OPPORTUNITIES IN ASSET-BACKED FIXED INCOME

Jeremy Schwartz — Global Chief Investment Officer
08/05/2022

On the latest episode of the *Behind the Markets* podcast, we had a fascinating conversation with Don Kohn, former Federal Reserve vice chair, and Dave Goodson, Head of Securitized Fixed Income and Senior Portfolio Manager at Voya Investment Management. We discussed:

- **A Policy Debate:** In the first half of the episode, Professor Jeremy Siegel and Don Kohn debated the inflationary impulse in the economy and the appropriate path for the Federal Funds Rate. Kohn is more hawkish than the interest rate curve priced into the market, and Professor Siegel is more dovish. Given Kohn's prior role at the Federal Reserve (Fed), this was an important conversation about how the Fed might approach policy over the coming meetings and into 2023. We are starting to see Fed speakers push back on market pricing that implies rate cuts in 2023 quickly after this hiking cycle, and Kohn's commentary reflects that thinking.

- **Quantitative Tightening (QT):** Goodson talks about the opportunities in the securitized credit space and how quantitative tightening could impact the mortgage-backed securities market. Fed transparency and guidance has helped market participants assess quantitative tightening and price in concessions to compensate for perceived risk to securitized debt. But the pace of balance sheet runoff will double in two months, and it is hard to know how an already jittery market will react.

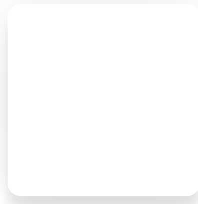
- **Attractive Valuations/Opportunities:** Currently, the spreads across most of the securitized debt markets Goodson invests in are at levels that reflect outlier scenarios that have occurred less than 1% of the time. Essentially, a lot of bad news has been priced into spreads already. This over-discounting reflects good value for the securitized debt market, in Goodson's opinion, even though there are many uncertain elements.
  - Goodson highlighted two corners of the non-agency residential mortgage-backed market where this over-discounting was pronounced
    - Credit Risk Transfer securities – a new type of security in which Fannie Mae and Freddie Mac compensate institutional investors to bear some of the credit risk of their portfolio
    - The non-qualifying mortgage-backed market, which pools mortgages from lenders that do not meet specific criteria demanded for mortgages pooled by the government-sponsored enterprises (GSEs)
  - For commercial mortgage-backed markets, Goodson sees opportunity in the multi-family space but remains leery of the office space given the trends in work-from-home mindsets

- **Diversifying Fixed Income Portfolios:** In Goodson's view, the securitized bond market is under-appreciated by investors, leading to sub-optimal allocations. If you consider the entire range of securitized debt (agency MBS, commercial MBS, non-agency MBS¸ asset-backed (ABS) and collateralized loan obligations (CLOs)), it totals more than $12 trillion (more than $9T in agency MBS and $3T outside of it). The securitized market dwarfs the high-yield market, emerging market bonds and bank loans and starts to compete in total size with the investment-grade corporate bond market.

- **With the Fed moving aggressively to tighten policy, Goodson notes** some signs of stress from less experienced borrowers and lower income consumers, as reflected in firming default levels for unsecured loans, despite very low levels of unemployment and high wage levels.

Goodson is the portfolio manager for WisdomTree's Mortgage Plus Bond Fund (MTGP) . For more details on the Fund, please visit the Fund's page.

You can listen to the full conversation with Kohn and Goodson below:



Important Risks Related to this Article

There are risks associated with investing, including the possible loss of principal. Fixed income investments are subject to interest rate risk; their value will normally decline as interest rates rise. In addition, when interest rates fall, income may decline. Fixed income investments are also subject to credit risk, the risk that the issuer of an investment will fail to pay interest and principal in a timely manner or that negative perceptions of the issuer's ability to make such payments will cause the price of that investment to decline. Investing in mortgage- and asset-backed securities involves interest rate, credit, valuation, extension and liquidity risks and the risk that payments on the underlying assets are delayed, prepaid, subordinated or defaulted on. Liquidity risk may result from the lack of an active market or a reduced number and capacity of traditional market participants to make a market in fixed income securities and may be magnified in a rising interest rate environment and/or with respect to particular types of securities, such as securitized credit securities. Non-agency and other securitized debt is subject to heightened risks as compared to agency-backed securities. High yield or "junk" bonds have lower credit ratings and involve a greater risk to principal. Derivative investments can be volatile, and these investments may be less liquid than other securities and more sensitive to the effects of varied economic conditions. Unlike typical exchange-traded funds, the Fund is actively managed using proprietary investment strategies and processes, and there can be no guarantee that these strategies and processes will be successful or that the Fund will achieve its investment objective. Due to the investment strategy of the Fund, it may make higher capital gain distributions than other ETFs. Please read the Fund's prospectus for specific details regarding the Fund's risk profile.

For standardized performance and the most recent month-end performance click here NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

Related Funds

+ WisdomTree Mortgage Plus Bond Fund

View the online version of this article here.

IMPORTANT INFORMATION

U.S. investors only: Click here to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an "as is" basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the "MSCI Parties") expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages (www.msci.com)

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Kara Marciscano, Jianing Wu, Brian Manby and Scott Welch are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only.

You cannot invest directly in an index.

DEFINITIONS

Inflation : Characterized by rising price levels.

Federal Funds Rate : The rate that banks that are members of the Federal Reserve system charge on overnight loans to one another. The Federal Open Market Committee sets this rate. Also referred to as the "policy rate" of the U.S. Federal Reserve.

Hawkish : Description used when worries about inflation are the primary concerns in setting monetary policy decisions.

Interest rates : The rate at which interest is paid by a borrower for the use of money.

Dovish : Description used when stimulation of economic growth is the primary concern in setting monetary policy decisions.

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Rate Cut : A decision by a central bank to reduce its main interest rate, usually to influence rates charged by other financial institution.

Rate Hike : refers to an increase in the policy rate set by a central bank. In the U.S., this generally refers to the Federal Funds Target Rate.

Quantitative Tightening : Quantitative easing is a process whereby a central bank targets lowering longer-term interest rates by purchasing bonds and other securities to stimulate the economy. Quantitative tightening is the reverse process whereby securities are either sold or the proceeds of maturing securities are not reinvested with the goal of tightening economic conditions to prevent the economy from overheating.

Credit : A contractual agreement in which a borrower receives something of value now and agrees to repay the lender at some date in the future.

Mortgage-backed securities : Fixed income securities that are composed of multiple underlying mortgages.

Valuation : Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

Spread : Typically refers to a difference between a measure of yield for one asset class and a measure of yield for either a different subset of that asset class or a different asset class entirely.

High Yield : Sometimes referred to as "junk bonds," these securities have a higher risk of default than investment-grade securitie.

Investment grade : An investment grade is a rating that signifies a municipal or corporate bond presents a relatively low risk of default.