

SECURITIZED SPOTLIGHT

Carry Now, Pay Later

JEFFREY T. KATZ | GORDON LI, CFA | 7 JANUARY 2025



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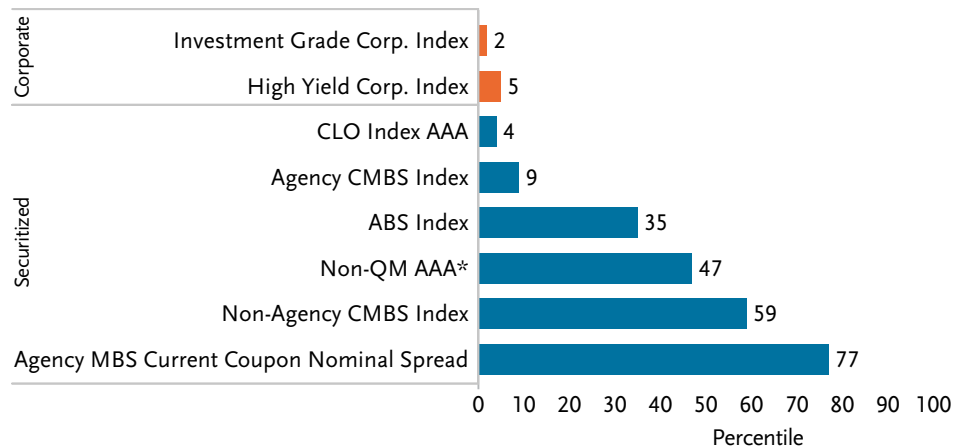
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Mr. Li is an Analyst in the Fixed Income group, specializing in mortgage-backed securities. Prior to joining TCW in 2019, he was a trader at HSBC Global Banking and Markets focused on asset-backed securities. Mr. Li earned a BS in Finance and Mathematics from the New York University Stern School of Business and a MS in Financial Economics from Columbia Business School. He is a CFA charterholder.

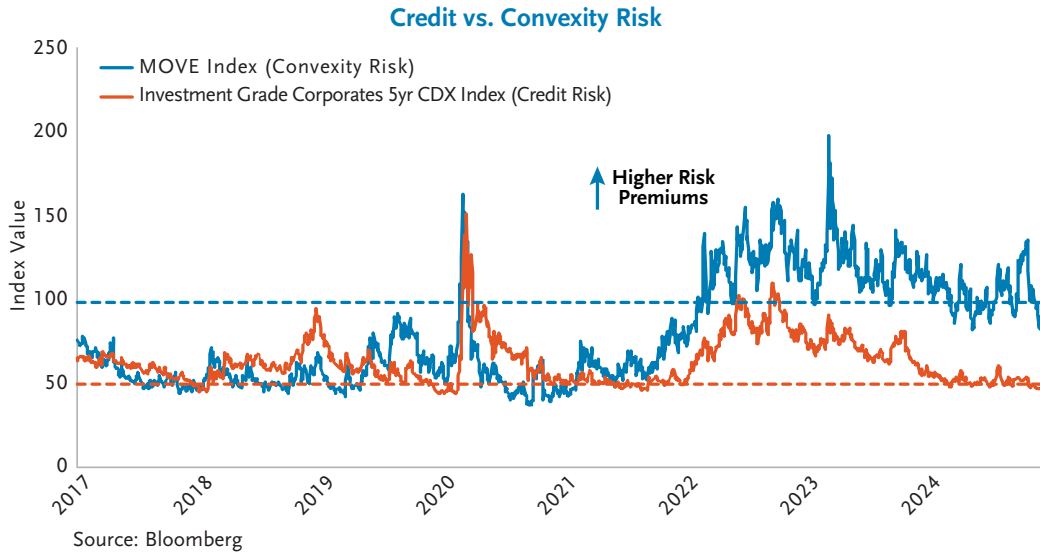
In a year that provided ample opportunity to derail markets, risk assets ultimately emerged unscathed. The onset of the Fed cutting cycle did little to lay out a definitive path for interest rates – market expectations whipsawed from ten to two cuts by the end of 2025 as September’s fiery 50-bp (basis point) cut on data misfires devolved into December’s meek “hawkish cut” on apparent economic resiliency. All the while, the specter of the election loomed before “resolving” in a Republican sweep that introduced further fiscal and inflationary unease. With risk-free yields still at the highest levels in a decade, and no *obvious* disasters on the horizon, complacent investors never had it easier: carry now, pay later!

For fixed income markets, this sentiment resulted in the continued richening of the “carry trade” as buyers – many tempted by all-in yields north of 6% – drove credit spreads to multi-decade tightness. Indeed, spreads for corporate credit, and its securitized cousin collateralized loan obligations (CLOs), have compressed to the tightest ranges in a decade as premiums for taking on credit risk vanished on exuberance for carry. Meanwhile, the rate-centric volatility that has come as part and parcel with monetary uncertainty this cycle has produced outsized opportunities in agency mortgage-backed securities (MBS) and resulted in the sympathetic cheapening across correlated securitized sectors – with spreads still hovering in the 50th to 80th percentiles. In other words, capturing high-quality spread in bonds backed by sound fundamentals, bulletproof structures, and cold hard cash (flows) makes much more sense to us today than banking on the promises of corporations, especially against the current economic backdrop and risk premiums.

Spreads Current Value Percentile (Last 10 Years)

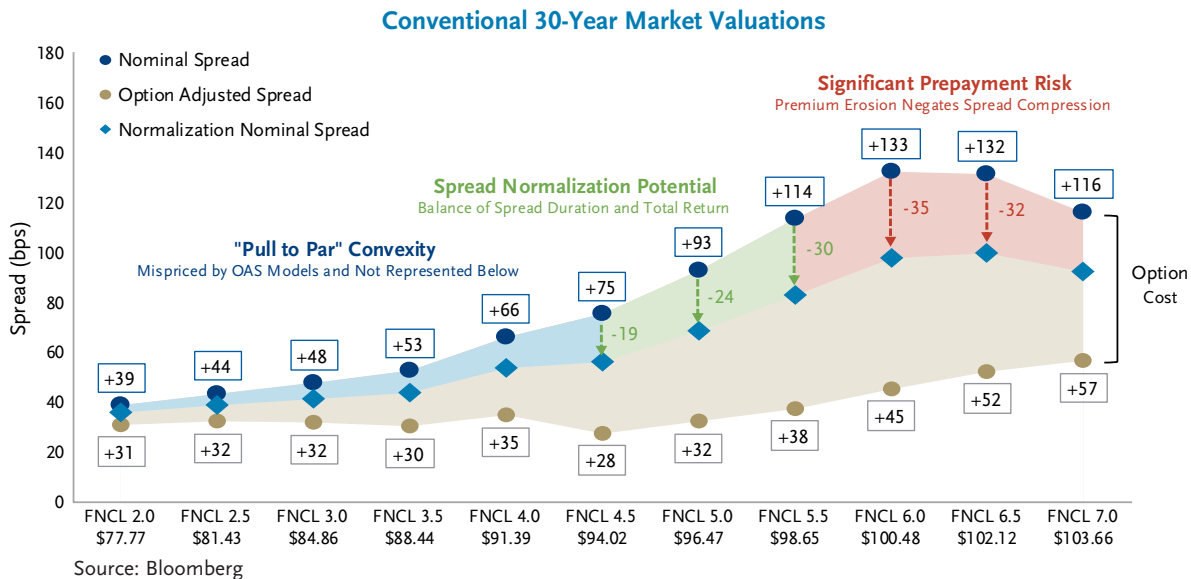


Source: TCW, Bloomberg, JP Morgan
*Non-QM data from 2019



The story of agency mortgages is fundamentally one about interest rate volatility, and that has been running higher than usual in the years following the pandemic. When tracking the MOVE Index, an indicator of the premium the market charges on prepayment risk, it appears that the onset of the Fed cutting cycle did little to stifle uncertainty as interest rate volatility is currently running at double pre-pandemic levels. This has proved to be a fundamental headwind for mortgage spreads and thwarted a return to normalcy. In the eventuality that models and the market recalibrate to lower volatility levels, prepayment uncertainty – option cost in the language of mortgage nerds – priced into MBS would fall, providing a boost to valuations and driving tighter nominal spreads.

That said, the agency mortgage “basis” is anything but uniform. Not all MBS overweights are created equal, and each part of the coupon stack offers investors distinct opportunities for alpha generation (and destruction). The belly coupons, priced at slight discounts, offer a balance of spread duration and total return and are likely to benefit the most from spread and volatility normalization. The lower coupons, priced at \$80, offer significant total return potential via “pull to par” convexity that is not captured by mortgage models (currently priced to historically low turnover speeds for life). On the flipside, premium erosion due to significant prepayment risk would negate any benefits of spread compression in the current coupons. As exemplified by the “vicious” rally in the third quarter – during which discount profile excess returns trounced that of the premium coupons – the comfort of carry evaporated rather quickly as the higher-for-longer narrative faltered and prepayment risk reemerged.





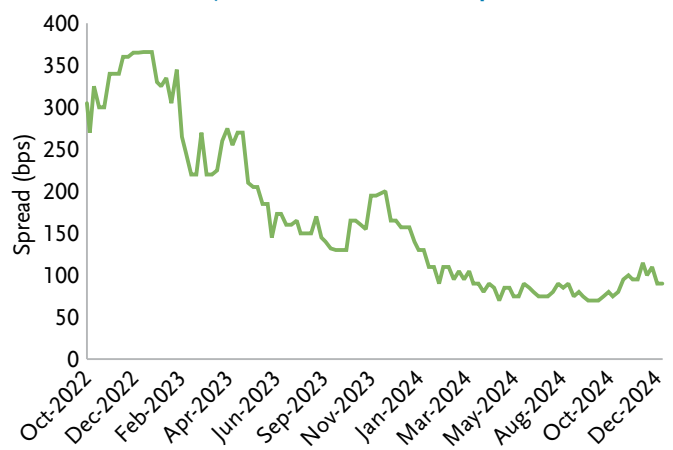
In securitized credit, insatiable demand for all-in yield fueled a “virtuous” cycle of reaching for returns further and further down the thinly offered capital stack. As in any market where demand far outstrips supply, prices went up. Coming into 2024, investors in newly issued commercial mortgage-backed securities (CMBS) could walk away with 200 bps of yield above risk-free rates for AA-rated risk. By the end of the year, those same investors would need to venture all the way down to the BBB-rated part of the stack to hit the same yield bogey. As the year wore on, this phenomenon reverberated across securitized markets as investors, dazzled by decade-high yields, threw their sensibilities regarding adequate risk pricing out the window. Credit curves – the spread difference between senior and subordinated bonds – flattened across sectors as mezzanine spreads compressed to near post-crisis tightness while AAA-rated risk remained somewhat anchored by historically wide agency mortgage valuations. To be sure, “normal” pricing of risk in decidedly less-than-normal times is certainly not an indication of bargains on the table and taking on *more* credit risk for *less* spread compensation hardly screams value.

CLO AAA-BBB Curve Steepness



Source: JP Morgan

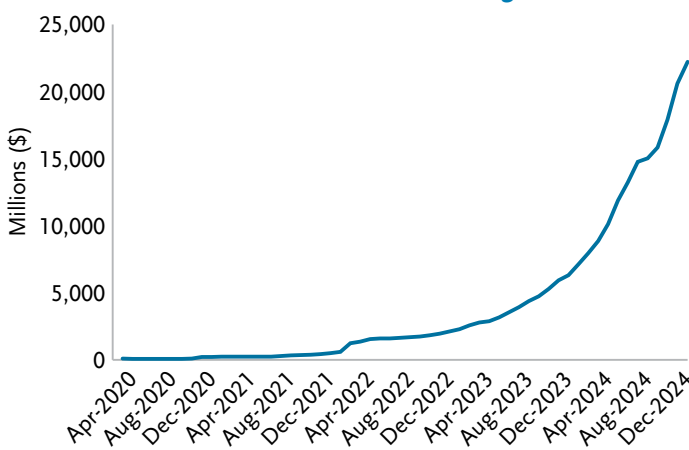
Non-QM AAA-BBB Curve Steepness



Source: JP Morgan

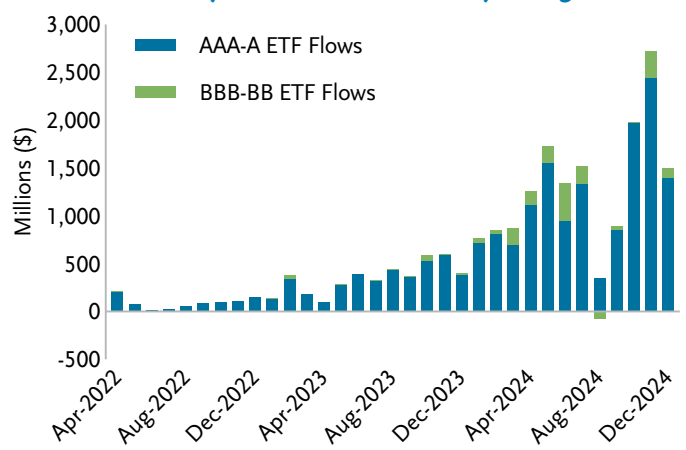
Retail investors have also thrown their hat in the ring. With net inflows of over \$15 billion last year, the CLO exchange-traded fund (ETF) sector has more than tripled its assets under management to \$22 billion and emerged as an asset class in its own right. For retail investors, the appeal of AAA-rated CLOs this cycle has been clear – stable returns, low volatility, great income – and access has been made particularly easy for both asset allocators and private wealth through the proliferation of dedicated ETFs. This dynamic, paired with historically high amortizations and liquidations that have disproportionately affected the AAA part of the capital structure, has driven CLO net issuance into negative territory and emerged as a powerful technical tailwind in support of spreads. Carry on!

CLO ETF Total Assets Under Management



Source: Bank of America

Monthly CLO ETF Fund Flows by Rating



Source: Bank of America

Income never is a full-cycle investment strategy, especially in a world where *risk-free* rates make up over 80% of *risk-y* yields... the highest since the Global Financial Crisis. In the tug of war between value and technicals – between spreads and yields – value will likely prevail as pricing for credit risk returns to its fundamental moorings. Lest investors forget the mathematical tenet that *strong* returns and *high* prices today equate to *lower* prospective returns and the greater likelihood of *softer* prices tomorrow. While a carry now, pay later approach to asset allocation may appear to be the path of least resistance at this juncture, the downsides may be more costly than anticipated when the time comes to close the tab. ■

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