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The U.S. Housing Trade Is Far From Over

Why Securitized Credit Should Be Considered a "Through-the-Cycle" Allocation

Executive Summary

- The U.S. housing market still has meaningful upside - in fact, from several perspectives, we are still in the recovery phase
- Market fundamentals are solid:
  - While home prices have just reached the pre-crisis peak, population, labor force and GDP have all increased significantly since the crisis
- Against this robust economic backdrop, we believe securitized credit is a compelling way for investors to diversify a broader credit portfolio—yet the potential benefits of the asset class remain broadly misunderstood

The U.S. Housing Market: Then and Now

While securitized credit has become an increasingly important component of multi-sector strategies like core and core plus, standalone exposure to the asset class has not been broadly accepted by the investment and consultant community. The small subset of investors who have embraced standalone securitized allocations tend to favor opportunistic strategies that emerged in the wake of the 2008 financial crisis, causing many to label securitized credit as a tactical "trade" that is often synonymous with the recovery of the broader housing market. While many investors are starting to question how long the current recovery can continue, we believe the housing market has room to expand. Comparing current economic data with 2007 economic data provides helpful context for the path forward (Figure 1).

Figure 1. Economic Data Suggests the U.S. Housing Market is Only Just Exiting the Recovery Phase

Measure	2007	2016	Change
Population	301MM	325MM	8.0%
Households	116MM	126MM	9.0%
Labor Force	153MM	160MM	5.0%
Nonfarm Payroll	138MM	145MM	5.0%
GDP	$14.5T	$18.6T	28.0%
S&P 500	1,468	2,239	53.0%
HH Net Worth	$66.5T	$92.5T	39.0%
Personal Income	$11.2T	$14.4T	29.0%
Case Shiller*	184.6	185.5	**0.50%**
HH Debt**	$12.7T	$12.6T	**-0.80%**
Housing Debt**	$9.75T	$8.95T	**-8.20%**

*Case-Shiller is an index that tracts nationwide, single-family housing values in the US; the beginning value is measured from its pre-crisis peak, which was set in July 2006
**Household Debt and Housing Debt are sourced from the Federal Reserve Bank of New York's Consumer Credit Panel/Equifax

On the surface, it's easy to see why many investors believe the "housing trade" is nearing its end. As the Case Shiller Home Price proxy in Figure 1 shows, home values have reached levels set during the pre-crisis peak in July 2006. Additionally, total household debt is roughly the same as it was in 2007. In isolation, these two metrics seem to suggest that the housing market has moved well past the "recovery" phase. However, a closer look at the broader macroeconomic backdrop tells a much different story:

- The U.S. population has grown by 24 million people, an 8% increase from 2007
- The U.S. labor force stands at 160 million, which is 7 million more than the labor force in 2007
- The current number of households and nonfarm payrolls are higher, by 9% and 5% respectively
- At nearly $19 trillion, GDP is 28% higher than it was in 2007

So while it's true that home prices and household debt have finally recovered to pre-crisis peaks, the current economic backdrop and demographics should provide ample dry powder to support continued demand for housing. We believe this will allow the housing market to move past the high-water marks set in 2006.

It's also important to note that the recovery has been achieved under a greatly enhanced regulatory regime, which was redesigned in the wake of the credit crisis and deployed in recent years. The implications are broad-based, impacting Government Sponsored Enterprises (GSEs), securitizers, banks, broker-dealers, rating agencies, mortgage servicers and—perhaps most dramatically—mortgage lending standards. With stricter lending dynamics in play, leverage is less and mortgage loans exhibit credit characteristics vastly superior to those underwritten before the financial crisis.

Of course, it's equally important for investors to consider that mortgage loans are just one of the many ways investors can access securitized fixed income. But before we explore the broader securitized market in more detail, let's take a closer look at how most investors currently view the asset class.

Common Applications of Securitized Fixed Income in Broader Portfolio Strategy

To capitalize on the extreme market dislocation created by the financial crisis, a slew of opportunistic securitized credit hedge funds emerged in 2008 and early 2009, attracting strong inflows from investors. In the years that followed the financial crisis, each sub-sector of the securitized credit market massively outperformed through the market recovery — where and what you invested in made little difference. This environment led to outsized returns for many of these opportunistic hedge funds. However, many of these alternative securitized strategies were concentrated in just one segment of the securitized market. Fast forwarding to today's environment, these concentrated strategies looking to deploy cash might be forced to invest in less attractive opportunities or pivot into areas of the market where the manager lacks expertise—this is a recipe that has all the ingredients for unexpected outcomes and underperformance for investors who enjoyed such strong returns in past years.

Perhaps more commonly, investors gain exposure to securitized fixed income via their core and core plus fixed income portfolios. However, the dominant securitized sector in most core and core plus strategies is agency residential mortgage-backed securities (RMBS), which accounts for more than a quarter of the Bloomberg Barclays U.S. Aggregate Index. Due to the nature of the agency guaranty in agency RMBS, there is minimal exposure to credit risk.

Figure 2. Securitized Fixed Income Represents Broad Diversification

	ABS	CLO	CMBS	Non-agency RMBS	Credit Risk Transfer
Primary Fundamental Driver	Consumer	Corporate credit cycle	Commercial real estate	Housing market	Housing Market
Secondary Fundamental Driver	Access to credit	Manager skill	Labor market	Labor market	Labor Market
Key Sector Specific Risk	Student loan market dynamics	Regulatory compliance	Maturity wall	Mortgage servicing risk	GSE Reform
Typical Credit Rating	High investment grade	Mid to high investment grade	Low investment grade	Below investment grade	Below - Low IG
Weighted Average Life	<= 5 years	<= 10 years	3-10 years	4-6 years	2-10 Years
Fixed or Floating	Mixed	Floating	Fixed	Mixed	Floating
Market Size ($ Billions)	$714	$440	$530	$859	$30

Source: Voya Investment Management, SIFMA and Bloomberg. Market size represents outstanding balances as of 9/30/16.

As a result, interest-rate risk is the dominant driver of return for agency-backed residential mortgages. While it's true that non-agency RMBS, commercial mortgage-backed securities (CMBS) and asset-backed securities (ABS) have become increasingly common in core and core plus fixed income portfolios, the total amount allocated to these sectors is still small.

We believe these common applications of securitized credit in portfolio strategy narrow the opportunity set too significantly or otherwise diminish its impact in the portfolio. For investors to truly benefit from the asset class on a sustained, through-the-cycle basis, transparent access to the broader opportunity set in securitized credit markets is much more optimal.

The Many Flavors of Securitized Credit: Why We Believe the Asset Class is a "Through-the-Cycle" Allocation

As figure 2 demonstrates (previous page), securitized credit represents much more than housing-related risk. The total size of the securitized credit market is more than $2.5 trillion—and risk related to the residential housing market only accounts for roughly one-third of the market.

Other primary fundamental drivers of performance in the securitized market include the U.S. consumer (common in many ABS sub-sectors), the corporate credit cycle (especially for CLOs) and the commercial real estate market (primarily for CMBS). In addition, securitized investments offer strong structural protections, relatively attractive yield and fixed and floating rate structures. The weighted average life of securitized credit investments also varies across sub-sectors, providing additional diversification benefits in a broader portfolio. Thus, not only can securitized credit provide diversification from other asset classes, a broad securitized allocation benefits from strong diversification benefits within the individual securitized sub-sectors.

Securitized credit managers with the appropriate expertise across each of the sub-sectors identified in figure 2 can tactically adjust allocations based on the most attractive opportunities and perceived relative value at any given time, which creates the potential for consistent outperformance as market conditions change during and through market cycles.

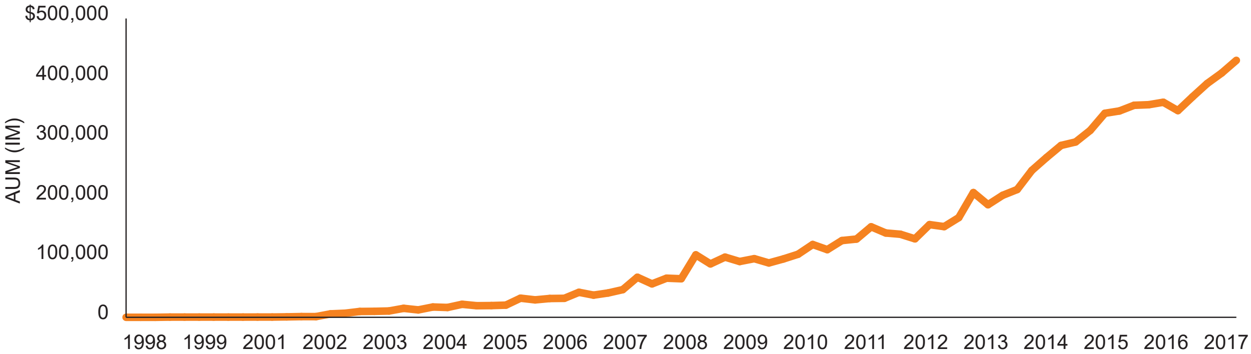
Conclusion: What's Next for Securitized Credit?

It was not too long ago that most investors and consultants viewed bank loans as an esoteric asset class with limited applicability in broader portfolio strategy. Sound familiar?

Figure 3 shows the extraordinary ascent of institutional assets allocated to standalone bank loan strategies in the last ten years. We believe securitized credit is poised to take off in a similar fashion as more investors come to understand and appreciate the benefits of the asset class. As consumers inevitably re-lever and mortgage credit availability potentially thaws, opportunities from higher net new supply may fall in place to help accommodate a truly transformative status for securitized markets.

Figure 3. Once Upon a Time, Institutional Investors Ignored the Benefits of Bank Loans—Securitized Credit is Poised to Take Off in a Similar Fashion

Institutional Bank Loan AUM



Source: eVestment. As of March 31, 2017.

Disclosures

Investment Risks

All investments in bonds are subject to market risks. Bonds have fixed principal and return if held to maturity, but may fluctuate in the interim. Generally, when interest rates rise, bond prices fall. Bonds with longer maturities tend to be more sensitive to changes in interest rates.

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