Peak COVID, peak convexity

As we are just passing the peak of the pandemic, it remains very difficult to imagine what a steady-state world will look like in a month, let alone a year from now. As better news from the health bulletins, unless the feared material second wave of infection appears, is reinforced with a progressive easing of lockdown restrictions in many countries, asset prices should start to reflect the anticipated rebound in activity through 2021. Structured credit bonds have in many cases seen their price drop compounded by the same illiquidity that hit other markets, but also by a specific extension risk only present in some asset classes. The latter is a risk we have always been extremely careful about, as it is often ignored in bullish markets, and causes some of the most painful hits to marks in bearish environments.

For example, some UK RMBS mezzanine bonds that might have priced to a call or refinancing in a couple of years a few months back would have seen price drops may be into the low or mid-90s as spreads doubled or tripled. As market participants started considering that these deals would not be called in such a market environment, alongside lower prepayment rates on the underlying collateral, however, they now believed that some bonds looked like 10, 15, or 20 year long bonds! Under these assumptions, such bonds would be consistent with prices in the 70s or lower in many cases, even for the stronger credits.

Although investors tend to avoid selling such underperforming bonds in that market context, liquidity pressures can create attractive opportunities to add these exposures at levels that sometimes overlook the fact that these bonds could suddenly be priced as 2-year bonds again should markets turn, compounding the upside potential for investors willing to accept the price volatility in a base case. We also focus on the stronger issuers, with a greater confidence level around their ability to call.

The first tsunami waves of downgrades are already crashing ashore

Like vultures descending upon a carcass, rating agencies have begun taking action on both the structured finance market and their underlying assets following the complete collapse in economic activity that has resulted from the Coronavirus pandemic driven global lockdown.

The negative actions from rating agencies have already encompassed a wide range of collateral from consumer ABS, CMBS, and RMBS but the potential damage in the high yield corporate debt sector elicits the most attention. Leveraged loans and CLOs find themselves directly in the crosshairs of this focus with an estimated 20% of leveraged loans in CLOs already downgraded or placed on a negative watch (the fastest pace of downgrades on record). The direct risk to CLOs is that triple C rated assets blow through their typical 7.5% allowance per agency resulting in OC test haircuts which combined with increased defaults will result in cashflow diversions in the junior part of the capital stack. It is estimated that triple Cs in US CLOs have already increased from approximately 4% to 9% in the US with plenty more rating downgrades on the horizon and some research desks believing that up to 20% of CLOs are already breaching OC ratios.

S&P has forecasted the leveraged loan default rate could reach 10% on the back of the recession triggered by the pandemic whilst Fitch suggests 7% in year 1 followed by 8% in year 2 for EMEA CLOs and 7.5% and 9% for US CLOs. Moody's expects global speculative-grade defaults to increase to 9.7%, which is lower than the peak of 13.4% during the GFC.

On 17th April Moody's put 358 US CLOs and 39 European CLOs on review for downgrade, in an announcement that placed 976 tranches at risk. Such action was part of a mass rating review by Moody's S&P and Fitch in which 1,000 CLO tranches were placed on negative watch/outlook. The rating action is mostly focused upon BBB and lower tranches in this instance and, whilst it is the junior mezz tranches (BBB and below) of CLOs that are widely expected to bear the brunt of all rating action, all 3 major rating agencies freely admit that when running more severe scenarios (i.e. where the virus takes longer to be contained and/or where the pandemic results in a 2009-level recession or worse) potential downgrades could be seen up the stack as high as AA.

We are seeing lower volumes of trading in the sub-IG portion of the CLO market largely driven by the expectation of downgrades and potential cashflow diversions. Junior CLO spreads have therefore remained, extremely wide here and not followed IG CLOs significantly tighter in their partial recovery over the past few weeks.

PRYTANIA ASSET MANAGEMENT

TALF program relaunched …. but is it needed this time?

Through the first week of March, US vanilla senior securitized credit seemed to be only marginally influenced by the broader market panic. This was logical given these are asset classes characterized by bankruptcy-remote cash-flowing asset pools, short maturities, and structures built to withstand immense amounts of macroeconomic stress. However, the subsequent mad “dash-for-cash” caused chaos as investors worried about Covid-19 uncertainties ahead looked to any pockets of liquidity to raise funds.

During March, secondary US ABS trading volume reached an astonishing $49.8bn, which is 2.2 times normal monthly average volumes of $22.7bn. This violent sell-off in an otherwise fundamentally sound corner of the credit markets caused credit spreads to approach GFC-era wides, and primary issuance markets came to a grinding halt by the second week. A large part of the US economy is driven by consumer spending, a significant proportion of which relies on healthy securitization markets to provide an ongoing cheap funding source for consumer credit. A non-functioning primary market means that new spending would be constrained and creates the potential for further exacerbation of a downturn. So the Fed picked up an old playbook from the shelf, dusted it off, and announced TALF 2.0.

The original TALF program can be credited for creating confidence, providing a pricing floor and restarting the securitization markets in 2009. It accomplished this by enticing new investors with equity-like returns in the safest part of the capital structure via incredibly attractive non-recourse financing directly from the NY Fed. Bypassing the bank liquidity bottleneck and not subjecting the government to any real credit risk was a hugely successful strategy. Of the original $200bn in authorized program size, only $71 billion in loans were actually utilized. Over the course of 12 months, credit spreads compressed to the point where the artificial support could be withdrawn and this part of the market was back to functioning normally again.

The circumstances are different this time around and, even though TALF 2.0 has not officially launched yet, the psychological effect of the initial announcement on March 23rd and subsequent Fed statement on April 9th has to some degree already had their desired effect. Secondary spreads (particularly in vanilla sectors) have rallied and primary markets for generic deals can be restarted without the need for TALF financing. However, credit spreads in certain sectors that are more heavily affected by the Covid-19 shutdown will stay elevated, causing some strain on issuance and it is these sectors that will benefit when the program officially launches. We believe that, while the extraordinary returns available via TALF 1.0 on the most supported asset may not be available as broadly this time around, investors that are able to move quickly will be handsomely rewarded in more off-the-run sectors, including being prepared for the inclusion of future eligible asset classes if the program is further expanded.

Credit Spread (bps)	30-Mar-19	31-Dec-19	31-Mar-20	08-Apr-20	16-Apr-20	YTD change
EUR CLOs						
AAA	103	118	250	275	200	+82
A	233	243	540	525	413	+170
BBB	338	378	860	860	675	+297
RMBS / CMBS						
UK Prime AAA 5yr £	76	69	160	145	135	+66
UK Prime BBB 5yr £	200	180	375	375	350	+170
UK Non-Conforming AAA 3yr £	111	96	240	210	195	+99
Spanish RMBS AAA 5-6yr €	135	113	215	190	175	+62
Italian RMBS AAA 6-7yr €	145	121	225	200	185	+64
Europe CMBS AAA 5yr €	117	103	245	235	230	+127
US Floating Cards AAA 5yr $	50	49	145	145	140	+91
US FFELP Student Loans AAA 3yr	50	60	230	180	150	+90
US CMBS AAA (Swaps+) 5yr	58	60	210	230	185	+125
US Prime Auto AAA 3yr	39	38	135	130	130	+92
US Private Credit Student Loans AAA 3yr	70	80	250	250	225	+145
US Sub Prime Auto AAA 2yr	35	44	300	300	165	+121

Source: Bloomberg, J.P. Morgan Chase & Co., Copyright 2020, data as of 16 April 2020.