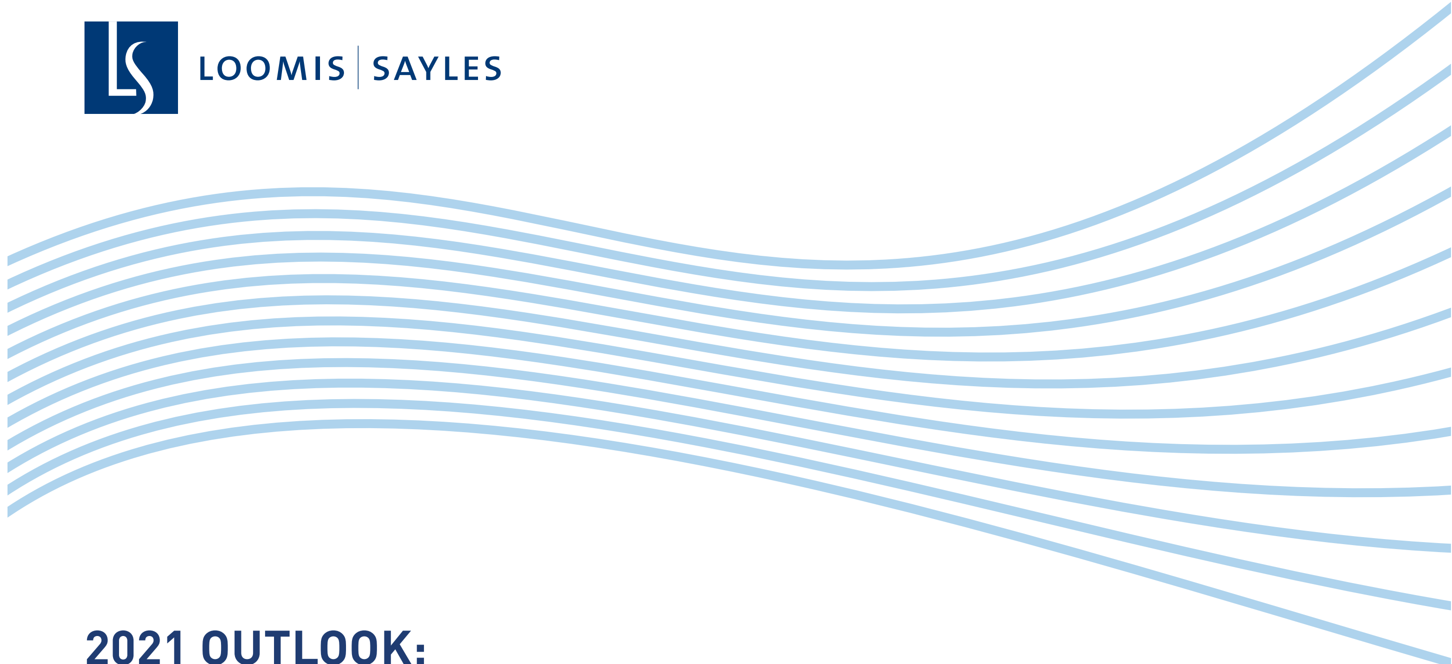
LOOMIS | SAYLES



2021 OUTLOOK: THREE QUESTIONS FOR LOOMIS SAYLES' SECTOR TEAMS

Editor's Note: We're changing things up. Every year, Loomis Sayles features outlooks from our sector teams — teams composed of traders, analysts, strategists and portfolio managers immersed in their respective sectors of the market. This year, we're tailoring our outlooks to focus on what's top-of-mind for many investors. We asked each sector team three questions that drill into key themes in their respective sectors.

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2021 OUTLOOK: THREE QUESTIONS ON THE MACRO BACKDROP

By Craig Burelle, Senior Macro Strategies Research Analyst – **JANUARY 5, 2021**

1
What are some key macro themes that could drive asset performance in 2021?

We see three key drivers supporting asset performance in 2021—COVID-19 vaccine distribution, supportive fiscal policy and monetary policy accommodation.

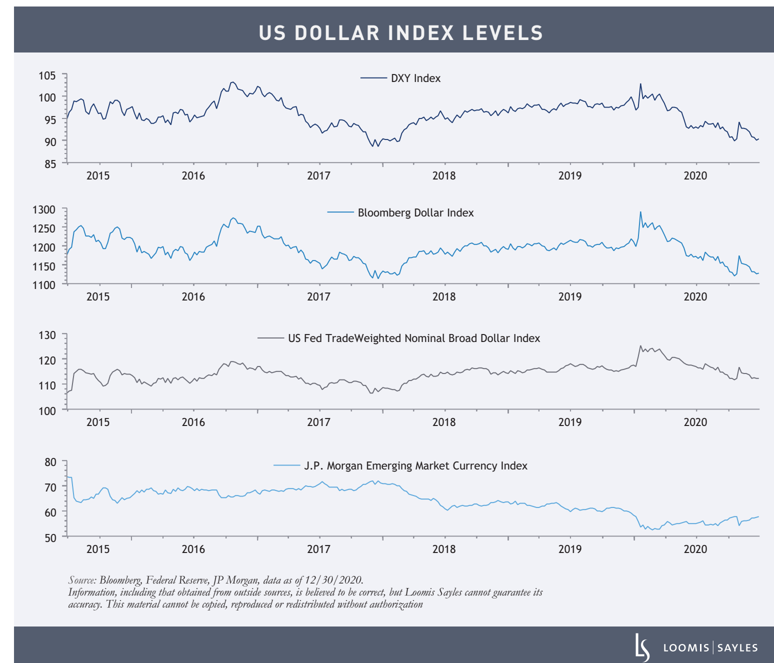
Let's look at the first driver, COVID-19 vaccine distribution. The likelihood of an effective vaccine and its distribution has had the markets priced for optimism as they anticipate an eventual end to social distancing measures. As long as the vaccine remains effective and distribution stays on track, risk sentiment should be positive. However, any setbacks may cause investors to reassess valuation levels.

We believe the second driver, supportive fiscal policy, is critical for carrying consumers and small businesses through what will likely be a difficult few months. We expect growth to moderate in the first quarter of 2021 as COVID-19 continues to surge, but continued fiscal support should help contain economic weakness and keep investors focused on the longer-term outlook.

Finally, central banks around the world have signaled their intention to keep monetary policy accommodative for a long period of time, likely beyond 2021. Markets appear satisfied with a dovish tilt to monetary policy. However, ultra-low rates and sizable liquidity are likely to keep developed market and investment grade corporate bond yields in a tight range.

2
The Loomis Sayles Macro Strategies Team believes we're in the recovery phase of the credit cycle, which is historically consistent with a weakening dollar. Do you see a weaker dollar trend in 2021?

Yes. We expect the dollar to slowly trend weaker as long as risk appetite remains strong and the global recovery continues. However, we're not calling for a multi-year dollar bear market; we think the weakness will be relatively modest. It's a space we're watching closely.



3
Which asset classes are positioned to perform well in this environment?

We believe relatively higher-yielding asset classes could perform well if the credit cycle progresses through the recovery phase, particularly in emerging markets and foreign exchange. US high yield corporate credit could also benefit from improved economic activity. However, for long-term investors, we believe security selection will be important for helping to distinguish quality securities from those that may be riding the tide of positive investor sentiment.

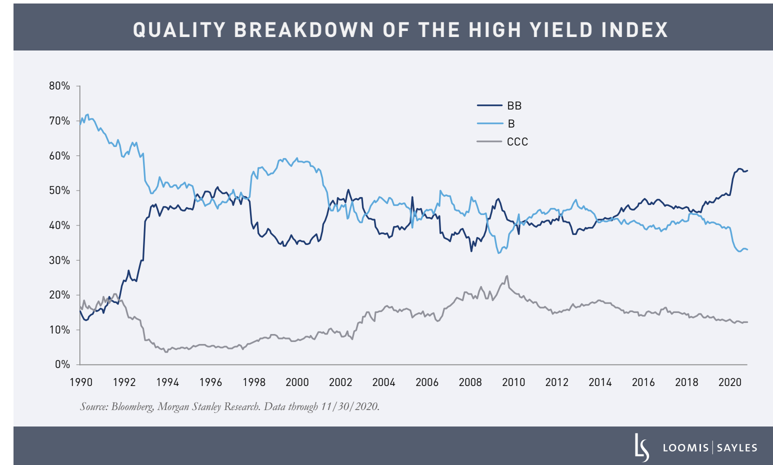
2021 OUTLOOK: THREE QUESTIONS FOR THE HIGH YIELD SECTOR TEAM

By the Loomis Sayles High Yield Sector Team – **JANUARY 6, 2021**

1

About $184 billion of investment grade debt was downgraded to high yield in 2020. How could these downgrades affect the high yield market in 2021?

Rating agencies downgraded a number of weaker investment grade credits in the wake of the COVID-19-induced downturn, flooding the high yield market with fallen angels and expanding the share of BB-rated debt. At the same time, CCC issuance continued to contract, a trend that began before the global pandemic. Together, these forces have helped to increase the overall credit quality of the high yield market. We believe the higher average quality of the market could help drive high yield spreads toward historic lows on the back of unprecedented amounts of global quantitative easing.



2

What are your default estimates for 2021? How do these expectations shape your outlook for spread levels?

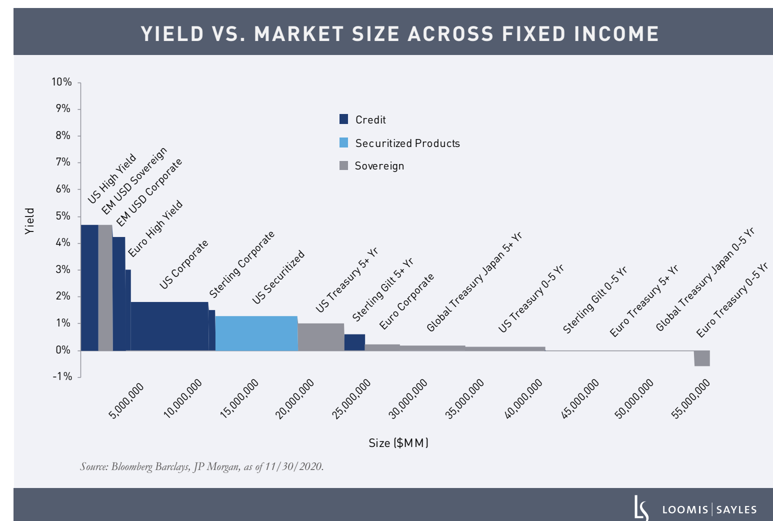
Generally, Wall Street has projected high yield default rates of 4%-6% over the next 12 months, but current market pricing suggests that number could be even lower. With less than 4% of the high yield index trading below $90 and less than 0.50% of the market trading below $60, the market seems to be betting on default rates being very low.[1] Further, the strength of the new issue market suggests market participants may be willing to refinance almost any capital structure, which we believe is a sign that the Federal Reserve has done its job to help ensure capital is freely flowing.

Given the recent positive news on multiple COVID-19 vaccine approvals and releases, we tend to agree with the market view on default and loss rates. We believe our expectations for low losses due to defaults could provide ample space for spreads to compress further.

3

Where do you see value in the high yield market?

Overall, we believe the US high yield market can offer strong yield potential relative to the global marketplace. Within the high yield market, we believe there are pockets of value in industries that were hit particularly hard by COVID-19, including airlines, leisure, commodities and aerospace/defense. These credits have generally outperformed recently on vaccination optimism, but we see opportunity for additional tightening.



1 Bloomberg Barclays, as of 12/29/2020.

2021 OUTLOOK: THREE QUESTIONS ON EMERGING MARKET EQUITIES

By Ashish Chugh, Portfolio Manager, Global Emerging Market Equities – **JANUARY 8, 2021**

1

Outside of Europe and Hong Kong, global equity markets are near all-time or 52-week highs. What is your view on emerging market (EM) equity valuations? Can EM equities continue the strong performance seen in the second half of 2020?

We see several factors that should contribute to strong EM equity markets in 2021:

- Stronger consumer and business confidence due to the COVID-19 vaccine rollout
- Manufacturing sector recovery from a low base
- A rise in global travel and tourism
- A US administration with a less hawkish attitude toward globalization
- Continued strong V-shaped recovery in China
- Accommodative monetary policy from the US Federal Reserve and the European Central Bank (ECB)

If growth in EM economies rebounds as we anticipate, inflation could play the spoilsport. However, we believe economic recovery could help supply chains normalize and aggressive developed market monetary expansion could help EM currencies appreciate, which should contain inflation pressure. Several of these emerging economies also have high real interest rates that should afford their central banks room to maneuver. EM economies have benefited tremendously from the surge in global liquidity unleashed by the Fed and ECB. This increased liquidity was one of the key factors supporting a significant increase in EM hard-currency sovereign debt issuance during 2020. Conversely, declining liquidity and/or a steepening of the US yield curve could certainly pressure the debt dynamics of some EM countries, which could hurt their equity markets.

EM equities currently look expensive on a price-to-earnings basis, trading at almost 15x compared to the 20-year mean of almost 11x.[1] However, when taking into account the prevailing low interest rates, we believe EM valuations look attractive on a forward-earnings-yield-ratio[2] basis, which is currently at around 8.0, two standard deviations cheaper than its long-term average of 5.0.[3]

2

Emerging market economies are a diverse bunch. As markets anticipate a global recovery, are there certain economies that you believe are well positioned?

We believe the Indian economy is well-positioned as we enter the new year. High-frequency indicators such as power demand, manufacturing PMI, passenger vehicle sales and tax collections point to a strong rebound in growth. Indian corporates have largely taken advantage of the environment to restructure, cut costs and raise capital for future growth. The resulting operating and financial leverage could help boost consensus earnings and macroeconomic growth estimates.

Further, the policy response from the government and the Reserve Bank of India (RBI) has bolstered investor confidence. The government passed historic agricultural bills that could make the sector more market-driven, boost productivity and attract investment. Other reform measures include incentives for manufacturing and proposals for privatizing India's rail system, one of the largest rail networks and employers in the world. Investors have also welcomed proposed labor reforms that could attract American and Japanese supply chains to India. In our view, the RBI has done a commendable job navigating through the storm by cutting benchmark interest rates, infusing domestic liquidity, easing regulations and communicating with the market. All of this, in addition to a good harvest and a recovery in exports, should continue to help investor sentiment.

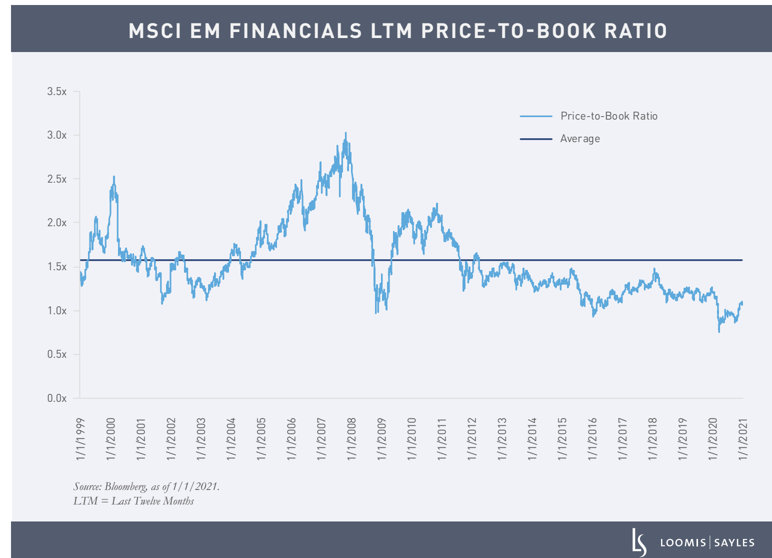
Going forward, the RBI will have to adroitly manage the "impossible trinity problem"—the trilemma of maintaining an open capital account, setting an exchange rate and having an independent monetary policy. This needs to occur within the context of a tight fiscal situation, as public sector borrowing could exceed 15% of GDP in fiscal year 2021 and the fiscal deficit could hit 7% of GDP—twice the budgeted amount. Furthermore, inflation has been creeping higher due largely to supply bottlenecks and ample liquidity.

3

At the height of the pandemic, the EM equity financial sector was selling off on concerns of liquidity, loan quality, and loan moratoriums. Were those fears unfounded? What is your outlook for the sector in 2021?

While the selloff in EM financials was understandable given the uncertain economic outlook at the time, we believe the price action in many financial stocks was too severe, reflecting valuations last seen during the global financial crisis. In response to the pandemic, many EM banks and other financial companies provisioned excessively due to concerns about worsening asset quality. They pulled back from lending, hoarded capital to maintain a defensive position, and suspended dividends. EM central banks also resorted to unconventional measures to help protect the financial sector, including loan moratoriums, easing of loan classifications, loan restructurings and relaxing non-performing loan (NPL) recognitions. These measures were in addition to the monetary and fiscal stimulus unleashed by developed and several EM central banks. As a result, the EM financial sector, for the most part, has been able to survive the storm quite well, incongruent with the initially dire view of the equity markets.

We believe a rebound in growth in EM economies should lead to a normalization of provisioning expenses and a recovery in credit growth. EM banks have remained well-capitalized. EM regulators that suspended dividend payments are likely to allow banks to resume those payments soon. The EM financial sector index ended 2020 down more than 8%, significantly underperforming the broader MSCI Emerging Markets Index, which was up more than 18%.[4] We believe valuations of EM financials remain attractive trading at 1.10x price/book compared to their long-term average of 1.58x price/book.[5]



Source: Bloomberg, as of 1/1/2021.
LTM = Last Twelve Months

1 Bloomberg, as of 1/1/2021.
2 Forward earnings yield ratio is defined as the reciprocal of the 12-month forward P/E ratio divided by the US 10-year Treasury yield.
3 Bloomberg, as of 1/1/2021.
4 Bloomberg, as of 1/1/2021.
5 Bloomberg, as of 1/1/2021.

2021 OUTLOOK: THREE QUESTIONS FOR THE EMERGING MARKETS DEBT SECTOR TEAM

By the Emerging Markets Debt Sector Team – **JANUARY 11, 2021**

1

Emerging markets (EM) corporate spreads have almost recovered to year-end 2019 levels, as strong issuance was met with even stronger investor demand. Do you see this trend continuing into 2021?

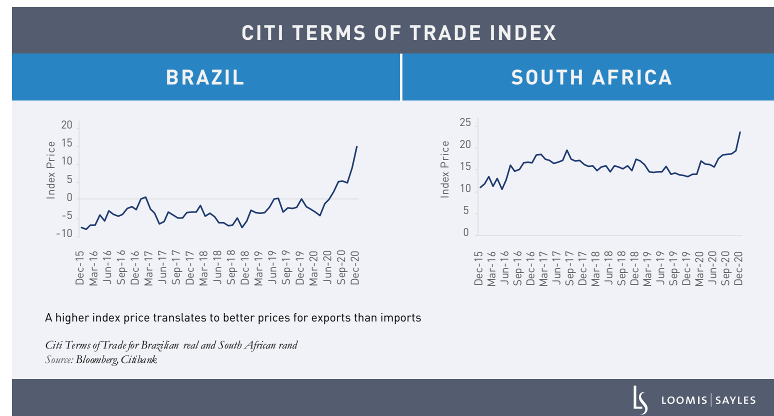
Yes, we see several factors that could drive EM corporate spreads tighter from here. The global economic recovery is the most important factor in our view. We believe widespread fiscal and monetary support and vaccination campaigns around the world could support a strong recovery. Additionally, spread levels have remained wide to historical ranges. EM high yield and investment grade both currently offer yield premiums versus their counterparts in developed markets; we believe this will attract yield-hungry investors to the asset class. Surprise upward growth revisions in Q4 2020 would also tend to support spread tightening.

We acknowledge that valuations are more challenged. Absolute yields have fallen, but considering the case for recovery, EM spreads likely have room to tighten toward their historical average range.

2

What is your outlook for emerging market foreign exchange (EMFX)? Is now the time to get into EMFX?

After a volatile year, we have an optimistic view of EM currencies for 2021. Risk sentiment has remained strong, and we currently consider many currencies undervalued. We believe the US dollar will continue to weaken in 2021 as the economic recovery gains momentum. This macro backdrop combined with higher prices for metal and food commodities could provide a nice tailwind for many currencies, such as the Brazilian real and the South African rand. Terms of trade[1] have already improved significantly in these countries, as shown in the charts below. This should encourage economic growth, helping to support stronger currencies. The Turkish lira's volatility made headlines during the last quarter of 2020, but a recent shift toward more orthodox economic policies from Turkey's central bank could lead the lira to a better path in 2021.



A higher index price translates to better prices for exports than imports

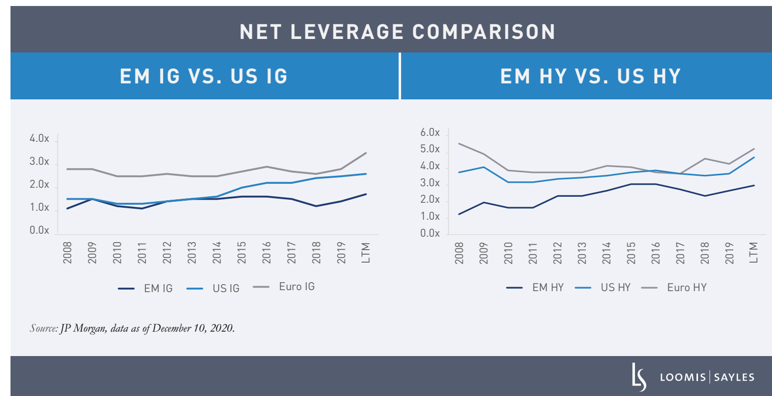
Citi Terms of Trade for Brazilian real and South African rand
Source: Bloomberg, Citibank

3

2020 was a tough year for leverage. Are you concerned about leverage or default rates going into 2021?

COVID-19 created significant challenges for EM sovereigns. In 2020, sovereign debt stocks ballooned and fiscal deficits widened. Defaults in the sovereign JP Morgan EMBI Global Bond Index are at the highest level since 2001. Looking ahead, we expect default rates to decline. The most vulnerable countries have, for the most part, restructured their debt. Low interest rates, demand for yield and an improved growth environment should support near-term improvement in sovereign balance sheets

In the EM corporate space, we considered fundamentals to be in good shape before the pandemic. EM corporates have staved off meaningful fundamental deterioration in 2020 with net leverage estimated to move modestly higher across both investment grade (+0.2x) and high yield (+0.3x). EM corporate net leverage has remained meaningfully below developed market levels. The 2020 default rate stood at 3.5%.[2] The sectors hit most by the pandemic (oil and gas, gaming, transport) drove leverage metrics up. Heading into 2021, we expect the overall trend of deleveraging to resume. The EM corporate default forecast is 2.5%.[3] We see several factors that could help mitigate defaults, including limited at-risk maturities, a constructive macro backdrop and issuer fundamental strength. We also anticipate that more sectors will benefit as the economy normalizes. We saw signs of this during Q3 2020, when many sectors improved upon second-quarter revenues and real estate, industrials and infrastructure reported positive year-over-year growth for the quarter.



1 The ratio of export prices to import prices.
2 Source: JP Morgan as of January 6, 2021.
3 Source: JP Morgan as of January 6, 2021.

2021 OUTLOOK: THREE QUESTIONS FOR THE GLOBAL CREDIT SECTOR TEAM

By the Loomis Sayles Global Credit Sector Team – **JANUARY 12, 2021**

1

Net leverage in the euro investment grade (IG) credit market reached all-time highs in 2020. About €47 billion of the market was downgraded to high yield during the year. What are your expectations for credit metrics going forward? How much of the market may still be at risk for downgrades?

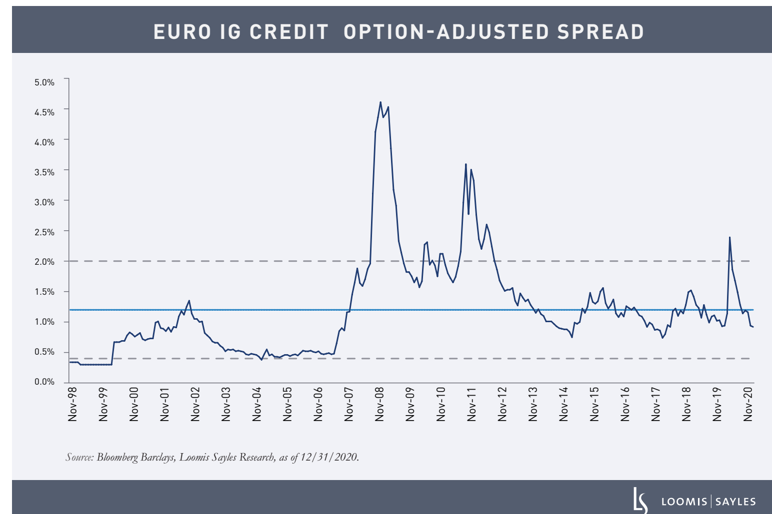
We expect to see an improvement in credit metrics starting in the second quarter of 2021, based on comparisons to last year and an anticipated recovery in economic activity as the COVID-19 vaccine is distributed. We believe the first quarter is likely to show further deterioration in credit metrics given the ongoing shutdowns and timing of the vaccine rollout. Leverage deterioration varies significantly by sector and appears broadly dependent on exposure to COVID-19-related shutdowns, with some sectors unscathed and others hit much harder.

Given our outlook for a significant bounce in economic activity in 2021, we expect fallen angel risk to be low. However, if the economic downturn is prolonged, we believe there is a large volume of IG names that may be at risk of downgrade. Within high yield, we expect the default rate to be lower in Europe versus the US, largely due to the European Central Bank's support of the corporate bond market. The ECB does not directly buy high yield bonds, but its participation in the IG market provides indirect support to the high yield market.

2

How do valuations look in the euro and sterling credit markets? Do you expect any opportunities or risks to arise as the Brexit process draws to a close?

The premiums in these markets have collapsed as the markets have rallied. However, improving company fundamentals and economic activity suggest the cycle is firmly in recovery and spreads may grind tighter. We believe COVID-19-exposed names and those in lower parts of the capital structure can offer a significant premium and should continue to compress as investors reach for potential yield. We believe the technical picture remains supportive—the ECB will continue to buy corporate bonds, supply is expected to decline in 2021 after a busy 2020, and cross-currency headwinds should diminish with euro corporates less rich than US corporates.



Source: Bloomberg Barclays, Loomis Sayles Research, as of 12/31/2020.

Now that the UK and Europe have agreed on a limited trade deal for the post-Brexit world, we expect the UK premium in credit, which had already mostly disappeared, to become non-existent. The UK faces significant, concurrent headwinds stemming from the change in its trading relationship, the COVID-19 shock, the Scottish independence issue, migration policy changes, and the prospect of fiscal tapering. We believe these issues could create opportunities in 2021. While we don't expect near-term corporate bond buying from the Bank of England given successful Brexit negotiations, it remains a tool in the BOE's arsenal that the market is unlikely to forget.

3

Any key themes you'll be watching in 2021?

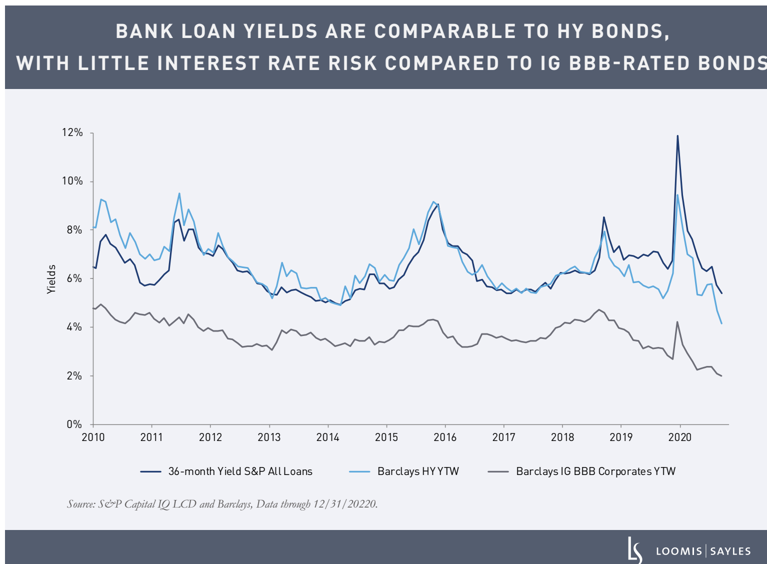
ESG remains a key focus for the euro and sterling markets. We expect ESG bond supply to increase in 2021, through a combination of green, social and sustainable bonds. ESG-related disclosure is becoming increasingly important across the UK and the European continent. As the market pays more attention to ESG, we expect valuations to adjust. Over time, we believe issuers with weaker ESG scores may be forced to pay a premium to sell their bonds—possibly as soon as this year.

2021 OUTLOOK: THREE QUESTIONS ON BANK LOANS

By John Bell, Portfolio Manager, Bank Loans – **JANUARY 13, 2021**

1
Loans are often overlooked when investors are hunting for yield. Why is that, and how do loan yields compare to other categories?

We think investors have been taught to think of loans as a bet on rising rates, while high yield bonds are typically viewed as a yield play and investment grade (IG) corporates are often considered a safer choice with a lower yield. But with rates expected to be low for a while, we think income-focused investors should view loans as one of several yield plays. Loans typically have short average lives, so when they are priced at a discount, their yields can be similar to or greater than the yields on high yield bonds priced over par. And while IG corporates may have little credit risk compared to high yield, when rates are this low, they typically offer limited yield and have relatively high interest rate risk. Loans have a floating coupon, so they currently offer an advantage in both yield potential and rate risk over investment grade bonds. Meanwhile, loans' seniority and security make them structurally more insulated from credit risk than most high yield bonds. We think loans deserve a place in any investor's hunt for yield.



2
Loans' default rates have been lower than many expected in 2020. What are you expecting in 2021?

Default rates across credit were generally lower than people feared, but that does not imply the pandemic was not a big economic shock. In our view, default rates were lower because the companies in the syndicated loan market and the high yield market are typically large enough to have levers they can pull—such as high cash balances, revolving lines of credit and cost cuts—to gain the liquidity needed to get through a short, sharp downturn. We think investors may have thought loans were going to small companies. However, most borrowers in the loan market are actually quite large, and large companies mostly did surprisingly well in 2020.

As we look forward to the rest of 2021, we see plenty of cash and credit availability for most of the companies we follow. Balance sheets suggest these companies can survive without a strong recovery, which may explain why prices have bounced back so strongly. Frankly, for the companies we lend money to, we see very few defaults coming this year. We do not see the balance sheets of most of the companies we have not lent to, but we believe it would be reasonable to model average default rates of about 2%-4%. Assuming the pandemic will recede this year, we believe this estimate is a starting point for thinking about index returns.

3
What role could collateralized loan obligations (CLOs) play in the loan market this year?

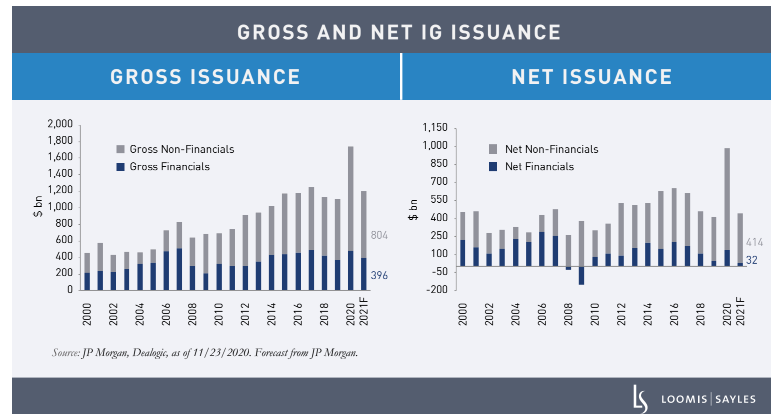
CLOs have accounted for the majority of loan demand for some time. That is because loans have been steady enough in their repayment potential that levered structures, such as CLOs, can be built around loans and can potentially deliver attractive returns all the way to the bottom of those structures. CLOs do not have to sell when prices decline because they have stable capital, so they have been a stabilizing force on loan prices. CLOs have shown to be robust investment vehicles. CLOs have historically survived under stress during recessions, the global financial crisis and the COVID-19 pandemic. Therefore, we expect CLO demand to remain strong in 2021 as investors continue to hunt for yield, which should support demand for loans rated above CCC.

2021 OUTLOOK: THREE QUESTIONS FOR THE INVESTMENT GRADE SECTOR TEAM

By the Loomis Sayles Investment Grade Sector Team – **JANUARY 15, 2021**

1
US investment grade spreads have returned to pre-pandemic levels. What are your expectations for spreads in 2021?

We remain constructive on the outlook for the investment grade (IG) bond market. While recognizing that valuations may appear full relative to historical levels, we think IG spreads can continue to grind modestly tighter in a recovery scenario. We expect the IG market to benefit from the rollout of the COVID-19 vaccine, an improving economy and additional fiscal support. We also anticipate a gradual but steady improvement in credit fundamentals as companies focus on balance sheet repair. Strong supply/demand technicals should also remain a tailwind in our view. Corporate bond issuance may decline meaningfully in 2021 following last year's deluge, and we expect investors to continue to flock to US credit, which currently offers relatively higher yields versus developed markets in Europe and Asia.



2
What areas of the market look attractive?

COVID-19-impacted industries continue to offer additional spread relative to the market, but even the most stressed issuer's bond spreads have tightened materially. We believe credit selection remains imperative. We prefer credits with better-than-average liquidity and manageable maturity profiles. Our focus, however, is shifting toward what companies will do with cash and debt that was built up during the height of the pandemic. We currently favor companies and industries that are showing a willingness and ability to repair their balance sheets. Rating agencies remained lenient throughout 2020, opting to take a wait-and-see approach in many cases, but we expect them to take a harder line as 2021 progresses.

3
What are some key risks you're watching? Is there anything you're worried about?

Over the next 12 months, we view the biggest risks to be:

- Widespread, significant lockdowns across major regions domestically and abroad as COVID-19 cases spike;
- Weaker-than-expected additional stimulus under the Biden administration; and
- A poorly executed rollout of the vaccine and/or efficacy rates that are worse than expected.

Even if the recovery plays out as we expect, companies may fail to follow through on deleveraging with an improving economic environment, ample liquidity and animal spirits running high. In particular, a potential resurgence in mergers and acquisitions could slow balance sheet repair and lead to higher-than-anticipated new issuance.

2021 OUTLOOK: THREE QUESTIONS FOR THE MUNICIPAL SECTOR TEAM

By the Loomis Sayles Municipal Sector Team – **JANUARY 22, 2021**

1

Many state and local governments have been under pressure due to the pandemic. What's your outlook for this sector in 2021?

The January 5 runoff election for Georgia's two Senate seats has tipped the delicate balance of power in the federal government from divided to unified with the new administration. This outcome has considerably altered the landscape for state and local governments, and for the municipal bond market itself. Last week's statement from then President-elect Biden confirmed that direct additional aid to state and local governments and an infrastructure package would form a critical part of his administration's economic policy agenda. Market participants appear to have welcomed both developments and we will assess the prospects of this agenda as the legislative session unfolds.

Revenue and capital outlay pressures remain, despite several states announcing less-severe-than-expected revenue declines. We believe this is a second-order effect of earlier rounds of fiscal and monetary support that helped fuel strong equity market gains and anticipated capital gain receipts. As an example, California's revenues are highly sensitive to personal income taxes, yet recently reported revenues through November were 23% ahead of the state's fiscal year 2021 expectations (July2020-June 2021). However, these announcements may not account for the reality that many states lowered revenue expectations substantially when formulating their budgets.

We expect fiscal pressure to remain significant over the medium term as the pandemic continues to weigh on large segments of the economy. Further, the revenue hit has varied widely, with some states facing substantial budget shortfalls. In our view, fiscal aid will likely be critical to limit deep cuts and additional layoffs. Of the 9.8 million nonfarm payroll jobs that have been lost during the recession, nearly 1.4 million have been in the state and local sector.[1]

2

What impact could the new administration have on the municipal sector?

In terms of direct market impact, much will depend on the details of the policy agenda and its prospects for passage in a closely balanced Congress. One key factor we're awaiting is the size and scope of the infrastructure package, which the administration is expected to outline in coming days. Roughly 70% of core infrastructure finance takes place in the municipal market. But the type of program—whether it proposes direct federal grants or a taxable subsidy like the Build America Bond Program—will determine the market impact due to the mostly distinct investors that participate in the tax-exempt and taxable municipal markets.

> "Roughly 70% of core infrastructure finance takes place in the municipal market. But the type of program—whether it proposes direct federal grants or a taxable subsidy like the Build America Bond Program—will determine the market impact."

Tangential to the pool of buyers is the prospect of an increase in the marginal corporate tax rate. The corporate tax cut instituted in the 2017 Tax Act largely dis-incentivized insurance company and bank purchases of tax-exempt municipals. Since the end of 2017, outstanding holdings of municipals declined by nearly 5% for insurance companies and more than 13% for banks.[2] And the dis-investment in the exempt market was probably understated as issuance shifted to the taxable market, likely expanding the proportion of taxable municipal holdings.

Finally, it may be a long shot, but the prohibition of tax-exempt advance refunding in the 2017 Tax Act could come into play. If the new administration seeks a rollback of the prohibition, it could have a large impact on tax-exempt supply, which was reduced by 15% to 25% as a result of the 2017 Act. We expect that any additional supply, whether tax-exempt or taxable, will likely be met with strong investor demand.

3

What's your view on municipal credit fundamentals? Do you see any prospects for improvement in credits that were hit hard by the pandemic?

We believe the prospects for municipal credit have been improving. Credit fundamentals for most municipal sectors typically change relatively slowly as tax and revenue generation tend to reflect longer-term economic trends. But the pandemic precipitated rapid changes in fundamentals that were largely the result of public health measures rather than economic factors; therefore, we anticipate relatively quick improvement in fundamentals once public health measures are lifted.

The pandemic is currently at severe levels, but the expectation of faster, wider-scale vaccinations could provide a rationale for anticipating improving economic activity as the year unfolds. Some sectors of the economy and the municipal market will likely take longer to recover. For example, the recoveries of mass transit and airports will likely be correlated to vaccination progress as well as difficult-to-anticipate behavioral changes. However, our medium-term outlook, particularly if accompanied by additional fiscal relief, is now less bleak than it was almost a year ago.

1 Bureau of Labor Statistics, The Employment Situation – December 2020.
2 Securities Industry and Financial Markets Association, as of September 30, 2020.

2021 OUTLOOK: THREE QUESTIONS FOR THE MORTGAGE AND STRUCTURED FINANCE SECTOR TEAM

By the Loomis Sayles Mortgage and Structured Finance Sector Team – **JANUARY 27, 2021**

1
The securitized credit sector has lagged the recent broad rally in risk assets. How do you expect the sector to perform in 2021?

In general, securitized credit sectors lagged the broader rally in risk assets. Unlike agency MBS and corporate credit, securitized credit sectors did not benefit from direct Federal support during the pandemic. While fundamentals remained favorable, technical pressures weighed on prices.

Consumers and housing—major drivers of underlying risk in securitized credit markets—did hold up well during 2020 given fiscal stimulus and increased housing demand. In our view, this dynamic coupled with relatively lagging spread tightening have left the sectors positioned to potentially outperform in a continued credit rally. In addition, the sectors' high carry (income) and short duration could provide downside protection amid potential volatility in an uneven economic recovery.

The securitized credit market currently appears bifurcated. On one hand, you have benchmark risk assets that rallied sharply on news of an effective vaccine in the last few months of 2020. Despite the rally, these assets may still offer compelling value in terms of risk (duration) and quality (rating) relative to corporates. In a tight spread environment, this carry (for the rating and risk) can be attractive. On the other hand, pockets of dislocation remain in areas more deeply impacted by pandemic-related shutdowns, such as transportation-related ABS and commercial real estate (CMBS). Investors able to navigate the complexities of these markets can potentially realize significant upside as the economy reopens and recovers. We believe that pricing pressure in these securities is largely contained, especially if we continue to see sustained improvement in the medical treatment of COVID-19 and the impact of increasing vaccination, which should allow for a return to travel (business and leisure) and other commercial activity.

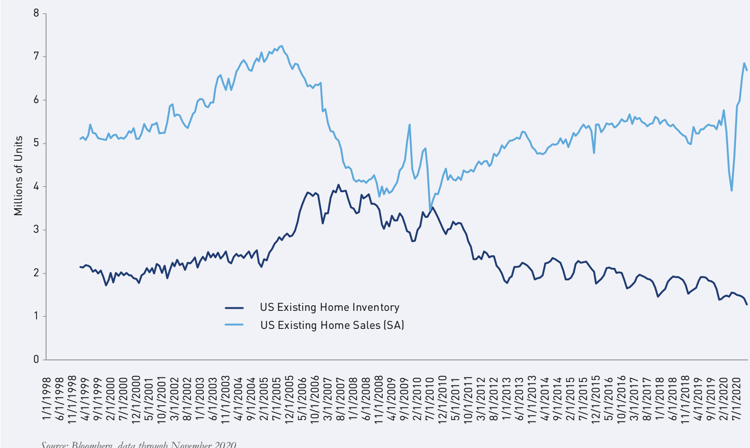
We acknowledge, however, that there are near-term risks that could give rise to bouts of volatility. Specifically, as COVID-19 cases continue to rise at an alarming pace throughout the country we could see (and in fact have seen in some areas) additional lockdowns, some of which could be protracted. In such instances, additional stimulus beyond what has been extended thus far may be needed to help support consumers and other sectors. Nevertheless, we believe the overall scarcity of risk assets in the securitized credit sectors, favorable carry and attractive valuations relative to other sectors may dampen the impact of any near-term volatility.

2
What are your expectations for the US housing market and implications for mortgage credit sectors?

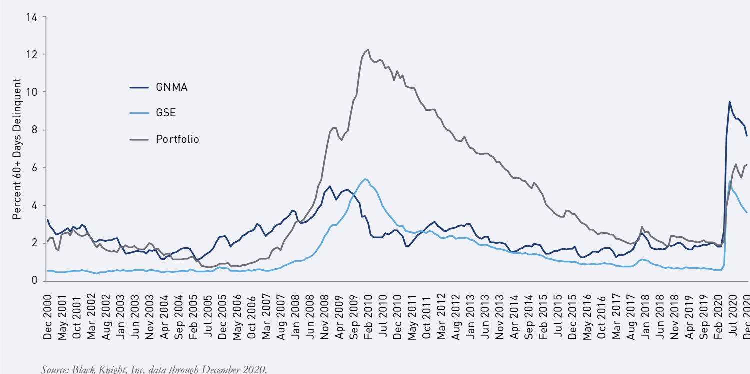
We remain positive about the long-term trends in US housing and US housing credit given insufficient housing supply and positive demographic demand. The implications of COVID-19 amplified supply and demand dynamics throughout the past year and contributed to exceptionally strong performance for US housing-related credit. However, while we believe the housing market is in a strong position as we begin 2021, reduced wage growth, high unemployment and strong 2020 performance have tempered our optimism somewhat. We do not envision a large drop in home prices, but the current pace of appreciation is likely unsustainable. We estimate a return to appreciation in the low single digits (3% to 5%) nationally.

It appears the financing markets have begun to heal, and a positive outcome of the forced deleveraging that occurred in March 2020 has been a more intelligent approach to leverage from lenders and borrowers. This has reduced the near-term probability of another liquidity shock and contributes to our positive outlook for asset performance in 2021. In addition, significant changes to the regulatory landscape may provide a catalyst for growth and outperformance. We expect the single-family rental, non-performing and re-performing loan sectors to continue to exhibit strong fundamental performance on continued high housing demand, and anticipate strong asset performance as a result. The non-qualified mortgage (Non-QM) market is still regaining its footing and the GSEs (government-sponsored enterprises) have remained disciplined in their extension of credit. Overall, housing credit is on a sounder footing following the March 2020 deleveraging, but there is a large cohort of non-performing borrowers and loans that will need to be resolved in 2021.

EXCEPTIONALLY STRONG DEMANDS AND MULTI DECADE LOWS IN SUPPLY BOLSTER PRICES



BUT A LARGE POCKET OF TROUBLED BORROWERS NEED RESOLUTION



3

What are the implications of additional fiscal stimulus for the consumer ABS sector? What's your view of the sector going forward?

With fiscal stimulus as a backstop, consumer ABS fundamentals remained stable throughout 2020 despite high unemployment. However, our 2021 outlook for fundamentals has shifted from neutral to negative. We believe that after expected stimulus in the first half, collateral performance will decline and return to historical patterns.

Given the better-than-expected collateral performance in 2020, spreads have continued to tighten on strong demand in the new issue and secondary markets. Despite the tightening, however, consumer ABS has still lagged the moves in financials. We believe the short duration of consumer ABS, as well as their favorable carry and lower volatility, make it an attractive alternative to short corporates.

Our stress testing indicates consumer ABS structures, aided by strong credit support, should avoid realizing losses even without additional stimulus and an elevated unemployment rate.

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