ZAIS Insights

January 2020

Synthetic Corporate Credit Update

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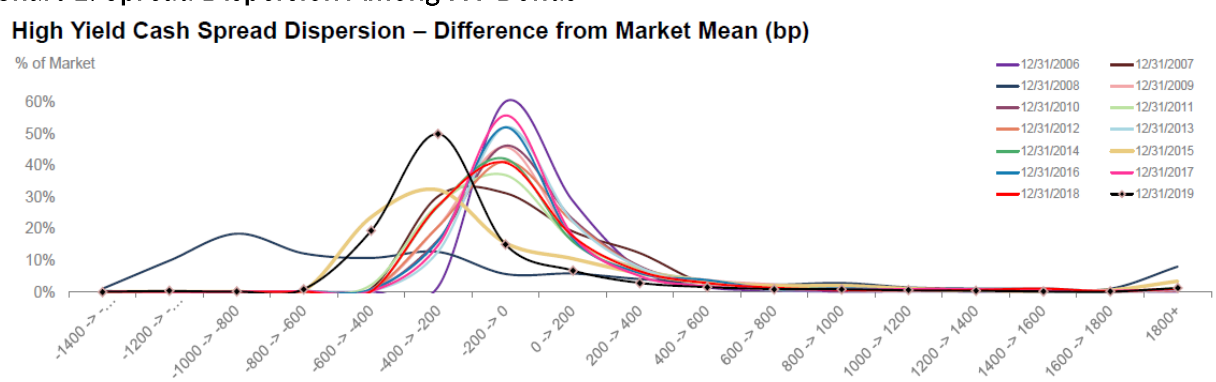
2019 turned out to be a year of strong performance for corporate credit returns as a whole. At the sub-sector level, however, there were differences: the high yield bond and loan markets experienced a significant uptick in dispersion, while the investment grade market was less affected, despite concerns of balance sheet leverage levels increasing for companies rated in A and BBB.

In high yield, we saw spread widening across several sectors on an idiosyncratic basis, as better quality names tightened while lower quality and storied credits widened.

There was also a meaningful uptick in downgrades versus upgrades in 2019, with net downgrades up 106% year over year as the effects of tightening monetary policy in 2018 took hold of levered credits.[1]

The credit curve, as defined by ratings, became very steep in the second half of the year through November.

Chart 1: Spread Dispersion Among HY Bonds



Source: "US Credit Strategy: 2019 Performance Recap", Morgan Stanley, January 6, 2020

Chart 2: 2019 Leveraged Loan Prices

Source: Morgan Stanley, "US Leveraged Loan Commentary: All is Well", January 10, 2020.

The dispersion in high yield bonds (see chart 1) and loans caused a significant selloff in the subordinate debt and equity tranches of both CLOs and HY indices,[2] as well as bespoke pools of credit with exposure to the tail credits.

Toward the end of the fourth quarter, the effects of the Fed's rate cuts and increased liquidity, coupled with a de-escalation of the trade conflicts, enabled a rally in credit, with the weakest assets performing the best.

As shown in Chart 2, the price difference between BB and B loans declined significantly in December 2019; the weakness has continued into January.

This rally in loan prices, especially in weaker credits, supported outperformance of subordinate tranches in CLOs and tranched corporate synthetics in December 2019.

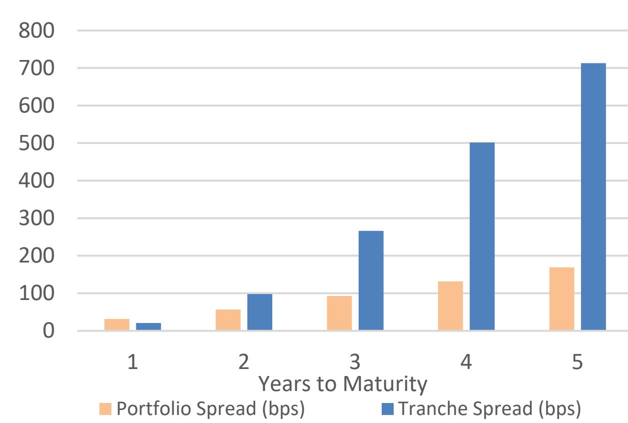
On average, spreads are still tight in high yield bonds and loans, yet there is still a large amount of dispersion among credits.

While we do not anticipate a very elevated uptick in defaults this year, given our benign growth outlook, we think some idiosyncratic defaults will continue to occur.

We currently favor subordinated debt tranches with exposure to high yield bonds and loans, but we target shorter dated exposures, typically found in the synthetic tranches, which we believe are poised to receive maximum benefit from the shortening weighted average life of the tranche as the credit risk declines and it trades tighter (i.e., optimal "roll-down").

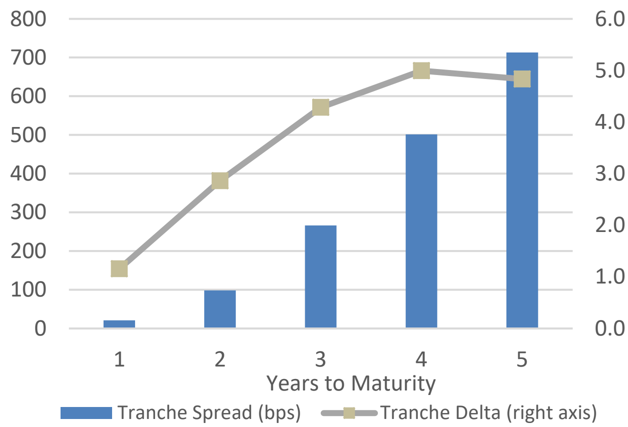
Charts 3 and 4 depict the recent underlying portfolio spreads of a currently available bespoke pool of High Yield and Investment Grade credits at various maturities, and the spreads on a sample mezzanine tranche off of that pool of credits at various maturities.

Chart 3: Sample Portfolio and Mezzanine Tranche[3]



Source: The sample portfolio and mezzanine tranche data presented is based on ZAIS's analysis of market data.

Chart 4: Mezzanine Tranche Spread and Delta[4]



Source: The sample portfolio and mezzanine tranche data presented is based on ZAIS's analysis of market data.

The roll-down is steep at each interval, and we tend to prefer maturities within three years, as we believe we may be approaching the later part of this credit cycle.

We believe these tranches should benefit significantly from a tightening of credit spreads as time passes, simply by rolling down the credit curve if credit spreads are range bound. Even in a scenario of modest spread widening, there will likely be some benefit from rolling down the credit curve, albeit less pronounced.

We also believe there are interesting opportunities to invest in senior tranches backed by investment grade credits with low spread diversion, all of which can be done with efficient leverage to enhance returns.

More information

As always, we are available to discuss our views with you. Please contact your Client Relations representative at +1 732 978 9722 or zais.clientrelations@zaisgroup.com to discuss this topic further.

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[1] Morgan Stanley Credit Desk, "US Leveraged Loan Commentary: All is Well", January 10, 2020.

[2] Bloomberg, "Leveraged Loan Buyers Are Running for Cover as Fear Ramps Up", October 25, 2019.

[3] The portfolio and mezzanine tranche data presented in Charts 3 and 4 reflect ZAIS's analysis of a currently available bespoke pool of High Yield and Investment Grade credits at various maturities, and the spreads on a sample mezzanine tranche constructed from that pool of credits at various maturities. Additional information about our analysis is available on request.

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