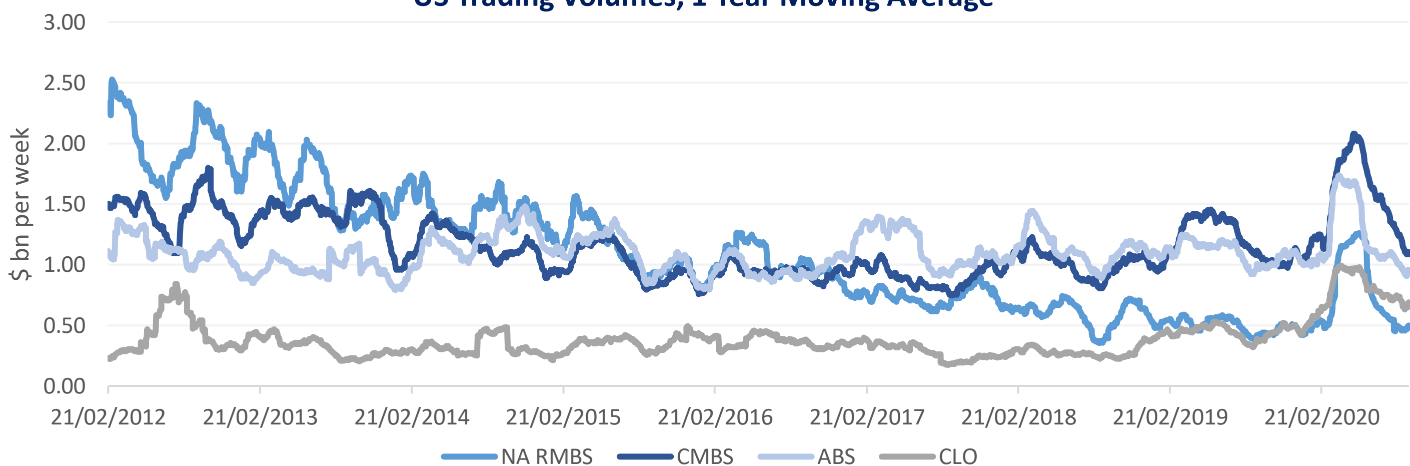
CLO Update

In the first week of October, loan prices retraced 3 weeks of gains before stabilising with the European Leveraged Loan Index down about a point to 94.5. This marked a significant change in market sentiment as risk assets sold off and investors put the brakes on what has been a large one-directional market recovery since March. Driving that about-turn were global economic concerns surrounding fears of a second lockdown amidst Europe's pickup in virus cases whilst in the US, such concerns were amplified as the potentially contentious presidential election neared.

CLO BWIC volumes were elevated and execution became weaker, typically in junior tranches as markets became choppier, however primary markets remained better insulated given strong demand and only steady supply. That said spreads now seem to be pointing slightly wider. We expected renewed bouts of volatility this autumn, in particular, due to the US elections and the UK's Brexit transition period nearing an end, with Covid-19 developments serving as an accelerator - in either direction - of spread movements.

A micro-focus upon CLO AAAs right now reveals an interesting dynamic playing out across both sides of the Atlantic. Whilst in the US CLO AAAs range from 125-160 DM depending on manager, credit profile and structure, the basis in Europe is far closer with top tier managers printing at 110 DM currently whilst those not as lucky to print there might be up to 15bps further back. Whilst part of the discrepancy is due to credit performance along with the far larger manager universe, it is also notable that bank demand for CLOs has significantly declined, leading to a market driven by many remaining investors, who are often focused on liquidity. This suggests tiering will remain relatively wide in the US and we can see the potential for this to become more pronounced in Europe if the sentiment is more cautious through the turn of the year.



Source: Deutsche Bank, Copyright 2020, data as of September 2020.

The past does not repeat itself, but it rhymes

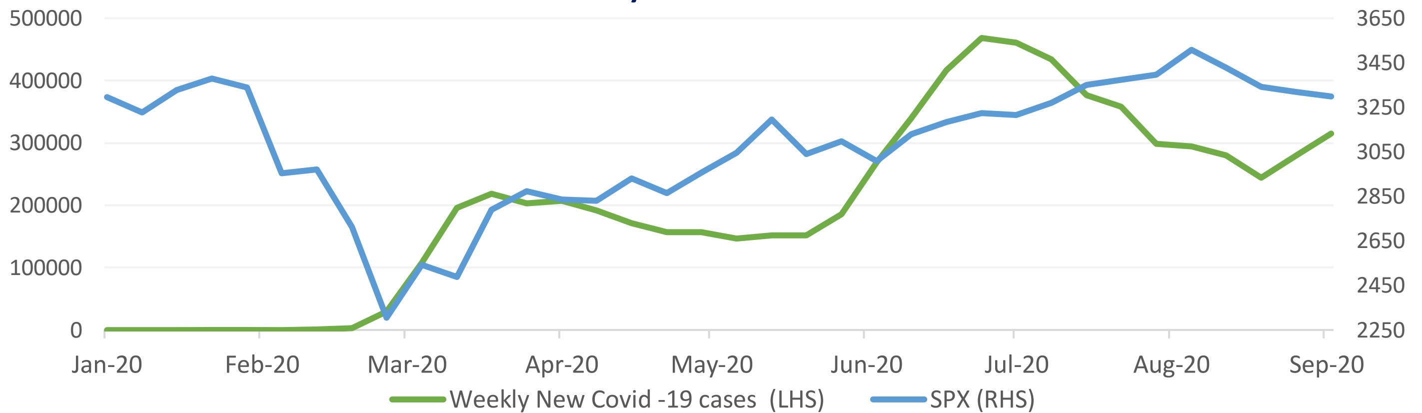
Following the sharp drop in risk assets during the initial wave of the pandemic, prices rebounded to reach historical highs over the summer, with the signs of a second wave of confirmed cases all but ignored by investors at that stage. The combination of fiscal and monetary support during that period certainly helped revive both the economy and financial markets' "animal spirits" and, perhaps, the fact that the ramp up in testing capabilities had boosted the number of positive cases provided investors with some comfort too.

Structured Credit markets also followed suit with a broad based tightening, any increase in supply being met with a seemingly never ending demand. New deals in primary were generally multiple times oversubscribed, almost regardless of the collateral type or credit quality. Only the sectors most directly affected by the pandemic – such as travel and hospitality – were excluded from that rally, and for good reasons given the longer term uncertainty around the solvency of many of those activities.

The latest resurgence in cases has now had a more pronounced impact on markets and there is a widespread belief that this is a turning point as many of the original temporary government support programs are scheduled to come to an end. This situation will certainly remind investors of the market-reliance on ever larger and more frequent Central Bank

interventions in the Great Financial Crisis, when market participants held their breath at each announcement, and market direction was largely driven by those technicals for years. With the monetary "ammunitions" now largely depleted, and given the particular nature of the current crisis, government support through public spending has to shoulder most of the burden of supporting the economy and the markets through 2021.

If we continue the parallel one step further, looking at Europe's experience in 2010-2012, withdrawing this public support too fast or too soon is likely to be seen by the consensus as a very dangerous path to take anywhere in the world.



Source: Bloomberg, September 2020.

Time to move on

The UK's COVID-driven economic shutdown between March and May came with an accompanying swathe of doomsday headlines predicting wholesale unemployment, the death of the High Street, the deepest recession in modern history and the collapse in the UK housing market – generally considered a major source of "wealth" for the average UK consumer.

Hindsight will be a wonderful tool when re-examining COVID responses, medical, social and economic, but one thing that has become clear is that the predictions of a collapse in the UK housing market are, so far, way off the mark.

As the crisis deepened Savills suggested a 10% drop in HPI, the Centre for Economic and Business Research (CEBR) a 13% decline and Knight Frank said total property sales volumes for 2020 would drop by around 40% vs 2019.

In reality, RICS reported in September that its house price growth indicator had hit a four year high whilst the Nationwide HPI Index shows a 4.98% year on year growth in capital values. UK (HMRC) official data showed 594,760 sales completed to the end of August '20, compared to 782,890 for the same period in 2019. Whilst 25% down year-on-year, the decline is nowhere close to Knight Frank's -40% forecast. With July reportedly having the highest number of agreed sales since records began there is also a strong chance sale volumes end the year close to 2019.

Yes, tax incentives are playing a part but it should be remembered that the Chancellor didn't remove the 3% additional stamp duty paid by second home buyers, usually BTL landlords who were said to be the key driver of HPI growth in prior years. The younger 16-24 age demographic are also suffering disproportionately from the economic fallout vs the wider population. This age group are typically not homeowners in the UK, possibly explaining why mortgage arrears are also low vs predictions of arrears levels not seen since the 1980's, mortgage defaults driving losses higher for domestic lenders and foreclosures seeing auction properties rise.

The economic outlook for the UK remains far from certain, with a potential hard BREXIT looming, and elevated levels of unemployment and – outside the public sector – declining earnings but, as far as predictions of an unparalleled collapse in property prices go, perhaps it is time to move on.

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