A World Drowning in Negative Interest Rates:

The Case for U.S. Securitized Debt

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May 2016

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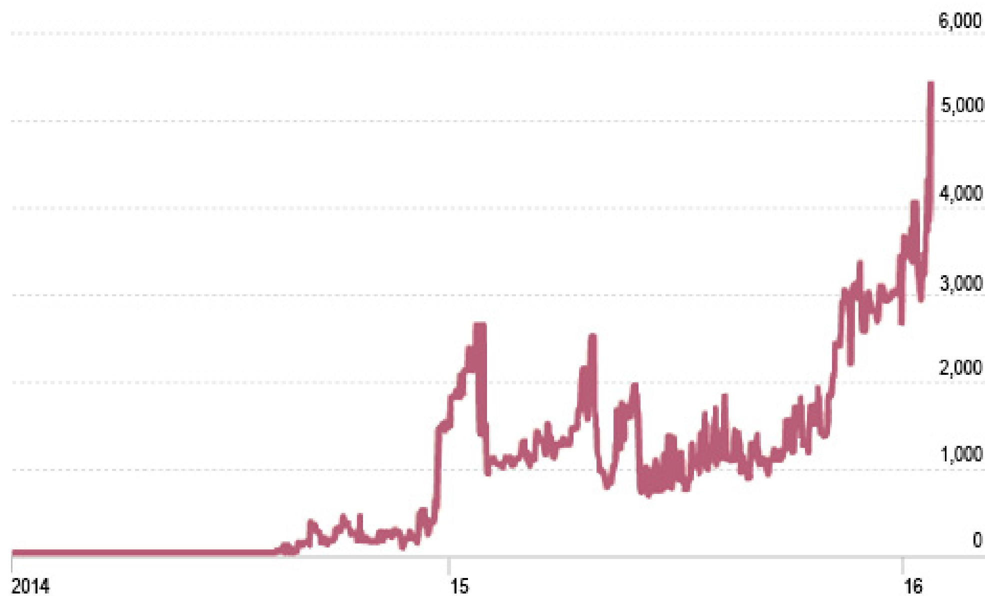
- Battling global deflation has given rise to negative government bond yields
- Securitized debt can offer attractive yields with high credit quality and low interest rate sensitivity
- The U.S. securitized market has accounted for 25% of U.S. fixed income issuance in recent years
- U.S. securitized markets offer more attractive opportunities than European ABS
- Post crisis regulatory changes have widened spreads in U.S. securitized markets
- We believe current spreads present attractive return opportunities

Battling global deflation has given rise to negative government bond yields

The specter of deflation giving rise to a recession or even a depression has driven central banks across the globe to aggressively move from a zero interest rate policy (ZIRP) to a negative interest rate policy (NIRP). Negative interest rates, virtually unthinkable a few years ago, are now almost commonplace globally.

Chart 1 shows that central bankers across the globe are punishing fixed income investors with approximately $5.5 trillion in government bonds now trading at negative yields. Thus far, five central banks (Denmark, Eurozone, Sweden, Switzerland, and Japan) have implemented negative rates, while other central banks are investigating whether their economies might also benefit from implementing them.

Chart 1 - Stock of Negative Yielding Government Bonds ($billion)



Source: JP Morgan, Financial Times.

Securitized debt can offer attractive yields with high credit quality and low interest rate sensitivity

So, what should an investor do in a world drowning in negative yielding government bonds? The credit markets often offer higher yields. Investors who seek yield but without taking significant interest rate and credit risks should be looking at high-quality, low-duration, or floating-rate securitized bonds as the solution. We believe the advantages of securitized debt include:

- Numerous sectors for diversification and asset allocation opportunities
- Credit quality ranging from AAA through non-investment grade
- Diverse range of maturities and weighted average lives
- Sizable issuance and secondary trading available across sectors
- Attractive yields and spreads relative to comparable global corporate bonds
- Large portion of the securitized market floats off the USD London inter-bank offered rate (LIBOR)
- Long history of strong relative performance with high relative Sharpe ratios

U.S. securitized market accounts for 25% of U.S. fixed income issuance

In the U.S. the main sectors of the global securitized market are asset-backed securities (ABS), residential mortgage-backed securities (RMBS), and commercial mortgage-backed securities (CMBS). Each of these sectors is composed of numerous subsectors. For example, within ABS, some of the better known subsectors are credit cards, auto loans, equipment, and student loans. For the RMBS sector, the main subsectors are agency MBS and non-agency MBS. Non-agency MBS is further broken down by loan quality categories such as prime, Alt A, and subprime. The CMBS sector is divided into single asset, single borrower (SASB) and conduit deals. SASB deals, as the name implies, have either one loan or one borrower underlying the deal. Conduit deals have many loans and borrowers. Typically, conduit deals pool 50-70 commercial real estate loans to create a diversified trust for investors. Within those subsectors, the deals are further characterized by commercial real estate loan type, such as hotel, office, multifamily, and storage. Having three very large sectors, each with numerous subsectors, is advantageous from a diversification standpoint. Additionally, securitized debt deals are typically tranched by maturity (from less than 1 year to 10+ years) and credit quality (AAA through to non-investment grade), which provide investors with many portfolio construction options and potential relative-value trading opportunities.

Table 1 illustrates U.S. fixed income market issuance. **The total issuance of securitized products has averaged 25% of the total U.S. fixed income issuance over the past five years.** The securitized debt market is not only large, but also actively traded.

Table 1 - Gross Issuance of the Fixed-Income Markets in the U.S. Since 2008

	TSY	Munis	Agency Debt	Agency MBS	Non-Agency MBS	CMBS Total	Consumer ABS	U.S. CLO	USD HG Corps	U.S. HY Corps	USD Lev Loans	EM HY Corps	EM Sov	Total Securitized Products	U.S. Fixed Income Issuance
	Gross Issuance ($billion)														
2008	911	389	1,078	1,140	30	23	131	17	748	44	71	15	31	1,341	4,629
2009	2,109	410	1,181	1,667	8	15	175	1	986	133	39	24	78	1,866	6,825
2010	2,247	433	1,327	1,320	5	37	121	4	745	228	158	58	75	1,488	6,759
2011	2,135	287	966	1,131	5	68	125	13	770	189	231	62	64	1,342	6,045
2012	2,513	380	840	1,663	10	102	201	56	969	280	295	61	90	2,032	7,099
2013	2,140	334	591	1,544	31	147	179	84	1,024	270	456	99	89	1,985	6,989
2014	2,215	337	482	924	50	146	202	124	1,099	239	377	81	106	1,445	6,382
2015 Forecast	2,119	400	490	1,315	58	190	235	100	1,222	210	272	39	72	1,898	6,722
2016 Forecast	2,119	440	490	1,155	51	230	200	70	1,200	196	252	15	109	1,706	6,527

Source: Bank of America Merrill Lynch Global Research, SIFMA, Intex, Bloomberg, Fannie Mae, Freddie Mac, Federal Home Loan Banks. As of 23 November 2015.

According to the Securities Industry and Financial Markets Association (SIFMA), daily trading volume in non-agency and agency securitized products has averaged close to $5 billion and $200 billion, respectively, over the past two years. As we would expect, AAA-rated bonds see the most trading and have the narrowest bid/ask spreads, depending on maturity, which range from less than one basis point to five basis points in a normal trading environment. Other than the subprime mortgage-backed security (MBS) segment of the non-agency RMBS market, the securitized market has withstood numerous credit cycles and has provided investors with significant liquidity and opportunities to add value to client portfolios.

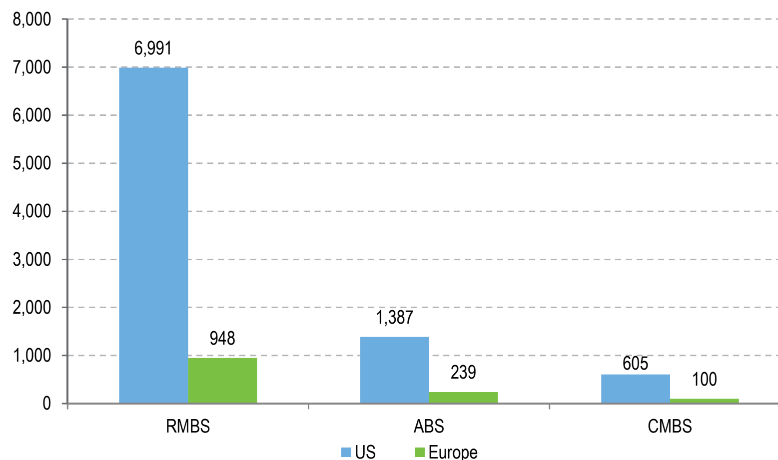
U.S. securitized markets offer more attractive opportunities than European ABS

Within the global securitized universe, we believe that the U.S. marketplace currently offers the most attractive set of opportunities for a number of compelling reasons. The spreads for most U.S. securitized sectors are much wider than elsewhere in the world. The U.S. market is significantly larger (see Chart 2), which typically results in superior liquidity and more relative value trading opportunities. Going forward, the diverging monetary policy between central banks will likely result in yields rising on floating rate bonds significantly sooner in the U.S. than the rest of the globe.

While most of the world is following accommodative monetary policies, the U.S. is diverging and has begun to normalize interest rates. **With higher U.S. interest rates becoming more likely, it is important for fixed-income portfolios to be structured with low interest rate sensitivity (i.e., duration).** A good way to accomplish this, in our view, is to allocate a portion of the portfolio to floating-rate bonds and, fortunately, one can source billions of floaters in the securitized market. According to SIFMA, the securitized market , excluding agency MBS, is approximately $4.5 trillion, and estimates indicate that several hundred billion is structured to have LIBOR floating-rate coupons. If the U.S. Federal Reserve (Fed) continues to hike interest rates, the coupon on these floating-rate securities, which mostly reset monthly, will adjust higher and thus protects these securities from the price erosion of higher interest rates.

We believe a short-duration, high-quality U.S. securitized portfolio should be attractive to any institution which finances itself in Europe or Asia or invests in global bonds in these markets. The European Central Bank (ECB) recently announced that in addition to pushing interest rates further into negative territory, it will shortly begin purchasing nonfinancial corporate bonds as part of its quantitative easing (QE) program. This will drive yields lower and spreads tighter on European and perhaps U.S. corporate bonds and, in our opinion, further increases the attractiveness of U.S. securitized debt.

Chart 2 - U.S. & Europe Securitized Debt Outstanding ($billion)



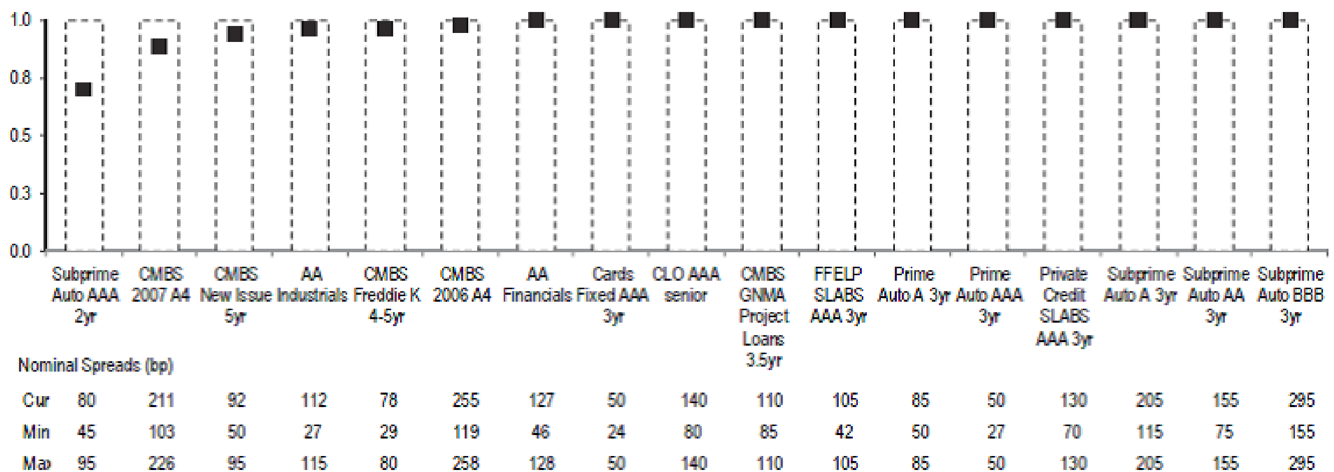
Source: SIFMA. As of 31 December 2015.

Post crisis regulatory changes have widened spreads in U.S. securitized markets

The global financial crisis was sparked by a crisis in the U.S. sub-prime RMBS market. Prior to the financial crisis, securitized debt posted some of the highest risk adjusted returns in the global fixed income markets (as measured by Sharpe ratios defined as the average excess return above the risk free rate per unit of volatility or total risk). Ironically, this led to excessive leverage being deployed in the sector by structured investment vehicles (SIVs), asset backed commercial paper programs (ABCPs), and collaterized debt obligations (CDOs). These vehicles grew so large (several hundred billion dollars) that not only did they force spreads to tighten excessively, but they also could only maintain their asset growth by becoming overly exposed to subprime RMBS. Once the U.S. subprime housing market weakened, short term financing for these vehicles dried up, and they were forced to liquidate their holdings. Over-levered SIVs, ABCPs, and CDOs overflowing with securitized debt, particularly subprime RMBS, no longer exist and we would not expect them to come back anytime soon. From our viewpoint, this is quite beneficial, as it allows investors who do their credit-work to seek to capture the wide spreads and solid return opportunities in the securitized space. In short, we believe that high risk-adjusted returns (i.e high Sharpe ratios) are back and here to stay.

The reaction of the U.S. regulatory authorities to the U.S. ABS markets during the post-crisis period has been severe. In particular, the Fundamental Review of the Trading Book (FRTB) proposal will mandate significantly higher capital requirements across most securitized products. In addition to global growth and financial stability concerns, securitized spreads have shifted higher on concerns that if the FRTB is enacted, liquidity will decline substantially as the profitability of secondary trading for dealers will be considerably lower. **However, we believe that liquidity will remain relatively high, as short-duration products will be in demand as the Fed tightens monetary policy.** Chart 3 shows that not only are securitized spreads at one-year wides, but also as the data below the bar chart shows, they are significantly wider than comparably rated corporate bonds.

Chart 3 - Rolling 52-week Normalized Spreads



Source: JP Morgan. As of 18 March 2016.

Table 2 - Floating Rate Bonds

	Floating Rate Bonds					
	Spread			Diff vs. Corps		
	AAA	AA	A	AAA	AA	A
Securitized:						
Credit Card ABS	61	80	105	6	5	5
Freddie Multi Family CMBS	78	200	300	23	125	200
Subprime Auto ABS	90	150	200	35	75	100
Single Asset Single Borrower CMBS	190	300	400	135	225	300
Single Family Rental RMBS	200	265	335	145	190	235
Corporates:						
Industrial	55	75	100	-	-	-

Source: Wells Fargo, JP Morgan, Stone Harbor Investment Partners LP. As of 18 March 2016.

We believe current spreads present attractive return opportunities

Table 2 shows current spreads across sectors and the credit quality for securitized assets. With floating-rate AAA spreads well above 100 basis points for many segments of the securitized market and AA-rated spreads north of 200 basis points, we believe this is an opportune time to invest in high-quality, lower duration, floating-rate securitized assets. Investment in high-quality floaters takes advantage of the dichotomy in the global monetary policy. Yields on many global government bonds are likely to remain negative for a considerable period of time, in our opinion, as the ECB, Bank of Japan, and other central banks attempt to reduce borrowing costs and reflate their economies. However, the Fed has ended its QE program and is in the process of normalizing interest rates, which means U.S. dollar LIBOR should be moving higher. In this environment, yields on floating-rate securitized bonds will also move higher, but unlike fixed rate bonds, prices on such bonds will not decline because the coupon will reset higher as LIBOR moves higher.

Stone Harbor believes that a well-constructed, short-duration, high-quality portfolio of securitized debt can be expected to earn 100-300 basis points (gross of fees) above USD LIBOR over a time period of two to three years. If the Fed normalizes interest rates over the next few years, Stone Harbor believes that such a portfolio likely will yield between 3% and 5%, or between 4% and 6% depending on whether the Fed moves short-term interest rates to 2% or 3%, respectively. Either way, we believe these potential yields are extremely attractive versus ***paying*** Germany 0.5% annually for the next two years for the privilege of borrowing from you.

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