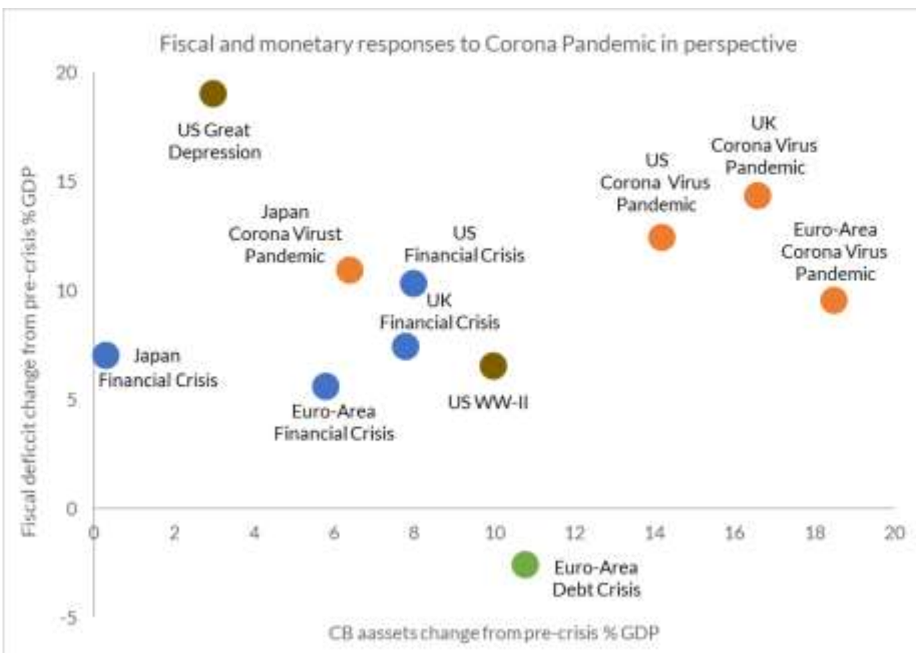
Dear Investors, Friends and Colleagues,

We hope you are keeping well and safe!

What a year it has been. At ZAIS, we produce an internal annual outlook for financial markets and on our asset classes in particular. Our outlook also includes a list of biggest surprises loosely modeled after Byron Wein's annual list.[1] A global pandemic had not made it to the list.

If the pandemic had made the list, we most certainly would not have expected markets to be where they are today. We believe the "whatever it takes" developed world approach of doubling down on the Global Financial Crisis playbook in "warp-speed" clearly helped to avoid bad outcomes as it relates to the financial markets, but has also now laid the foundation for major challenges ahead.[2]

Chart 1[3]



Before we discuss long-term implications, we would like to take a look at 2021. After this year's experience, looking a year ahead might already feel like a lifetime to some of us.

Our macro picture for 2021 is guided by:

- Multiple vaccines being widely distributed by spring
- Massively pent up consumer demand for anything resembling the "old normal"

- Improving business outlook for heavily Covid-affected sectors – as long as they survive the next six months
- Falling unemployment but with lingering business and labor market dislocations caused by the recession unlikely to heal quickly
- An additional fiscal support package
- Continued record low rates coupled with further $3-4 trillion in asset purchases by Global Central Banks

Given this background, we expect our asset classes to perform strongly. The table below depicts our best guesses for 2021 total returns in a selection of BB tranches in some of the sectors we invest in. [4] As you can see, (a) we expect spreads still will be significantly wider than pre-Covid and (b) spreads don't even need to return to pre-Covid levels to get to a return exceeding 10%.

Asset Class	Current spread	Pre-Covid Spread	Assumed 12-month change in Spread	12-month Carry	Predicted 12-month total Return
ABS BB	550 bps	275 bps	-150 bps	6.25%	10%
CLO BB	815 bps	510 bps	-150 bps	7.20 %	16%
RMBS (CRT B1/B2)	675 bps	365 bps	-100 bps	7.50%	11.50%
CMBS BB	1,250 bps	550 bps	-175 bps	6.40%	13.40%

Target Returns are not a reliable indicator or future performance

There are obviously many other rating categories and asset classes. Nevertheless, we believe that if current circumstances continue, in 2021, investors should be able to earn solid returns in structured credit in a world of zero interest rates. That said, not all securities are created equal and this will remain a credit pickers' market. We expect CRE and CMBS markets to show the most dispersion, followed by corporate loans, as it appears to us those sectors will have Covid-related winners and losers.

We also expect increased opportunities in renewable asset classes, including solar, where we believe various market opportunities exist.

As someone who grew up in Fixed Income, I find it very troubling to see how little fixed income in a traditional sense is left for an investor to earn today. I believe we have reached a point where the term Fixed Income does not even make sense anymore. Over 25% of investment grade securities in the developed world return negative yields. [5]

As is evident in the chart below, the last decade has seen the longest period of negative real policy rates recorded in the last 160 or so years, except during the Civil War, WWI and WWII. [6]

This historically low-to-negative rate environment has lifted valuations on many other asset classes to very extreme levels. [7]

Many popular investment approaches like 60:40 and risk parity will be challenged going forward. Hedging historically expensive equities with historically expensive bonds might be an exercise in futility. Models build on past relationships might struggle to perform in a fundamentally different environment, potentially leading to underperformance in the years to come.

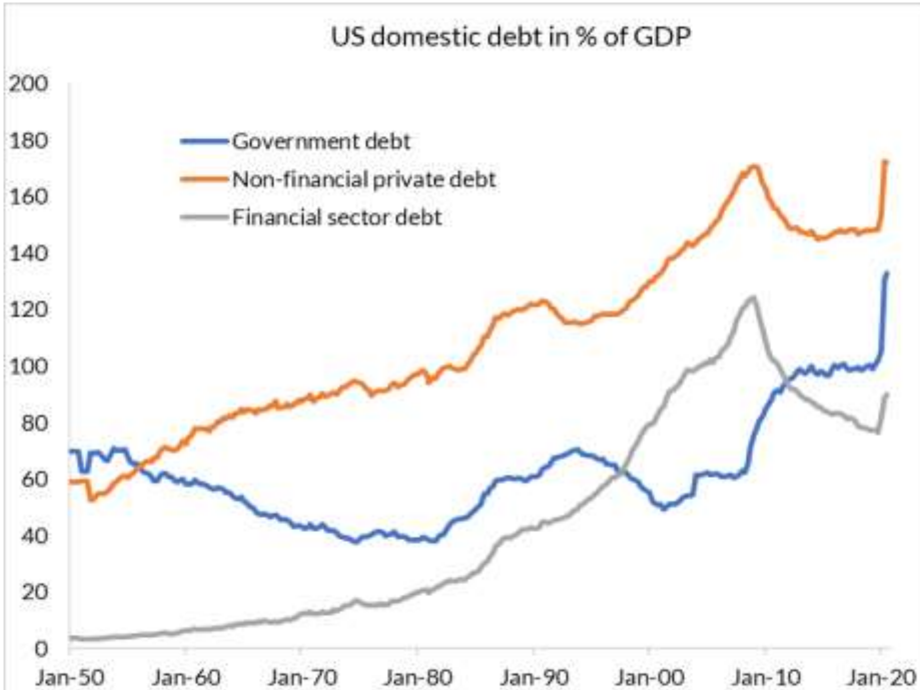
If we assume yields just go up 25bps one year from now, a newly issued 10-year Treasury bond price would fall by 2%, losing more than two years of income.

If bond yields rise from their current levels, the price declines would overshadow the increase in income, unlike during the 1970's when fairly rich coupons of 8% or higher offset price drops.

How likely is it that long-term rates will go up and, if so, by how much? Are we facing a paradigm shift not unlike 30 years ago with the fall of the Berlin Wall and the emergence of China as the supplier of the West?

We believe there are strong arguments to be made that we are looking at a return to a more negligent "pre-Volcker" monetary policy coupled with subsiding global deflationary forces.

Moreover, when Volker tightened policy in the late 1970s, public debt was less than 40% of GDP, while today that ratio is more than 130%; private non-financial debt was less than 100% of GDP, (today, more than 170%) and financial sector debt was less than 20% of GDP (today, 90%). Overall domestic debt was about 150% of GDP in the early Volker days and today it is touching 400% of GDP.[8]

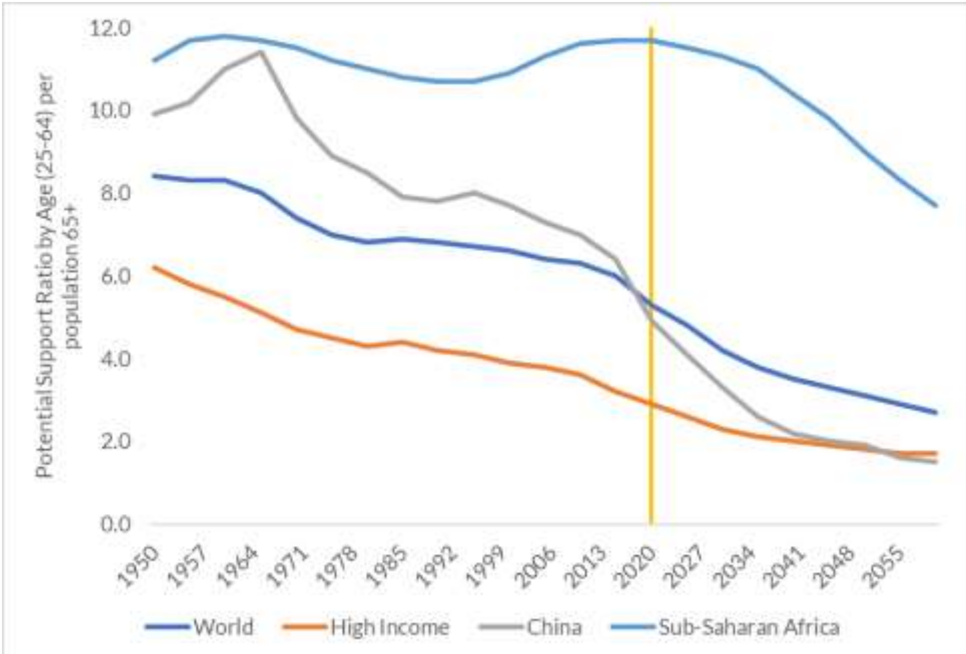


This creates a perpetual cycle: the US Federal Reserve Bank ("Fed") is keeping interest rates low to maintain stability and leverage keeps rising; as long as interest rates are low, deficits don't really appear to matter.[9] Modern Monetary Theory proponents take it even further, arguing that as long as a country borrows in its own currency, deficits never matter.[10] With the Fed balances having almost doubled this year alone one could argue we are well on our way.[11]

The modern-day Fed is at risk of repeating the "anguish of central banking."[12] Arthur Burns drew the following conclusion in his remarks in 1979:

"It is illusory to expect central banks to put an end to inflation that now afflicts the industrial democracies[; this] does not mean central banks are incapable of stabilizing actions; it simply means that their practical capacity for curbing an inflation that is continually driven by political forces is very limited."

Furthermore, we believe a rapidly aging labor force in both the West and China will, at a minimum, eliminate the deflationary forces we have seen at work over the past 20+ years, further supporting the case for lasting changes. Back in the 1970's when capital and trade flows were more restricted and the world was split along ideological lines, US workers were sheltered from global competition. The fall of the Berlin Wall and China ultimately joining the WTO added roughly 1.6bn workers to the global work force; interestingly the only area that will see an increase in working age population will be Sub-Saharan Africa.[13]



What inflation rate can be expected? Is there such a thing as an ideal inflation rate? The Fed publicly has stated that higher inflation can be tolerated.[14]

If you assume a rate of 3.5%, prices would double in 20 years. Everything else being equal that would halve the deficit in nominal terms.

We see inflationary pressures bubbling up, which are being curtailed by the pandemic; once the pandemic lifts so will inflation, and with that long-term bond yields.

In conclusion, one day Fixed Income will mean something again. Until we get there, we believe investors should stay invested in Structured Credit. Our markets should pay you an excellent return while you wait for higher government bond yields. Or, another way of saying it is: what government bonds did for portfolios back in the late 1970's, structured credit markets will deliver this time around.

We at ZAIS recognize and appreciate the trust you have placed in us over the past 20 years and we look forward to continuing working with you.

Wishing you a healthy and happy Holiday season,

Christian Zugel

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[1] Blackstone, "Byron Wien and Joe Ziddle Announce the Ten Surprise of 2020" January 6, 2020.

[2] Mario Draghi, European Central Bank ("ECB") President, in a speech to the ECB, July 23, 2012.

[3] Percent of GDP: International Monetary Fund, World Economic Outlook Database, October 2020. Central Bank Assets: Federal Reserve Bank of St. Louis Economic Data, "Eurostat, Gross Domestic Product (Euro/ECU series) for Euro Area (19 Countries)," "Total Assets for Japan," "Bank of England, Total Central Bank Assets for United Kingdom," "Board of Governors of the Federal Reserve System (US), Assets: Total Assets: Total Assets (Less Eliminations from Consolidation)," November 20, 2020.

[4] As of November 2020, based on ZAIS's observations in the market throughout 2020. The specific figures on the table are based on internal modeling. ZAIS used either representative bonds or index in our assumptions.

[5] Bloomberg, World's Negative-Yield Debt Pile Has Just Hit a New Record, November 5, 2020.

[6] Federal Reserve Bank of St. Louis Economic Data, "National Bureau of Economic Research, Call Money Rates for United States," "National Bureau of Economic Research, Index of the General Price Level for United States" November 18, 2020.

[7] Oaktree Capital, "Howard Marks' Latest Memo: Coming Into Focus," October 14, 2020.

[8] Federal Reserve Bank of St. Louis Economic Data, "U.S. Bureau of Economic Analysis, Gross Domestic Product [GDP]," November 24, 2020.

[9] Jason Furman and Lawrence H. Summers, "Who's Afraid of Budget Deficits," January 28, 2019.

[10] For additional information on MMT and ZAIS's view on this subject, please see our ZAIS Insight – MMT is Flawed. This article can be found on our website or upon request.

[11] Federal Reserve Bank of St. Louis Economic Data, "U.S. Bureau of Economic Analysis, Gross Domestic Product [GDP]," November 24, 2020.

[12] The Per Jacobsson Foundation, Arthur F. Burns, FED Chair 1970 -1978 "The Anguish of Central Banking" September 30th, 1979.

[13] United Nations, Department of Economic and Social Affairs, Population Division (2019). World Population Prospects 2019, custom data acquired via website.

[14] Five year – five year forward inflation expectations have already etched back up to 2.2% and are at the highest level since early to mid-2019. Strategas, "Macro Findings From 3Q Earnings Season – The Daily Macro Brief," November 30, 2020.

Opinions

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