U.S. Structured Credit Outlook

Key takeaways

We believe non-agency RMBS bonds will present a very attractive investment opportunity in 2023.

Prepayment-sensitive assets (e.g., agency IOs) provide a particularly compelling diversification story due to the countercyclical nature of the sector, in our view.

Our current base case is that a recession is likely inevitable, although its timing and depth depend on how quickly the Fed reacts to visible signs of an emerging economic slowdown.

Looking forward, the risk of a larger economic slowdown is high so long as the Fed maintains its hawkish stance. Although it appears inflation is past its peak, it’s difficult to envision achieving the Fed’s stated target while the labor market remains strong. Our current base case is that a recession is likely inevitable, although its timing and depth depend on how quickly the Fed reacts to visible signs of an emerging economic slowdown. This scenario likely leads to a modest rise in unemployment and a tepid housing market. Eventually, the Fed will have to choose between price stability and growth. We anticipate the U.S. economy will enter recession by early 2024 and that unemployment will rise slowly to a more historically normal range of 5%–6%.

MACRO BACKDROP

Recession looms

The macro landscape looks markedly different today than it did a year ago. After more than two years focused on the pandemic, investor concerns now center on persistent inflation, central bank tightening, and heightened geopolitical tensions. The U.S. Federal Reserve pivoted away from accommodative policy by bringing an end to its purchase program, embarking on a hawkish rate-hike path, and signaling its commitment to reining in inflation. Markets left few places to hide as Treasury rates spiked upward and risky assets sold off, pushing credit spreads wider. Many investors are now heavily focused on the Fed’s meaningful impact on rates and other macroeconomic forces, contributing to heightened volatility in virtually all markets and creating pockets of lower liquidity.

STRUCTURED CREDIT STRATEGIES

Cautious optimism

Despite broader volatility through 2022, the fundamentals across many structured credit assets remain on solid footing and, in some cases, continue to improve. Still, market spreads widened significantly last year with some areas underperforming other comparable risk markets. For example, the spread on the ICE BofA BBB CMBS U.S. Fixed Rate Index widened by 371 bps during the year to settle at 683 bps as of December 31. In comparison, the Bloomberg U.S. Corporate High Yield Index widened 186 bps to end the year at 469 bps.

Nonetheless, we do not believe risk markets have fully priced in a recession, so we expect volatility to remain elevated in the near term. We prefer to maintain a lower level of risk in this environment but will selectively take...
sector return expectations (over cash)

<table>
<thead>
<tr>
<th>Prepayment (agency IO)</th>
<th>Residential mortgage credit (non-agency RMBS)</th>
<th>Commercial mortgage credit (CMBS)</th>
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<tbody>
<tr>
<td>4%–7%</td>
<td>3%–7%</td>
<td>3%–7%</td>
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For illustrative purposes only. Expected returns and projections represent probabilities and possible outcomes, not promises of future performance. Security prices fluctuate in value unpredictably, and returns cannot be predicted with certainty. The base case scenario provided above is based on numerous assumptions that are subject to risk and may not be realized. Changes in such assumptions could produce materially different results. The return expectations shown are hypothetical in nature, do not reflect actual results, and are not guarantees of future results.

advantage of attractive opportunities as they arise. This currently includes higher-quality liquid securities with shorter spread durations that now offer attractive spreads with relatively low risk due to significant spread widening during 2022.

The table above provides our current base case return expectations for the three primary sectors we focus on.

U.S. HOUSING

Lack of affordability

U.S. housing prices soared during the pandemic, driven in no small part by strong monetary and fiscal policy responses, heightened pandemic-fueled demand for housing, and constrained supply. But the dynamics that fueled the recent housing rally have shifted. Most notably, the Fed abandoned its loose-money policy by ending the monthly purchases of agency mortgages and aggressively raising the federal funds rate, which caused mortgage rates to spike to the highest level since 2008. In combination with two years of double-digit home price growth, housing affordability has fallen substantially and dampened demand. Meanwhile, supply has slowly started to recover. As a result, the housing market has begun to slow, both in terms of existing home sales as well as valuations. This trend is likely to continue into 2023 as mortgage rates remain elevated and the probability of recession and higher unemployment rises due to the Fed’s aggressive rate hikes. We expect home prices to fall between 5% and 10% in 2023, followed by tepid growth in subsequent years.

This housing correction will not repeat the late 2000s

The significance of an emerging housing correction should not be understated. Looking back over the past 35 years, there have only been two periods when year-over-year home price growth turned negative: 1990–1991 and 2007–2012. Peak to trough, home prices fell –3.1% and –27.4% during those periods, respectively, as measured by the S&P CoreLogic Case-Shiller U.S. National Home Price Index. So, our base expectation for home prices to fall 5% to 10% is historically significant. However, the downstream impacts will be much more contained than they were during the global financial crisis.

Recall that the housing run-up in the 2000s was fueled in large part by loose lending standards. Mortgage originators issued non-traditional loan products, which were not always in the best interest of the consumer, to a wide borrower base with questionable credit. This pushed housing demand to record levels, which spurred home builders to ramp up production. The result was a cascading effect after the credit box slammed shut, demand plummeted, and a glut of supply sent home prices lower, leaving many homeowners with more debt than their homes were worth. The story we see today is markedly different. Underwriting standards have remained tight since 2008, and the vast majority of the outstanding mortgage market is in the traditional 30-year fixed-rate product with a record-low average mortgage rate close to 3.5%. As a result, the consumer balance sheet is now in very good shape, and homeowners are much less levered by debt. This limits the likelihood that the forthcoming housing correction leads to widespread defaults and delinquencies that would put further downward pressure on the market.
Borrower fundamentals are much healthier today than pre-2008

Higher credit scores and lower household leverage

Emerging opportunities
The combination of declining home prices and rising unemployment typically translates into a deteriorating credit profile — and thus lower prices — for non-agency RMBS because the risk of loss is higher. True to form, residential mortgage markets have responded to the weaker housing outlook by pushing prices lower and yields higher across the board. After entering 2022 with historically rich valuations, we’re ending the year with what appear to be historically cheap valuations for newly issued securities. Nonetheless, residential balance sheets remain well positioned, supported by the combination of ultra-low mortgage rates that homebuyers have already locked in and the very high home price appreciation they have experienced in recent years. This limits the likelihood of a housing and/or economic correction leading to widespread defaults and delinquencies, so supply is not likely to increase substantially due to distressed home sales. Meanwhile, the supply of new homes, while rising, is still not high enough to create oversupply on a national level.

Due to the combination of these factors, many of the RMBS bonds we’ve analyzed would see no fundamental losses under most potential housing and employment scenarios short of an unlikely repeat of the 2008 GFC environment. And yet, the yields and spreads offered in the market today are historically high. As a result, we believe this sector will present a very attractive investment opportunity in 2023.

AGENCY MARKETS AND PREPAYMENT TRENDS

Rate volatility and market technicals drive the basis
The past year was a tumultuous one for the agency mortgage market, which delivered its worst calendar year performance on record in terms of total return and excess return. When the economic outlook deteriorates, the credit markets’ negative excess returns can be attributed to increasing credit risk. In contrast, agency MBS carry virtually no credit risk, and in this instance, excess returns were driven negative largely by technical factors. After nearly two years as the largest source of demand for agency MBS, the Federal Reserve backed away from the market and left investors to wonder who might step in to fill the void. Banks have historically absorbed the bulk of supply but have shown reluctance to add to their exposure. The result was a historic downward repricing of agency MBS that, in combination with rising long-term interest rates and increased volatility, caused mortgage rates to soar. Late in 2022, money managers recognized the growing opportunity in the market and stepped in to cover their underweights and to take advantage of the historic cheapness and relative value to other high-quality assets, offering a marginal source of demand that brought prices back in line with fair value.

Looking forward, the carry profile of agency MBS and agency interest-only (IO) securities remains attractive and...
Fed’s QE program squeezed the mortgage basis

This gap widened as the Fed backed away in 2022

Prepayments grind slower due to “lock in” effect

The pandemic-era refinance wave, driven by ultra-low mortgage rates and historic home price appreciation, wound down in 2022 as interest rates spiked and the housing market lost steam. The percentage of existing borrowers with an interest-rate incentive to refinance quickly plummeted from 35% to 3% during the first quarter and now sits near 0%, as measured by the Morgan Stanley Truly Refinanceable Index. In fact, the rate increase was so drastic that the average borrower’s mortgage rate is nearly 3% lower than the current offering rate, creating a “lock in” effect whereby homeowners become reluctant to forfeit their existing mortgage for a new one. This significantly reduces expectations for cash-out refinancing demand and may also deter many homeowners from selling their existing home to purchase a new one. With expectations for recession and a slowing housing market, we anticipate prepayment speeds will continue to decline in 2023.
Diversified risk premium with attractive spreads and potential for upside

We believe that prepayment-sensitive assets (e.g., agency IOs) provide a particularly compelling diversification story due to the countercyclical nature of the sector. They benefit from an economic slowdown, change to supportive fiscal policies, and/or a sustained sell-off in rates. In contrast to the mortgage credit market, a scenario of falling home prices, lower turnover and mobility, and/or capacity or underwriting constraints would slow prepayments and benefit the prepayment sector.

In our view, many prepayment-sensitive assets offer an attractive risk-adjusted return potential at current price levels even if prepayment speeds remain at their current levels. The sector could realize significant upside potential if speeds continue to grind lower. We see value across a variety of collateral types that appear attractively priced based upon current prepayment speeds.

COMERCIAL REAL ESTATE

Property values will face pressure

The outlook for commercial real estate is mixed as the U.S. economy continues to reopen to travel, office use, and retail spending while the Fed’s efforts to contain inflation will likely push the country into a recession. In addition, capitalization rates are increasing with rising interest rates, although this is somewhat mitigated by a shrinking spread between comparable Treasury rates and cap rates. Nonetheless, a higher cap rate leads to lower property valuations unless rental income growth can offset the higher cost of capital. Broadly speaking, we think rental income is unlikely to provide the necessary growth and may even be susceptible to decreases if demand slows. And in contrast to housing, which has experienced increased demand and slower new supply during the pandemic, commercial real estate (CRE) continues to see new development despite uncertain demand as tenant leases expire in the future. Overall, we expect that national CRE prices could face pressure over the medium term, although this will vary significantly by geography and property type. For instance, we believe new office properties in large metro areas will continue to see high demand thanks to the amenities and
ESG-friendly enhancements they offer, which allows them to command premium rent. In contrast, older properties that are in need of capital expenditures may see tenants ask for concessions or potentially leave.

**Credit premiums growing with recession risk**

Despite the deteriorating macro environment and risk-off sentiment, fundamentals for CMBS conduit deals broadly continued to improve in 2022. Cash flows picked up with rent and occupancy growth; forbearance agreements and other loan modifications were successful on well-positioned and well-operated properties; and delinquency rates continued to shrink. Another sign of fundamental strength is higher-than-anticipated payoff rates/refinancing even at now higher interest-rate levels. Furthermore, having real assets serve as collateral and the ability to adjust rents should offer CMBS some protection against inflation. With that said, the market continues to struggle with valuations, weighing this fundamental strength against the increased likelihood of a recession. The market is shifting its concern from hotel and retail properties, which were impacted during Covid and then outperformed early pandemic expectations, onto office properties where lesser-quality assets could suffer from work-from-home and hybrid models. We don’t believe recession has been sufficiently priced in, and this will likely lead to additional spread widening in the first half of 2023.

**Opportunities will arise, but deep credit research is needed**

Macro-driven volatility pushed spreads wider across the sector in 2022 despite the continued fundamental improvements, creating strong opportunities for security selection. We expect greater return dispersion across the market in the near term, which increases the importance of rigorous loan-level analysis to uncover relative value. We currently favor shorter spread duration assets, namely seasoned mezzanine tranches on deals with high-quality collateral, which offer very attractive relative value and should be insulated from losses even in recessionary scenarios, in our view.

Macro-driven volatility is creating opportunities in CMBS

CMBS credit bonds offer relative value to comparable corporates

![Graph showing nominal spread (basis points) over time for CMBS BBB- 2011–2014 vintages (liquid), HY CDX (5 year), and CMBS A 2015–2019 vintages]

Sources: Bloomberg, Putnam, as of 12/31/22. For illustrative purposes only. Past performance is no guarantee of future results. CMBS represent a Putnam estimate of the overall CMBS market for the given credit tranche and vintages. HY CDX represents the Markit CDX North America High Yield Index, which is composed of 100 non-investment-grade entities. All spreads are in basis points and measure a nominal spread versus comparable Treasuries and are not loss-adjusted. Pre-Covid-19 average represents the average month-end nominal spread over the 3-year period ending December 2019.

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CONCLUSION

In summary, we remain constructive on structured credit markets in 2023. We expect the macro environment will continue to put strain on broad fundamentals and spread levels, which is creating attractive opportunities for credit pickers. Overall, we believe that structured credit currently offers both diversification benefits and attractive relative value to corporate debt.
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