CONNING®

ConnText Podcast

April 2024

TRANSCRIPT

Structured Securities and Esoteric ABS with Mike Nowakowski, Head of Structured Products

Conning ConnText is a quarterly podcast that features our firm's view of capital markets, trends and investment strategies for the insurance industry, hosted by Rich Sega, Conning's Global Chief Investment Strategist.

[OPENING MUSIC]

SEGMENT 1 – OPENING

[Rich Sega (RS)]

Hi, I'm Rich Sega.

Since our last podcast, we've had a bridge collapse in Baltimore, an earthquake hit New York, a feckless Fed taking more turns than a country road, and the capital markets outrunning it all. With the first quarter down and out, the Fed now has more data, but it looks like they're opening the second quarter with even more questions. Welcome to the Conning ConnText podcast for the second quarter of 2024.

Today I'm joined by Michael Nowakowski, Managing Director and Head of Structured Products here at Conning, a key component in bringing income and diversification to our clients. We'll discuss the risks and opportunities that always accompany uncertainty, and where to find value in this richly diversified asset class. It's going to be a great conversation.

SEGMENT 2 – ECONOMIC/CAPITAL MARKETS OVERVIEW

[RS] (Time stamp – 1:02)

Markets were loving life in the first quarter, with steady rates, tight credit spreads, and the S&P closing out a +10% gain in one of the best years since the 1950s. Rate cuts and easy money were coming back.

But now, it looks like it's going to be higher for longer. At least that's what everyone's reaction was to the jobs data released on April 5. Nonfarm payrolls rose 303,000 in March, and nobody saw that coming. "It's much too soon to think about cutting interest rates," said Dallas Fed President Lorie Logan after the report; the day before, Minneapolis President Neel Kashkari hinted at no cuts at all this year. Markets will have to spend a little more time and effort to digest all this.

While it's very early to draw conclusions as to the impact on inflation from the container ship crash and subsequent collapse of the Francis Scott Key Bridge, Baltimore is critical to several industries' both imports and exports so re-routing will create delays. Also, there will be greater reliance on ground transportation, at least until the passageway

to the Baltimore port is re-opened; that should happen pretty quickly. But the shift to ground and away from the damaged bridge coincides with higher fuel costs and further jamming the already crowded I-95 corridor.

So, the 2023 disinflation was already stalling. The outcome of the recent Fed meetings seemed contradictory. The committee improved their outlook for economic growth and labor markets while also increasing the median for inflation. One might think this would mean fewer projected cuts in 2024, but they held to three. The Fed's dot plot shows a wide range of future interest rates within the FOMC, illustrating the lack of agreement on the path of monetary policy. The chairman prefers unanimous decisions but that can lead to group-think and hinder effective policymaking. Investors might be disappointed to find that Powell's comments about cuts starting "later this year" could mean December.

In economic growth, we have solid growth but it's slowing here in the U.S. We expect a consumer-led slowdown later in 2024, though it may not reach the technical definition of a recession. Economists continue to downgrade the probability of recession, currently at 35%, as many subscribe to the "soft-landing" narrative. We continue to believe that a soft landing is unlikely and, if no recession this year, then the "no-landing" scenario, where both growth and inflation don't recede, and the Fed is less likely to ease policy. That would put a floor under the front end of the yield curve while long rates would move gradually higher.

SEGMENT 3 – STRUCTURED PRODUCTS AND ESOTERIC ABS

[RS] (3:52)

Today I'm speaking with Michael Nowakowski, Managing Director and Head of Structured Products. Hi Mike, welcome to the podcast!

[Michael Nowakowski (MN)]

Hey Rich. Thanks for having me on.

[RS]

Michael and his team are responsible for the research and analysis of the various parts of the structured product investment universe, a critical component of portfolios we manage at Conning, bringing our clients high-quality income and diversification.

Mike, with fiscal spending propping up the consumer and monetary policy on shifting sands, how have the structured product markets responded?

[MN]

On the whole, I think, very well. In terms of deal and collateral performance, the consumers really surprised us with their resiliency but there's still some lingering pockets of concern, especially with subprime and near-prime borrowers in the consumer space. We've seen delinquencies across certain collateral types that are up but they seem to be getting to at least an inflection point. And of course, we all see the office headlines regarding commercial real estate. Away from a couple areas of concern, the prime borrower and segments like travel, transportation and equipment fundamentals look really solid.

In terms of investment performance, we see excess returns across most structured products as being positive, especially since the December Fed meeting, which is kind of in line with what we see in other markets like investment grade and high yield. Subprime credit has performed really well, while convexity products like agency mortgages have lagged a little bit. We've seen some pretty remarkable credit-curve flattening, especially in esoteric ABS and CMBS.

[RS] (5:34)

Mike, thinking back to the fourth quarter of last year and into early this year, almost everybody – though, notably not we here at Conning - expected the central bank to commence an aggressive rate-cutting regime in early March. There's been a stark reversal of that, and spreads have tightened across most risk sectors. How has your outlook changed with these developments?

[MN]

Yeah, I totally agree with you there: spreads have really ground in tighter so far year to date, and a lot of sectors within structured are certainly looking a bit snug here on an absolute basis, just as they are in many other fixed income credit sectors. But across products, on a relative-value basis, similar to investment grade, we're about at fair value broadly speaking.

But we do see some opportunities in esoteric ABS, and we are looking to certain corners of the non-agency RMBS market that present value as an "up in quality" opportunity. We are a little less convinced that the Fed should begin dialing back their restrictiveness with the labor market and inflation where it is. We've described the credit markets right now as "priced to perfection" so if markets need to adjust we think we'll get a better entry point going further down in credit.

[RS]

That esoteric ABS market is really interesting; we'll get to that in a minute. But first, a big part of your team's purview is the research in RMBS, residential mortgage-backed securities. At last year's end, bids from large, non-economic buyers like the Fed and others getting out of the flows allowed true price discovery in this market and we really liked RMBS valuations. Is that still true?

[MN]

Yeah. When we were first excited about this trade, spreads on current-production agency mortgages were about 180 to 190 basis points over treasuries, and more importantly they were picking up about 50 basis points in spread to the broader investment-grade index. Historically that spread has been the other way around, with investment grade picking about 30 basis points to mortgages in the post-"Great Financial Crisis" world. Mortgages have been trading in the 140-190 basis points context over treasuries over the last 12 months, so we're still pretty optimistic about prospects here for performance.

[RS] (8:01)

Switching over to asset-backs for a minute, ABS spreads are quite tight by historical standards and heavy new issuance hasn't seemed to loosen them up. Are you expecting that to continue?

[MN]

Yeah, one thing that's interesting about structured credit is that spreads tend to operate on a one- or two-week lag to the investment grade market, but we've traded in lockstep during this latest round of risk-on ever since the December Fed meeting. And you're right, supply has been very heavy both in the on-the-run and esoteric ABS. We're running about 40% to 50% higher versus this time last year. I suspect that issuance will keep pace for a little while longer; what we've been hearing from some other programmatic issuers in the market is that they'd rather get issuance out the door ahead of any election-related market volatility or potential volatility. While the treasury curve remains inverted and yields are still somewhat elevated by historical standards, spreads have come in pretty materially since the fourth quarter of last year, so the all-in cost of debt has come down when you're comparing to, say, the second half of 2023.

You're right to point out that demand has easily kept pace. We've seen dealer secondary inventories diminished and when new issue deals do come out they are very well subscribed, sometimes demand is multiples of what is being offered, and we see that especially within the esoteric transactions given the spread pickup to the more on-the-run collateral types like cards and autos.

[Music interlude]

[RS] (9:42)

That's a great segue to my next question. ABS, particularly esoterics, seem to have formed a "sweet spot" in the FI duration v yield charts. How does the team evaluate the wide range of issuers there?

[MN]

Yeah, esoteric is directly in our wheelhouse. We look at a lot of that for our clients and it does seem to be emerging as a more popular asset class, particularly with insurers. We were at the structured finance conference in February and it seemed like esoteric ABS was more of a focus than it had been in prior years. There's a lot to choose from in terms of deal collateral, but we like to bucket it into three broad categories between consumer, commercial, and this new emerging sector called digital Infrastructure.

In terms of how we evaluate it, we look at the whole structured credit universe – not just ABS – and start with a number of quantitative metrics. Then we flag what's sticking out and take a deeper dive into why. We'll review our rates and fundamental lean and try and match that up with the best opportunities. On a deal level, we also incorporate things like stress tests, loss coverage ratios, we look at the quality of the issuers, among a host of other things.

[RS]

So much of this asset class's performance - and the U.S. economy as a whole, too - is supported by consumer demand. Have you seen any tiering in demand strength or delinquency trends by income level?

Yeah, the consumer is an interesting story. Clearly, there's been a lot of ink spilled across the press about the state of the U.S. consumer, but we think it's a bit more nuanced than the consumer as a whole. We've seen a divergence in the rate of change in delinquencies between prime, near prime, and subprime borrowers. The subprime cohort have certainly felt the pain of inflation a bit more, but the job market is strong, so we don't feel as though we are at

an overly concerning stress point. I think if the labor market turns, then we'd want to take a more cautious approach. And there's been this interesting phenomenon with respect to FICO drift that might be showing itself when we're looking at collateral performance. Essentially what this is is borrowers that were subprime pre-pandemic might now be near-prime or prime borrowers from all the debt paydown and consumer balance-sheet normalization as a result of all the Covid-related government stimulus. This sort of near-prime borrower is showing some signs of being a little stretched. But borrowers that were prime before Covid are in great shape, and they've enjoyed rising home prices and rising equity markets along with a pretty healthy labor market.

[RS] (12:39)

Thanks. Now let me move to the third leg of the structured product stool, commercial MBS. Long duration, low yield, continuing strong demand. Where is the value in that market, and are there any other stressed CMBS sectors beyond office buildings that you're watching?

Office is certainly grabbing the majority of the headlines; we don't view that as a systemic problem that could result in a larger distress. The market is growing far more comfortable with the fact that office will be a multi-year resolution rather than, say, two or three quarters. Sure, we've seen some regional banks have their fair share of issues but we've seen loan reserves increase and we don't see it as a GFC-style event.

But multi-family is another sector that we've had our eye on, especially those that have exposure to what are called "rent-controlled" properties. What we've seen is that properties that have flat or fixed-rate rent escalators are not being able to keep up with the amount of inflation that we've seen, broadly speaking, in the economy. So, flat or minimal rent growth combined with an increased cost of utilities and repairs has resulted in negative rent growth in a few of the major metropolitan areas. Again, it's worth watching, but to us it's not a show-stopper. It's more of a yellow card, not a red card, for soccer fans.

[RS]

Great. When the FOMC finally does make its first rate cut, do you expect significant repricing across all the structured subsectors? What would you say will be the best structured product opportunities when the Fed does finally ease?

[MN]

Speaking about rate vol, as I mentioned earlier, I think agency mortgages will respond well because vol should come down. That being said, I don't think the rest of the structured market will have much to do in terms of repricing. The structured credit markets have been operating under the assumption that we're in sort of a "Goldilocks" environment in which the Fed can bring inflation down while initiating a shift to a less-restrictive policy rate. Most of the sectors we look at are in this sort of "priced to perfection" state.

I also think that shorter non-agency mortgages and esoteric ABS have some good total return opportunities given their position on the curve. If the trade of 2023 – which didn't happen, the bull steepener – finally comes to fruition this year and the curve does rally on the front end, I think it'll be a benefit to those shorter-duration sectors that have had some spread tightening but haven't seen much of the duration move that's been anticipated by the market.

That said, I think the biggest risk is for a repricing the other way. So if the Fed finds itself in a position where it can't begin to dial back policy rates as they have signaled, then that tells the markets that were priced to this outcome that they need to shift and we'll look for spreads to go a bit wider. The idea of being priced to perfection will have to move with Fed expectations as those evolve over time and we get more data prints.

[RS]

Thanks much Mike, for a great discussion of an essential part of our clients' asset allocations.

SEGMENT 4 – CLOSE

[RS] (16:18)

One thing is clear from the experience of the past couple of years: we need to reassess the current economic models and expectations post-2020, given that the economy has changed significantly. We have higher government spending, changing consumer behaviors, it all alters the landscape for inflation and growth. The persistent focus on 2% inflation as a target may be outdated; it's been only a few years since the target was truly stable prices, that is, zero inflation – a more appropriate target, in my opinion.

Thanks for listening in to our discussion. We hope this information is helpful and we always welcome your feedback and questions. You can get messages to us through your relationship manager, your portfolio manager, or send them directly to us at ConnText@Conning.com (that's ConnText w/ 2 Ns).

[FADE TO MUSIC]

Conning (www.conning.com) is a leading investment management firm with a long history of serving the insurance industry. Conning supports institutional investors, including insurers and pension plans, with investment solutions, risk modeling software, and industry research. Founded in 1912, Conning has investment centers in Asia, Europe and North America.

©2024 Conning, Inc. This document and the software described within are copyrighted with all rights reserved. No part of this document may be distributed, reproduced, transcribed, transmitted, stored in an electronic retrieval system, or translated into any language in any form by any means without the prior written permission of CHL Group. CHL Group does not make any warranties, express or implied, in this document. In no event shall any CHL Group member be liable for damages of any kind arising out of the use of this document or the information contained within it. This document is not intended to be complete, and we do not guarantee its accuracy. Any opinion expressed in this document is subject to change at any time without notice.

This document contains information that is confidential or proprietary to CHL Group. By accepting this document you agree that: (1) if there is any pre-existing contract containing disclosure and use restrictions between you or your company and any CHL Group member, you and your company will use the information in this document in reliance on and subject to the terms of any such pre-existing contract; or (2) if there is no contractual relationship between you and your company and any CHL Group member, you and your company agree to protect the information in this document and not to reproduce, disclose or use the information in any way, except as may be required by law.

This document is for informational purposes only and should not be interpreted as an offer to sell, or a solicitation or recommendation of an offer to buy any security, product or service, or retain CHL Group for investment advisory services. The information in this document is not intended to be nor should it be used as investment advice.

C: 18040634