

# Relative Value in Securitized Credit: Prepare to Nibble

April 2022 | Phil Gioia, CFA



## Federal Reserve and U.S. Treasury Rates

The old saying “It’s the journey, not the path, that matters most” seems applicable to the path that the Federal Open Market Committee (FOMC) set following its March 16 meeting. The Fed’s hiking cycle began with a 25-basis point (bps) increase in the target federal funds rate (FFR), the first increase since December 2018. Following the meeting, several Fed officials reiterated a hawkish message, arguing for the need to move interest rates back to neutral relatively quickly, and signaled their openness to raise the FFR by 50 bps at future meetings, if necessary. The market’s expectation for the terminal FFR, as well as the Fed’s median dot forecasts, have both moved higher since December 2021 as inflation remains elevated. Since the start of the year, the Treasury curve flattened as front-end yields, which are more influenced by changes in monetary policy than the longer end of the curve, continued to reprice higher. (Figure 1) While the moves at the front end have been most pronounced, yields across tenors have risen and are now higher than February 2020 pre-pandemic levels, with the 10-year Treasury yield at its highest level since early 2019. The journey to higher rates might not be over yet, as the Fed has indicated that the path of monetary policy tightening has the explicit goal of taming inflation.

U.S. Treasury Curve | As of April 8, 2022

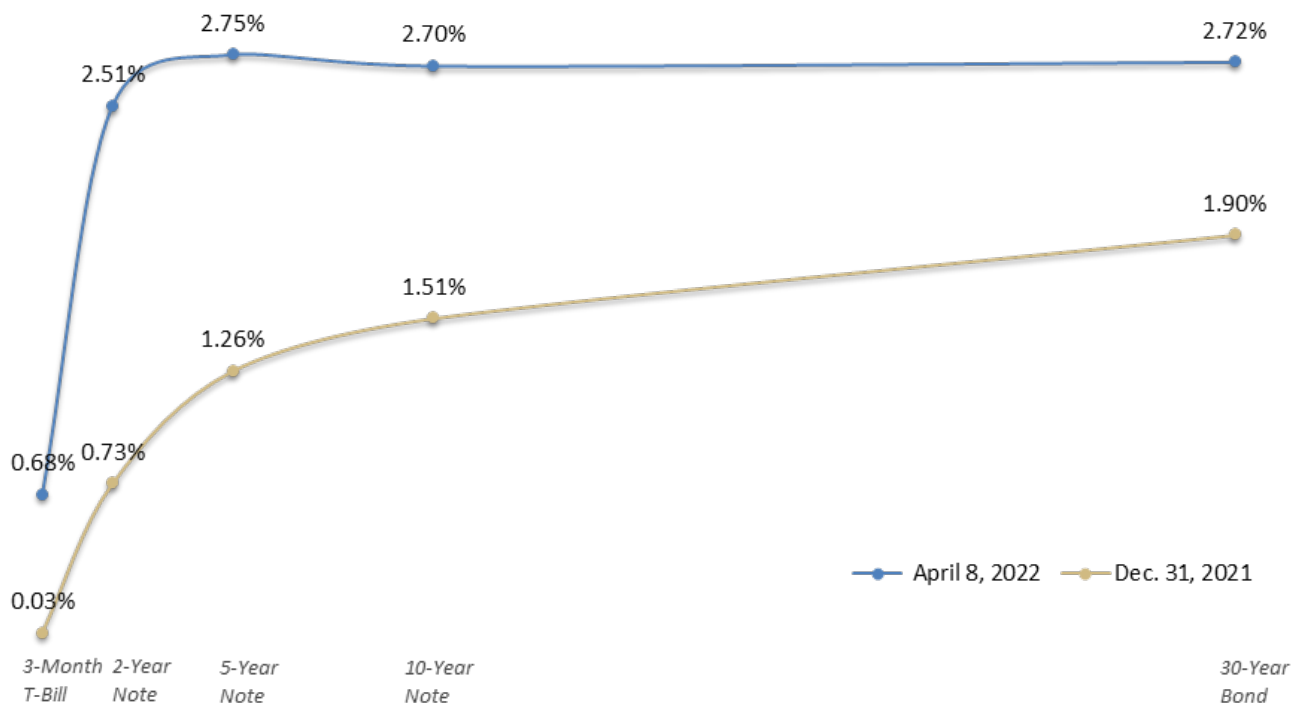
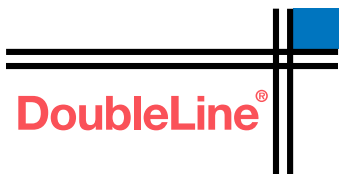


Figure 1  
Source: DoubleLine, Bloomberg



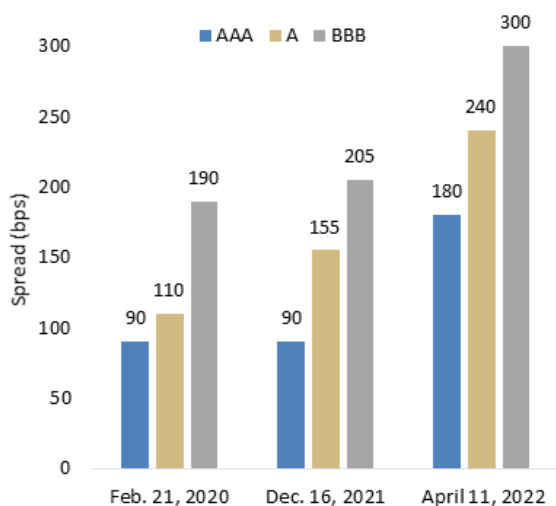
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## Securitized Credit Spreads

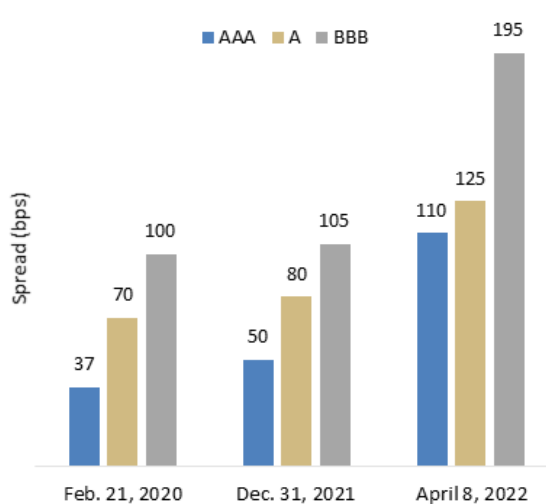
The credit spread widening that began in the final months of 2021 has picked up materially in 2022. Apart from the months immediately following the onset of the pandemic in 2020, many securitized credit spreads across the capital structure are wider today than they've been in over three years. Several factors have contributed to spread widening, including a heavy issuance calendar, a more hawkish Fed and broader macro volatility brought about partly by geopolitical uncertainty. While supply technicals and macro volatility have been the main reasons for widening, fundamentals supporting most of the securitized credit markets remain strong, which should keep defaults and losses relatively contained. We believe underlying fundamentals and more balanced technicals could potentially support a recovery in spreads from current levels into year-end.

**Non-Agency RMBS Non-QM Spreads | As of April 11, 2022**



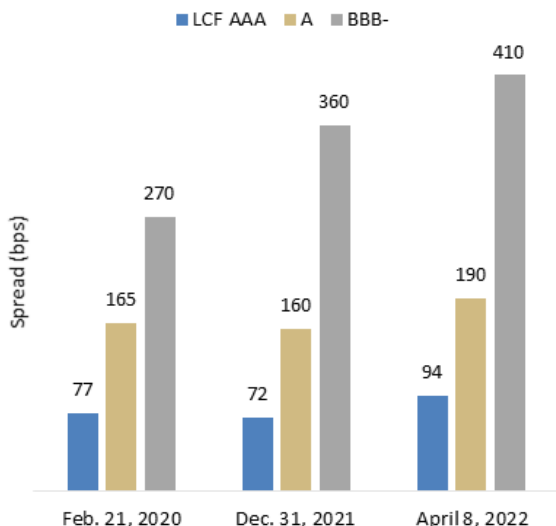
Source: DoubleLine, Bloomberg, Morgan Stanley Research Non-Qualified Mortgage (NQM). Spread over i-Curve.

**ABS Auto Loan Non-Prime Spreads | As of April 8, 2022**



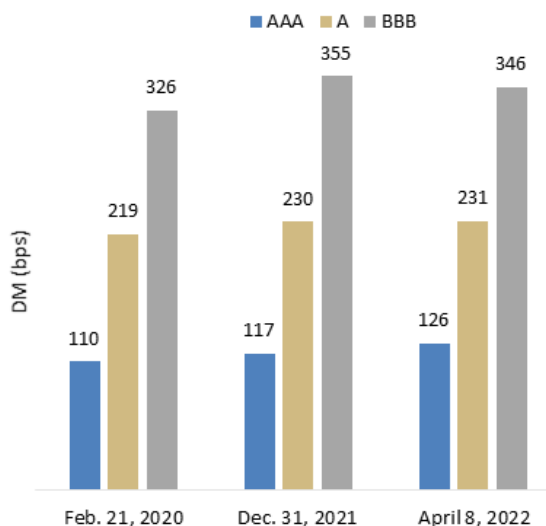
Source: DoubleLine, BofA Global Research

**Non-Agency CMBS Conduit Spreads | As of April 8, 2022**

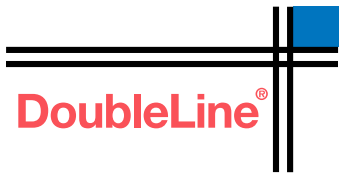


Source: DoubleLine, BofA Global Research. Last Cash Flow (LCF)

**CLO Spreads | As of April 8, 2022**



Source: DoubleLine, Palmer Square. Discount Margin (DM)



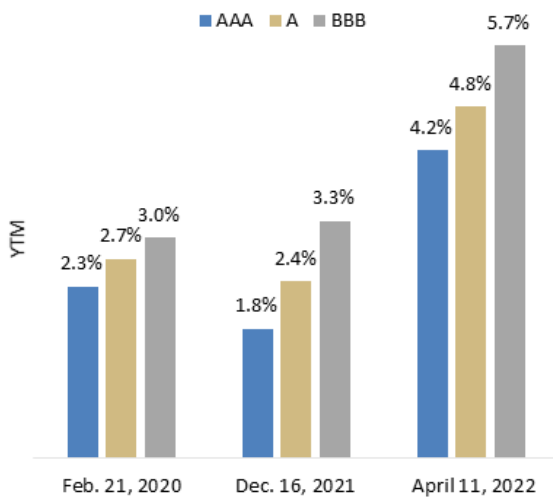
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## Securitized Credit Yields

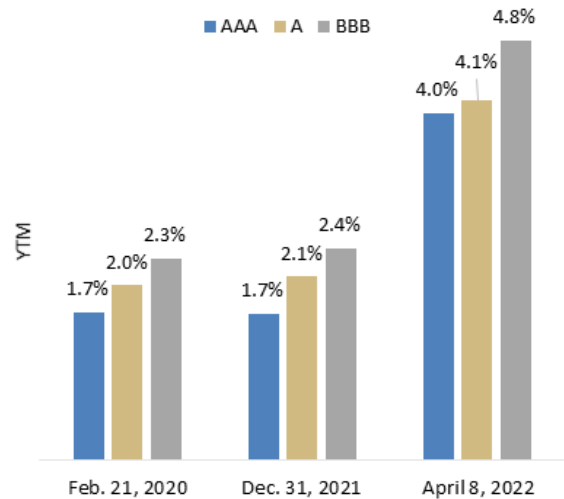
The combination of higher Treasury rates and wider credit spreads has led to higher all-in yields across the capital structure, which represent more-attractive levels today relative to even just a few months ago. At the top of the capital structure, yields are in the range of mid-3% to mid-4%. The mezzanine portion of the capital structure is pricing yields in the mid- to high single digits. Relative to history, senior-rated bonds are trading at some of the highest yield levels in nearly five years. ■

**Non-Agency RMBS Non-QM Yields | As of April 11, 2022**



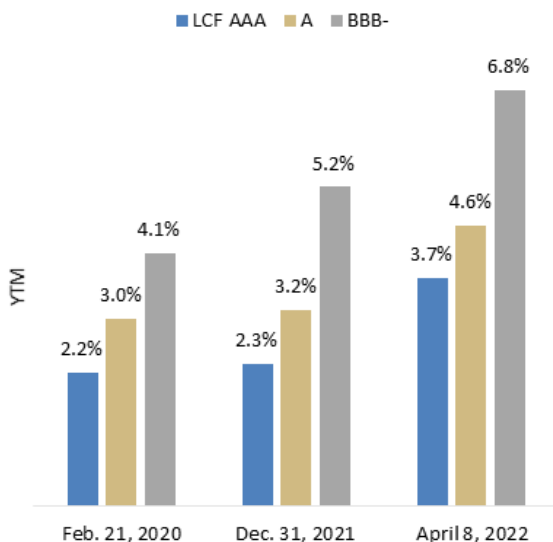
Source: DoubleLine, Bloomberg, Morgan Stanley Research  
Non-Qualified Mortgage (NQM). Yield to Maturity (YTM).

**ABS Auto Loan Non-Prime Yields | As of April 8, 2022**



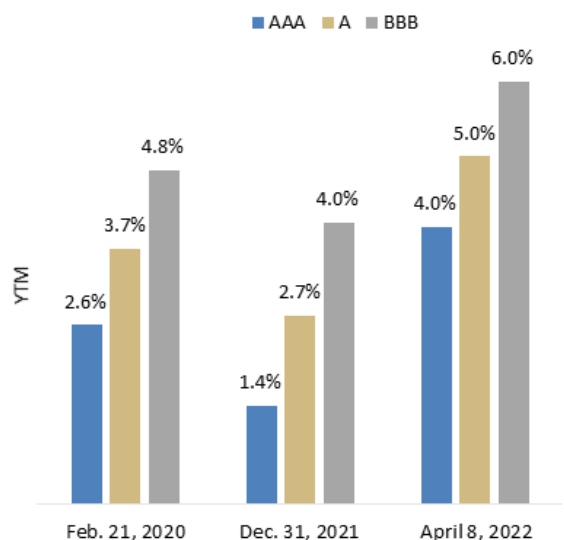
Source: DoubleLine, BofA Global Research

**Non-Agency CMBS Conduit Yields | As of April 8, 2022**

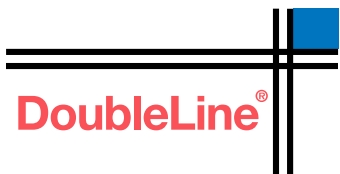


Source: DoubleLine, BofA Global Research. Last Cash Flow (LCF)

**CLO Yields | As of April 8, 2022**



Source: DoubleLine, Palmer Square



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## Definitions

**Asset-Backed Security (ABS)** – Investment security, such as a bond or note, that is collateralized by a pool of assets, such as loans, leases, credit card debt, royalties or receivables.

**Basis Points (BPS)** – Basis points (or basis point (bp)) refer to a common unit of measure for interest rates and other percentages in finance. One basis point is equal to 1/100th of 1%, or 0.01% or 0.0001, and is used to denote the percentage change in a financial instrument. The relationship between percentage changes and basis points can be summarized as: 1% change = 100 basis points; 0.01% = 1 basis point.

**Collateralized Loan Obligation (CLO)** – Single security backed by a pool of debt.

**Conduit Loans** – Type of loans, also known as commercial mortgage-backed securities (CMBS) loans, that are commercial real estate loans pooled together with similar commercial mortgages and sold on the secondary market. On the secondary market, conduit loans are divided into tranches based on risk, return and loan maturity.

**Discount Margin** – Average expected return of a floating-rate security (typically a bond) that is earned in addition to the index underlying, or reference rate of, the security. The size of the discount margin depends on the price of the floating- or variable-rate security. The return of floating-rate securities changes over time, so the discount margin is an estimate based on the security's expected pattern between issue and maturity.

**Dot Plot** – Simple statistical chart that consists of data points plotted as dots on a graph with x- and y-axes. Dot plots are well known as the method that the Federal Reserve uses to convey its benchmark federal funds rate outlook at certain Federal Open Market Committee (FOMC) meetings.

**Federal Funds Rate (FFR)** – Target interest rate, set by the Federal Reserve at its Federal Open Market Committee (FOMC) meetings, at which commercial banks borrow and lend their excess reserves to each other overnight. The Fed sets a target federal funds rate eight times a year, based on prevailing economic conditions.

**Federal Funds Terminal Rate** – This rate is what economists call the “natural” or “neutral” interest rate. It is the rate that is consistent with full employment and capacity utilization and stable prices.

**Federal Open Market Committee (FOMC)** – Branch of the Federal Reserve System that determines the direction of monetary policy specifically by directing open market operations. The FOMC comprises the seven board governors and five (out of 12) Federal Reserve Bank presidents.

**Last Cash Flow (LCF)** – Last revenue stream paid to a bond over a given period.

**Morgan Stanley Capital International All Country World Index (MSCI ACWI)** – This market capitalization-weighted index is designed to provide a broad measure of stock performance throughout the world. It comprises stocks from 23 developed countries and 27 emerging markets.

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**Mezzanine Debt** – Occurs when a hybrid debt issue is subordinated to another debt issue from the same issuer. Mezzanine debt has embedded equity instruments attached, often known as warrants, which increase the value of the subordinated debt and allow greater flexibility when dealing with bondholders. Mezzanine debt is frequently associated with acquisitions and buyouts, for which it may be used to prioritize new owners ahead of existing owners in case of bankruptcy.

**Non-Agency Commercial Mortgage-Backed Security (CMBS)** – Debt-based security (similar to a bond), backed by the interest paid on loans for commercial properties. “Non-Agency” refers to CMBS not issued by the government-sponsored enterprises.

**Non-Agency Residential Mortgage-Backed Security (RMBS)** – Debt-based security (similar to a bond), backed by the interest paid on loans for residences. The interest on loans such as mortgages, home-equity loans and subprime mortgages is considered to be something with a comparatively low rate of default and a comparatively high rate of interest, since there is a high demand for the ownership of a personal or family residence. “Non-Agency” refers to RMBS not issued by the government-sponsored enterprises.

**Non-Qualified Mortgage (Non-QM)** – Any home loan that doesn't comply with the Consumer Financial Protection Bureau's existing rules on qualified mortgages (QMs). Usually this type of alternative mortgage loan accommodates people who are not able to prove they are capable of making the mortgage payments. Just because it is a non-QM mortgage loan does not necessarily mean high risk or subprime mortgage risk, and in many cases these non-QM mortgage loans require a high FICO score but simply do not check all the boxes associated with a QM loan. Non-QM loans for mortgages are protected by the lender against any type of lawsuit should the borrower become unable to afford the loan.

**Prime** – Classification of borrowers, rates or holdings in the lending market that are considered to be of high quality. This classification often refers to loans made to high-quality “prime” borrowers that are offered “prime” or relatively low interest rates.

**Spread** – Difference between yields on differing debt instruments, calculated by deducting the yield of one instrument from another. The higher the yield spread, the greater the difference between the yields offered by each instrument. The spread can be measured between debt instruments of differing maturities, credit ratings or risk.

**Yield to Maturity (YTM)** – The total return anticipated on a bond if the bond is held until it matures. Yield to maturity is considered a long-term bond yield but is expressed as an annual rate.

You cannot invest directly in an index.

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