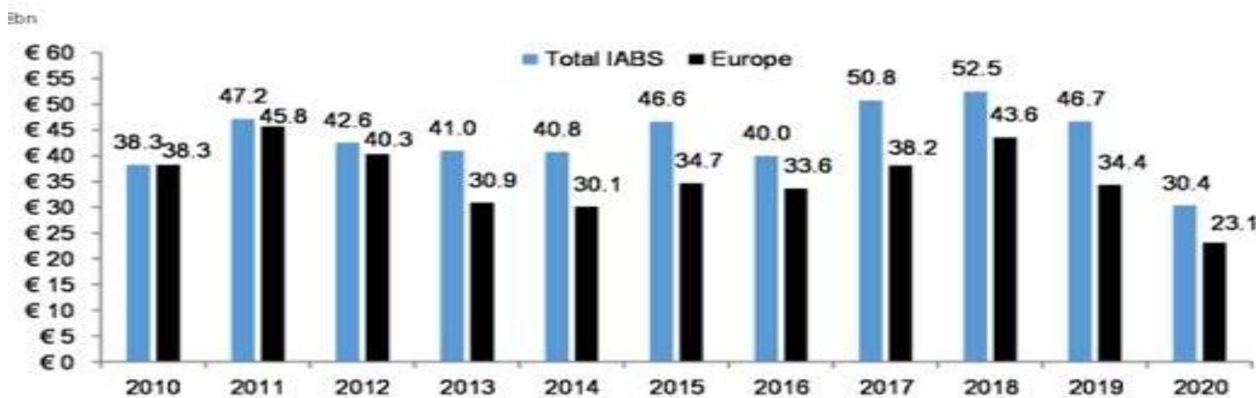
ABS New Issue Supply – Down But Not Out

The Covid-19 pandemic effectively shut down the issuance of new ABS deals in the European markets since March as spreads on all risk assets including ABS widened dramatically. The consequent decline in government bond and then corporate yields prompted record amounts of corporate bond issuance in Europe once spreads had stabilised, with borrowers taking the opportunity to issue debt at absolute low rates and to shore up their liquidity positions. The Euro IG non-financials supply stands at €317bn YTD up 55% v 2019.

The ABS market, being mainly tied to floating rate indices like LIBOR and SONIA, did not see this surge in issuance activity, coupled with the fact that Central Banks were providing bank issuers very cheap funding via various repo and other programmes. However, ABS supply has picked up recently especially from non-bank lenders in sectors such as UK non-conforming and Buy-To-Let RMBS which has been met with good demand from investors, although it has been noteworthy that much of the issuance has been pre-placed to small groups of buyers rather than being broadly syndicated. At the half year mark, issuance for International (non-US) and European ABS now stands at €23.1 billion, down 24%. In light of the overall slowdown in economic activity during the Covid-19 crisis with the concomitant reduction of new collateral production in e.g. residential mortgage and auto loans, we would not expect to see new issuance to make up the lost ground this year and will remain below the previous few years' levels.

H1 2020 YTD Distributed International and European ABS Issuance since 2010



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

US ABS – Shrinking Supply, Increasing Demand

New issuance in the US ABS market in the initial phase of the Covid-19 crisis all but shut down and during the usually busy second quarter period, a paltry total of $15 billion in deals were recorded. The announcement of TALF and extraordinary provisions of liquidity by the Fed to backstop markets then led to a flurry of activity with roughly $39 billion in transactions pricing in June and July. However, the psychological effect of the backstop is what really reignited activity and the extent to which available government liquidity has actually been utilized has been minimal. Over the first 4 TALF subscription dates, only $2.6 billion (2.6% of max program size) in loans were requested with a vast majority (circa 85%) being put to work to acquire SBA pools and secondary CMBS. The current carry available in the TALF trade is in the low to mid-single digits with higher returns only possible through continued spread compression.

TALF Subscription Summary ($ m)

ABS Sector	TALF Loan	Bond Notional	Est. Equity	% (By Notional)	% (By Equity)
Auto	-	-	-	-	-
Commercial Mortgage	813	956	143	33.4%	55.6%
Credit Card	-	-	-	-	-
Equipment	-	-	-	-	-
Floorplan	-	-	-	-	-
Leveraged Loan	-	-	-	-	-
Premium Finance	107	115	8	4.0%	3.1%
Small Business	1,432	1,507	75	52.6%	29.2%
Student Loan	254	285	31	10.0%	12.1%
Total	**$2,605**	**$2,863**	**$258**	**100.0%**	**100.0%**

Source: Federal Reserve Bank of New York, data as of August 2020.

PRYTANIA ASSET MANAGEMENT

While the healthier supply has spanned the range of sub asset classes from vanilla autos to less-followed sectors like cell towers and timeshares, there has been a notable absence of credit card and dealer floorplan transactions and total year-to-date numbers are still far behind 2019 levels. Covid-19 linked lower expectations for GDP, reduced consumer spending and tighter lender underwriting standards have also led the market to now dramatically revise its 2020 total supply expectations to be roughly 30-40% lower than last year.

Investor's penchant for the higher relative yields available in securitized credit in this extended low rate environment combined with continued structural safety and the reduced supply story has meant that deals are being successfully executed often in a matter of 1 or 2 days after initial announcement and at massively oversubscribed levels. For example, the junior-most tranche in a recent timeshare ABS transaction - a sector which is naturally considered "higher-risk" - was roughly 8.4x oversubscribed even after the deal was upsized from its original announcement.

CLOs again defy their critics and shake off rating agency downgrades

CLOs are yet again proving themselves in 'battle' as we saw in 2008-2009. Wells Fargo reported that OC cures are now outpacing new OC failures by 10x in July 2020. Only 17% of US CLOs are currently failing an OC test, down from 21% at the end of June, whilst just 2% of European CLOs are failing an OC test, reflecting a far better performance profile. Unlike the dire forecasts we saw earlier in the year around waves of CLO tranches deferring interest payments, Wells Fargo suggests that in Q3 just 2.3% of CLO tranches PIK'd (deferred interest). Whilst CLO equity payments did indeed reduce 1.1% QoQ from 3.2% in April to 2.1% in the US in July, and 0.6% QoQ from 3.2% in April to 2.5% in Europe in July, the majority of missed payments were not in fact caused by OC failures but in fact voluntary deferrals to allow managers flexibility in the reinvestment of remaining interest proceeds. The reduction in CLO equity payments was largely driven by a small uptick in defaults as well as from borrowers switching from monthly/quarterly payment schedules to 6 monthly schedules.

S&P and Moody's Combined				Resolution Detail (by small rating)					Resolution Detail (by rating category / class)			
Prev Class	OnDG Watch	Resolved	Resolved	Affirmed	DG 1 notch	DG 2 notch	DG 3 notch	DG 4+ notch	Same Class	DG 1 class	DG 2 class	DG 3+ class
AAA	0	0										
AA	9	3	33%	33%	67%	0%	0%	0%	100%	0%	0%	0%
A	84	21	25%	33%	57%	10%	0%	0%	90%	10%	0%	0%
BBB	509	75	15%	45%	49%	4%	1%	0%	49%	51%	0%	0%
BB	712	124	17%	19%	61%	8%	6%	6%	22%	74%	4%	0%
B	317	69	22%	30%	32%	28%	7%	3%	38%	62%	0%	0%
CCC	37	8	22%	0%	38%	63%	0%	0%	50%	50%	0%	0%
TOTAL	**1668**	**300**	**18%**	**29%**	**51%**	**13%**	**4%**	**3%**	**39%**	**60%**	**2%**	**0%**

Data Source: Amherst Pierpont, S&P ratings, Moody's, data as of August 2020

Secondary European AAA CLO spreads have retraced 82% of the March 2020 Covid-19 led widening, currently reflecting 160 DM, which is some 45bps wider than February 2020 levels. We see the same 82% retracement in secondary European single-B spreads, which have tightened from a wide of 2,250 DM back to 1,150 DM, which is some 245bps wider than February 2020 levels. Combine that with the slowdown in loan downgrades and the marked rebound in CCC loan prices and there is little surprise that market sentiment has approached a state of near-bullishness. The Prytania CLO team, however, remain cautious for H2 2020 and note the ongoing CLO liability downgrades. Less than 20% of the 1,000+ bonds put on downgrade watch negative in April 2020 have been affirmed or downgraded meaning there is plenty more downgrade potential. We think the majority of BBs and single-Bs on watch negative will indeed be downgraded whilst the BBB tranche is perhaps the fulcrum tranche where there is far less certainty whether a downgrade will occur.

However with spreads still wider than long term averages, we still think there is plenty of opportunity in CLOs, especially for IG bonds.

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