# Is now the right time to consider diversifying into securitised credit?

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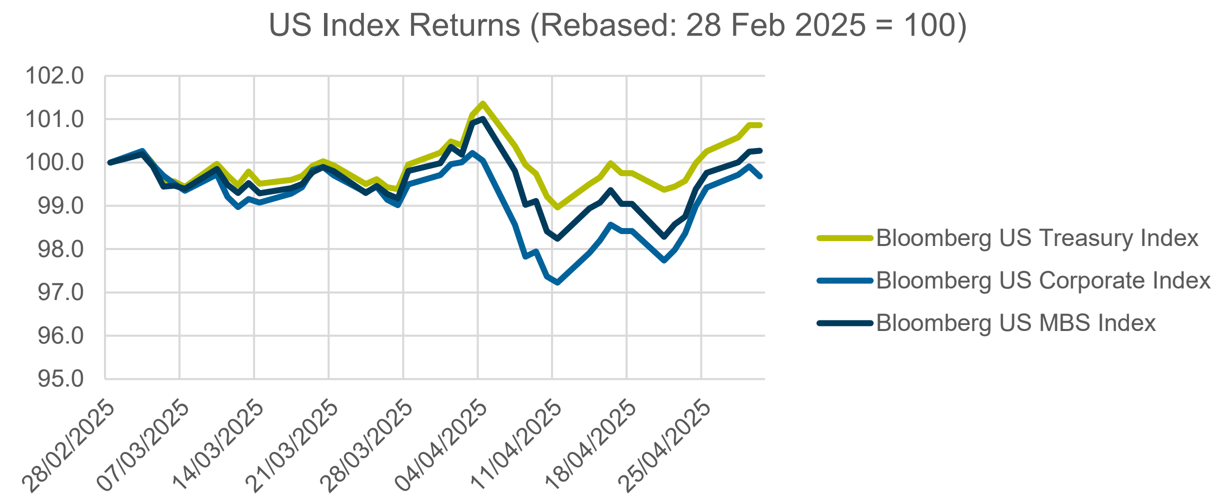
# Given current market volatility and downside risks to credit spreads, is now the right time to consider diversifying into securitised credit?

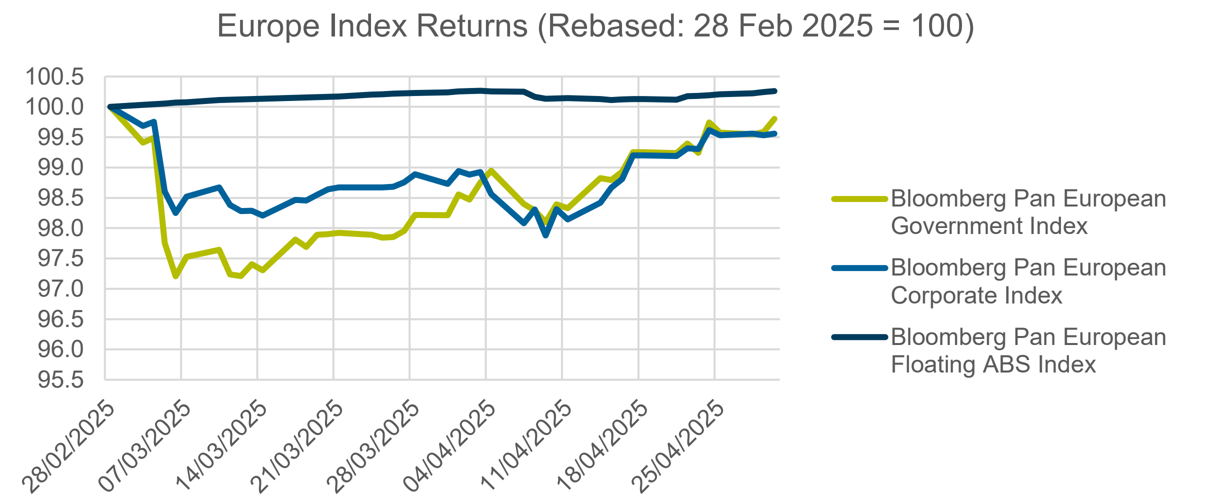
## Market volatility has been high during March and April

With credit spreads towards post GFC tights across sectors at the end of February, markets have proved particularly volatile during March and April with the impact of the “Liberation Day” tariff announcements. Credit spreads widened slightly in March in the run up to the announcements, while there were sharp falls in European government bonds on the back of German plans to loosen fiscal rules. April saw sharper moves wider credit spreads as the Tariff announcements were harsher than market participants expected. Following the 90day pause in implementation for most tariffs, spreads rebounded during the month to post positive returns during April, despite the concerns around economic and credit outlook, and the potential for a continued volatile near term environment.

In securitised credit, volatility was lower than corporate credit given lower credit spread duration and higher average ratings. This was further dampened in European (and Australian) securitised credit by the low exposure to rate volatility as assets are predominantly floating rate.




*Source: Bloomberg, 30 April 2025*



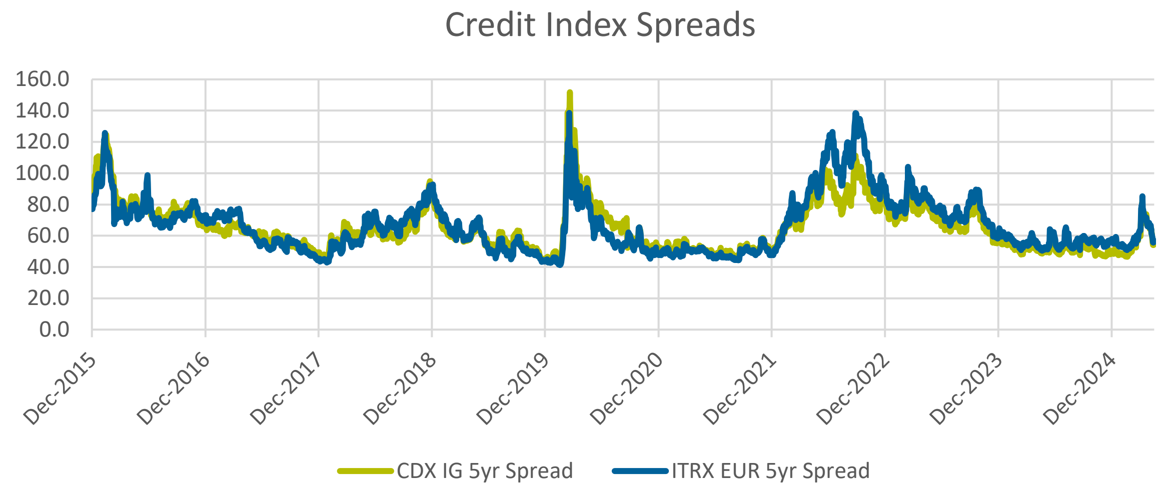

*Source: Bloomberg, 30 April 2025*

March and April have again shown the benefit of floating rate securitised assets naturally having lower market volatility through not being directly exposed to material interest rate risk. Although the best demonstration of this in recent years was the LDI crisis in 2022. Securitised products provided a great source of liquidity for UK LDI strategies given the relatively low price discounts to par compared to alternative government and corporate bond sale candidates following the steep shift in interest rate curve following the UK budget.

## Compensation for the credit component is low versus historic levels

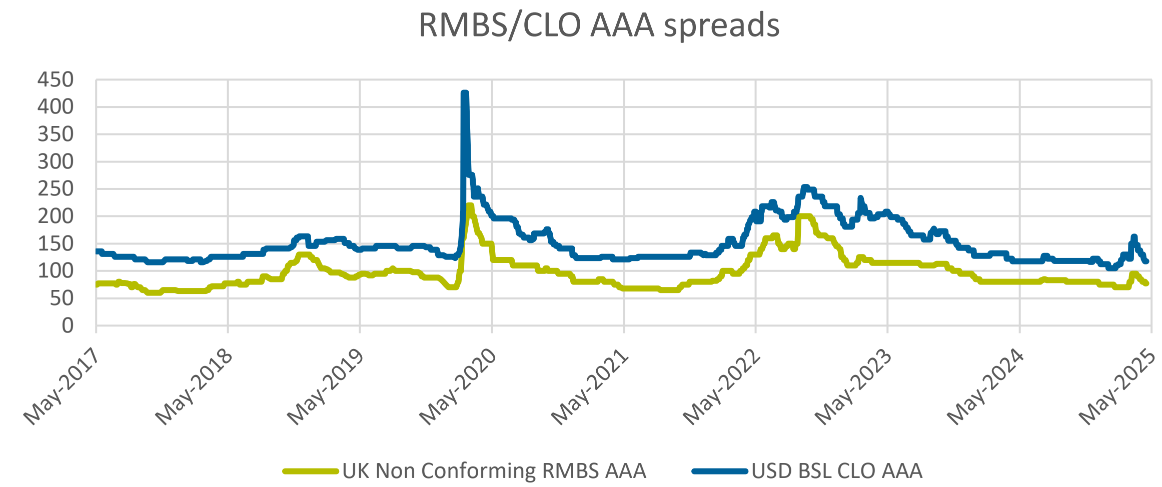
Focusing on IG corporate credit specifically, the compensation for bearing credit risk – as measured by credit spreads – started 2025 towards historically low levels. The spread widening seen in March and April took spreads to higher levels than seen throughout 2024, but spreads have since retraced nearly all of that widening by mid May.

Even if positive on credit fundamentals, or at least understanding that periods of stable/low spreads can persist, the risk vs. return trade-off is now asymmetrically poor for long credit duration, offering limited upside from potential further spread compression vs the risk of large downside in adverse scenarios.




*Source: Bloomberg, 16 May 2025*

A similar situation is seen in securitised products, with both RMBS and CLO spreads towards the tight end of historical levels.




*Source: Citi, 16 May 2025*

## Characteristics of securitised assets contributing to reduced volatility

There are a couple of key characteristics that securitised assets have that can reduce price volatility for these assets compared to typical corporate credit exposures:

1. Credit duration of new issue ABS investments is typically significantly lower than that of corporate credit, reflecting shorter expected credit widows for these assets, and reducing price volatility for similar spread moves
2. European (and Australian) securitised assets are also predominantly floating rate, reducing volatility due to low interest rate exposure.

In a more volatile market environment, having these features can dampen volatility across a fixed income portfolio.

Some key high level differences between benchmark US and European corporate and securitised indices are shown below, highlighting the higher interest rate duration and credit spread duration typically seen in corporate credit:

| Index | Bloomberg US Corporate Bond Index | Bloomberg US MBS Index | Bloomberg Pan-European Aggregate: Corporate | Bloomberg Pan European Floating ABS Bond Index |
|---|---|---|---|---|
| Currency | USD | USD | EUR | EUR |
| Yield (%) | 5.1 | 4.9 | 3.4 | 2.9 |
| Credit spread over swaps (bps) | 156 | 97 | 106 | 72 |
| Interest rate duration | 5.8 | 6.0 | 4.6 | 0.1 |
| Credit spread duration | 5.8 | 5.6 | 4.8 | 2.2 |
| Average rating (S&P equivalent) | A-/BBB+ | AA+ | A-/BBB+ | AA+ |

*Source: Bloomberg 30 April 2025*

Credit spread pick up shown above is higher for corporate credit but the lower ratings should be noted. Credit spreads for equivalent rated securitised credit are significantly higher at the same rating level. So a greater spread pick up in securitised products could be achieved, without a substantial increase in credit duration, by adding mezzanine exposure rather than focusing on senior securitised as shown in the below table:

| UK Non Conforming RMBS (indicative levels) | | | | | |
|---|---|---|---|---|---|
| Rating | AAA | AA | A | BBB | BB |
| Yield (%) | 5.3 | 5.9 | 6.3 | 6.7 | 8.3 |
| Credit spread over swaps (bps) | 85 | 140 | 180 | 220 | 380 |
| Interest rate duration | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 |
| Credit spread duration | 2.5 | 3.5 | 3.5 | 3.5 | 3.5 |

*Source: Challenger IM, 30 April 2025*

## Conclusion

In conclusion, for investors focusing on reducing credit duration and potential market volatility in the current environment, while still maintaining accretive spreads, securitised credit remains a valuable tool for downside volatility management in portfolio construction. Securitised products are often highlighted as a higher risk asset class although their performance in these spells of volatility continues to highlight their defensive nature.

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