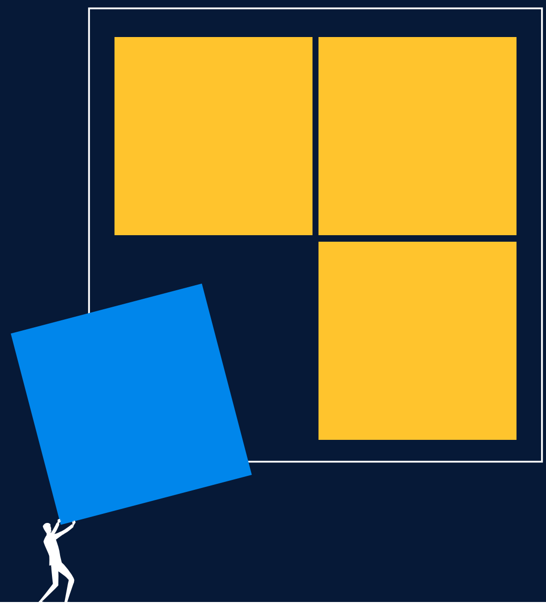
T. Rowe Price

Perspectives on securitized credit



From the Field
Q3 2024

Key Insights

- Securitized credit markets rallied along with other fixed income sectors but generally lagged corporate credit in the third quarter.
- Supply remains heavy but has been well absorbed amid limited fundamental concerns and attractive yields.
- Valuations are generally fair across sectors, and we continue to favor asset-backed securities.

Christopher Brown, CFA
Head of Securitized Products and Portfolio Manager, Fixed Income

Ramon de Castro
Portfolio Manager, Agency and Non-agency Mortgages

Jean-Marc Breaux, CFA
Sector Portfolio Manager, Securitized Credit

Securitized credit markets participated in the broad third-quarter (Q3) fixed income rally that was fueled by positive inflation trends and signs of a softening labor market. These developments convinced investors that the Federal Reserve will be able to cut interest rates more deeply than previously thought. The Fed easing policy while the U.S. economy is still in a relatively healthy state was beneficial for U.S. government bonds, driving yields lower, as well as risk assets, as a proactive Fed reduced concerns that tight monetary policy will tip the economy into recession. Although securitized assets delivered positive excess returns[1] over the quarter at the index level, they underperformed investment-grade corporate bonds after outperforming in the previous quarter.

The Fed, which had held its policy rate in a 5.25% to 5.5% range for more than a year, cut rates by an unusually large 50 basis points at its mid-September meeting. In their updated summary of economic projections, policymakers forecast more rate cuts by the end of next year than they did in June as their focus shifted from combating high inflation to maintaining a strong labor market. At his press conference, Fed Chair Jerome Powell justified the rate cut by saying that the objective is to restore price stability "without the kind of painful increase in unemployment that has come sometimes with disinflation," indicating that the central bank is keenly aiming to engineer a soft economic landing.

[1] Excess returns measure the performance of a bond relative to a similar-duration U.S. Treasury security.

However, following quarter-end, upside surprises in U.S. economic data caused the market to price out some of these rate cuts. Treasury yields rebounded following a steep decline since late April, and interest rate volatility spiked to new year-to-date highs.

Generally solid performance

Commercial mortgage-backed securities (CMBS) delivered some of the strongest returns among our sectors in Q3. The non-agency segment of the CMBS market generated total returns of 4.55% and excess returns (versus similar-duration[2] Treasuries) of 0.51% at the index level.[3] However, performance for individual bonds varied widely due to high idiosyncratic risks for individual properties.

Asset-backed securities (ABS) produced positive, but less robust, total returns of 3.35%, due in part to their lower-duration profile in a falling rate environment.[4] The sector broadly generated excess returns of 0.15% for the quarter. However, lower-rated tranches and out-of-benchmark segments—such as bonds backed by data centers, commercial equipment, and whole-business cash flows—recorded stronger results.

Similarly, collateralized loan obligations (CLOs)[5] generated positive, but lower, returns due to having low sensitivity to movements in interest rates given their floating rate coupons (instead, returns for the CLO sector are driven more by spread duration, or sensitivity to movements in credit spreads).[6] The broad sector returned 1.84%, which translates to excess returns of about 0.45%.[7] Like the ABS market, lower-rated CLOs were the best performers, reflecting strong risk appetite and fading near-term recession concerns.

In the diverse non-agency residential mortgage-backed securitized sector, where there is not a comprehensive market benchmark, jumbo mortgage loan bonds, which are longer-duration securities, produced strong results. Single-family rental (SFR) bonds and re-performing loans also performed well. Credit-risk transfer securities (CRTs),[8] which had performed strongly over the past year, delivered less impressive results given that valuations were already quite expensive.

Healthy demand for a wave of supply

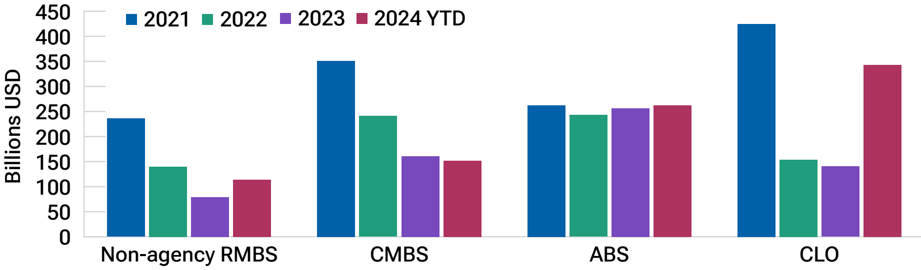
The four major securitized credit sectors have experienced heavy issuance year-to-date that has already exceeded the totals for full-year 2023 (Figure 1). Issuance has been on a record-setting pace in the ABS market, totaling USD 262 billion in early October compared with USD 256 billion last year.[9] But demand remains just as strong as the supply glut has helped keep spreads in the high-quality sector at relatively attractive levels.

Issuance of non-agency RMBS, at USD 114 billion, is already 44% higher than the total for all of 2023. We anticipate that supply will remain relentless due to refinancings of earlier deals and new production in the pipeline, which could accelerate if mortgage rates resume falling. Demand for new issuance has been

[2] Duration measures the sensitivity of a bond's price to changes in interest rates. Bonds with longer duration have higher sensitivity to changes in interest rates.
[3] Source: Bloomberg Non-Agency CMBS Index.
[4] Source: Bloomberg US Aggregate ABS Index.
[5] CLOs are securitized portfolios of bank loans structured into slices, or tranches, of varying credit risk. An outside firm manages the portfolio of loans.
[6] Credit spreads measure the additional yield that investors demand for holding a bond with credit risk over a similar-maturity, high-quality government bond. Option-adjusted spreads are adjusted for any early repayment options that issuers may have.
[7] Source: J.P. Morgan CLOIE Post-Crisis Index.
[8] CRTs are a type of RMBS issued by Fannie Mae and Freddie Mac but with credit risk borne by private investors. They can incur losses if enough homeowners in a pool of mortgages default on their loans.
[9] Source for ABS, CLO, CMBS, and RMBS issuance totals: J.P. Morgan. All totals in U.S. dollars as of September 30, 2024.

Securitized credit issuance the heaviest since 2021

(Fig. 1) Issuance of ABS and CLOs on a record-setting pace



Source: J.P. Morgan (see Additional Disclosure).

choppier than in the ABS market. However, insurers have shown voracious demand for the sector due to attractive yields, particularly focusing on the nonqualified mortgage subsector.

Benefiting from broadly improved sentiment amid hopes for rate relief, CMBS issuance has been robust year-to-date, reaching USD 152 billion. That puts the sector well on its way to exceed the amount for last year, which was the lowest since 2016, but well short of the record high of USD 351 billion in 2021 when rates were lower and the floodgates were wide open. Single-asset/single-borrower issuance has increased the most by far, but sponsors have also brought more conduit deals to market this year in response to the improved demand environment. While deals backed by lower-quality properties have continued to struggle to find buyers, demand for issues backed by strong collateral has been ample.

CLO issuance, including refinancings and resets of previous deals, has been enormous at USD 344 billion around quarter-end. But demand has been resilient. Domestic banks have started buying again, and Japanese institutions remain active participants. Exchange-traded funds that focus on CLOs, which have grown in number, continued to receive an influx of cash. The Fed's rate-cutting regime could eventually reduce demand from some yield-focused investors. But a moderate cutting cycle and sustained U.S. economic expansion—our economics team's base case—are unlikely to cause a mass exodus from the sector. And, despite spreads being narrow, we believe that spreads for AAA rated tranches could tighten further into year-end.

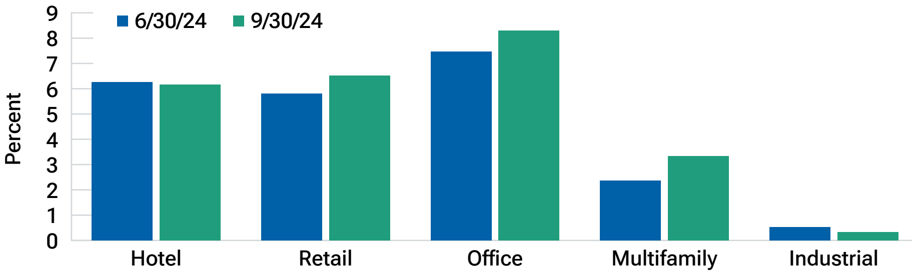
Fundamentals mostly benign

The fundamental trend for securitized credit sectors isn't on an improving path, but it's also not overly concerning. In the ABS market, we expect continued—but manageable—delinquencies and losses in consumer segments like auto loans and credit cards. A normalization in credit fundamentals following massive pandemic-related stimulus measures that bolstered consumer balance sheets has arrived. While this is impacting all borrowers, pressures are most acute for lower-income borrowers. Credit card balances are elevated, but, positively, repayment rates remain higher than they were in the pre-COVID period. Yet market pricing doesn't reflect any deterioration in fundamentals, which is apparent in the flatness of the credit curve (i.e., spreads on lower-quality issues are tight relative to higher quality). Spending at restaurants also bears monitoring, especially for weaker and less established whole-business securitization issuers, as stretched consumers rein in spending.

In the CMBS market, delinquencies, transfers of loans to special servicing, and negative headlines are most glaring in the office segment (Figure 2). Fundamentals there remain highly bifurcated. Bonds backed by high-quality, in-demand properties have seen strong demand. On the other hand, there is limited appetite

Delinquencies highest in the CMBS office sector

(Fig. 2) The hotel subsector also bears watching



Source: J.P. Morgan (see Additional Disclosure).

for bonds backed by older buildings that have seen tenants depart for newer structures offering more amenities or simply have less need for office space due to a shift to remote working. Cash flows in the lodging segment, which benefited from a surge in post-pandemic travel, have also been declining more recently, which bears watching. Cash flows remain stable in the industrial and multifamily areas of the market.

For CLOs, the structure of deals matters, and we are focused on the higher-quality areas of the market. The percentage of defaults and distressed exchanges in the bank loan market reached a 43-month high of 3.7% in September according to J.P. Morgan. There has been moderate improvement in credit rating downgrade activity, but the lowest-quality CCC rated area remains a concern. However, the Fed lowering rates should help ease the pressures caused by high borrowing costs. The lower-rated tranches of the CLO market (BBs) are most impacted by loan defaults, downgrades, and haircuts stemming from liability management exercises by debt-laden companies.

Fundamentals in the non-agency RMBS market are largely neutral. Affordability remains a problem, but existing homeowners have built up substantial equity as housing prices continue to rise. A strong labor market and slower, but still high, wage growth enables homeowners to make loan payments on time. As such, credit performance has been holding up.

Valuations largely neutral, but pockets of value exist

Credit spreads were relatively steady over the quarter, although they meaningfully tightened for some areas like CMBS and subprime auto loan ABS. Spreads have generally tightened further in October. CMBS continued to offer the widest spreads, followed by RMBS, but those sectors also possess higher spread duration compared with ABS, a sector that tends to be more defensive and less volatile in times of market turbulence.

Looking at specific sectors, these are our current views:

- **ABS:** With the recent increase in market volatility, ABS is our favored sector that generally screens as more attractive than other parts of securitized credit markets. Valuations are fair, liquidity is relatively good, and investor sentiment for the sector remains positive. We also expect the torrid pace of issuance to slow heading into year-end, which could provide technical support. We like areas like discount-priced whole-business securitizations, synthetic prime auto loans (an instrument that banks use to transfer credit risk from their balance sheet to investors), and floorplan ABS that auto dealers use to finance their for-sale inventories.

- **CLO:** Valuations look expensive on a historical basis and relative to corporate bonds, but investor demand remains robust. This should keep spreads from significantly widening, and we believe there is potential for further tightening. Lower rates should be fundamentally supportive for loan issuers struggling with high financing costs. Additionally, the potential for the Fed to loosen tight policy, but by less than the market is currently pricing, may help sustain demand. We favor higher-quality (AAA and AA) rated CLOs. Longer new issue and reset transactions should benefit from very strong demand technicals, while refinancings of shorter-maturity, amortizing transactions are an attractive proxy for segments of the ABS sector.

- **CMBS:** While fundamentals for many issues are negative, particularly within the office space, they may be no longer worsening. Liquidity and sentiment have broadly improved this year amid expectations that rates will fall to more economical levels and the economy will remain healthy. The financing market has also reopened for issuers owning solid assets. We are favoring higher-quality new issue conduit deals. The quality of collateral has improved, as have underwriting standards. Many older-vintage conduit deals look cheap, but investors are unlikely to earn the returns implied by yields and credit spreads due to default risk.

- **RMBS:** Our securitized team downgraded its view on the sector to negative in August. Although we were comfortable with credit fundamentals due to healthy amounts of homeowner equity, we believed the market was underestimating the potential for faster prepayment speeds following the decline in mortgage rates, which have more recently climbed again. RMBS valuations improved somewhat since August, and we now have a generally neutral view on the sector. However, valuations still aren't cheap, and we anticipate high levels of supply. And with rates recently rising again, discount dollar-priced bonds may not benefit as much as investors were anticipating. We are biased for shorter-duration, higher-quality bonds that have more upside potential than downside risk and are relatively liquid. Seasoned SFR bonds and select, seasoned prime jumbo and agency investor bonds that are priced at a discount are areas where we see opportunities.

All in all, we remain constructive on the securitized credit asset class. Fundamentals remain benign. Though index-level valuations aren't screaming as attractive, there continue to be pockets of value versus competing credit sectors. Yields are also attractive, which should sustain demand for yield-focused investors like insurance companies and pension funds. We continue to rely on our strong credit research and trading platforms to identify fundamentally sound, reasonably priced opportunities.

INVEST WITH CONFIDENCE™

T. Rowe Price identifies and actively invests in opportunities to help people thrive in an evolving world, bringing our dynamic perspective and meaningful partnership to clients so they can feel more confident.

Additional Disclosure

Information has been obtained from sources believed to be reliable, but J.P. Morgan does not warrant its completeness or accuracy. The index is used with permission. The index may not be copied, used, or distributed without J.P. Morgan's prior written approval.

Important Information

This material is being furnished for general informational and/or marketing purposes only. The material does not constitute or undertake to give advice of any nature, including fiduciary investment advice. Prospective investors are recommended to seek independent legal, financial and tax advice before making any investment decision. T. Rowe Price group of companies including T. Rowe Price Associates, Inc. and/or its affiliates receive revenue from T. Rowe Price investment products and services. **Past performance is not a reliable indicator of future performance.** The value of an investment and any income from it can go down as well as up. Investors may get back less than the amount invested.

The material does not constitute a distribution, an offer, an invitation, a personal or general recommendation or solicitation to sell or buy any securities in any jurisdiction or to conduct any particular investment activity. The material has not been reviewed by any regulatory authority in any jurisdiction.

Information and opinions presented have been obtained or derived from sources believed to be reliable and current; however, we cannot guarantee the sources' accuracy or completeness. There is no guarantee that any forecasts made will come to pass. The views contained herein are as of the date written and are subject to change without notice; these views may differ from those of other T. Rowe Price group companies and/or associates. Under no circumstances should the material, in whole or in part, be copied or redistributed without consent from T. Rowe Price.

The material is not intended for use by persons in jurisdictions which prohibit or restrict the distribution of the material and in certain countries the material is provided upon specific request. It is not intended for distribution to retail investors in any jurisdiction.

Australia—Issued by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 28, Governor Phillip Tower, 1 Farrer Place, Sydney NSW 2000, Australia. For Wholesale Clients only.

Canada—Issued in Canada by T. Rowe Price (Canada), Inc. T. Rowe Price (Canada), Inc.'s investment management services are only available to Accredited Investors as defined under National Instrument 45-106. T. Rowe Price (Canada), Inc. enters into written delegation agreements with affiliates to provide investment management services.

Colombia, Chile, Mexico, Perù, Uruguay—This material is prepared by T. Rowe Price International Ltd - Warwick Court, 5 Paternoster Square, London, EC4M 7DX which is authorised and regulated by the UK Financial Conduct Authority - and issued and distributed by locally authorized distributors only. For professional investors only.

DIFC—Issued in the Dubai International Financial Centre by T. Rowe Price International Ltd which is regulated by the Dubai Financial Services Authority as a Representative Office. For Professional Clients only.

EEA—Unless indicated otherwise this material is issued and approved by T. Rowe Price (Luxembourg) Management S.à r.l. 35 Boulevard du Prince Henri L-1724 Luxembourg which is authorised and regulated by the Luxembourg Commission de Surveillance du Secteur Financier. For Professional Clients only.

Hong Kong—Issued by T. Rowe Price Hong Kong Limited, 6/F, Chater House, 8 Connaught Road Central, Hong Kong. T. Rowe Price Hong Kong Limited is licensed and regulated by the Securities & Futures Commission. For Professional Investors only.

New Zealand— Issued by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 28, Governor Phillip Tower, 1 Farrer Place, Sydney NSW 2000, Australia. No Interests are offered to the public. Accordingly, the Interests may not, directly or indirectly, be offered, sold or delivered in New Zealand, nor may any offering document or advertisement in relation to any offer of the Interests be distributed in New Zealand, other than in circumstances where there is no contravention of the Financial Markets Conduct Act 2013.

Singapore—Issued by T. Rowe Price Singapore Private Ltd. (UEN: 201021137E), 501 Orchard Rd, #10-02 Wheelock Place, Singapore 238880. T. Rowe Price Singapore Private Ltd. is licensed and regulated by the Monetary Authority of Singapore. For Institutional and Accredited Investors only.

South Africa—Issued in South Africa by T. Rowe Price International Ltd (TRPIL), Warwick Court, 5 Paternoster Square, London EC4M 7DX, is an authorised financial services provider under the Financial Advisory and Intermediary Services Act, 2002 (Financial Services Provider (FSP) Licence Number 31935), authorised to provide "intermediary services" to South African Investors. TRPIL's Complaint Handling Procedures are available to clients upon request. The Financial Advisory and Intermediary Services Act Ombud in South Africa deals with complaints from clients against FSPs in relation to the specific services rendered by FSPs. The contact details are noted below: Telephone: +27 12 762 5000, Web: www.faisombud.co.za, Email: info@faisombud.co.za

Switzerland—Issued in Switzerland by T. Rowe Price (Switzerland) GmbH, Talstrasse 65, 6th Floor, 8001 Zurich, Switzerland. For Qualified Investors only.

UK—This material is issued and approved by T. Rowe Price International Ltd, Warwick Court, 5 Paternoster Square, London EC4M 7DX which is authorised and regulated by the UK Financial Conduct Authority. For Professional Clients only.

USA—Issued in the USA by T. Rowe Price Associates, Inc., 100 East Pratt Street, Baltimore, MD, 21202, which is regulated by the U.S. Securities and Exchange Commission. For Institutional Investors only.

ID0007592
202411-3987593