STRUCTURED FINANCE ASSOCIATION

Research Corner

July 13, 2020

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Research Corner - Market Signals

Market summary. The primary and secondary securitization market were relatively quiet in the first week of July. New issue activity was limited to three CLOs totaling $1 billion.

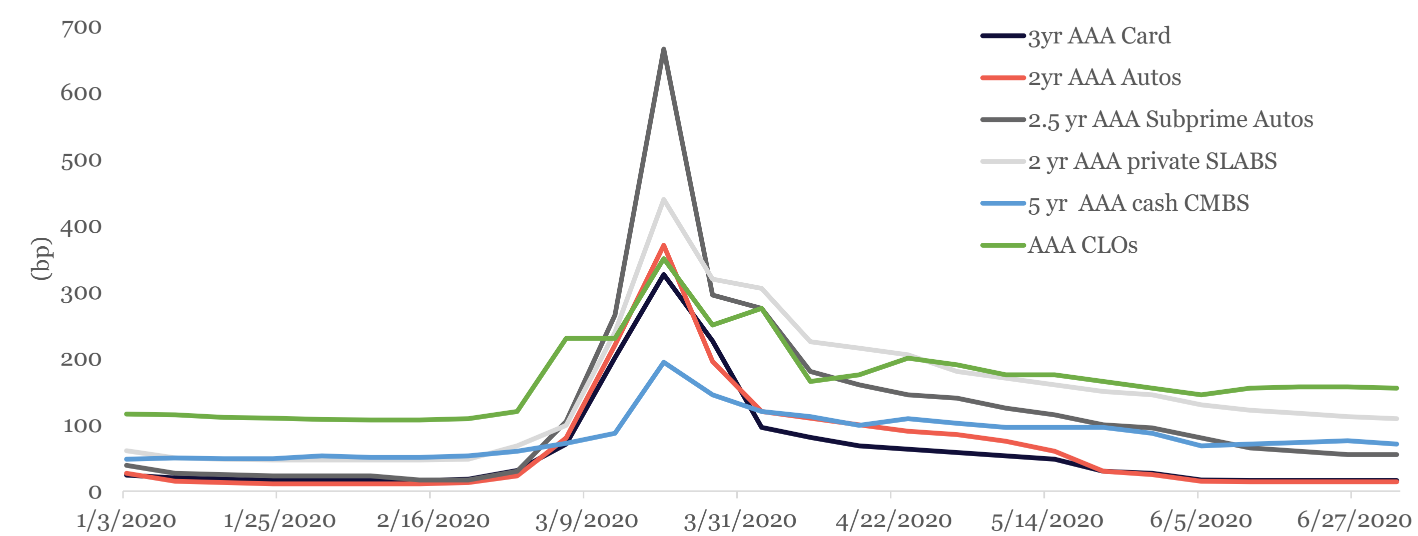
The bid-ask spreads for triple-A rated bonds in the most active sectors were unchanged for the week. As we wrote in our last report, constrained supply and robust demand have kept bid-ask spreads on triple-A bonds in the most liquid sectors at or near the tightest levels of the year. As market conditions have stabilized investors have been more willing to pick up assets that are perceived to be incrementally riskier, such as non-triple-A investment grade bonds in liquid, actively traded sectors, in exchange for incrementally higher yield. Our table below shows the spread difference between a triple-A prime auto ABS with a 3-year maturity and double-A, single-A and triple-B bonds from the same sector and with the same maturity. The spread difference between a triple-A prime auto ABS and a triple-B prime auto ABS averaged 90 bp pre-pandemic. That difference widened out by as much as 804 bp in April as investors, uncertain about market direction, required more compensation for bonds that were perceived to be riskier than safe-haven triple-A bonds. As markets firmed, particularly in active liquid sectors such as prime auto ABS, interest in non-triple-A investment grade bonds rose, closing the spread difference between triple-A bonds and bonds that carry a non-triple-A, but still investment grade, rating.

Spread difference between triple-A ABS and non-triple-A rated bonds (Prime auto ABS, 3yr maturity)

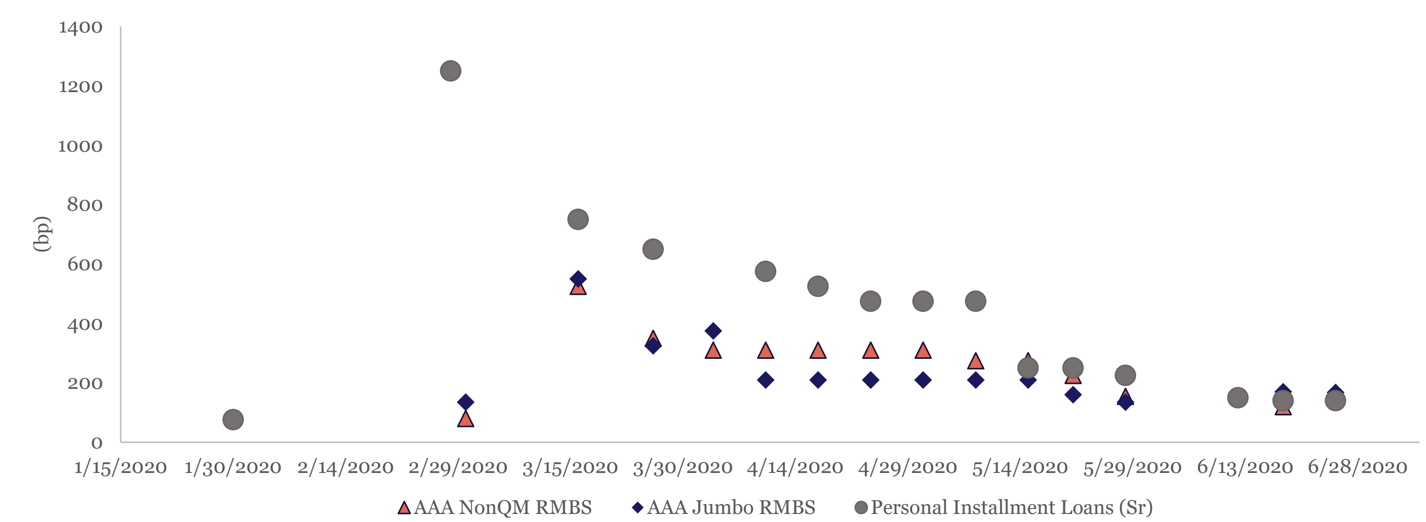
	AA-AAA	A-AAA	BBB-AAA
1/3/20	45 bp	57 bp	90 bp
2/7/20	45	57	89
3/13/20	119	149	164
4/3/20	229	479	804
5/1/20	107	257	457
6/5/20	83	218	328
7/3/20	67	180	214

Source: Deutsche Bank Research

Secondary Market Spreads

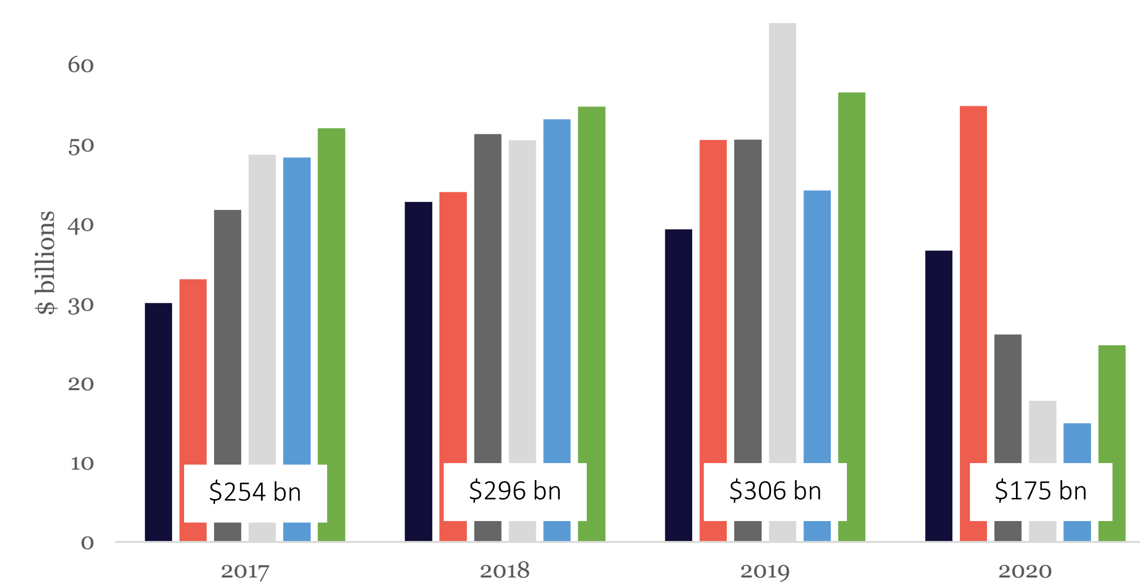


Source: Deutsche Bank Research



Source: Market Compilation

New Issue Activity



Source: Deutsche Bank Research

What We're Watching

What we're watching –

We start off with what has become an increasingly elusive metric-- jobs. Following the announcement that the official unemployment rate declined to 11.1%, the U.S. Bureau of Labor and Statistics reported that for the week ending July 4, another 1.3 million Americans filed for unemployment benefits for the first time. This represents a 5% improvement from the week of June 27 when 1.4 million people entered joblessness but is still 2 times greater than the peak weekly jobless claim reported during the 2008 crisis. The rate of week-over-week improvement did pick up slightly from June 20 and June 27, which saw improvements of 2% and 4%, respectively.

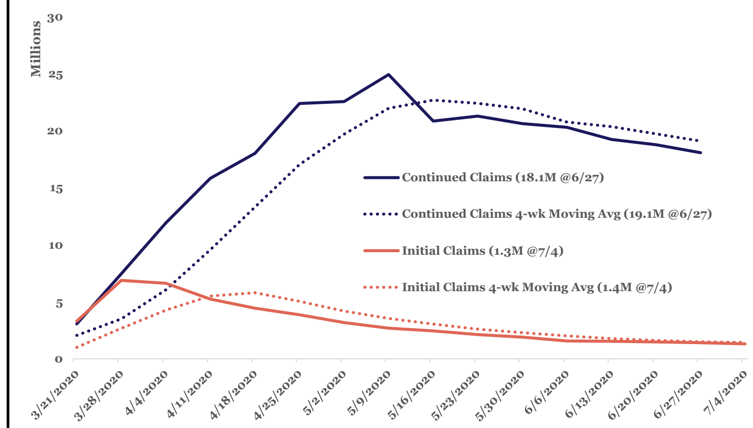
Private-sector employment increased by 2,369,000 from May to June, on a seasonally adjusted basis, according to the ADP Employment Report, which measures ADP payroll data. The increase was led by 937,000 small business workers (1-49 employees) returning to work. More jobs in June contributed to a 12 point rise in the Conference Board's Consumer Confidence Index. A closer look at the index shows that while the Present Situation Index improved by 17.8 points on the month, the Future Expectations Index only improved 8.4 points as consumers remained wary about the sustainability of the economic recovery, a particular concern as coronavirus cases in the U.S. rise at an alarming rate.

As contagion risks loom large, COVID-19 health concerns continue to shape consumer behavior despite business re-openings and more lax lockdown policies. Near real-time data from Safegraph, an AI data company that tracks foot-traffic data from business and consumer points-of-interest, shows that consumers have begun to retrench, reversing some of the improvements in commercial activity recorded in late May/early June. Newly reopened bars, restaurants, coffee houses and movie theaters saw declines in activity. While re-openings have restored some jobs and incomes, the resurgence of the virus is having negative impact on consumer demand.

Lastly, we look at the rise in commercial bankruptcy filings. So far this year, the American Bankruptcy Institute has recorded 3,604 Chapter 11 filings, 749 more filings than in 2019 at this time. Chapter 11 filings allow a business to restructure its debt and remain in operations, while a Chapter 7 bankruptcy involves liquidation. With bankruptcy filings on the rise, the focus has been on CLOs, as some of the companies seeking bankruptcy protection carry term loans held by CLOs. While the rise in bankruptcies has been painful for all holders of term loans, it is worth noting that these loans typically sit in the first-lien position and have had recovery rates of 60-70%. That said, the impact on CLOs will vary by a bond's position in the CLO capital structure. With 30-40% credit enhancement behind them, triple-A and double-A CLO tranches will be able to withstand significantly high levels of default before losing $1 of principal. It's for this reason that triple-A and double-A CLO tranches are unaffected by recent negative rating actions. For those interested in listening to a deeper dive on CLOs, please join Structured Finance Association (SFA) and S&P Global Ratings for a live discussion on CLOs, corporate loans, and COVID-19 on Tuesday, July 14 at 3:30 PM EDT. Registration is here.

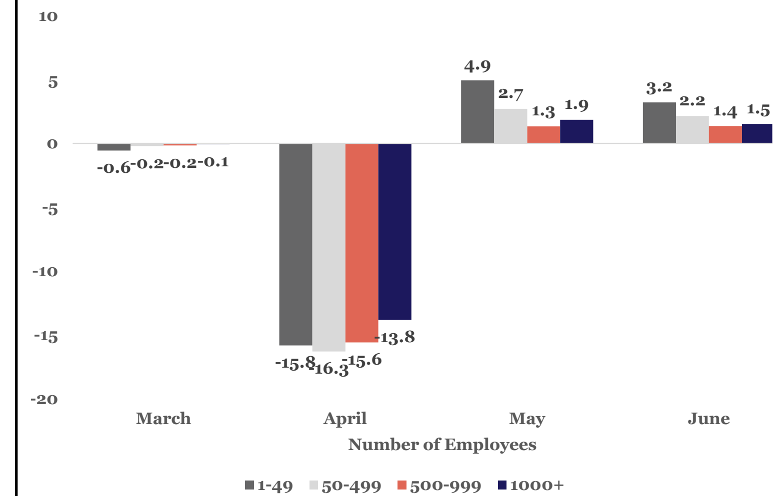
What We're Watching

Initial jobless claims down by 5% @1.3M (as of 7/4); Continued Claims at 19.1M (as of 6/27)



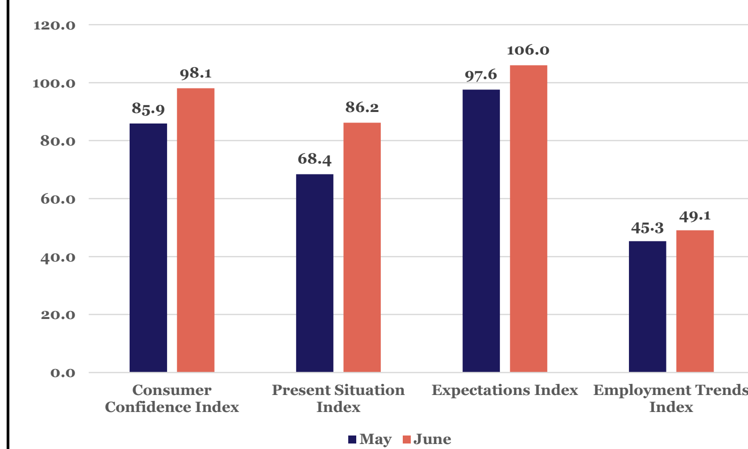
Source: Department of Labor

Improvements in Private Sector Employment led by small business



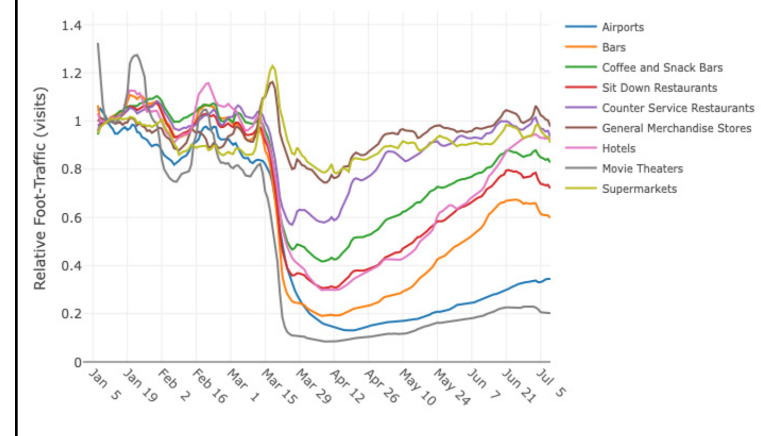
Source: ADP Employment Report

Consumer Confidence Index rises in June as consumers have more positive assessment of their present situation



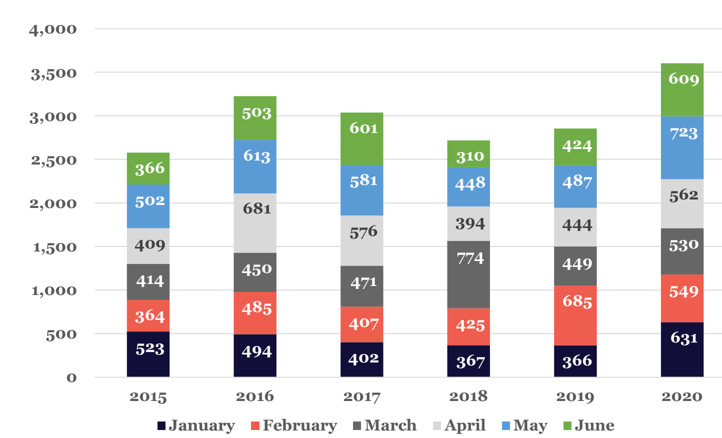
Source: Bureau of Economic Analysis

Consumer activity, measured by high frequency foot traffic data, shows improving trends are reversing in July for some industries despite widespread re-openings



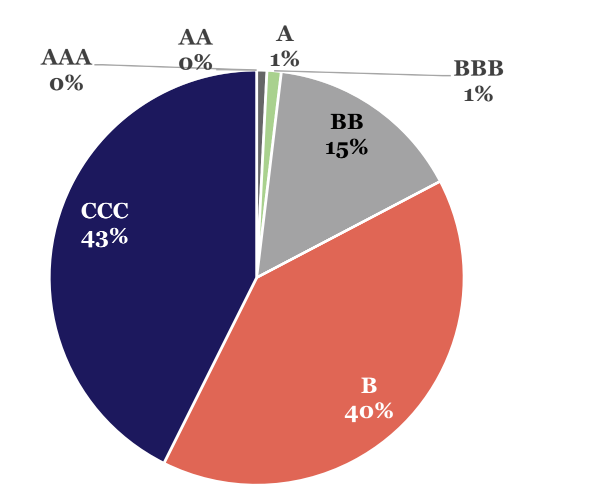
Source: Safegraph

Chapter 11 Corporate Bankruptcies rise 26% over 1H 2018 fueled by April and May filings



Source: American Bankruptcy Institute

10% of all S&P-rated CLO ratings are on CreditWatch Negative; AAA and AA tranches unaffected



Source: S&P Global