Securitized Credit Outlook 2024: Room to Run

Much of the securitized credit market displays improving fundamentals and is benefiting from the current encouraging economic growth—but expect some turbulence as overly optimistic Fed prognostications are brought down to earth.

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Executive summary

With three out of four sectors in recovery or early expansion mode, and with the market underpinned by friendlier monetary policy and positive economic growth, securitized credit is exiting its recent winter of discontent with "room to run." At the same time, the preferred portion of the opportunity set has changed significantly between 2023 and 2024. CLOs—last year's star bet—are likely to face difficulties this year, while CMBS—which might as well have been radioactive last year—are now seeing a constructive reframing of risk following 4Q's rate rally and given the market's expectation for Fed rate cuts.

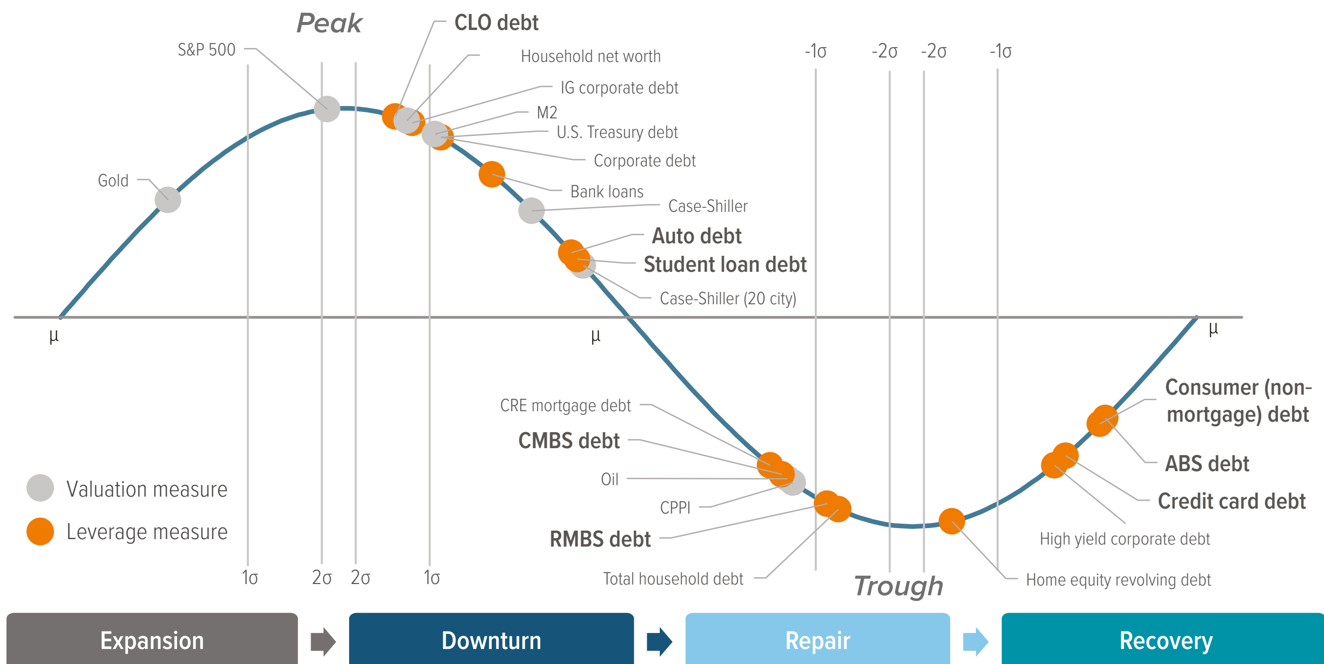
Macro environment

- While rate cuts will broadly benefit much of the securitized market (excepting CLOs), we expect **volatility to reemerge** as market expectations for five cuts in 2024 are brought down to earth.
- **Positive economic growth will broadly benefit** holders of credit risk—and specifically **investors in securitized credit sectors,** especially underlying borrowers in ABS, CMBS and RMBS.
- **Equity and fixed income returns will likely decouple,** returning to a traditional negative correlation in 2024, as disinflation continues and focus on economic growth returns.
- 2023 securitized issuance ranged from strong in ABS to significantly down in CMBS and RMBS. We expect a **modest pickup in mortgage-backed issuance,** fostered by lower rates. ABS should be full steam ahead, and CLO issuance is likely to be "sneaky strong."
- Geopolitical risks always seem to lurk on the horizon, but they remain disconnected from securitized credit market dynamics.

Securitized credit sectors

- **CMBS** activity and issuance volumes remain depressed, but the sector **is early cycle, emerging from its trough, and very cheap**; anticipated rate cuts are significantly reframing opportunities in the sector.
- Higher-quality **consumer-oriented ABS offers the steadiest source of total returns,** with a strong labor market, easing rates and moderating inflation providing a tailwind for most consumers.
- **Non-agency RMBS continues to deliver,** thanks to the **"golden handcuffs" of sub-5% mortgages,** strong labor markets and historically high homeowner equity.
- After a head-turning streak of outperformance, **CLOs are vulnerable** to falling rates and slower (but still positive) economic growth, with the sector **facing valuation challenges** as an unprecedented number of deals navigate their post-reinvestment windows.

Exhibit 1: The credit life cycle: RMBS and CMBS approach recovery; ABS is on the upswing



As of 02/07/24. Source: Voya IM.

Securitized credit in a fixed income portfolio

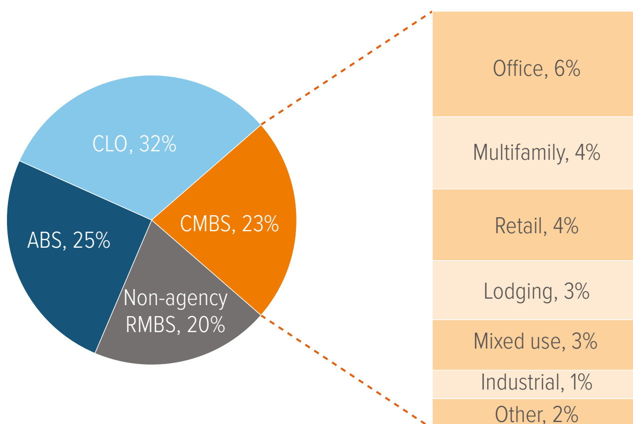
Securitized credit is a well-established, mainstream fixed income market—highly diverse, with $3 trillion in outstandings. The market is roughly divided into four sectors: commercial mortgage-backed securities (CMBS), residential mortgage-backed securities (RMBS), collateralized loan obligations (CLOs) and asset-backed securities (ABS) (Exhibit 2). The securities themselves cross all ratings categories, from AAA through below investment grade and unrated. Their weighted average lives range up to (and in some cases over) 10 years, and they can be fixed or floating rate. The sector is underrepresented in major indexes but does have eligible subsectors across ABS and CMBS.

Within the context of a larger fixed income portfolio, **securitized credit offers a highly liquid source of both diversification and alpha.** However, it is a huge market with tremendous breadth. Its sectors and subsectors are frequently all at different points in the credit cycle (Exhibit 1). While the temptation may be to look at securitized as an occasional, opportunistic, tactical play (a "trade"), the breadth of risk types allows for an allocation that delivers outperformance opportunities across a full economic cycle.

At Voya, **we consider securitized to be an evergreen strategic allocation,** and our team of specialists is able to shift attention within the strategy to the most attractive subsectors at any given time—offering the benefits of exposure to this diverse, exciting market without the stress and challenge of managing to a discrete trade.

Exhibit 2: A highly diverse, $3 trillion market

Non-agency securitized credit, U.S. outstanding issuance (%)



As of 12/31/23. Source: J.P. Morgan; Voya IM.

Macro outlook: The aftermath of the pivot party

While longer-term performance tends to be driven by sector-specific fundamentals, there are a few significant macro factors that we see tactically impacting securitized credit markets in 2024.

Lower rates and easier monetary policy foster greater activity, especially in mortgage sectors. High rates depressed issuance volumes in 2023; non-agency CMBS and RMBS issuance dropped by over 33% and 46% (respectively, vs. 2022 levels), and CLOs were off by 11%.[1] While issuance is still cool in CMBS and RMBS, we expect a pickup in the months ahead as lower rates and volatility coincide with a recovery in most parts of the commercial real estate sector. ABS (the one sector that grew in 2023) and CLOs have already seen a surge of new issuance in the first weeks of 2024, and they will also be a large source of actionable supply.

Optimistic markets are vulnerable to Fed disappointment. The last couple months of 2023 enjoyed a hardcore "pivot party" in all things risk, as sentiment in the market rallied around the impression that rates had peaked. While we do seem to have reached terminal rates, the market is now pricing in five rate cuts from the Fed in 2024. We expect volatility to return, as the Fed will likely disappoint the market in timing and/or magnitude of cuts. Markets that outperformed in 4Q—equities and parts of corporate credit—are particularly vulnerable.

The economy's slow improvement. The market's preference for weaker growth has shown up in an uncomfortable correlation between fixed income and equity returns. At some point, as the economy's uneven disinflationary path continues, we expect to see a more traditional negative correlation return. Meanwhile, holders of credit risk will benefit from a resilient labor market and moderating inflation, especially pockets of leveraged borrowers collateralizing ABS, CMBS and even CLOs.

Our thoughts on the four major securitized credit sectors follow. In general, we are quite constructive on opportunities in securitized credit markets, as unique drivers in each sector combine to offer investors a diverse set of potential sources of alpha in fixed income portfolios.

[1] As of 12/31/23. Source: Voya IM, Bank of America Global Research, J.P. Morgan.

CMBS: Back to life, back to reality

The realization of lower rates in 4Q and pricing of a Fed pivot in 2024 have **reframed the opportunity set in CMBS more than in any other securitized sector.** After months of spread pressure and weak liquidity, there has been a noticeable shift in sentiment in the market, with spreads tightening significantly and in a sustained fashion. This has been visible across both primary and secondary markets, with ample evidence that investors are coming off the sidelines and back into the market.

The thought process behind this is intuitive and appealing: If the Fed has indeed pivoted, we've hit terminal rates and easier monetary policy is ahead. This environment is likely good for economic growth prospects and credit risk. **The accompanying outsized rally in most other risk markets has left CMBS the cheapest thing in fixed income,** by far, at the start of 2024. And, excepting the troubled office property market, it will likely be judged as bang at the bottom of its cycle, with an exceptionally long runway to proceed through its recovery and expansion phases. When evaluated from this perspective, CMBS is the most attractive opportunity in securitized right now.

A 100-basis-point rally in CMBS isn't going to fix office. From a fundamental perspective, the key issues facing the sector are still going to take a long time to play out. But lower rates directly help all of commercial real estate, and they could especially mean that some of the more edge-case situations—such as loans on transitional properties collateralizing CRE CLOs—are able to refinance more efficiently and gain time to execute on their plans. **The bottom line is that a slow healing process has begun.**

Another key factor at play is the depressed transaction volume. In 2023, while CMBS issuance slid 33% compared with 2022, overall transaction volume cratered 50% year on year. Worst hit were multi-family, hospitality and (surprising nobody) office. However, although most sectors posted flat or declining 4Q numbers versus the 1Q–3Q average, there was a modest surge in office and hospitality transactions as bargain-hunting investors moved off the sidelines in advance of potential rate cuts.

We expect transaction volume to inch back towards a more normal level in 2024, supported by lower rates and an overall reframing of risk in the commercial real estate sector.

Saying that, are we charging back into the risky/sub–investment grade end of the market? Well, no. We're still wary towards office, which accounts for 25% of outstanding CMBS issuance (Exhibit 2). We're also a little less sanguine on floating-rate securities given the Fed pivot under way—although non-AAA floaters should see a net benefit from improved refi prospects.

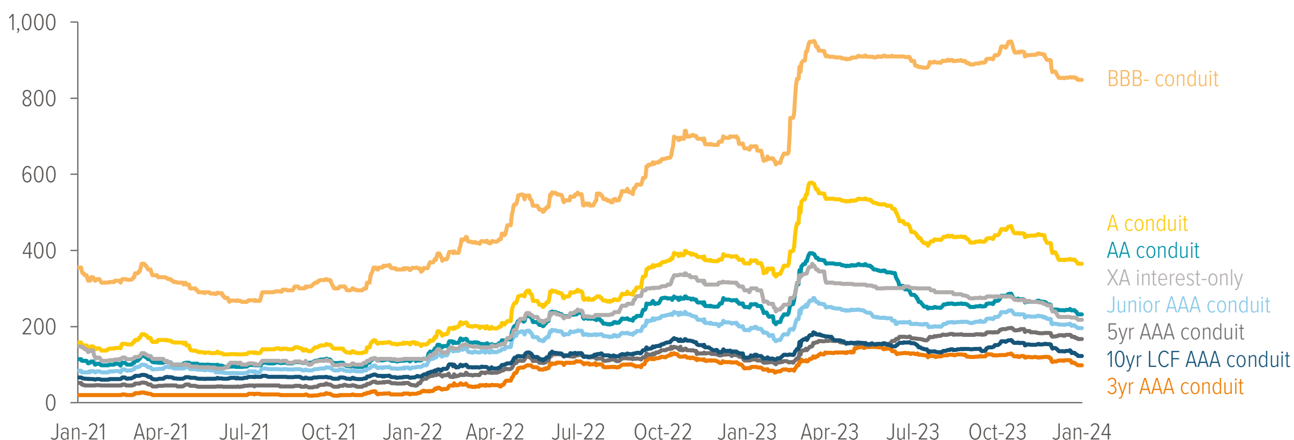
Going into 2024, **our top picks in the sector are non-office fixed-rate single-asset single-borrower (SASB) securities,** where the risk is centered around one discrete asset; **seasoned interest-only securities,** which benefit from current low prepayment speeds and the low coupon rate of most outstanding mortgage principal; and **higher-rated, seasoned conduit loans** with compelling refinance characteristics on the underlying collateral.

Exhibit 3: CMBS current risk assessment

	Hurting values	Helping values
Macro	Pandemic fallout (work from home) Current monetary policy	**Financial condition improvements** **4Q Treasury rate move** **Potential for looser monetary policy**
Micro	Office demand Near-term refinancings Financing for transitional properties Liquidations of distressed office properties	Lower cap rates Improving NOI for non-office properties Healing in CRE debt markets; pickup in CMBS supply

As of 02/02/24. Source: Voya IM. Items in **bold text** reflect factors likely to actively impact valuations.

Exhibit 4: Spreads across CMBS are slowly recovering from mid-2023 lows



As of 01/15/24. Source: Voya IM, J.P. Morgan, Wells Fargo. Conduit loan spread is to swap; interest-only spread is to Treasuries.

Exhibit 5: CMBS current opportunity set breakdown

Love	Like	Leave
Non-office fixed IG SASB	Static CRE CLO AAs–AAAs	CRE CLO BBBs–As
“Esoteric” SASB	Multi-family credit risk	Conduit BBBs
Seasoned conduit A/AAs	Freddie “K” re-REMICs	Mall credit
Seasoned IOs	Ginnie Mae project loan “Zs”	Office credit
	“High-quality” floaters	Transitional multi-family
		Below IG-rated bonds

As of 02/02/24. Source: Voya IM.

U.S. ABS: “Steady Eddy”

Rarely a volatile or exciting securitized credit sector, **consumer-oriented ABS is likely to do more of its usual this year: provide a stable—albeit unspectacular—return experience.** Truly, ABS is the “Steady Eddy” of securitized markets, and in 2024 this juxtaposes nicely with the admittedly early-cycle nature of CMBS market dynamics. There are established, solid opportunities to take risk in prime consumer ABS, which benefits from having several subsectors with compelling risk attributes. The U.S. economy’s apparent soft (or maybe no) landing is also likely to provide a boost for much of the ABS sector. A strong labor market, easing rates and moderating inflation will help most consumers—but not all.

While there are compelling risk/reward opportunities in the higher-quality collateral ends of ABS, we believe that lower-income consumers are struggling after decades of income inequality and, more recently, inflationary pressures and higher borrowing costs. Because of that, we would **avoid the most vulnerable areas of consumer credit:** buy now pay later, subprime consumer loans and subprime auto loans. We highlight **subprime auto as especially vulnerable,** suffering from a triple whammy of borrower troubles, used car disinflation, and bad actors among originators and servicers.
The cracks in short-term consumer loans and subprime auto are evidenced by more volatile and still elevated credit spreads. Private student loan debt has also endured spread widening, but here we see value opportunities, particularly in borrowers with established incomes that have refinanced out of their federal student loans.

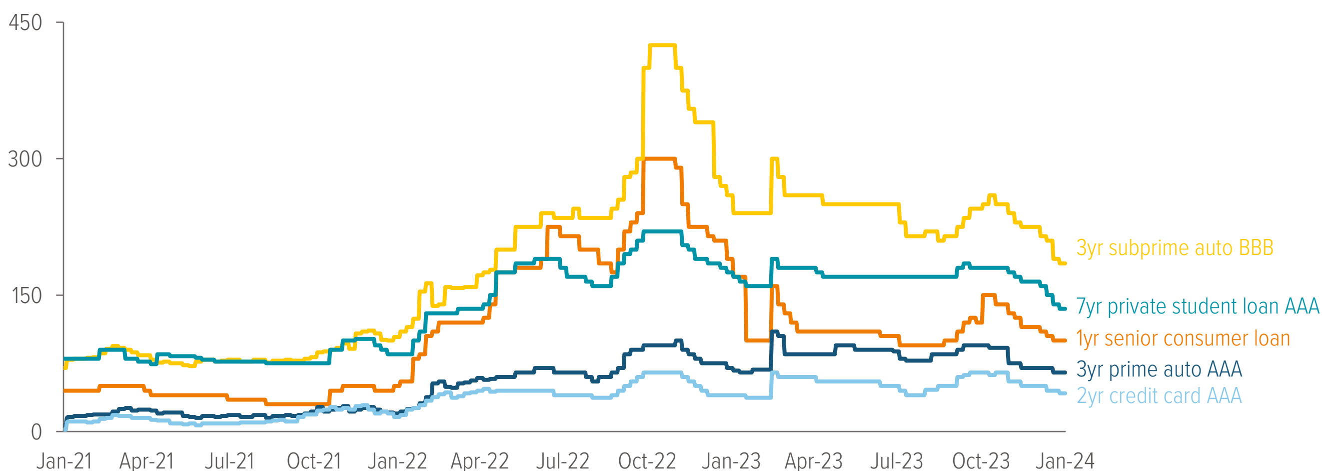
So, **in the ABS market, we favor private student loans as well as benchmark new-issue offerings,** where supply technicals will create pockets of relative value with supportive liquidity dynamics.

Exhibit 6: U.S. ABS current risk assessment

	Hurting values	Helping values
Macro	Current restrictive monetary policy	Labor market strength **Financial condition improvements** **4Q moves in Treasury rates** Inflation improvements
Micro	Originator/servicer bad actors (fintech, subprime auto) Used car disinflation	Fiscal largesse

As of 02/02/24. Source: Voya IM. Items in **bold text** reflect factors likely to actively impact valuations.

Exhibit 7: Subprime auto spreads have widened considerably



As of 01/15/24. Source: Voya IM, J.P. Morgan, Wells Fargo. Auto, consumer and credit card are all spread to swap; student loan is spread to SOFR.

We've recently become **more cautious on residential solar loans** because of structural nuances we've uncovered in our modeling process. Specifically, slow prepayment speeds could impact creditworthiness of some subordinate positions with yield-supplement overcollateralization (YSOC). What this means is that if you have very low rates for a long time (which we did), some of the subordinate bonds from some of these solar deals could take losses, even if defaults are relatively modest. **Senior tranches collateralized by solar loans remain well supported** and have attractive risk/reward characteristics.

Exhibit 8: U.S. ABS current opportunity set breakdown

Love	Like	Leave
Benchmark new issue + Discount private student loans	**Tier I/II whole business -** Stranded cost/utility Prime consumer loans Discount solar seniors	Subprime consumer loans **Solar subs -** Subprime auto < BBB Buy now pay later Fiber

As of 02/02/24. Source: Voya IM. Items in **bold text** reflect raised (+) or lowered (-) assessment vs. previous update.

Non-agency RMBS: Golden handcuffs

Non-agency RMBS has perhaps the most durable setup going into the new year. As such, **the sector is probably our top trade in terms of risk-adjusted return,** and, while oversimplified, the reason can be summed up in two words: golden handcuffs. With 87% of outstanding residential mortgage principal having coupons of 5% or less (and the majority hovering around 3%), you've got a major cohort of mortgage holders in the U.S. with eminently affordable mortgages; they aren't going to default, and they will work hard to defend their homeowner equity.[2]

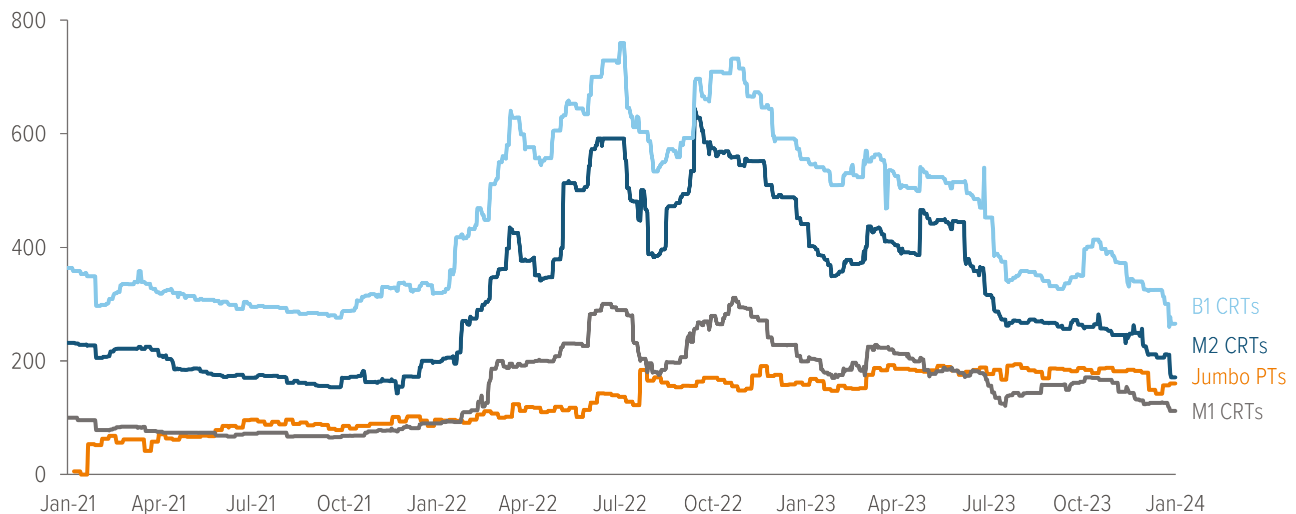
This is reflected in the current conditional prepayment rate, which is hovering around 4% (the low end of its historical range). While there is not enough high-coupon mortgage principal outstanding to trigger a significant spike in prepayments due to refinancing incentives, we do expect a modest rise in prepayment speeds as natural turnover pressures build and potentially conspire with further rate reductions to pull buyers and sellers off the sidelines. Even a modest increase in prepayments will de-lever structures and shorten duration profiles, driving higher total returns and additional spread tightening. **Our projected biggest net winners from gently rising prepayment speeds are prime-oriented subsectors,** particularly "middle" coupon mortgage pools currently trading at meaningful price discounts.

Exhibit 9: Non-agency RMBS 2024 current risk assessment

	Hurting values	Helping values
Macro	Still-elevated mortgage rates Housing supply dynamics	**Financial condition improvement** **4Q moves in Treasury rates** **Quantitative tightening to quantitative easing** Amassed homeowner equity Labor market strength
Micro	Mortgage originator stability Credit standards (non-QM, GSEs) WAC dispersion (non-QM)	**4Q agency RMBS performance**

As of 02/02/24. Source: Voya IM. Items in **bold text** reflect factors likely to actively impact valuations.

Exhibit 10: As prepayment speeds increase, credit risk transfer and passthrough spreads are likely to tighten further



As of 01/15/24. Source: Voya IM, J.P. Morgan, Wells Fargo. Jumbo PTs are spread to swap; M1, M2 and B1 CRTs are spread to SOFR and assume a CPR of 10.

[2] As of 11/22/23. Source: Voya IM, Fannie Mae, Freddie Mac.

Exhibit 11: Non-agency RMBS current opportunity set breakdown

Love	Like	Leave
Prime jumbo PTs	**2019–2021 CRT M2s–B1s**	Equity share
GSE inv PTs	Seasoned non-QM A3s	Seasoned CRT B2s
Prime senior-support	On the run CRTs, **including B2s +**	New-issue non-QM (DSCR)
High-WAC prime IG subs	Closed-end seconds	RPL/NPL

As of 02/02/24. Source: Voya IM. Items in **bold text** reflect raised (+) or lowered (-) assessment vs. previous update.

On the credit risk transfer (CRT) side, these same fundamental dynamics provide solid backing for the underlying credit of these bonds. **Prime senior-support, high weighted average coupon (WAC) prime investment grade subordinates, and 2019–2021 CRT M2s–B1s are nicely underpinned by the strong housing market,** where most homeowners have a positive equity position. Valuations present a bit of a challenge, but market technicals (low supply, regular tender offers) partially mitigate them and will likely keep us involved.

As with other parts of the securitized market, **we are avoiding the lower end of the RMBS sector,** especially debt service coverage ratio (DSCR) loans, non-qualifying mortgages (non-QM) with nasty loan terms and/or high coupon dispersion in collateral pools, and reperforming/nonperforming loans.

Exhibit 12: CLOs 2024 current risk assessment

	Hurting values	Helping values
Macro	Potential for Fed rate cuts Late-cycle leveraged loan market dynamics Geopolitics	**Apparent soft/no landing** **Financial condition improvement** Current Fed rate policy
Micro	Bank capital strains Seasoned amortizing deal dynamics	Slightly improved “arb” Private credit CLO dynamics

As of 02/02/24. Source: Voya IM. Items in **bold text** reflect raised (+) or lowered (-) assessment vs. previous update.

CLOs: The double-edged sword

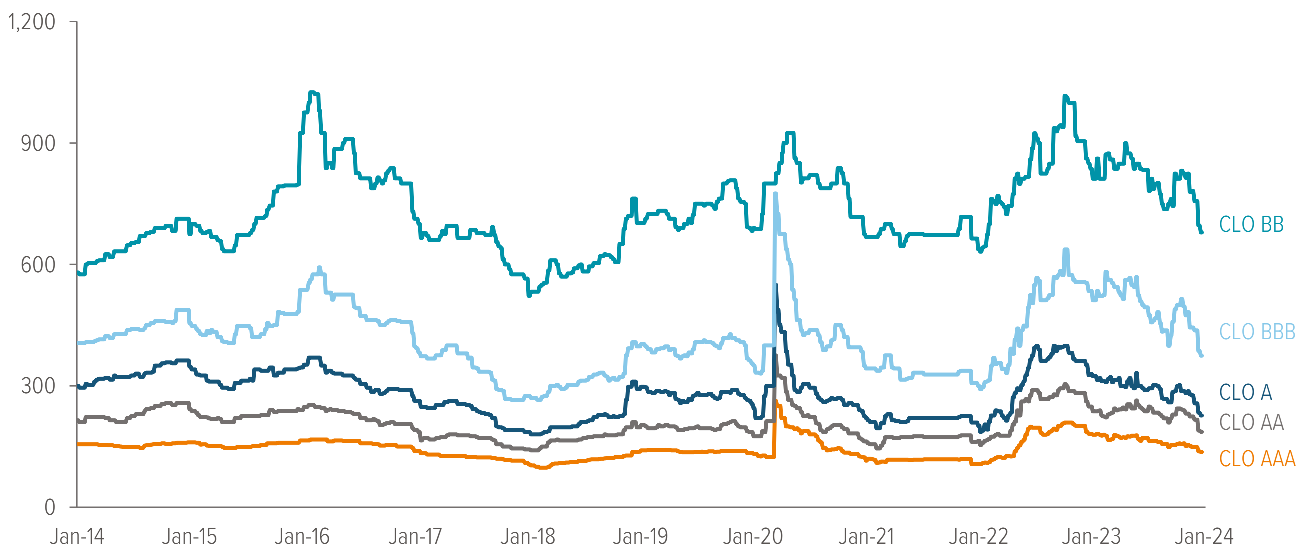
CLOs were the stars of 2023, with index measures showing nearly uninterrupted positive excess returns since March. While the substantial carry driven by Fed hikes boosted total returns in these mostly floating-rate instruments, underlying loan market dynamics have proven stubbornly resilient and kept investors in risk-on mode.

CLOs are, of course, just financing vehicles, and if they pay high coupons to their debt investors, the managers need to go out and source bank loans that will be able to cover those higher costs. This has **strained the arbitrage typically available to equity holders and changed issuance dynamics.** While improved in recent months, the situation has fostered a historically large population of CLOs that are out of their reinvestment periods and are amortizing. **Exposure to CCC or lower credits, particularly in these more seasoned CLOs, has become more of a problem** as managers have struggled to cover their liabilities. CCC and below exposure in CLOs currently averages 7% and is likely to increase during 2024.[3]

The way CLO managers make money is by running the CLO for a while and then, when AAA spreads tighten below what they were when the CLO was issued, refinancing or resetting the deal. The problem right now is that a lot of these CLOs were issued before 2018, when liabilities were considerably tighter than they are today. Most have AAA spreads tighter than 130 bp, and spreads are currently hovering around 150 bp for top-tier managers.[4] Spreads would have to tighten by at least a further 20 bp for refinancing to be widely practicable.

[3] As of 1/30/24. Source: Voya IM, Bank of America.
[4] As of 1/30/24. Source: Voya IM, Bloomberg.

Exhibit 13: While CLO spreads are tightening, refi is still a struggle



As of 01/15/24. Source: Voya IM, J.P. Morgan, Wells Fargo. CLO spreads are measured against Libor until 01/01/22 and SOFR thereafter. A -26 bp adjustment has been made to the SOFR spreads (post 01/01/22) to account for its historical discount to Libor.

Compounding the issue is that most of these older CLOs are exiting their reinvestment phase, so they have very little time left to wait out spreads. **The share of outstanding CLOs in post-reinvestment** at the end of 2023 was around 38%, and we estimate it **could exceed 50% by the end of 2024,** barring aforementioned refinancing windows reopening.[5] When a CLO is in its post-reinvestment stage, managers are much more limited in terms of what they can do within their portfolio. This increases risk for investors if they're in the wrong CLO, or even if they're down the capital structure in the right one.

With limited maneuverability for these deals from 2018 and earlier vintages, we see **junior overcollateralization (OC) cushions at risk,** which could shut down equity cash flows under more stressed levels of CCCs and defaults.

We're cautious on this sector as a whole, but **we are looking at AAs and carefully selected post-reinvestment As–BBBs with de-leveraging potential.** Specifically, we're looking at deals from debt-friendly Tier 1 managers where we have a firm grasp on what the deal's exit looks like. This means deals that will pay off in an orderly fashion and won't be subject to triggers that could shut off cash flows to our tranches (which is starting to happen in some of these "dinged up" older deals).

Exhibit 14: CLOs current opportunity set breakdown

Love	Like	Leave
Post-reinvestment BBBs	**AAs** As, Tier I AAAs	BBs Tier II/III BBBs–AAAs Equity Middle market deals < 3yr reinvest new issues.

As of 02/02/24. Source: Voya IM.

[5] As of 1/30/24. Source: Voya IM estimates.

Conclusion: A moderating economy still offers opportunity

The tremendous breadth available to investors in securitized credit markets means that there are pretty much always opportunities with compelling value—as well as areas we wouldn't touch with a barge pole. In today's environment, here are the key themes to navigate:

- **Macro growth momentum is here** and, while lower than in 2023, could prove durable on the back of potential easier monetary policy.
- There are **vulnerabilities in the U.S. economy,** particularly as slower (but still positive) economic growth manifests.
- The **next phase of the market cycle should favor** sectors that didn't participate as fully in the 4Q run-up in values, such as **CMBS, RMBS and higher-quality consumer-oriented ABS.**

An advantage of Voya's securitized credit strategy is that our dedicated team is able to take **a measured approach to risk while also reacting efficiently to changes in the market's landscape,** which enables us to provide attractive risk-adjusted returns to our clients. Our deep fundamental expertise in the sector helps us identify upcoming trouble spots in specific areas—such as the YSOC risk in residential solar ABS we discovered last year—often before they become broadly known.

Our team would welcome the opportunity to discuss how a strategic securitized credit allocation could add value in your portfolios.

A note about risk

The principal risks are generally those attributable to bond investing. Holdings are subject to market, issuer, credit, prepayment, extension, and other risks, and their values may fluctuate. Market risk is the risk that securities may decline in value due to factors affecting the securities markets or particular industries. Issuer risk is the risk that the value of a security may decline for reasons specific to the issuer, such as changes in its financial condition. The strategy invests in mortgage-related securities, which can be paid off early if the borrowers on the underlying mortgages pay off their mortgages sooner than scheduled. If interest rates are falling, the strategy will be forced to reinvest this money at lower yields. Conversely, if interest rates are rising, the expected principal payments will slow, thereby locking in the coupon rate at below market levels and extending the security's life and duration while reducing its market value.

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