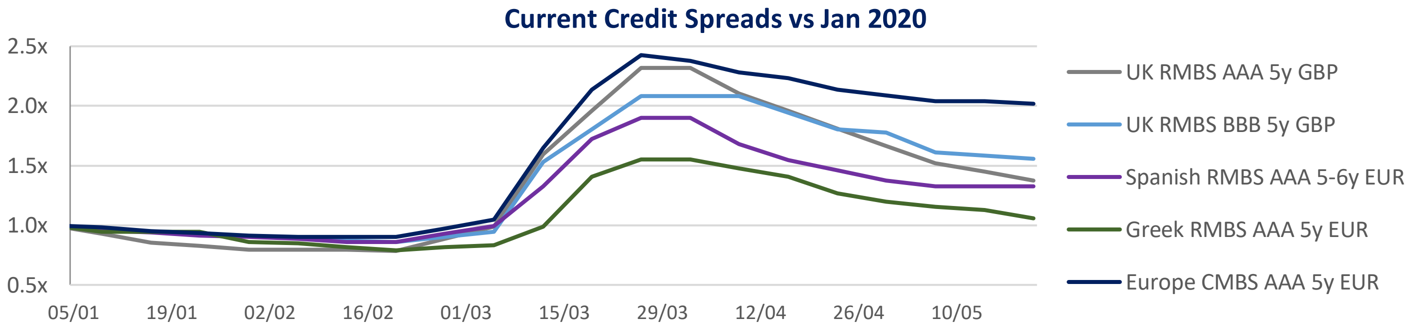
A rising tide lifts all boats

As the recovery rally continues unabated, investors feel pushed towards riskier tranches and more esoteric asset classes, driving spreads tighter and prices higher across the market. We mentioned last month the appeal of senior European CMBS bonds and that part of the market has seen an increase in liquidity and demand since then. As positive news emerged on the lockdown, bonds backed by retail parks, hotels and student accommodation are also seeing higher prices, as investors deem the protections offered by structures sufficient despite the fundamental challenges ahead.

Lower CLO mezzanine bonds have also performed well, as the loan market recovery points to lower expected default rates than was observed in March and April. Generally, we continue to see default and restructuring risks on the underlying collateral and further rating agency downgrade risks at the securitisation tranche level until year end at least but the variability of outcomes has certainly reduced, allowing the market to put a more confident price to take most types of risk. With the massive monetary and public support to risk assets ongoing, investors should still be very conscious of the challenges ahead for many borrowers and try not to get carried away by the 'Fear Of Missing Out' on the price rally that has been a dominant sentiment in recent weeks.



Source: J.P. Morgan Chase & Co., Copyright 2020, data as of June 2020.

US ABS - Crisis, What Crisis?

Over the past few weeks US senior ABS, like most other markets, has also staged a sharp recovery. While credit spreads are still elevated to historical averages in most cases, the QE driven rally in rates means that all-in yields for most of the market is now once again close to pre Covid-levels. This is remarkable, especially since remittance reports for some high beta sectors have exhibited worsening collateral quality related to the Covid shutdown. For example, there has been a sharp rise in forbearance rates in private student loans pools (one issuer had an increase of 10x from pre-Covid levels to 12-13%) and dealer floorplan payment rates have declined due to the reduction in auto purchases (one issuer declined from 43% to 28% MOM). However, so far, consumer loan performance has exhibited more relative stability mostly due to the immediate impact of the unprecedented direct governmental stimulus to consumers.

The price rally can be best explained by the following: (i) the psychological effect of having a government guaranteed "TALF price floor" at + 125 to 150bps, (ii) relative value of senior ABS i.e. short weighted average lives combined with high level of credit enhancement and strong structures that insulate senior bonds from any real credit risk even taking into account Covid stress, and (iii) a massive reduction in new issue supply without a corresponding decrease in demand ($27billion in primary ABS supply, which is about 50% compared to the same period last year).

Post-Covid New Issue Average Spreads (bps)

	April	May	June		April	May	June
Spreads by Ratings (All Sectors)				**AAA Spreads (By Sector)**			
AAA	142	92	79	Prime Auto	117	74	39
AA	303	250	196	Prime Lease	N/A	N/A	69
A	366	348	272	Subprime Auto	158	122	68
BBB	533	540	448	Equipment	175	97	84
BB	N/A	762	578	Pvt Stud Loans	N/A	170	170
B	N/A	1,000	N/A	Esoteric	350	N/A	250

Source: Finsight, Prytania Asset Management, data as of June 2020.

PRYTANIA ASSET MANAGEMENT

Aircraft tracker: please fasten your seatbelts!

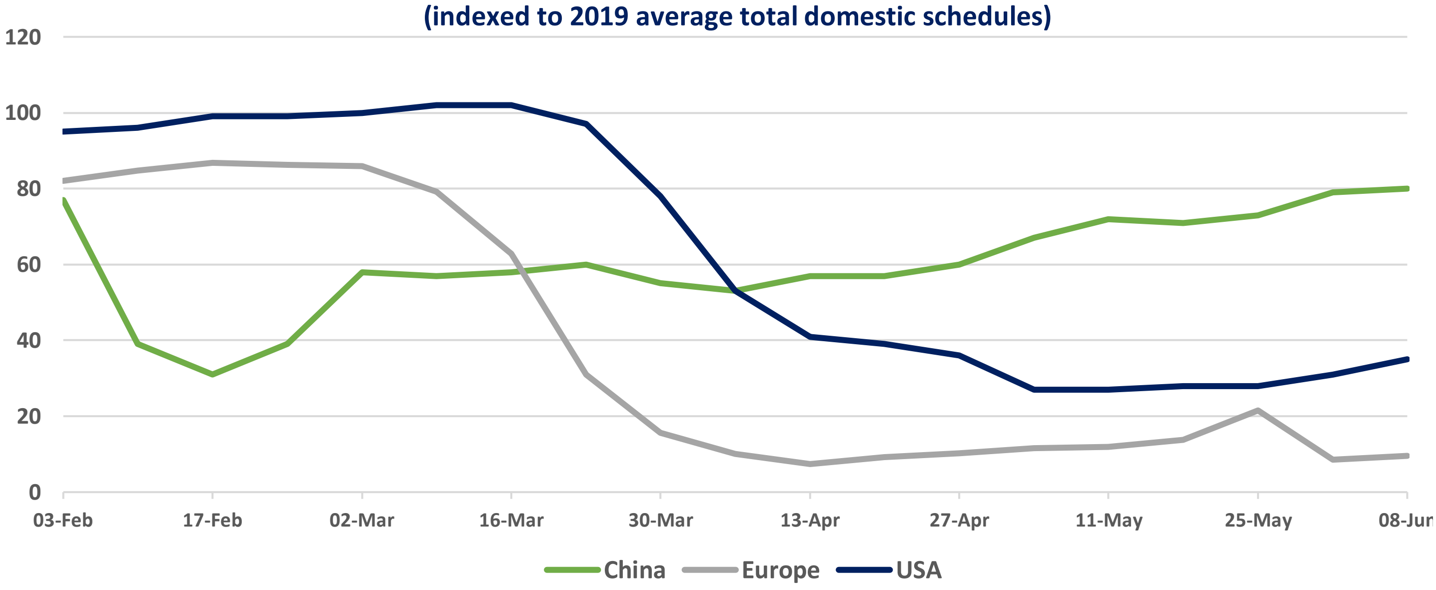
Airlines are desperate for easing of travel restrictions to survive this unprecedented crisis in modern aviation times to capture the fledging revival in passenger demand. Covid-19 brought aviation to an almost complete stop, as governmental lockdowns, quarantine and social distancing measures only allowed for cargo flights and very limited passenger services. Many major airlines had to be bailed out by their home governments as high leverage and low liquidity left them crashing towards imminent bankruptcies. Others are not so lucky and have defaulted, with the risk of more casualties to come.

The recovery is already well on the way in the P.R. China, with domestic flights flown back to 74% of January peak demand while international flights flown linger at 5% (hardly up from the 2% trough). US airport travel throughput is gradually increasing from YoY low of 4% to 15%. Spain has announced they will drop any quarantine requirements for passengers arriving to 'jump start' their tourism industry. We should expect further easings to occur in the EU and elsewhere which, in turn, will benefit airlines and lessor loans, bonds and shares, as well as aircraft ABS.

The pictures of most fleets grounded on the tarmac is manifested in aircraft lease ABS transactions where 50% to 75% of the airlines are not paying their lessors. As a result, all aircraft ABS will or already have, shut-off payments of P&L to the Class C and equity notes, and are behind in scheduled principal payments.

Purchasing the senior Class A notes in ABS deals at a yield of around 7% to 9% to maturity, however, has seemed an attractive risk reward to us since early April for a currently single A rated asset. With plane values and future rental revenue dropping, further rating downgrades will occur in the sector. Looking at a downside scenario, if all senior tranches are downgraded 5 notches or more to sub-IG levels, that would be challenging for ratings sensitive investors. The Class B notes can be bought at prices around the 60s, generating a cash yield of close to 10% and yield to maturity close to 20% depending on the scenarios run. This could also be an interesting purchase for the higher quality deals if investors can take a longer term view over the next 2 years.

Total (domestic and int'l) scheduled flights index (indexed to 2019 average total domestic schedules)



Source: OAG Schedules Analyzer; J.P. Morgan Chase & Co., Copyright 2020, data as of June 2020.