Resilient U.S. consumers boost structured assets

Jason Callan, Senior Portfolio Manager, Co-head of Structured Assets
Ryan Osborn, Senior Portfolio Manager, Co-head of Structured Assets

Banner Title: The state of the U.S. consumer

Jason Callan: It's a world where you believe that the consumer should exhibit a little bit more stress given the magnitude of how elevated interest rates are from where they came from, that over time, through the lens of financial conditions and traditional lags of monetary policy, that it would start to slow consumption and start to eat into consumer-based delinquency metrics. And the reality is it hasn't for the most part.

So the linchpin that's holding this all together is really the strength of the housing market and maybe the robustness of consumer balance sheets and income statements going into this environment. We came from an environment where consumers had built up a high degree of what's referred to as excess savings from the variety of different forms of fiscal stimulus that's been provided.

And so the wealth effect is definitely real for consumers, and it's certainly provided a greater degree of resiliency even though interest rates have risen quite a bit.

Ryan Osborn:

Higher rates are impacting U.S. households very differently. We're looking at more affluent borrowers, and they're continuing to perform very well. And if we think about how inflation has impacted households, that is part of it, where households with more affluence have more discretionary income, they're able to absorb the increased cost of gas and groceries much easier. On the other hand, less affluent households are more challenged right now. When the price of gas at the pump goes up, when groceries go up, they are impacted more.

Banner title: Positioning: Opportunities and risks

I think what we're most excited about right now, in structured products, is really two things. Agency mortgage-backed securities, which are currently at very elevated spread levels. As we reach the end of a hiking cycle, we think that we'll start to see some stability in the valuations in that segment. And we should see spreads tighten, very meaningfully.

The other area is in non-agency mortgage-backed securities. Now, housing is a little bit challenged right now, in terms of affordability, but delinquency rates are at all-time lows. We have a supply shortage across the country, in terms of available units for sale. So, home valuations are actually holding in quite nicely.

We think there are risks to that market, particularly if rates remain elevated or move even higher. But we can mitigate that risk through security selection. And this is really driven by our credit research team. We're targeting a very specific type of borrower.

We're cautious on commercial real estate. We think that this is a story that's going to take a long time to play out, especially if interest rates remain elevated. But even aside from that, there's some real fundamental concerns, whether it's demand for office space and businesses reevaluating how much space they need in light of the hybrid or work-from-home environment that we've all been in.

But also we're a little bit concerned about some of the lower end borrowers. So subprime borrowers or middle tier borrowers that have been really pinched by inflation, and also are more vulnerable to higher rates because they tend to be people that carry a balance on credit cards.

I think investors need to be thinking about moving out of cash at this point in time. The returns in cash and cash-like instruments have been very attractive for the last 12 months, but I think it's time to start thinking about extending duration and I think that is agnostic of whether or not we're going into a recession or we have a period of slow growth.
