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## Leveraged loans and securitized mortgages — A closer look at two balance sheets

There is broad consensus among investors that the global economic expansion is in the latter or even late stages of the cycle. Growth in 2019 is positive but decelerating. Global central banks are signaling or actively implementing looser monetary policies to maintain the expansion. At this stage in the cycle, investors are worried about the pricing of risky assets as risks of a U.S. recession rise. But, just as importantly, they are concerned about the health of balance sheets and the fundamentals that impact them.

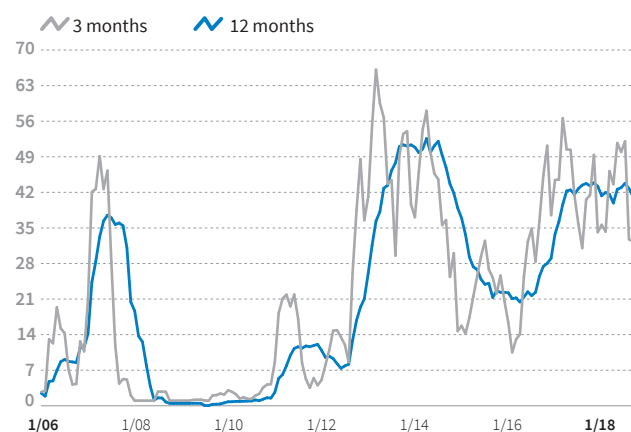
In this context, we address balance sheet questions by comparing the underlying characteristics of two markets that investors typically consider for their fixed-income strategic allocations: leveraged loans and securitized mortgages. Certain data on underwriting standards and leverage supports the view that U.S. households have relatively stronger balance sheets compared with companies with leveraged loans. Historically, Putnam has viewed allocations to the securitized sector as an effective form of diversification to other fixed-income risk premiums. At this stage of the cycle, the relatively stronger fundamentals make for an even more compelling case for investors to consider the securitized sector.

### Underwriting standards

Over the history of credit cycles, trends showed an increase in defaults and losses as underwriting standards loosened. One indicator of more aggressive issuance in the leveraged loan sector is the volume of covenant light deals that come to market (see chart below). The issuance of covenant light loans has increased since the global financial crisis. Although the market downturn of 2015–2016 interrupted this growth, covenant light issuance is currently higher than before the crisis.

### Issuance of covenant light credits has increased

(% of market size, rolling 3- and 12-month periods)



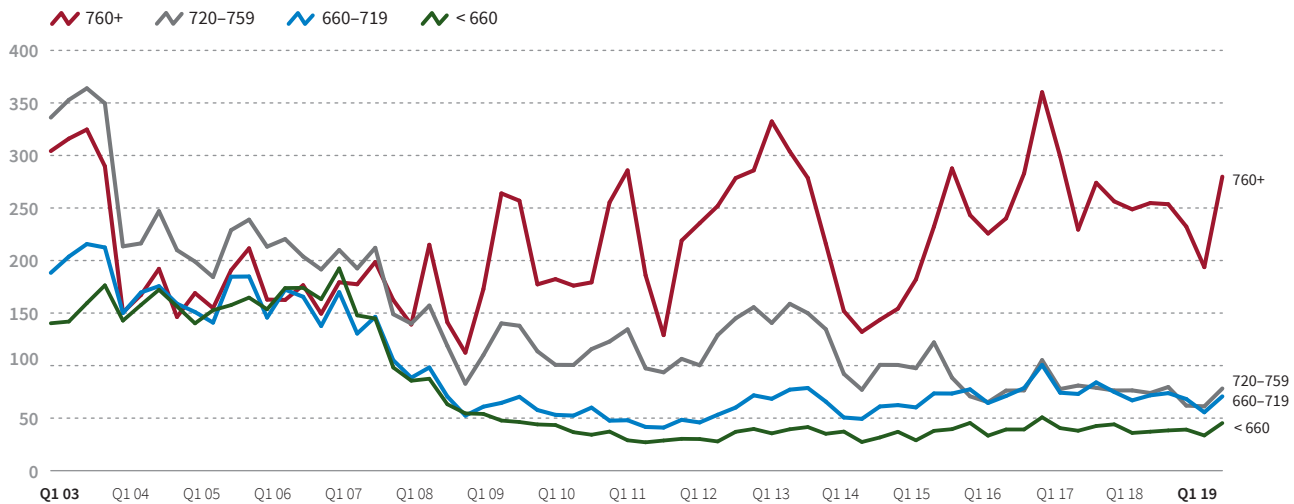
Source: Bank of America, as of 11/30/18.

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## New mortgages and FICO scores before and since the global financial crisis

(\$U.S. billions)



Sources: Federal Reserve Bank of New York, Equifax Consumer Credit Panel, as of 6/30/19.

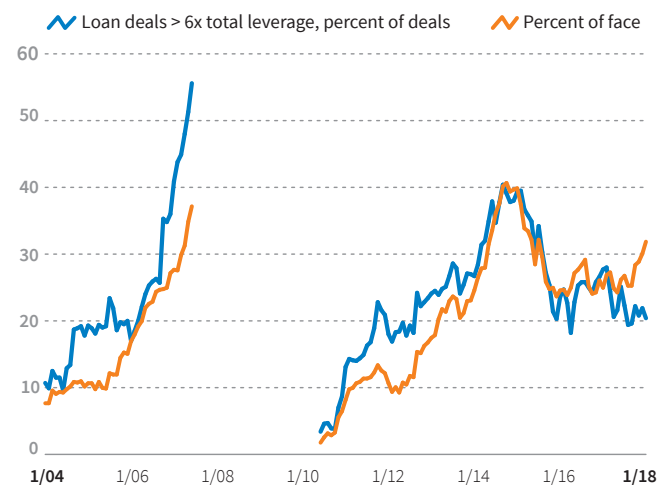
Meanwhile, in the mortgage space, underwriting standards can be assessed using various metrics. The widely used FICO credit score measures an individual's creditworthiness. Higher FICO scores generally correspond to a lower risk of homeowners defaulting on mortgage loans. The chart above shows the volume of mortgage origination prior to the 2008 financial crisis when credit was extended to borrowers across the FICO score spectrum. In the aftermath of the crisis, new regulations and legislation encouraged and/or required tighter lending standards for originators. This resulted in a sustained decrease in the volume of mortgage loans extended to borrowers with lower credit scores that is still evident today.

### Corporate leverage and household debt

Trends in corporate leverage show that when the cost of capital declines, companies tend to borrow more to fuel growth. This can lead to overleveraging. However, when the cycle starts to turn, being overleveraged can lead to higher levels of defaults and losses. The chart to the right illustrates borrowings by companies with balance sheets that are more than six-times leveraged. Since the financial crisis, there has been a significant increase in corporate debt and an uptick in leverage.

## Corporate leverage trends higher

(% of deals)

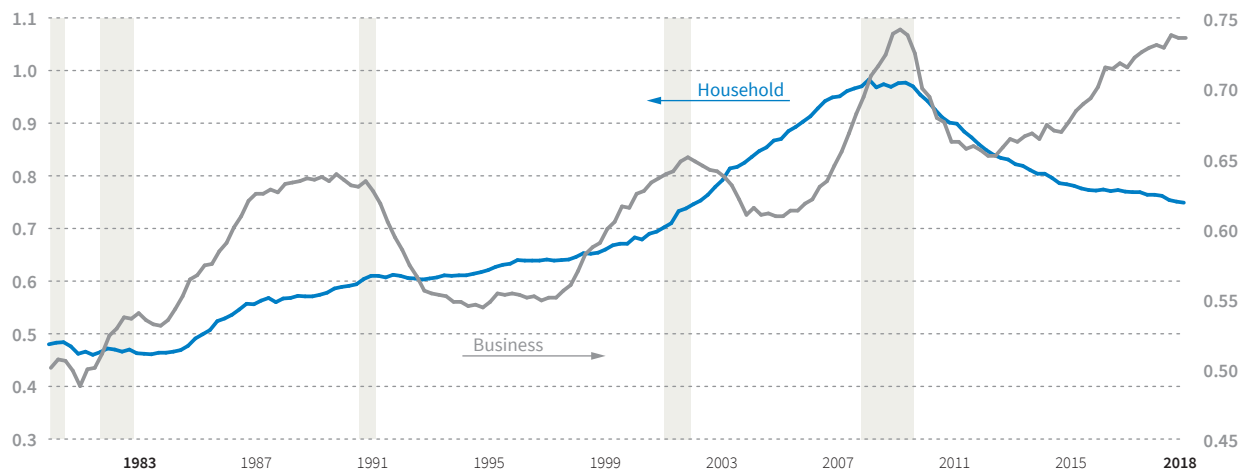


Source: Deutsche Bank, as of 1/31/18.

Gap in lines represent period where there was no issuance of deals with above 6X leverage.

## Household debt has trended lower as business sector credit rises

### Business and household sector credit-to-GDP ratio



NOTE: Data are quarterly. The shade bars indicate periods of business recession as defined by the National Bureau of Economic Research. GDP is gross domestic product.

Sources: Federal Reserve Board, Statistical Release Z.1, "Financial Accounts of the United States," Bureau of Economic Analysis vis Haver Analytics, national income and product accounts, Table 1.15: Gross Domestic Product Federal Reserve Board staff calculation, as of 3/31/19.

Another relevant leverage metric is the credit-to-GDP ratio. This data provides a more direct comparison for the health of households and corporate balance sheets. Business sector credit relative to GDP has been trending up for years and is now at or near record levels. Meanwhile, household debt is still below its peak of 2007 and is currently at levels seen at the beginning of the 2000s. The household credit-to-GDP ratio has actually declined despite the current economic expansion and the relative strength of U.S. consumers.

### Securitized products can enhance diversification

Our research shows that U.S. household balance sheets appear stronger on a relative basis compared with the aggregate balance sheets underlying leveraged loan companies at this stage in the economic cycle. The persistent low cost of capital (over a number of years) has incentivized corporate borrowing, causing the risk to increase. At the same time, not every company is at a higher risk of default, and companies have sustained growth in part by utilizing cheap capital to invest. This growth has fueled expansion for both companies that borrow as well as the broader economy. Still, as the economic cycle turns, we will start to see more risks to corporate balance sheets, on average, giving us relative caution.

From an investment perspective, it is important for investors to understand differing credit fundamentals and balance sheet trends in each market. This knowledge can help them plan their future allocations and to realize the benefits of balance sheet diversification. Ultimately, we believe that investing in the securitized sector is essential for diversification regardless of where we stand in the market cycle. In the current environment, however, household balance sheets look more robust than the aggregate balance sheets of leveraged loan companies. As such, we believe there is a strong case for investors to consider an allocation to securitized products.

## ABOUT THE AUTHORS

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Diversification does not guarantee a profit or ensure against loss. It is possible to lose money in a diversified portfolio.

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