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ABS/Securitized credit: the best offense is a good defense

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As a child growing up during the '80s in Chicago, I always thought the adage was "the best offense is a good defense." While, in fact, the adage as penned by George Washington was the opposite, as any good Chicago Bears fan knows…offense wins games and defense wins championships. I was particularly enamored by the cast of characters that made up the '85 Bears, including the fact that they believed in their team and system of play to such an extent that they performed a music video "The Super Bowl Shuffle" before making the Super Bowl in 1985.

At the end of the day, sitting at Soldier Field, freezing fans would cross their fingers and hope for the offense to *leave* the field, so the defense could come out. The Bears defense was a thing of beauty for two reasons:

1) they scored points
2) they left the team in great offensive field position.

Surveying the current state of the market in general, we believe that playing a good defense, especially as market volatility has increased, makes sense. In fact, scoring a few points, and maintaining good field position for when you switch to offense, sounds much better than potentially losing ground. In this paper, we refer to the consumer segments (asset-backed securities, or ABS, and mortgage-backed securities, or MBS) as Main Street. We refer to Corporates as Wall Street. We believe that given the conditions today, Main Street is in better shape than Wall Street and given our defensive bias we think it's a more attractive way to play the game.

We'd argue that it is critical to keep three key factors in mind: 1) the potential for change in policy 2) level of leverage in the different sectors, and 3) the level of outstanding debt and issuance. In doing so, we believe we can identify a defensive core allocation among more consumer-driven areas of the market and earn income while avoiding exposure to investments with imbalances, high valuations, weaker fundamentals and high sensitivity to shock as policy changes.

Policy: Reversal of QE

Post Global Financial Crisis (GFC) there was globally coordinated easing which has provided substantial liquidity to markets. Ubiquitously known as quantitative easing (QE), the policy pumped more than $14 trillion of liquidity into financial markets through 2018.

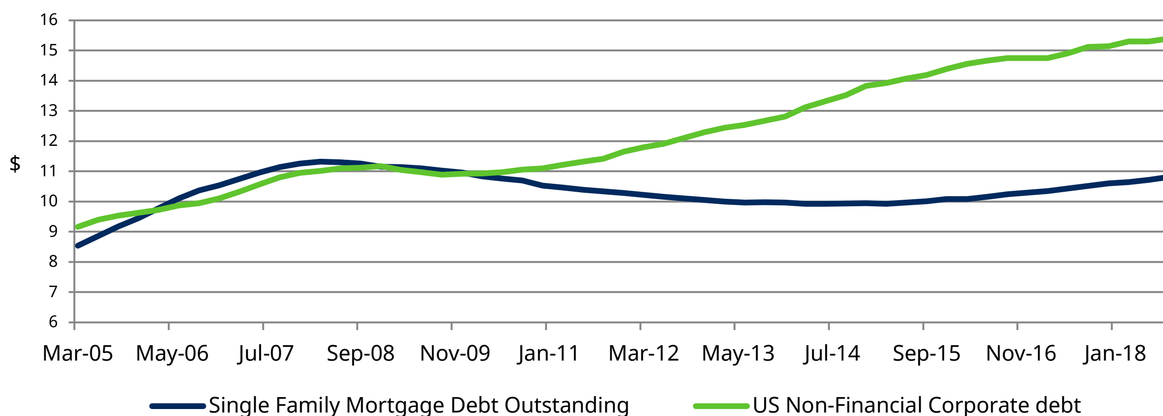
Of the larger QE providers, Central Bank purchases for balance sheet allocation varied, but were substantial.

- US: $4 trillion is held with $2.3 trillion of US Treasuries and $1.7 trillion of Agency MBS
- Bank of England (BoE): $575 billion is held with $565 billion in Gilts and $13 billion in Corporate bonds
- European Central Bank (ECB): $3.8 trillion is held with $2.4 trillion in Government bonds, $850 billion in Repo, $300 billion in Covered bonds, $202 billion in Corporate bonds, and $32 billion in ABS
- Bank of Japan (BoJ): $4.9 trillion is held with $4.2 trillion in JGBs, $468 billion in Corporate Commercial Paper, bonds and loans, and $200 billion in stocks.

However, QE as we know it in the US is coming to an end and that end is quantitative tightening (QT). With QT in mind, particularly where capital flows were increased by QE, we should expect reversion back to more normal levels of risk premium, volatility and valuations. We believe we are seeing the beginnings of that re-valuation now.

So where did QE have the most significant impact? That answer lies in two places: 1) where was it easy to deploy capital (e.g., where regulation did not limit the capital flows by restricting lending or limiting issuance of securities), and 2) the converse; where was capital more limited. Post GFC, in the US there was a focus on de-leveraging among the financial institutions and consumers. As a result, banks, consumer lending and mortgage finance became heavily regulated. Mortgage debt and financial corporate debt have declined since 2007, both outright and as a percentage of US GDP. US non-financial corporate debt has increased. Looking at debt outstanding over time, we have seen more than $4 trillion in growth which occurred in non-financial corporate debt during the QE era. Over the same period, mortgage debt modestly declined.

Record high corporate debt while single-family mortgages still below 2007 levels (in trillions)

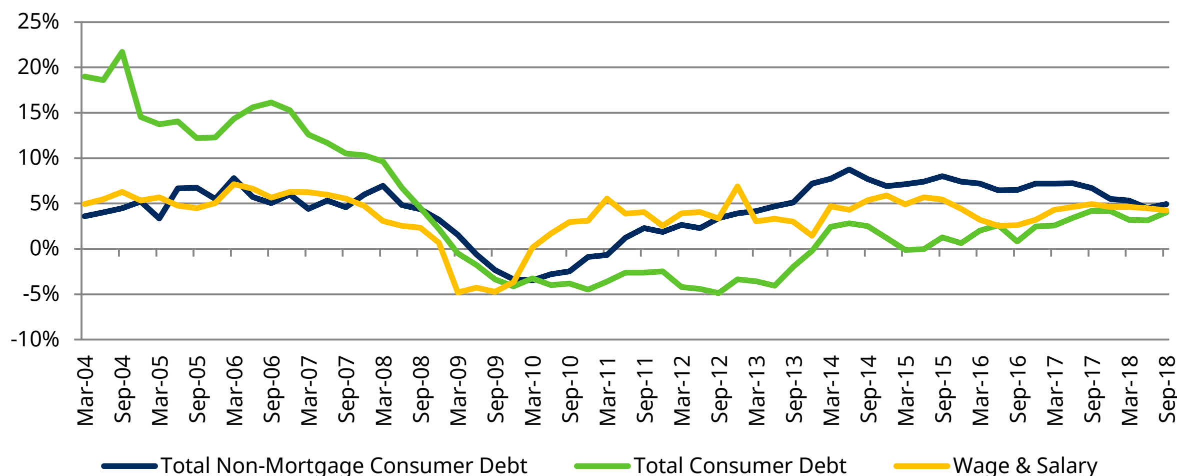


Source: Bloomberg, IMF, Federal Reserve as of June 2018.

The annual growth in first-lien mortgage debt (the largest of all consumer debts) has been well below pre-crisis levels, even as population and wages have increased. This is owing to the more stringent lending standards.

More telling, post GFC the total US consumer debt (green line) has grown at a slower rate than wages and salary (yellow line), even as wage growth has arguably been a laggard in this recovery. Non-mortgage consumer debt growth (dark blue line) has also slowed over the last two years as this credit cycle has been longer compared to historical cycles.

Consumer debt growth has lagged wage growth (year-over-year growth)

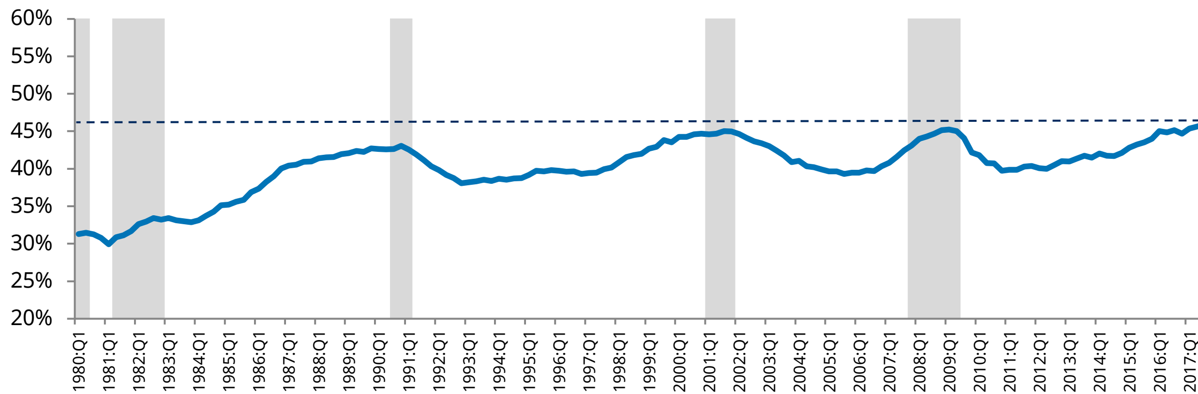


Source: Bloomberg as of September 2018.

The impact of regulation on access to credit for consumers and specifically for housing, has substantially improved the fundamental position of housing and of the consumer today. Leverage, as measured by debt service ratio (DSR), has fallen sharply from pre-crisis levels, and remains low compared to longer historical averages.

In addition, US household debt as a percentage of GDP has fallen, whereas US non-financial corporate debt is at or reaching new highs, as shown below. The restriction in mortgage and consumer lending can be contrast with corporate lending, which has grown sharply in products like leveraged loans since the GFC, but especially over the past two years.

US non-financial corporates debt, % of GDP



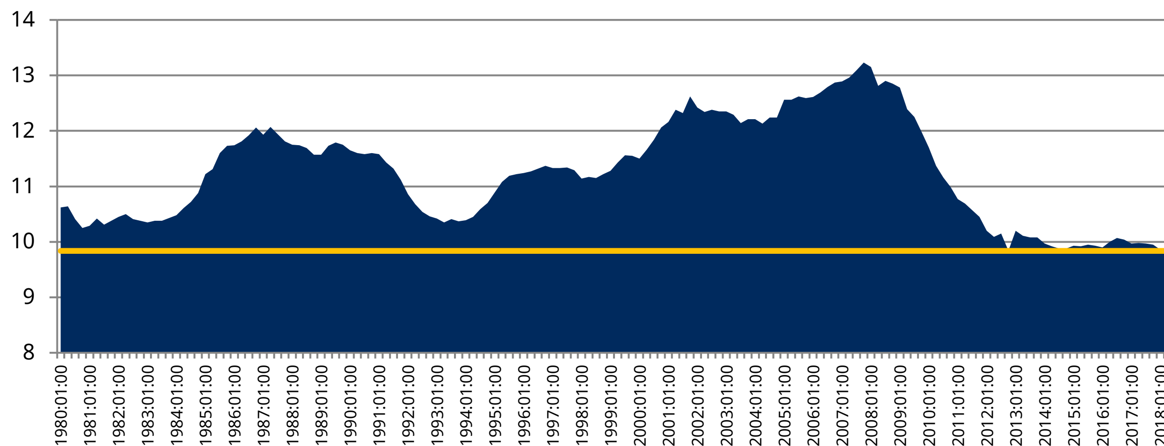
Source: Federal Reserve, MBER. Shaded areas reflect recessionary periods.

This increase in corporate debt is a function of QE:

1) Direct demand for yield grew as investors were crowded out by QE
2) Regulation of other debt, such as financial corporate debt, bank debt, and mortgage debt
3) International demand for the yields seen in the US by foreign investors
4) Ease of access to corporate debt of all kinds in daily liquid funds and ETFs.

By the same token, with regulation, far fewer debt products offered exposure to consumers, and the low fixed-rates offered on most consumer and mortgage debt, the consumer debt-to-income ratio is close to 40-year lows.

Current consumer debt-to-income ratio (%) is close to 40-year lows

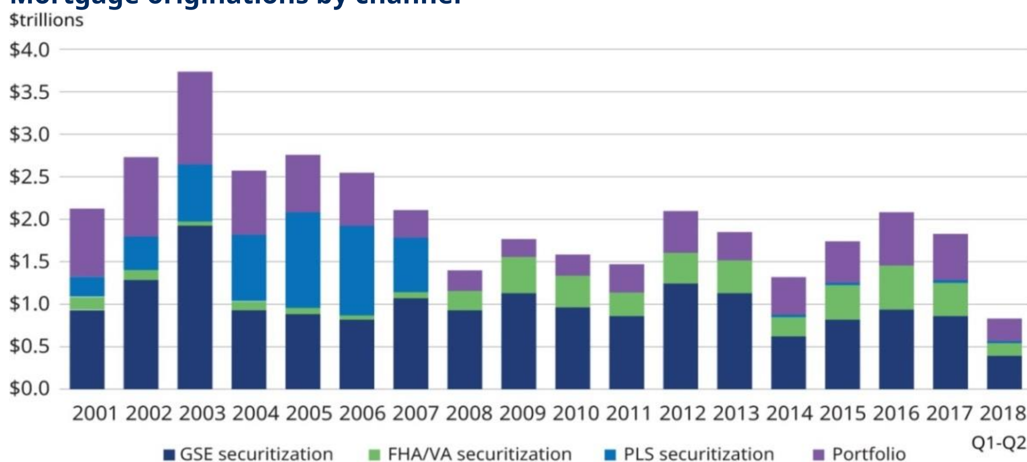


Source: Federal Reserve, through Q2 2018. Current ratio level reflected by yellow line.

Regulations that impacted consumer debt / housing debt included limits to lending based on loan characteristics, restrictions on underwriting which include income standards, and requirements to offset an originate to sell model. Much of this regulation sits in the Dodd-Frank Wall Street Reform and Consumer Protection Act, but there are substantial other regulation that limit lenders and buyers of securitized debt, such as Basel III, Solvency II, or EU risk retention. Entities established to protect consumers such as the Consumer Finance Protection Bureau (CFPB), and the numerous lawsuits of originators, underwriters, and mortgage servicers have also had an impact. And lesser known, but no less important, the Credit Card Accountability Responsibility and Disclosure Act has had a limiting effect on the offering of credit card debt.

Today, more than 75% of all mortgage loans originated are guaranteed through the US Government Sponsored Enterprises (GSEs) or Ginnie Mae (FHA/VA), with the remainder held on the lenders (bank) balance sheet. Very little of today's mortgage origination goes through the former private label securitization execution channel. While this is likely something that could, and should, change over time, it is noteworthy in terms of the type of supply the market sees. As we know, the GSE and FHA/VA securities are not securities which carry traditional risk as their payment (that is, their credit risk) is guaranteed by the US government.

Mortgage originations by channel



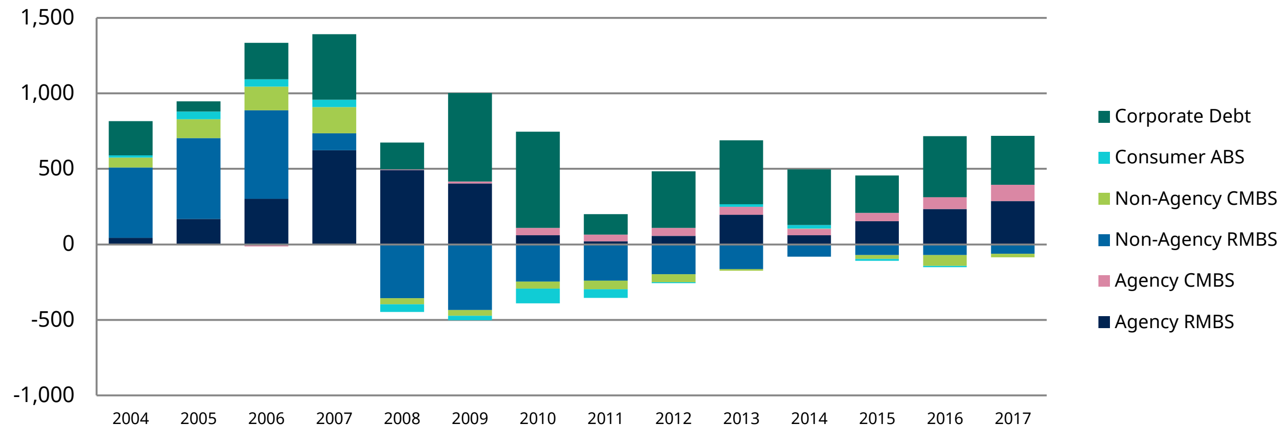
Sources: Inside Mortgage Finance and Urban Institute. Last updated October 2018.

There are other interesting issuance dynamics in today's market versus the pre-GFC era. In the non-agency mortgage-backed securities (Non-agency MBS), there is no government guarantee, so these securities actually offer a credit risk premium. But, there is very little supply and, in fact, a negative net supply situation. What exists in these markets is secondary supply driven by the $400 billion market of outstanding and seasoned vintages of 30 year mortgage securities issued before the financial crisis. In terms of new issue markets for non-agency MBS, excluding agency MBS issuance, the amount of issuance is quite a bit lower than in the past. The non-agency market outstanding beyond the older pre-crisis securities is:

1) $50 billion market in GSE credit risk transfer
2) $25 billion market in seasoned re-performing or non-performing mortgage loans
3) $20 billion market in non-Qualifying Mortgages (non-QM loans not meeting agency standards).

Considering US mortgage debt is a $**10 trillion** market, the $20 billion in non-QM outstanding issuance is a far cry from the peak of non-prime mortgage issuance outstanding, which reached nearly $1.5 trillion in 2007, as shown on the next page.

ABS Net Issuance ($ billions)

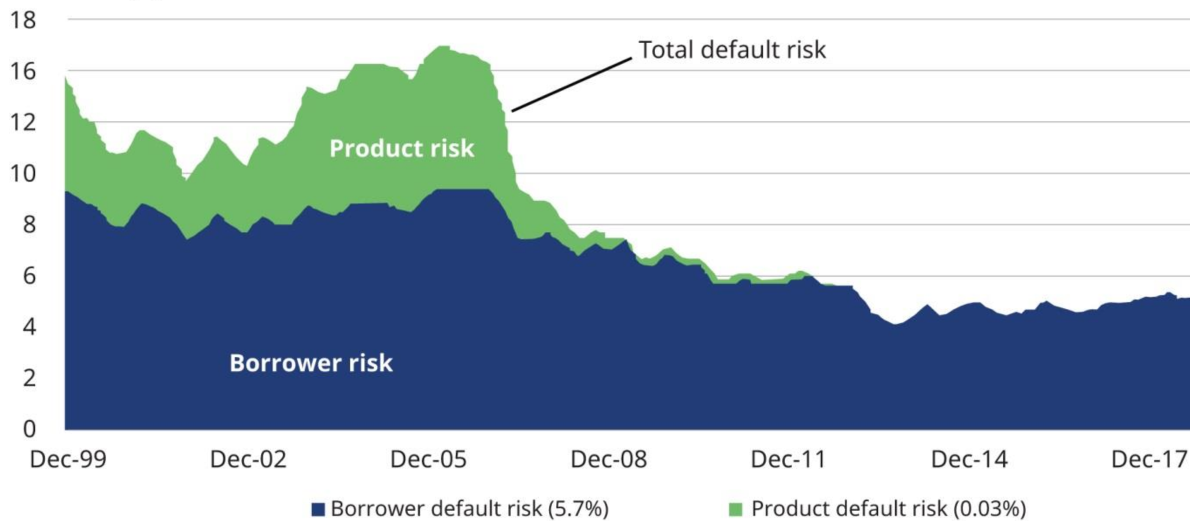


Source: SIFMA as of September 2018

Owing to the much more stringent underwriting, the housing finance mortgage default risk is at the lowest level, recorded by the Urban Institute.

Default risk well below pre-crisis levels

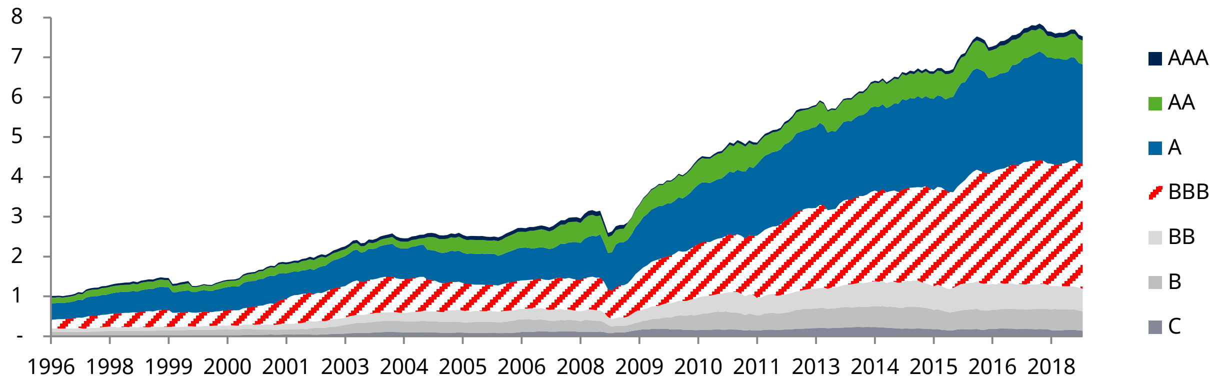
Default risk (%)



Source: Urban Institute, December 2018

Moving from consumer to corporate finance, we believe a very significant impact of the QE policies has been the increase in access to credit for non-financial corporations, given significant demand for assets with a credit risk premium, low levels of yields or return, and low volatility. This led to an explosion in the percent of investment-grade debt issued as BBB, as corporations leveraged up, shown in the following area graph.

Value of corporate debt by rating (in $ trillions)



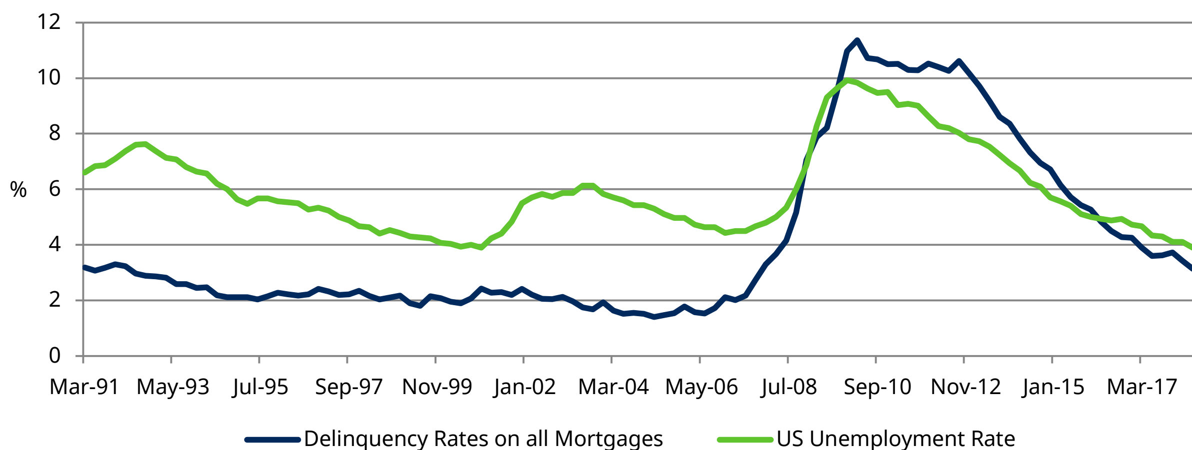
Source: Bloomberg as of December 2018.

Play defense with consumer credit exposure

Coming back to our original analogy of playing strong defense, we think now is the time to consider exposures that capture the consumer-driven segments of the market. What made the '85 Bears' defense so formidable was that they were so well prepared for anything that opposing offenses threw at them. This has relevance now as the reduction in QE will be anything but predictable, unlikely to be coordinated globally, and it is also very likely to be a longer-term proposition given that some central banks still continue to add to their balance sheet such as the BoJ. As global central bank balance sheets normalize, risk premiums should return to more normal levels. Further, there will be more supply of liquid and safe assets, like US Treasury Notes, that will likely reverse the dynamic of the investment flows seen during QE.

In terms of leverage, supply and demand, or the potential for policy shocks, the consumer (Main Street) seems to be at a much earlier stage in its credit cycle versus more traditional Corporate exposures (Wall Street). We think this view is supported by very favorable metrics in terms of delinquency, default rates, debt-to-income, net worth, disposable income and savings rates. In short, Main Street feels like a defensive alternative.

Mortgage delinquency rates move lower with unemployment

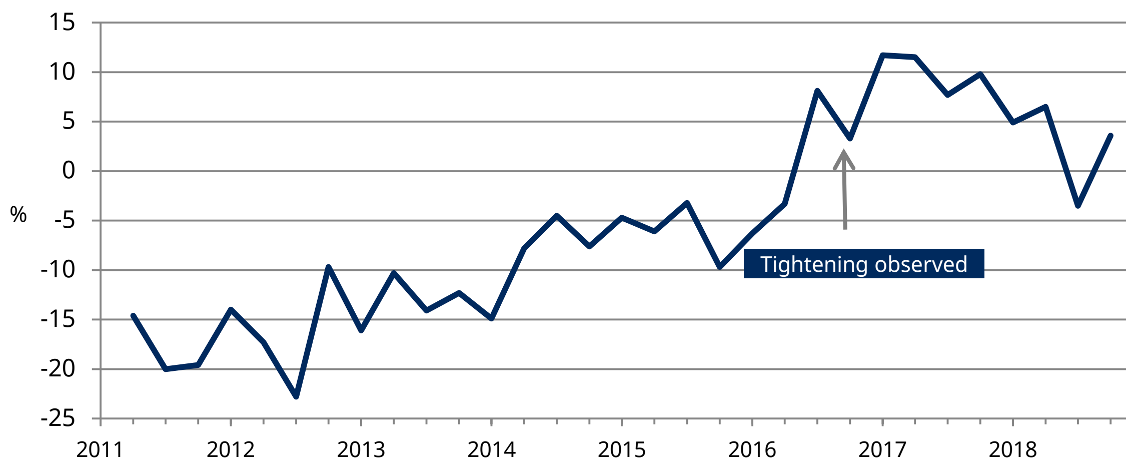


Source: Federal Reserve, Bloomberg as of September 2018.

The main types of debt expanding within the consumer credit universe have been student loans and peer-to-peer lending. This type of lending is not dominated by banks and is therefore less regulated. That said, the more sizable debt within this group is student loan debt, at nearly $2 trillion outstanding. The state of the student loan market is obviously a concern from a consumer debt burden perspective, but the vast majority of this debt is held or guaranteed by the US government through the Department of Education.

For auto loan finance, a $1 trillion market, 20% of that market is non-prime lending and has gone through a tightening of lending standards over the past 2.5 years, as subprime in the sector was a growing concern. We see this reconciliation as a sign of a more disciplined, credit sensitive process.

Fed survey of auto loan underwriting standards

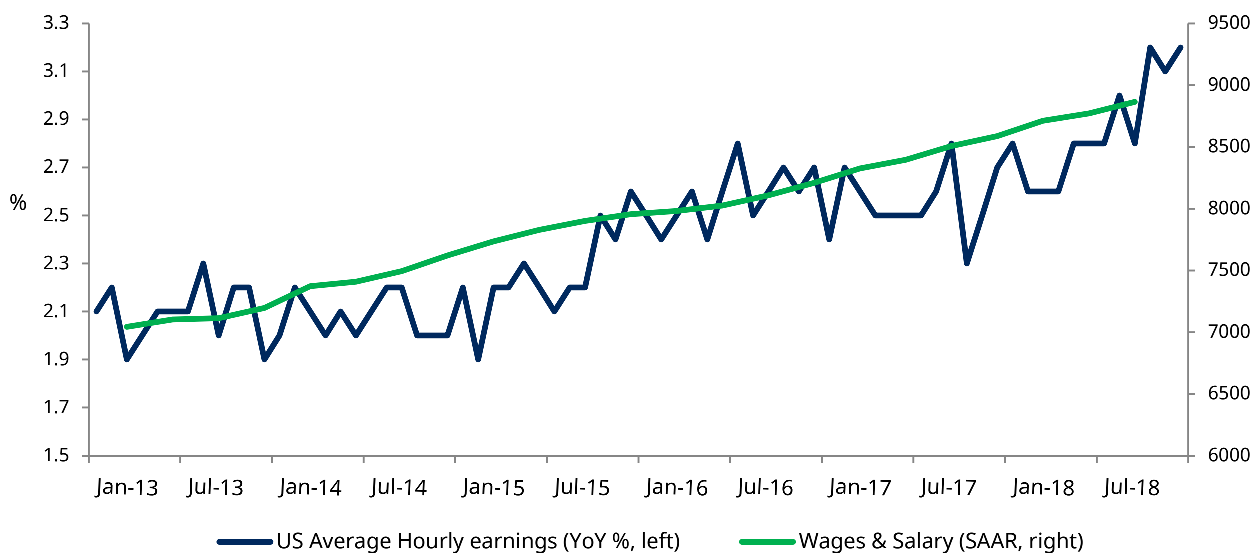


Source: Bloomberg as of October 2018.

The best way to access consumer credit?

Much of the $13.3 trillion consumer debt is on lender balance sheets. The high deposits mean that banks have retained a substantial amount of the mortgage loans and the unsecured credit card receivables that they have originated. But, outside of owning financial corporates, the main means of accessing exposure to the consumer is through securitized markets or through direct debt ownership. This investment exposure is directly supported by the consumer's ability to repay the financial contract. This is a concept inherent to the ABS market. The debt is backed by repayments on financial contracts. So long as the consumer is healthy or stable, the primary exposure is to the consumer's ability to repay the debt.

Underpinning the strength of the consumer are strong wage and salary numbers



Source: BEA, BLS, December 2018.

There is a secondary source of repayment, which would be the worth of any collateral that can be liquidated in the event of default. As well, a key tenet of ABS is the sale of the financial contracts to a trust, which then owns the receivables remote from the risk of the lender. In our view, aside from owning the financial contracts directly (as whole loans), ABS and MBS are the most direct way to access the consumer credit risk in the US today.

Within the US, the Agency MBS market is principally a consumer prepayment and risk mitigating consumer story, at $7.4 trillion. Another $2 trillion of consumer debt sits in the US non-agency MBS and ABS markets.[1]

Post GFC, even with QE, non-agency RMBS, ABS and CMBS did not benefit from a material expansion in demand, due in large part to onerous capital rules put in place for banks and for European insurance companies. As well, given that **most** non-guaranteed ABS, CMBS and non-agency MBS are typically excluded from the major fixed income indices (like Bloomberg Barclays) there is little in the way of indexing or ETFs with these products. As a result, ABS and MBS seem to us to be a defensive way to position from a technical perspective, particularly in contrast to distortions in corporate credit.

Conclusion: Play smart offense, but win with the defense

According to BofAML Index performance, only a few asset classes offered positive returns and positive excess return in 2018, among them were ABS and MBS. As well, investors in non-agency residential mortgage-backed securities were yet again rewarded for being long credit and spread duration. We expect similar results in 2019 as mortgage credit performance, consumer credit performance, and underwriting remain strong.

In several asset classes like corporate debt, equities and loans, we have classic, late-cycle dynamics such as high leverage, technical imbalances, potential for policy shocks, low yields/risk premiums and high valuations. Over recent history, investors in these sectors have not experienced material negative returns over an annual period, and a potential reversal alone could cause a significant momentum change, especially given the involvement of retail investors through ETF and mutual fund investments with daily liquidity.

At the end of 2018, the market for risk assets began to re-price dramatically. The conditions driving the re-pricing, and the corresponding increase in volatility, remain in place as we open the books on 2019. Under these conditions, we think playing a bit of defense is the right call.

As discussed in the paper, select ABS sectors can be a great way to accomplish this, with fewer late-cycle characteristics and less exposure to the shift away from QE. In addition, ABS offers diversification to more traditional corporate credit risk given its underlying consumer-oriented fundamentals, and investors can pick up a lower volatility product with:

1) stable income potential
2) lower sensitivity to interest rates, while,
3) remaining in a good position to play offense as opportunities unfold.

[1] We also think the US housing market is healthy and find select opportunities in less efficient, or underbuilt commercial real estate markets. These debts should be less correlated to corporate credit.

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