CQS Insights

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ABS: Alpha Opportunities in 2023

Summary

As the uncertainty that markets experienced in 2022 is expected to continue, we believe Asset-Backed Securities (ABS) may help offset potential volatility and capture mispriced, attractive returns.

ABS' **main benefits** include:

- High, stable income
- Loss protection
- Strong embedded value
- Short duration
- Ability to tailor and diversify

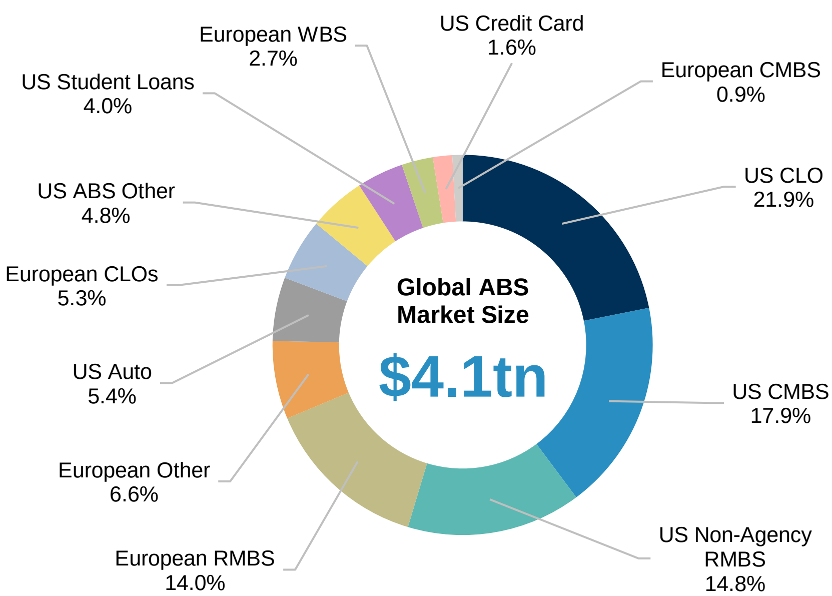
At present, we see the following **opportunities in**:

- European CLOs
- Residential Mortgage-Backed Securities
- Commercial Real Estate
- Regulatory Capital

We believe ABS can help investors protect their capital without compromising on upside potential, as some asset-backed securities may be purchased at a deep discount: in 2023, we expect to see more dispersion of both credit performance and asset pricing. In potential market downside scenarios, the structure of ABS helps protect investors in more challenging credit environments.

Global in nature, the ABS universe is large enough to give investors jurisdiction, sector and risk level choice. ABS securities, for instance, are backed by bank loans, residential and commercial mortgages, auto loans, and other sectors, as seen in Figure 1. Such variety allows sophisticated investors to optimize exposures to create a portfolio of stable, high-income assets with potential upside.

Figure 1: The Global ABS market: depth and breadth gives investors choice



Source: CQS analysis, SIFMA(www.sifma.org), AFME(www.afme.eu), and CitiVelocity as at 30 June 2022.

The main benefits traditionally offered by ABS include:

- **High, stable income:** Residential and commercial mortgages, corporate loan pools and bank Regulatory Capital transactions, to name a few, offer steady income streams when securitized and sold to investors. This stable income is generated by the principal, interest, lease and rental payments from the underlying assets.
- **Loss protection:** ABS deals are comprised of senior bonds, junior bonds, and equity. Any potential losses on the underlying loans are first absorbed by the equity, and then, by junior bonds. Investors can choose which part of the capital structure best suits their risk appetite given their view of the underlying collateral and the market price. Investors can also choose a deal's vintage (the time when the underlying assets were originated and/or a deal's remaining time to maturity), which can increase return resilience from both a collateral and a structural perspective.

- **Strong embedded value:** At CQS, we believe that last year's volatility led to mis-pricings in certain securities. Central banks' rapid tightening of monetary policies has led to different views about the expected losses in ABS collateral pools; we believe that certain sectors have been overly punished, while others have yet to fully price in likely losses. This is expected to lead to both long and short alpha opportunities for sophisticated investors with the tools to differentiate among securities and their collateral pools.
- **Short duration:** A large number of ABS deals bear a floating rate, reducing interest rate risk.
- **Ability to tailor and diversify:** Investors may choose across different geographies, sectors and parts of the capital structure. This flexibility helps investors access the precise exposure that best suits their income needs and risk appetite.

Current Opportunities

At present, we see opportunity in the following sectors:

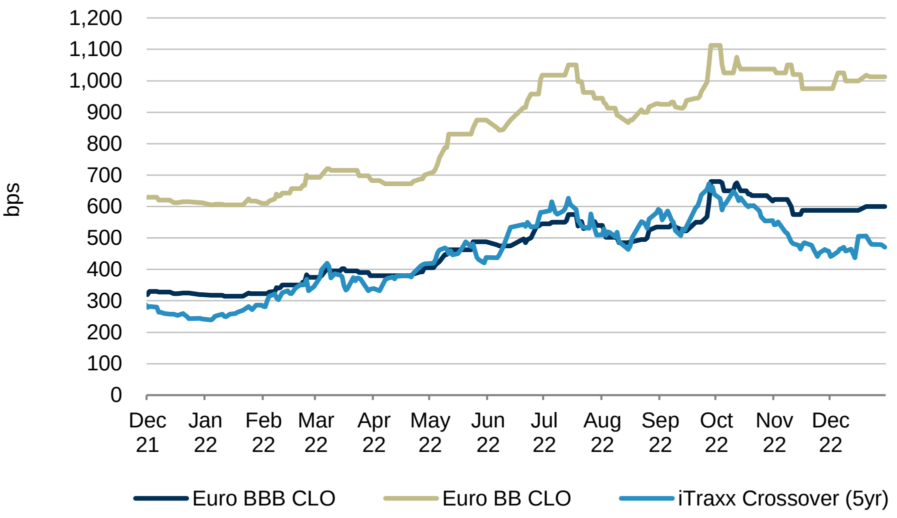
European Collateralised Loan Obligations (CLOs)

CLOs have demonstrated robust historical performance through multiple periods of stress.

Backed by actively managed, diversified pools of leveraged loans, European CLO tranches offer attractive relative value to other corporate credit sectors whilst benefiting from structural protection against an increase in defaults. The asset class has also demonstrated robust historical performance through multiple periods of stress, with only 0.5% cumulative defaults between 1996 and 2021 (across 4,432 Standard & Poor's-rated Euro CLO tranches). In the present rate-rising environment, the floating-rate nature of CLOs also allows investors to benefit from higher short-term rates whilst avoiding significant rate duration in the portfolio.

In our opinion, the asset class is attractively priced: with tranche prices lower by up to 15 - 20 points in 2022, the dislocation has created significant price convexity with cash prices in the 70s and 80s, leaving room for large potential capital appreciation alongside healthy running income. As seen in Figure 2, European BBB and BB CLOs offer a spread pick-up to other lower-rated credit markets. After lagging the rally in corporate credit spreads over recent months, we believe CLO tranches are well positioned to capture strong potential total returns, whilst remaining defensive given their underlying collateral and structural protections.

Figure 2: European CLOs: attractive valuations, quality collateral
Spreads: Euro CLOs vs iTraxx Crossover



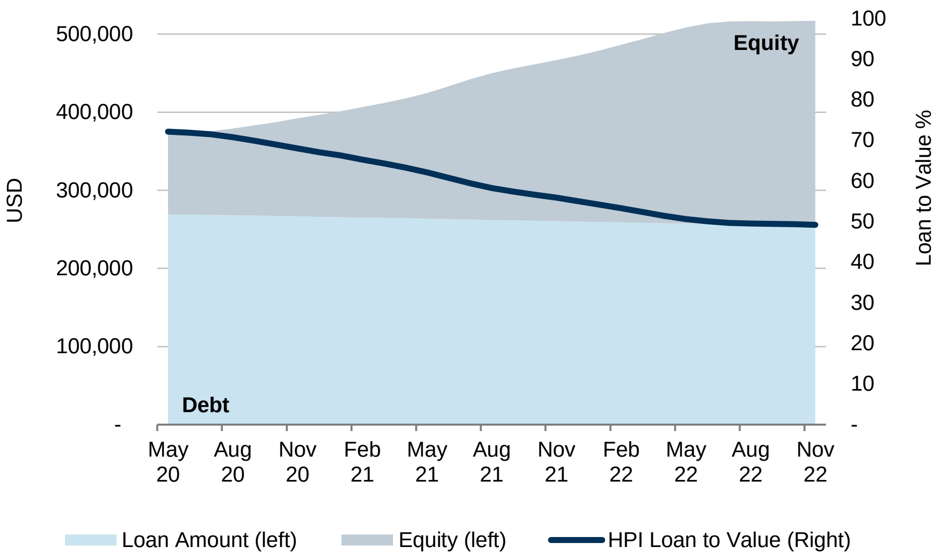
Source: CQS, Bloomberg as at 31 December 2022.

The 2022 sell-off in broader risk and the slowing of the US housing market have created attractive opportunities in seasoned (older vintage) US mortgage securitizations.

Residential Mortgage-Backed Securities (RMBS)

The 2022 sell-off in broader risk and the slowing of the US housing market have created attractive opportunities in seasoned (older vintage) US mortgage securitizations, where the underlying loans have built significant homeowners' equity. Fannie Mae and Freddie Mac (US government-sponsored agencies) issue Credit Risk Transfer (CRT) deals backed by prime, fixed-rate mortgages. CRT bonds issued prior to the post-COVID surge in home prices benefit from both high-quality loans with low loan-to-value ratios and low fixed interest rates, as well as uncapped floating-rate bond coupons currently providing 12-15% yields. Furthermore, the 2020/2021 surge in mortgage refinancing rapidly paid down senior bonds in these deals, with the remaining bonds moving higher in the capital structure and more removed from the risk of loss. These seasoned CRT bonds can withstand substantial stress scenarios while providing high income and ample opportunity for price appreciation.

Figure 3: US CRT mortgages: better quality makes stronger ABS collateral



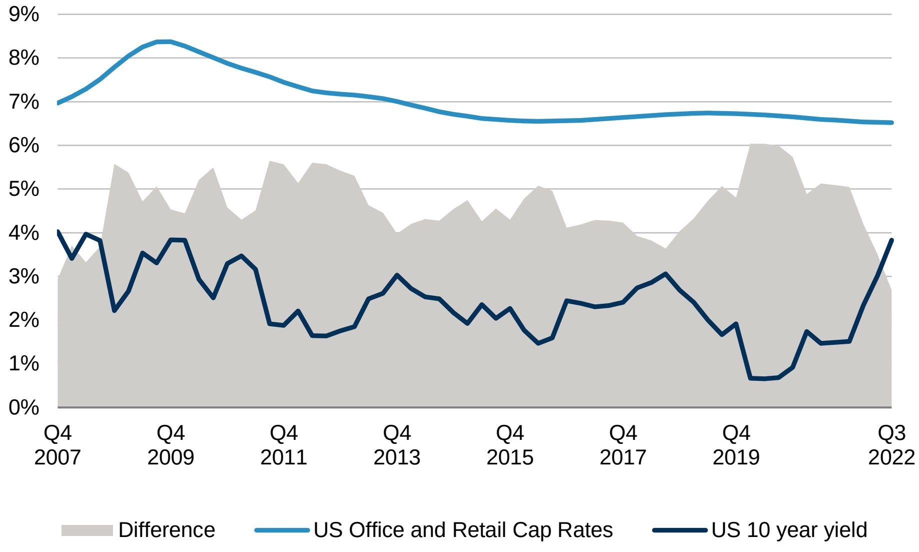
Source: CQS and Intex as at 31 December 2022. HPI is House Price Index.

The spread between interest rates and cap rates is now at the lowest since at least 2008.

Commercial Real Estate (CRE)

The CRE market, especially office properties, may see a valuation and interest rate shock as office utilisation rates have not recovered materially after the pandemic, and office vacancy rates remain high. "Working From Home" trends are weighing on the sector. This may lead to opportunity, especially as capitalization (cap) rates (the real estate sector's discount rate, or cost of capital) have not materially moved up – unlike Treasury yields, as seen in Figure 4. The spread between interest rates and cap rates is now at the lowest since at least 2008 (269 bps) vs a normal average of 300-500 bps. If discount rates normalize and interest rates stay at c.4%, cap rates may increase from c.6.5% to c.8.5%, which implies CRE property values would drop 23.5%. This shift in valuations should feed through to ABS backed by these properties, creating opportunities on both the long and short side for investors with the analytical tools to evaluate both the underlying CRE assets and the ABS structures.

Figure 4: US real estate markets and US Treasuries are telling a different story



Source: Bloomberg and CoStar as at December 2022. REIT stands for Real Estate Investment Trust.

Introducing ABS to portfolio construction may provide returns and stability not just for this year but also the longer-term horizon.

Regulatory Capital (Reg Cap)

More stringent bank regulation following the 2007-8 Financial Crisis requires banks to increase their capital buffers. To free-up capital – and therefore be able to lend more – banks in Europe and North America have partnered with strategic investors to share risk, creating an asset class previously not available to most investors. Through a Reg Cap structure, investors may now access the bank loan universe, which typically provides high-quality, stable income from a diversified pool of borrowers.

Reg Cap securities are junior tranches backed by high-quality collateral; the leverage created by this tranching allows Reg Cap bonds to pay high levels of income (up to 14%). In general, the loans underlying Reg Cap deals have an equivalent credit rating of BBB- (the lowest Investment Grade ranking) or BB+ (the highest non-Investment Grade category). The asset class further benefits from low volatility and low correlation from wider equity and credit markets. To learn more about Reg Cap, don't miss our recent article: Regular Capital: Long-Term, Stable Income, at CQS Insights.

Conclusion

We believe the ABS market offers high, stable income and alpha opportunities to generate attractive, risk-adjusted returns in 2023.

The ability to select strong credit profiles with structural protection will offer opportunities to outperform other investments in a year of increased performance dispersion. Introducing ABS to portfolio construction may provide returns and stability not just for this year but also over the longer-term horizon.

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