Macro Markets Podcast Episode 87: The Complexity Premium in Structured Credit: The Opportunity Set Today (Part 2)

Date: June 10, 2026

This transcript is computer generated and may contain inaccuracies.

Jay Diamond: Hi everybody, and welcome to part two of our discussion of Structured Credit. In part one we address the fundamentals of structured credit investing, how it has become such an important differentiator for our approach to active fixed income investing, and why we believe this sector is attractive on an absolute and relative basis. Part two digs deeper into the opportunity set and risks and current market conditions. I'm Jay Diamond, head of thought leadership for Guggenheim Investments. And back with me again is Karthik Narayanan, Head of our Structured Credit Team. With that, let's get started with part two. Karthik welcome back. So in part one of this episode you discussed the breadth of the structured credit market. So, to begin, walk us through the market dynamics in the important subsectors of structured credit and where you are seeing value right now.

Karthik Narayanan: What we find in structured credit, and this is true of all bond investing in general, you need a favorable intersection between valuation and fundamentals. Technical factors may affect your timing, but as a long-term, credit-oriented credit-first-type investor, we want to be comfortable with the intersection of valuation and fundamentals. And not all sectors is going to check all those boxes all the time, which highlights the importance of being involved in all these markets, even if the opportunities are limited at a given point in time, because that'll change. So let's just go around the horn and talk about the four major sectors and sort of what we see going on there. So first is ABS. So within the ABS market there's really two major flavors. There's one consumer ABS, which is about 60ish percent of the overall $750 billion ABS market. These are deals where the obligor are individual consumers: think auto loans, unsecured personal loans, student loans. Now the other 35 to 40 percent is what we call commercial abs. Sometimes people call it esoteric ABS, but I prefer the term commercial ABS. And really it's called commercial abs because the obligor, is a commercial entity or contracts originated to a commercial entity. So examples of this might include royalty backed ABS, where the contractual claim is on royalties that are derived from intellectual property. It could be on music royalties, on franchise restaurant royalties. It could be cash flows generated by leases on operating assets such as rail cars, aircraft, etc. It could be digital infrastructure, it can be leases of data centers, any of those things. These all fall under the category of commercial ABS, which itself is a subset, so call it 40 percent of the overall ABS market. So, a subset within a subset, and where we see value here right now is in a few places. One is in these royalty backed ABS deals, two is in data center backed in digital infrastructure back deals, it could be on optical fiber networks, cell towers, data centers as well as in aircraft ABS in some selected fund finance deals. So these are scalable pockets to a degree. They're scalable, at sort of the portfolio scale we're talking about, which is good for us. They're not infinitely scalable. But they're not so small that they're not accessible in an institutional scale. Now, within this market, generally, the senior most first priority classes of these deals have maturities in the, let's say, 5-to-7-year range. They're typically singly or triple-B rated and these are coming to the market between a 5.5 percent and a 6.5 percent yield right now. So, if we step back and say these, and based on our belief and our analysis, that these are generally loss-remote instruments, they're investment grade rated, their loss remote based on independent work we're doing as investors in our capacity, you're talking about 5.5 percent to 6.5 percent yield in a world where corporate bonds are yielding 4.75 for similar and actually, maybe marginally lower than that for, the same kind of duration. Now, if we want to take more risk and go below the investment grade graded part of the ABS market, this is an even smaller market. But their yields can approach 8 percent or 9 percent. So those are more selected opportunities that we avail ourselves of on occasion for higher risk tolerant strategies. But those opportunities exist as well. So really, commercially this is giving us some pretty meaningful additional yield with a lot of credit diversity. It’s one of our higher conviction areas right now.

Jay Diamond: What are you seeing in residential mortgage-backed securities?

Karthik Narayanan: So, speaking of other higher conviction areas, residential mortgages is one of our other, higher conviction areas. And really, the case for residential mortgages begins with the borrower. If you think of U.S. home prices, they have more than doubled over the past decade. Post GFC underwriting reforms are still in place. Those acted to strengthen loan quality, and the subsequent buildup in home prices results in homeowner equity that's something like four times the amount of debt that's outstanding. So, the equity that homeowners hold is four times the debt that they owe. So, this is a real key change from before the financial crisis, where that ratio was like 1 to 1 debt to equity. So, from a lender's perspective, this market is under levered. And that equity cushion means that home prices would have to fall a long way before investment grade debt starts to bear any kind of losses. And second point on residential is, is, the lock-in effect And what that does for callability. Normally borrowers build up their equity, they'll refinance, they'll take out a bigger loan. But in today's mortgage rate world, a lot of homeowners are sitting on very low mortgage rates with a lot of built up equity and have very, a big disincentive from losing that initial mortgage rate and going into a six-point-something percent current mortgage versus a 3 percent mortgage that they may have. So, a lot of what we're starting to see is an increase in home equity lines of credit and closed-end second lien origination. It's very small, but we expect it to grow. And it's addressing this sort of under-leverage problem that exists in terms of wealth extraction in the home equity market. Now, from a lender standpoint, how is that a good thing by reducing equity? Well, it's fine if it's at a prudent level, which we think there's a lot of room to run there. But really, what the interesting thing that happens here is that these loans are not very callable. So usually when you talk about agency mortgages or jumbo mortgages, they're incredibly sensitive to interest rates. And as an investor you have to factor that into the yield you will accept on these instruments. With some of these type of emerging mortgage types like closed-end seconds or non-qualified mortgages, the callability is much more suppressed. So, those are really two fundamental factors we like here. Now, credit standards I mentioned have tightened a lot since the GFC era. And in fact, they've actually tightened even more in the last one or two years. So, we're seeing credit scores on some of the non-Agency mortgage loans which are not gone to the same standard down the fairway underwriting as the agency eligible loans. So obviously there's additional requirements that are needed there and credit enhancement that we and other investors will demand. But actually credit standards, when you look at credit scores and, and loan-to-value ratios have actually been improving even further. So, the credit story is good. The valuation story is good. We don't think the call ability difference is or fully priced in the market. And it makes residential mortgages one of our other higher conviction trades and structured credit.

Jay Diamond: Let's move on to other areas in the structure credit universe. What are you seeing in CLOs or collateralized loan obligations?

Karthik Narayanan: This is more of a mixed bag. Well, constructive on certain parts of the market. We're cautious on others. Now, the macro market backdrop for credit in general is supportive and for CLOs as well. Some delay in fed cuts could improve the carry profile for CLOS. It keeps floating rate paper attractive. The market stays bid. And traditionally the largest buyer of senior CLO tranches which are banks are likely to improve their participation over time as some of the regulatory frameworks are sort of finalized, they're very close to that at this point. There's increasing demand from ETFs and other, investment strategies in CLOs. And if we look at just trading volume in CLOs, it's running something like 50 percent ahead of where it was last year. So definitely a lot of activity in this market. Now on the underlying loan side, we talked about wanting to think about an intersection of fundamentals as well as valuation. On the fundamental loan side, at the aggregate level, loans are doing okay. But what we're really more keeping our finger on the pulse is elevated dispersion in the tails. And that's really driven by, as what our listeners know, has come into the market in the form of AI disruption risk to software and technology businesses that comprise something like 13 percent of the leveraged loan market, which is the underlying collateral for see of CLOs. So, in January, the overall loan market was trading at about 96.5 cents on the dollar. When a lot of this narrative kicked in, the on conflict began, the overall market sold off to about $0.94 on the dollar. And then it's rallied about halfway back at this point to about 95, and a half cents. So, this journey created a lot of dispersion in underlying loans, which is important if you're investing directly in loans. It's important if you are an investor in junior CLO tranches. And those are areas where we're cautious. But it is less important for the investment grade tranches of CLOs. Research generally shows that that loan prices, once they go below about 80, it's a pretty good indicator of short-term defaults. To start the year, the loan market had something like 3.5 percent of loans trading below 80. That number is something like 6.5 percent now. And back then in January, 10 percent of those loans were software companies; now about a third of them are. So, the market is pricing in some amount of distress in that world, and it's going to take some time to play out. But that dispersion is going to put pressure on parts of the CLO market, particularly on deals that are already outstanding, as opposed to new deals where managers have flexibility to select for different types of collateral, can select away from those types of distressed sectors, which I know my colleagues on the corporate side have been doing actively. So where does that leave us? In CLOs it's really in positioning in single-A and higher tranches where we stress test these two Great Depression type default rates. And these tranches recover full principal in those scenarios. And we're earning a 100-plus basis points above comparable, comparably rated corporate bonds for what is sort of loss remote type profiles. So that's really where we're spending time on CLOs.

Jay Diamond: Karthick to wrap up our tour of the four major sectors of structured credit, what is your view of opportunities in commercial mortgage-backed securities or CMBS?

Karthik Narayanan: We think this market is turning a corner and kind of entering a new phase. We've seen a big rebound in securitization issuance. It's being met by a lot of healthy investor demand. We're seeing on the underlying loans, especially office loans where there's been a lot of distress, work out timelines of probably peaked and they're starting to shorten. And then, we're seeing the rate at which new distressed loans are going in special servicing is actually falling below the rate at which loans are coming out of workout. So the market sort of entering a new phase of clearing these distressed loans, but there's still a ways to go. And it's really amounting to a tale of two markets. One for legacy assets that don't have visible business plans. Maybe not repositionable without significant capital injection. Maybe backed by loans that then are difficult to formulate a resolution. That's those problem assets both in the commercial real estate market as well as in CMBS. And then there's another part of the two markets is in for, is in assets where there is a clear business plan, there are visible valuations and comparables, and you are able to secure financing in today's market. So really is a huge bifurcation in both the underlying real estate as well as in the debt market for CMBS. So we are cautious on seasoned junior CMBS where the outcomes can be very binary. And we've found better opportunities in commercial real estate-backed CLOs, which are primarily backed by multifamily properties that are undergoing some amount of transition. We think these deals—and we tend to focus on deals with capable sponsors and operators—it's a small market. It's not infinitely scalable, though scalable enough. And there's significant credit enhancement here in prudent underwriting. So that's really where we've been focused in CMBS.

Jay Diamond: So, Karthik, you mentioned loss remote. What does that actually mean?

Karthik Narayanan: So, when we evaluate any credit investment, we want to understand what the likelihood could be of not returning principal. So, we can never know with certainty and that's sort of why we do the credit work we do. But we want to come up with estimates of the likelihood of that happening. So, in order to do that, we run stress tests that are proprietary. Typically what we do at Guggenheim, and it's served us well through cycles, is to run historically worst-case-type-performance scenarios. So really underwriting to a trough and looking at what the outcomes are, and we're evaluating whether principal loss would be likely to happen in that scenario. So, it's not a prediction. It's not a guarantee. We cannot forecast these things. But we want to know when bonds start to go non-linear where they go from par 90, 95, 85, 80 to 30 and really avoid situations that can become very non-linear. So, that doesn't speak to what the short-term price volatility is. That's something that's determined by the market. But we want to look at the long-term hold-to-maturity likelihood of getting all your money back.

Jay Diamond: Now, I've been keeping track as you've been going through, as you call them, the four major food groups. But it sounds like the range of yields and again, it'll vary by subsector, is anywhere from, say, 5.5 to 9 percent in the sectors that you're looking at.

Karthik Narayanan: That's right. It's going to be something like 5.5 to 6.5 percent of the investment grade level, and then higher in the non-investment grade part of the market.

Jay Diamond: To wrap up, I do want to spend time talking about headline issues that investors might be interested in hearing your point of view. So, let's start with the investment that's going into AI and data center-related structures that are driving enormous financing needs across the fixed income spectrum and across the economy. Are there areas within structured credit where you're seeing these trends, and are you seeing them in a positive way?

Karthik Narayanan: It's true that the digital transformation of the economy has tremendous amount of capital requirement, in part, and that has to get fulfilled in multiple ways. Speaking about data centers, we see that the large tech companies are spending a huge fraction of their free cash flow, in some cases over 100 percent of their free cash flow on digital infrastructure build out. So just to put a scale around the enormity of this, that is going to not be a question of do you finance this in the high grade market, in the private market, and the high yield market, in the ABS market, the real estate market, it's all of the above just because of the magnitude of capital we're talking about. So, it does create opportunities as well as risks. And we see that in the ABS market and in the CMBS market maybe to a lesser extent, but really in the ABS market. Data center financing has sort of, it's emerging the different platforms people are using, but it's sort of falling into three broad categories. One is very, very large-scale pre-construction projects that are pre-leased to household name, hyperscale type tech companies. Those are getting done mostly in the corporate market. And they're being done through a corporate guarantee on either the residual value of the assets or on construction delivery or some combination of all those things. So, it's a way for the lessee or the tenant to monetize their enormous balance sheet in an off balance sheet sort of guaranteed way. And that's happening in very big size in the high-grade market. When you get to the structured finance market, it tends to be data centers that are built or almost nearly built, but have already been leased up, usually to the household name type hyperscale tech companies. But not always. Those deals tend to be more portfolio based, where there's multiple data centers, and they tend to be single A-rated in a lot of cases. And the yields are quite attractive relative to comparable corporates, on the order of double the credit spread of what you'd see on, or 100 basis points higher. So even greater than double the credit spread of what you'd see on intermediate duration single-A corporates. So that definitely creates opportunities. There are, there are more edge cases where there are non-investment grade tenants. There are investment grade tenants that have outs in their leases; and sort of, lease premiums that are not, we view satisfactory in all cases to pay off the debt. So there are some variability in structures that we want to be mindful of. But we do think this is a pretty meaningful opportunity in ABS.

Jay Diamond: Now also it related to that, is the impact of AI on business operations of big swaths of the economy. And investors have been increasingly concerned that software represents one of the biggest subsectors and leveraged loans and therefore CLOs that might be exposed to AI competition. What is your take on that?

Karthik Narayanan: CLO investors, this is a real problem, but it's a manageable problem. And it's going to take some time to play out that. What I mean by that is if you look at the concentration of software companies in the CLO market, it's something like 13 percent. If you add in sort of adjacent business services and technology companies, it's something like 16 or 17 percent. So it's a very meaningful exposure. Not all those companies are going to default. Not all of those loans are going to recover zero. There will be elevated stress there. But it's going to take some time to play out. The majority of those loans mature in 2028, 2029. So, there's a little bit of time, and I'm not going to sit here with a crystal ball and predict exactly how this is going to play out for every company. I don't think anyone has the ability to do that. But as prudent investors, we want to think about the range of outcomes that could happen and what potential mitigates or non-linearities may arise from those various outcomes as it flows through these, structured finance waterfalls. And really what we're talking about on an underlying business level is a lot of these companies have contractual revenues, that are sticky and stick around for a while. And really, what we're talking about is a hit to enterprise value that was going to play out over a longer period of time and could affect refinance ability of existing debt. So, there's a bit of a fuse to burn down on some of these things. But just to put some context around it, something like out of that 13 or so percent of the market that are software companies, something like 3 percent or 4 percent, percentage points are trading below 80, where investors are handicapping a high probability of default in the near term. So, there will be some recovery on those. It may not be very pretty or it may be lower than historical averages. But if you compare that to the 11, 12, 13 percent credit enhancement that you're going to see on the lowest investment grade CLO, let alone the sort of mid-to-high teens credit support you'll see on a single-A CLO. You are multiples of loss coverage away from having issues with recovering principal. So is it a problem for junior CLOs. Yes. Is there a problem for equity? Yes. Is it a problem for the leverage loan market? Yes it is. We don't view it as big of a problem for the investment grade CLO market.

Jay Diamond: No. We also have the economic backdrop, which are all investors are thinking about. And it's a bit of a mixed bag, but they are becoming increasingly concerned that consumer fundamentals may be weakening, high oil prices are starting to take a bite out of household balance sheets and corporate performance. How is this impacting your outlook?

Karthik Narayanan: We’re cautious on consumer fundamentals for all of those reasons. It's sort of cliche in the financial press to talk about the k-shaped economy. And, I think you see that in credit performance of businesses that rely on consumers that have a smaller amount of discretionary income and a smaller amount of wealth are seeing changes, not necessarily so dramatic in losses or defaults or delinquencies, but in preferences and behavior. And so they're definitely being impacted. Now, what does this mean from an investing in ABS and structure finance standpoint? We’re tending to focus on consumers or consumer related debt that is exposed to individuals or households that have a higher financial capacity. A lot of that set rotates around homeowners, where they have significant equity and higher incomes on average, and significantly higher credit scores than non-homeowners. And sort of emphasizing credit that's backed by that population. And, and really being cautious on the lower end of the credit spectrum in consumer. We just think there's too many uncertainties relative to what you can potentially get paid there.

Jay Diamond: This is terrific. If someone is investing with us now or coming into a new product or an opportunity that we're managing, and they wanted to understand what you're looking forward to over the next six to 12 months in structured credit, what are some of the key risks and metrics and opportunities that you're watching most closely?

Karthik Narayanan: The biggest opportunity I'd say is just relative value. So, if you look at where credit spreads are in the corporate market, in the high-grade market, it's sort of historically lowest 20th percentile or lower. So very tight spreads on an historical basis. And a lot of that is justifiable based on where we are in the credit cycle and the fact that corporate earnings are healthy. And corporate credit metrics are also healthy in terms of leverage and coverage. So tight spreads probably justified. However, doesn't create much of an income opportunity for investors. Now, in structured credit, you look at the delta between corporate credit and structured credit and the yield pickup, it is not at historical tights, it's sort of near historical averages. So even if you don't go out and make an assumption that they're going to converge back to historical tights, and we don't have that expectation, there still is a pretty significant opportunity to earn additional income in the structured credit market. So that's on the income side and on the return side. There could be additional benefit if we do see some spread convergence, but we're not necessarily betting on that given some of the crosswinds in play right now in the macroeconomic environment. The second point on the opportunity is within structured credit with prudent security selection or in many cases, just the selection, you can do better than the structured credit indices. There's a cumulative benefit to being in the market as opposed to being able to push a button and sort of replicate an index. So to summarize, it's really an income opportunity with favorable fundamentals, which speaks to the potential for losing some of that yield due to losses, which is probably more of a concern in the bank loan market, where there's some higher distress that's flowing through there relative to other parts of the corporate credit market, or even within structured credit. Now, in terms of other risks that we're keeping our eyes on, the consumer is one of them. And then other geopolitical developments that could put pressure on corporate earnings in the intermediate term. There's risk of overinvestment or misdirection of capital within, the digital infrastructure buildout, which is almost guaranteed in the longer term just given the scale of what's going on. So that's something that behavioral history would tell you is something to watch out for. But our view is that we're very early in this process. And prudent investing is really what investors need to keep in mind in that market. And so security selection is going to continue to be important.

Jay Diamond: Karthik, again, I have to thank you so much for all this time that you've given us on a very busy week. But before I let you go, do you have any final takeaways that you would like to leave with our listeners today?

Karthik Narayanan: I would just thank everyone for taking the time to listen. Structured finance is little opaque and sort of hard to paint the broad strokes. So, I appreciate everyone's interest in sort of taking this tour with us.

Jay Diamond: Thank you very much, Karthick, and I hope you'll visit with us again soon. And thanks to all of you who have joined us for our two-part podcast on structured credit. If you like what you're hearing, of course, please rate us five stars—it helps people find us. And follow us on your podcast platform of choice so you won't miss an episode. If you have any questions for Karthik or any of our other guests, please send them to Macro Markets at GuggenheimInvestments.com and we will do our best to answer them in a future episode or offline. If you want more information on structured credit, you can find it on our website at GuggenheimInvestments.com/perspectives. You can go deeper in the ABCs of asset backed finance, or in a publication called Understanding Collateralized Loan Obligations. And you can also get frequent market updates in our Fixed Income Sector Views, which comes out every quarter. I also want to mention that we're going to be producing a new quarterly piece that will feature developments focused in the structured credit market. So please keep an eye out for that on our website. I'm Jay Diamond and I look forward to gathering again for the next episode of Macro Markets with Guggenheim Investments. So long.

Important Notices and Disclosures

Investing involves risk, including the possible loss of principal.

Structured credit, including asset-backed securities or ABS, mortgage-backed securities and CLOs or complex investments, are not suitable for all investors. Investors in structured credit generally receive payments that are part interest and part return of principal. These payments may vary based on the rate loans are repaid. Some structured credit investments may have structures that make their reaction to interest rates and other factors difficult to predict, making their prices volatile and subject to liquidity and valuation risk. CLOs bear similar risks to investing in loans directly, including credit risk, interest-rate risk, counterparty risk, and prepayment risk. Loans are often below investment grade, may be unrated, and typically offer a fixed or floating interest rate. Stock markets can be volatile. Small and medium capitalization companies may involve greater risk of loss and more abrupt fluctuations in market price than investments in larger companies.

Stock markets can be volatile. Investments in securities of small and medium capitalization companies may involve greater risk of loss and more abrupt fluctuations in market price than investments in larger companies. The market value of fixed income securities will change in response to interest rate changes and market conditions among other things. Investments in fixed-income instruments are subject to the possibility that interest rates could rise, causing their value to decline. High yield securities present more liquidity and credit risk than investment grade bonds and may be subject to greater volatility.

This podcast is distributed or presented for informational or educational purposes only and should not be considered a recommendation of any particular security, strategy or investment product, or as investing advice of any kind. This material is not provided in a fiduciary capacity, may not be relied upon for or in connection with the making of investment decisions, and does not constitute a solicitation of an offer to buy or sell securities. The content contained herein is not intended to be and should not be construed as legal or tax advice and/or a legal opinion. Always consult a financial, tax and/or legal professional regarding your specific situation.

This podcast contains opinions of the author or speaker, but not necessarily those of Guggenheim Partners or its subsidiaries. The opinions contained herein are subject to change without notice. Forward-looking statements, estimates, and certain information contained herein are based upon proprietary and non-proprietary research and other sources. Information contained herein has been obtained from sources believed to be reliable, but are not assured as to accuracy. No part of this material may be reproduced or referred to in any form, without express written permission of Guggenheim Partners, LLC. There is neither representation nor warranty as to the current accuracy of, nor liability for, decisions based on such information. Past performance is not indicative of future results.

Guggenheim Investments represents the investment management businesses of Guggenheim Partners, LLC. Securities are distributed by Guggenheim Funds Distributors LLC.