GMO
FIXED INCOME
INSIGHTS

AAA CMBS

Loss-remote, liquid, and cheaper than IG

Ben Nabet and Rachna Ramachandran | March 2023

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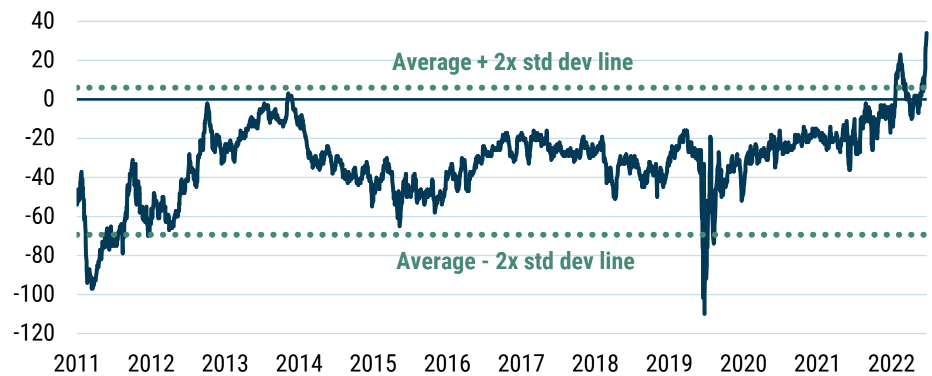
10-YEAR AAA CMBS SPREAD VS. IG CORPORATE BOND OAS



Source: JP Data Query, Bloomberg
Chart shows 10-year new issue AAA CMBS spread to Treasuries versus the option-adjusted spread of the Bloomberg Investment Grade Corporate Bond Index.

Fixed income spreads have widened across sectors over the past few months. With a looming recession and continued inflationary concerns, our preference is to own assets that can withstand credit shocks and compensate well for the downside risks assumed. In this context, we believe structured credit is a compelling alternative to corporate credit, offering ample spread relative to the underlying risks.

- CMBS spreads, for example, are currently the cheapest they've ever been relative to comparable corporate bonds, presenting a rich, value-driven opportunity in the sector.
- Headwinds, such as tighter credit conditions and inflationary pressures in the form of higher property and financing expenses, do exist. As do secular challenges, such as the proliferation of work-from-home practices, that have negative valuation effects.
- But we believe current spreads at AAA levels more than compensate investors for these risks.
- AAA CMBS is a liquid, loss-remote sector that has historically traded inside IG corporates. Amid the negative narrative surrounding commercial real estate and potentially limited credit availability, however, they now offer 30 bps more in spread.
- The spread on these senior claims now rivals what lenders have been paid for making mortgage loans, which are a form of illiquid non-diversified risk with no loss protection.
- AAA CMBS also have features that we believe help to mitigate the risk of principal loss or extension:
    - They have 30% credit support, a loss level that has never been breached, not even during the GFC.
    - Among the most aggressively underwritten pre-GFC vintages, losses only reached 11.17%, implying a coverage ratio of 2.7x. This coverage ratio should keep these bonds safe from nearly any ratings downgrade.

Ben Nabet

Mr. Nabet is a portfolio manager for GMO's Opportunistic Income Strategy. He is a member of GMO's Structured Products team, also contributing research focused on commercial mortgage-backed securities. Prior to joining GMO in 2015, he was Director of Global Arbitrage Trading and previously the Vice President of Global Arbitrage and Trading at RBC Capital Markets. Mr. Nabet earned his engineering degree in Control and Dynamical Systems from Ecole Nationale de l'Aviation Civile (ENAC), in Toulouse, France. He received his PhD and MA in Mechanical and Aerospace Engineering from Princeton University.

Rachna Ramachandran

Ms. Ramachandran is a portfolio manager for GMO's High Yield Strategy. She is a member of GMO's Structured Products and High Yield teams, also contributing research focused on macro credit. Prior to joining GMO in 2019, Ms. Ramachandran held numerous positions at Bank of America Merrill Lynch most recently as a Director in Credit Trading, covering macro and quantitative credit strategy. Previously at Bank of America Merrill Lynch she held positions as a credit portfolio strategist and a credit derivatives strategist. Ms. Ramachandran earned her BE in electronics and telecommunications from the University of Mumbai and her MS in financial mathematics from City University of London.

Disclaimer

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  - As new 10-year loans, these bonds do not need capital markets to be open in the near to medium term, shielding them from refinancing risk.

- Structured credit is an inherently fragmented and inefficient market, as this CMBS opportunity illustrates. This ability to obtain high spread with much lower risk relative to other credit assets is what we think makes structured credit a vital tool in a fixed income portfolio.
- GMO's Opportunistic Income Strategy, which follows an unconstrained, value-driven approach to investing in structured credit, has meaningfully increased exposure to AAA CMBS in recent months.