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Q&A

Patience - and Economic Recovery - May Benefit Securitized Investors

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Securitized markets may offer investors opportunities as 2021 progresses and Conning thinks the less favored credits of today may be more attractive over time. In this Q&A Paul Norris, Head of Structured Products, also discusses the state of the CMBS market and the path to better incorporating ESG principles in structured securities investing.

1. *Where are we finding opportunities in securitized markets?*

Anything that is mainstream is really tight, even compared to before Covid-19. We are seeing fixed income spreads at all-time tights for some of the main securitized asset classes including credit cards, autos and agency mortgages. We think there is value in some of the nonmainstream sectors like esoteric asset-backed securities (ABS). Spreads should continue to tighten for those asset classes that have not participated fully in the tightening we have seen elsewhere.

As we begin 2021, quantitative easing (QE) is an important driver for securitized markets. The Federal Reserve (the Fed) maintains that the economy will need to materially change for it to stop QE. The Fed wants to see considerably higher inflation and significantly stronger growth.[1] With the continued QE support, we anticipate the economy will continue to recover throughout 2021.

Given the impact of the pandemic and now the vaccine, the pent-up demand and other positive attributes will begin to come to the fore in the second half of 2021. Conning believes that some of the weaker credits today are going to become the positive stories of tomorrow, so that might include consumer credit, where the spreads have not tightened as much. That might also mean there will be value in the BBB-rated and A-rated consumer loans. We expect better opportunities in higher-yielding assets over investment grade, and then investment grade over mortgage-backed securities; in structured that means we expect to find value in esoteric ABS and CMBS as well.

2. *What are the opportunities in CMBS?*

Looking at the larger picture, with vaccines now available, we can see a little bit of light at the end of the tunnel. We think people are going to start venturing back to some of the more hard-hit asset classes in CMBS: malls, hotels, office space. People will start going to hotels again. Certainly, malls are troubled, but not every mall is troubled; people will likely return to some types of shopping centers.

The office sector is a tough one to call longer term; the impact on this sector will not be clear for some time because it's still two to four years before leases are up and we find out what will happen.

In terms of commercial real estate, there is still stress but as we look around to see what spreads and yields are out there, we believe spreads have seen their widest point and will tighten in CMBS.

Conning believes this is a great environment for CMBS in that we can go through these bond by bond to find the ones that we think are going to do really well. We expect there will be a lot to pick from.

3. *Is interest growing in environmental, social and governance (ESG) investment principles?*

Like many firms, we have been doing ESG investing for a long time; we just did not call it "ESG." For example, we have always looked at the servicing practices of the issuers we're buying. We are always looking at their management practices. How do they treat their customers? What kind of interest rates are they charging?

> *"Conning believes some of the weaker credits today are going to become the positive stories of tomorrow."*
>
> *- Paul Norris*

Interest in ESG investing has recently accelerated in the U.S. market. There is a notable difference between how the corporate and securitized sides do things. Structured finance in general lags corporates and equities regarding ESG, primarily due to a lack of data and a lack of standardization.

For example, corporates have adopted standardized ESG metrics. Structured finance does not yet have that and cannot really piggyback on the corporate framework. It is difficult to compare an ESG metric for consumer ABS with a commercial ABS transaction because the metrics are so different. The securitized market needs to develop disclosures and data that get the asset class closer to what the corporate bond side is doing in terms of ESG.

Both issuers and investors are trying to determine what data is necessary to create a usable ESG framework. Regulators in Europe have created several mandatory provisions regarding climate change risk, but the U.S. has been slow to adapt. An important question is: how do we get more data to separate the good actors from the bad? In addition, structured products are unique in that important indicators are primarily in the social and governance areas, not so much environment-related.

ESG investing for securitized products needs to start at the ground level. Mortgage issuers need to reprogram their systems and add data fields, and downstream they need to instruct originators on the ground to collect that data in a uniform manner so it can be passed along to end investors. Setting up these systems will take a long time. As such, investors in this asset class will move in fits and starts to get ESG data to catch up to corporates, but it is definitely a groundswell. Issuers will need to recognize the importance of ESG before they start collecting the necessary data.

4. *What are your expectations regarding the new administration's potential impact on the securitized market?*

The Obama administration hampered the ability to get mortgage originations off the ground due to rules and regulations such as the Ability to Repay/Qualified Mortgage (ATR/QM) rule and regulations that the Consumer Financial Protection Bureau (CFPB) established. These rules and regulations required significant documentation that many in the industry considered unnecessary and was burdensome on originating product.

The Trump administration loosened some of these regulations at the edges resulting in considerable origination and gave more people access to credit. It remains unclear if the Biden administration will reinstate some of the Obama administration's more onerous rules and regulations.

The vaccine rollout is likely to benefit GDP, especially in the second half of 2021. This growth is expected to be supportive of many of the structured asset classes, especially areas related to consumers. Conning believes these asset classes have weathered the worst of the storm. The ride may be bumpy, especially in the first quarter as we see what happens with the new administration and with the vaccine. It remains unclear how the first half of 2021 is going to play out, but that will give us a good view into the second half of the year.

Paul Norris is is a Managing Director and Head of Structured Products and oversees the team involved in the research and trading of structured securities. Prior to joining Conning in 2017, he was a hedge fund portfolio manager focused on mortgage derivatives. Previously, Mr. Norris was head of securitized products at Dwight Asset Management, where he led a team of portfolio managers, traders and analysts, and also has served as director of mortgage and non-mortgage investments at Fannie Mae. Mr. Norris earned a BS in finance from Towson University and an MBA from the University of Maryland.

ABOUT CONNING

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FOOTNOTES

[1] The Board of Governors of the Federal Reserve System, Federal Open Market Committee Press Release dated Dec. 16, 2020

https://www.federalreserve.gov/newsevents/pressreleases/monetary20201216a.htm

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