Investors, as at 28 September 2021.

CLO equity arbitrage – current level and its evolution

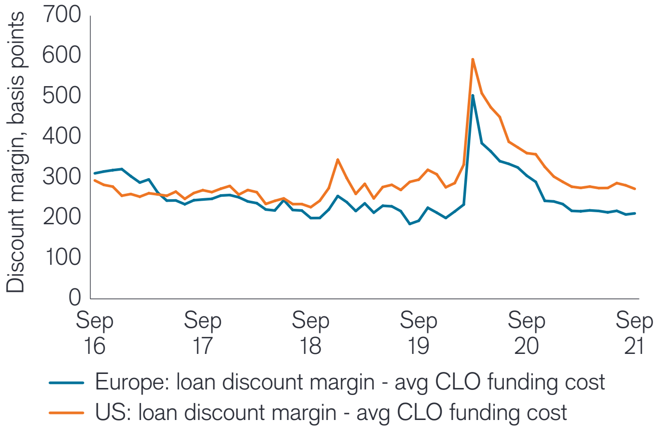
The higher the excess spread in a potential CLO transaction, the more attractive the equity arbitrage is to equity investors (possibility of higher cash flows to the equity tranche)[2], therefore it is more likely for a CLO deal to be issued. As secured loans and CLO debt spreads as well as market expectations of potential loan defaults vary over time, CLO arbitrage also varies over time, impacting the levels of primary CLO issuance.

1 Structural leverage: the CLO equity tranche, representing a small stake within the CLO structure (at around 9 to 10%), is exposed to the outcome of the arbitrage for the whole structure as well as the full impact of any loan defaults (ie, the equity tranche is last in line to receive cash flow from loans income and is the first to be impacted by any collateral losses arising from potential loan defaults).

2 Equity tranches receive excess cash flows after all the debt tranches and other fees have been paid. Thus higher excess spreads present the possibility of higher cash flows to the equity tranche. Additionally, in an existing deal, wider spreads allow the CLO managers to buy higher yielding assets with repayment proceeds, which would enhance the excess spread given that the cost of debt funding is fixed for the life of the CLO transaction.

Figures 2 shows a simplified version of CLO equity arbitrage in the US and Europe – taking the difference between secured loan spreads and the cost of funding for a typical CLO debt structure, but not adjusting for administrative costs and potential losses from loan defaults.

Figure 2: simplified picture of CLO equity arbitrage



Source: Credit Suisse, JP Morgan, City Velocity, Janus Henderson Investors, as at 29 September 2021.

The current level of CLO arbitrage is at around median levels by historical standards and combined with the relatively benign credit default environment, creates favourable conditions for new CLO formation, evidenced by the strong primary supply across Europe and the US this year.

CLO equity arbitrage – a self-correcting phenomenon

Analysing the CLO equity arbitrage through time reveals an interesting feature of the market; it is self-correcting through various economic cycles and market conditions and remains resilient even through the most distressed market conditions.

Taking the period from March 2020 (the onset of COVID-19 crisis) as an example, as market volatility increased across the globe, so did the spreads on CLO debt and the underlying secured loans. In fact, the difference between those spreads reached the highest historical level of 500 basis points in the European market. Higher levels of excess spread are beneficial to CLO equity investors, and if secured loan default expectations remain low, the CLO arbitrage becomes most attractive to issue a new deal. This is of course based on the assumption that market liquidity remains open, and indeed from April 2020 we observed a continuous, albeit in somewhat reduced volumes, issuance of new CLO deals both in Europe and the US.

On the other hand, if the excess spread is low and CLO arbitrage is less attractive, as seen in 2018, new CLO deal formation slows down or stops altogether. This, in turn, has a positive technical impact on the CLO debt market, pushing spreads tighter and reducing the cost of funding. At the same time demand for loans to ramp up new CLO deals also slows, which has a negative technical impact on secured loan spreads, pushing their spread wider. Higher loan spreads and reduced cost of funding lead to a rise in the excess spread and thus improvement in the CLO arbitrage, as the CLO market self-corrects again.

CLO equity arbitrage – indirect impact on leverage loan spreads

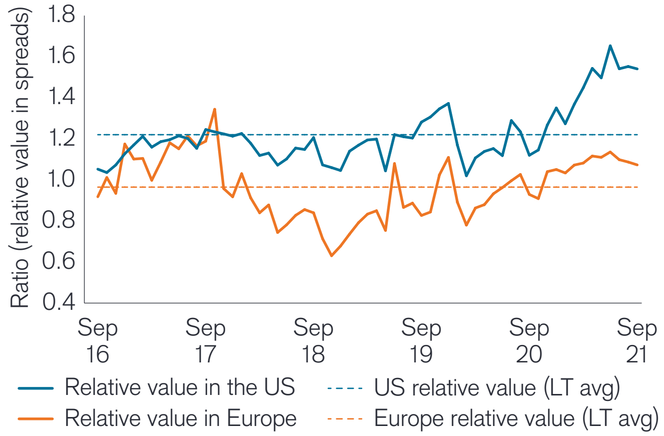
The CLO market holds a substantial purchasing power over the secured loans market, in fact over 50% of secured loans across Europe and the US are financed through CLO transactions. This substantial purchasing power combined with the desire to maintain an attractive CLO arbitrage by CLO equity investors, results in an interesting dynamic for secured loan spreads.

First, the stable nature of CLO issuance through varying cycles provides stability to the secured loans market, resulting in a significantly lower long-term spread volatility compared to the broader high yield market.

Second, depending on the cost of funding as well as loan default expectations, CLO transactions need a minimum level of spread on secured loans to maintain an attractive arbitrage. This has resulted in secured loan spreads being currently anchored around certain levels, finding it hard to compress further, despite the strong technical forces that push spreads tighter across the broader credit markets.

Figure 3 shows the relative value between secured loans and high yield bond spreads over time. Given the CLO arbitrage, secured loans spreads have remained elevated compared to high yield, resulting in the highest ratio between the spreads in these markets historically.

Figure 3: Historical relative value – US and European secured loans versus high yield bonds



Source: Credit Suisse, Bloomberg, Janus Henderson Investors, as at 28 September 2021.

Note: Relative value in spreads; ratio between discount margin for leveraged loans and option-adjusted credit spreads (OAS) for high yield bonds

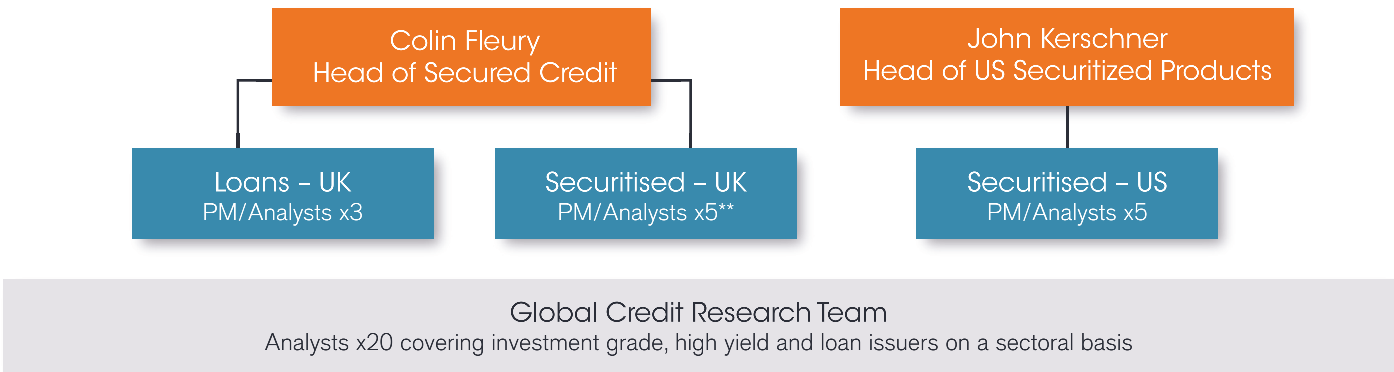
CLOs – a complex asset class requiring expertise in analysis

CLOs have demonstrated their resilience as an asset class over several credit cycles and continue to offer attractive return profiles as well as providing stability to the underlying secured loans market. However, investors in these complex transactions need to be aware of the various features and risks such as structural, credit, market and manager capability, as well as the fact that the high levels of embedded leverage could lead to a wider range of returns across CLO debt and equity in the capital structure, thus requiring expertise in analysis.

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 15 investment professionals. Team members have a range of specialisms, with average industry experience of 16 years and an average tenure with Janus Henderson of eight years. They manage tailored mandates for institutional clients, assets within multi sector strategies and mutual and exchange-traded funds. Overall structured debt assets under management at Janus Henderson exceed US$17bn.*

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 30 June 2021.

** includes a portfolio analyst supporting both loan and ABS specialists.

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