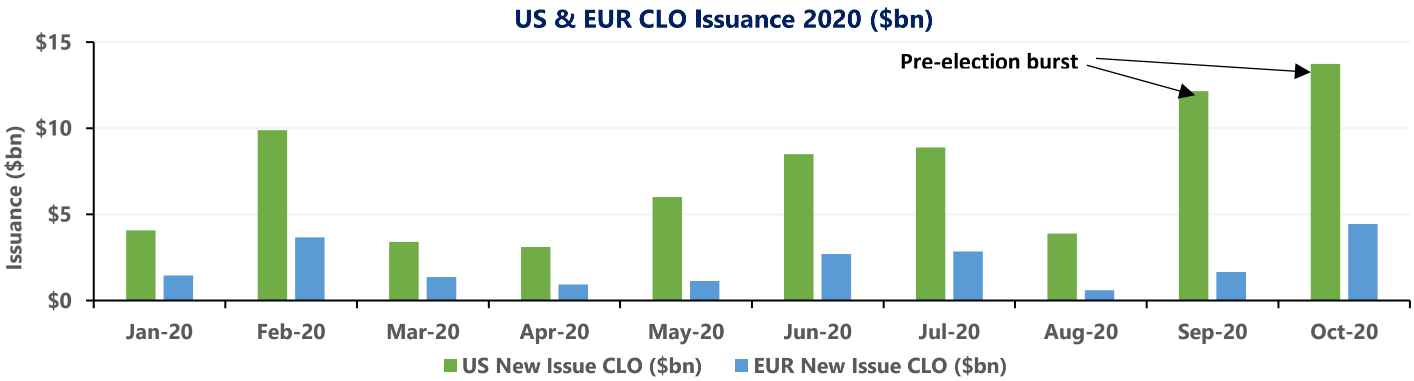
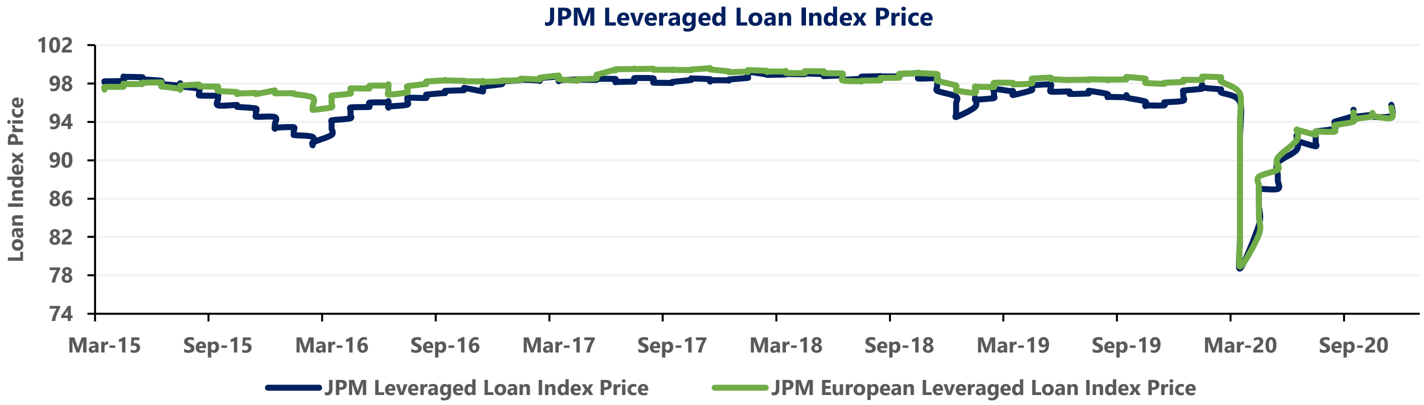
CLOs: autumn storms dissipate

As many major European countries have entered a second national lockdown to restrain Covid-19, CLO investors were braced for a series of storms that often characterize both the weather and the markets at this time of year. The weakness that developed in the wider global markets in the latter part of September spread into CLOs, particularly in the junior tranches, through October. Some of the widenings in spreads came from nervousness about politics, especially in the US and the UK with respect to the looming Brexit deadline without a trade deal but the largest factor was the second wave of Covid-19 spreading across many leading countries. A progressive tightening of lockdown restrictions in each economy could cause another wave of delinquencies, defaults and tranche downgrades. These fears have all abated in early November, triggering a strong rebound in asset prices globally and the whole of the CLO curve has seen a pronounced bounce in prices. As seen in very bullish equity or corporate bond and loan markets, the question going forward for investors is whether the apparent disconnect between current fundamentals and asset prices is understandable and whether it can persist.

Fundamentals and technicals appear much improved when compared to the depression in the Spring. Rating agency downgrades are now far reduced and corporates with less liquidity and weaker business models/performance have long since been downgraded or even pushed into restructuring. The remaining universe of corporates often enjoys Balance Sheets that are cash-rich, having pulled on the variety of liquidity levers to allow them to navigate through this next phase of the Covid-19. Whilst higher levels of leverage is, of course, a concern in time, the market does not as yet expect another aggressive rating downgrade wave or any significant pick up in defaults than has already been assumed. CLO tranche market value coverage is improved following the strong loan price recovery and OC cushions, governing cashflows, improved as a consequence, assisted by active portfolio management and risk reduction in the form of lower CCC balances in many cases.



Source: Prytania Asset Management, November 2020



Source: J.P. Morgan Chase & Co., Copyright 2020, November 2020.

October saw the highest monthly global CLO issuance ($18.1bn) since April 2019 and with YTD issuance at $94.4bn, volumes are some 27% lower year-on-year. CLO secondary volumes have hugely increased with US CLO volumes (per TRACE) increasing 80% year-on-year, setting a record for annual secondary volume by mid-July! Whilst many sources of potential market volatility remain, we note some of these are less problematic than in the past. For example, retail loan investors who have historically often been a source of loan price volatility, now make up just 5% of the leveraged loan investor base. Looking past the current adverse impact of Covid infections and lockdowns, we continue to anticipate a renewed recovery through 2021. The capacity of investment grade CLOs to withstand both repeated market volatility and credit deterioration over multiple cycles and in an interest rate environment we expect to be lower for longer, shines a spotlight on the asset class as a rare combination of lower risk and higher yield for return seeking investors.

PRYTANIA ASSET MANAGEMENT

Movie Royalties: a Joker up the sleeve?

Movie royalties ABS is one of the rare asset classes which is largely less correlated to the overall economy and has performed solidly throughout Covid-19. Consumers will continue to watch movies, whether through streaming services, pay TV or regular TV. Covid-19 has not stopped the demand for entertainment and the lockdowns have served primarily to change the distribution of consumption of media products. The segment of the movie commercialisation chain that has been hit extremely hard – cinemas - feeds off newly released blockbuster movies and relies on screening to large, closely seated audiences. Delays in releasing the new James Bond movie and other scheduled blockbuster movies has depressed cinema visits while the renewed current, and potential future, lockdowns are likely to be a final nail in the coffin for many of the highly levered cinema operators. Cashflows for newly released movies are uncertain and, thus, volatile but once the initial film viewings and movie ratings are known, the subsequent commercialisation cashflows are more predictable. Movie right owners can also increase the expected future movie cashflows by creating sequels, which increase the value of the prior movie.

Village Roadshow Entertainment Group recently came out with their first VINE 2020-1 transaction. The A/B/C notes, rated A/BBB/BB by DBRS, WAL of 4.5/3.6/3.6 years, LTV of 75%/79%/82%, were placed at S+395/450/775bps. The movie portfolio contained blockbusters like Joker and The Matrix. Given the infrequent issuance of movie and royalty ABS in general, the asset class has a more limited buyer base but investors can balance the less liquid nature against the benefits that it brings in portfolio diversification.

Second wave Covid restrictions less onerous

Almost all countries have implemented a lighter version of the lockdowns imposed during the first wave of the Covid-19. A balancing act between the economy, politics and Christmas is being attempted. The major European countries with the tightest restrictions are Ireland, followed by France and the UK, while Germany/Italy/Portugal/Spain have all tightened restrictions even if they are still considerably lighter than Spring. Given the high Covid case numbers and restrictions, we should brace ourself for negative GDP numbers for countries such as France/Ireland/Spain/UK in Q4. The success of this lighter lockdown is being measured by sub-1.0 R rates to allow for an easing over the Christmas period.

Location	Continent	Spring Restrictions Index	Summer Restrictions	Nov Restrictions Index
France	Europe	88	46	79
Germany	Europe	77	57	59
Ireland	Europe	91	39	81
Italy	Europe	94	47	67
Netherlands	Europe	80	36	62
Portugal	Europe	88	55	63
Spain	Europe	85	39	71
United Kingdom	Europe	80	64	75
United States	North America	73	63	63
Average		84	50	69

Source: Oxford Covid-19 Government Response Tracker

Vaccine optimism fuels further market advances

The autumnal gloom over the surge in cases and renewed lockdowns was lifted by the news that a vaccine developed by Pfizer/BioNTech has shown 90% efficacy against Covid-19 in their Phase 3 trial results. Subsequent similar announcements on two other vaccines, with more in the pipeline, added to the optimism of an imminent escape from the depression in 2020. However, momentous milestones still lie ahead: 1) mass production to levels not seen before, 2) logistical difficulties to transport and store vaccines (e.g. at -70C for the Pfizer/BioNTech example), 3) mass immunisation logistics require large numbers of trained nurses, 4) actual willingness to be vaccinated which hovers around 34% to 52% in latest polls. Material herd immunity probably will not be reached in advanced economies until the first half of 2022 and, more globally, 2023. Overall, while there may be adverse news from day to day, we expect the ongoing positive vaccine news over the medium- to long-term to provide a continuous boost to stocks and risky assets, particularly for the hardest hit industry segments.