SFA RESEARCH: GUEST CORNER

UNIQUE PERSPECTIVES ON OUR MARKET

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Prior to establishing First XV in 2020, John held the position of Managing Director and Head of Consumer ABS Research at Wells Fargo Securities. Upon his arrival in 2007, he delivered strategies to clients to determine attractive risk-adjusted investments based on thorough credit analysis, quantitative modeling and relative value research. John constructed and published on a monthly basis industry leading credit indexes on credit card and auto loan ABS. His expertise has been recognized as a frequent moderator and panelist at industry conferences, such as ABS Vegas and ABS East in Miami. John placed as an *Institutional Investor* Fixed Income All-Star for ABS Strategy for 2017-2019.

In 2004, John joined Asset Allocation & Management Co. in Chicago where he was portfolio manager and trader responsible for a $1 billion+ ABS and non-agency MBS portfolio, as well as a $450MM commercial paper portfolio. From 1997 to 2004, he was a member of the ABS Research Group at Banc One Capital Markets. Prior to BOCM, John worked at Duff & Phelps Credit Rating Co. as an analyst and manager in the ABS Ratings Group.

John began his career as an associate economist in the Economic Research Departments of the Federal Reserve Banks of Chicago and Cleveland, publishing research in the areas of monetary policy and financial market regulation. John earned an MBA from the University of Chicago-Booth School of Business, and a B.A. with honors in economics and philosophy from Saint Louis University.

STRUCTURED FINANCE ASSOCIATION

Pricing ABS Risk Under COVID-19: Conflicting Signals from Fundamentals and Technicals

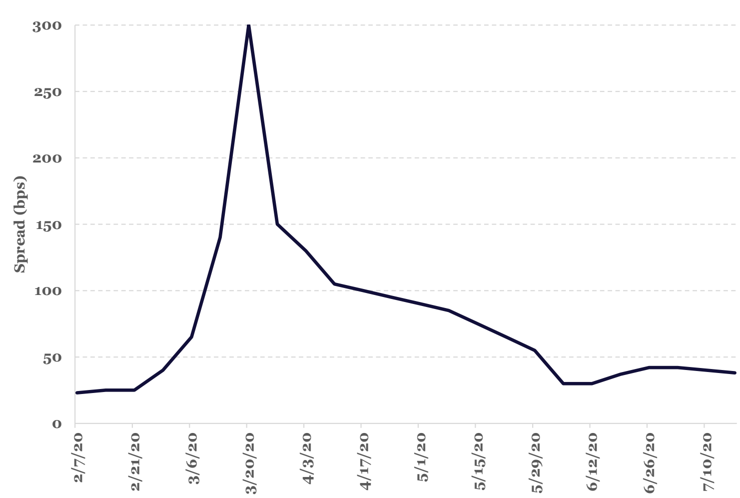
John McElravey – First XV Partners

"One of the great mistakes is to judge policies and programs by their intentions rather than their results." - Milton Friedman

Credit is provided to borrowers when lenders can, to the best of their ability, measure and price appropriately the risk being taken. As the risk of expected credit losses rises, the price of risk in terms of spreads or yields increases, and/or the availability of credit decreases. The government policy response to the spread of COVID-19 has been to lockdown the economy in an unprecedented way. Unemployment jumped to post-WWII highs, and business bankruptcies are on the rise.

After an initial shock in March, credit spreads have rallied, and are now close to pre-COVID levels in many fixed income sectors (Chart 1). Spreads on prime auto loan ABS have returned to pre-lockdown levels. The market response to date can be traced largely to the financial backstops provided by the government and the Federal Reserve. These programs are intended to provide liquidity to market makers, mitigate credit losses to investors, and even substitute or supplement income losses for households.

Chart 1: AAA Prime Auto ABS Spreads



Source: Wells Fargo Securities

This report reviews spread movements in the ABS market against the economic outlook. Government support seems to have reduced liquidity risk and credit risk in the near term. The results of the policies and programs, such as extra unemployment benefits under the CARES Act, so far have been good. However, there seems to be a significant disconnect between current spread levels and a longer run outlook for the economy, assuming a gradual or halting reopening.

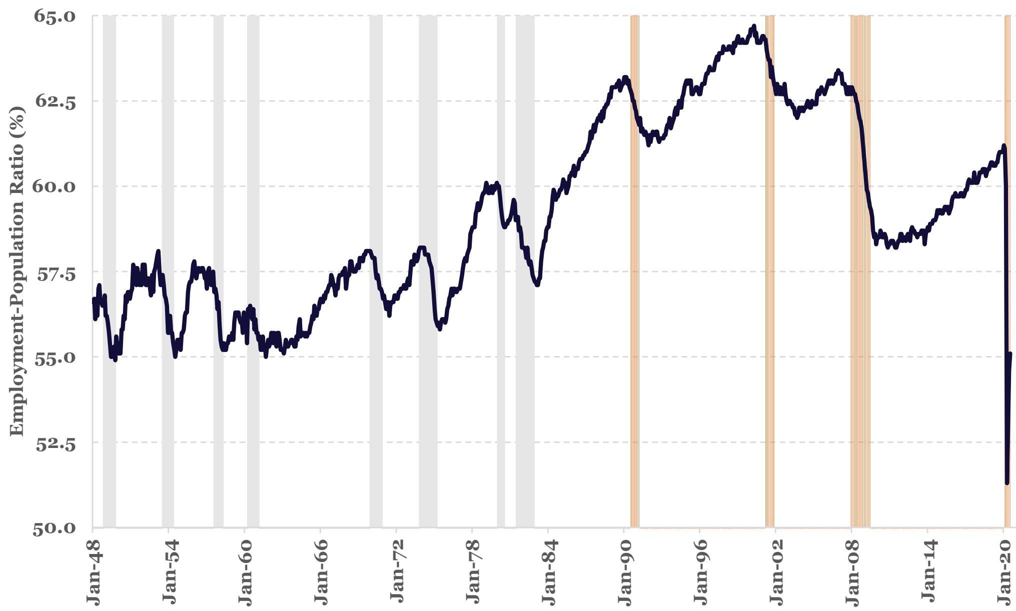
The Economy Stalls

To say that the current economic situation is unusual would be an understatement. The recession of 2008-2009 was primarily a financial crisis which spilled over into the real economy. In 2020, it is the real economy that is on the ropes. Layoffs increased rapidly, and weekly initial jobless claims hit an unthinkable high of 6.9 million in March. The latest figures have still been running in the range of 1.2mm – 1.4mm workers, roughly 6x the pre-COVID run rate. Meanwhile, the unemployment rate has been 10%-15% for the last three months.

Given the weakness in the economy, banks have been building loan loss reserves in expectation of increased credit losses. Nevertheless, credit trends have been masked to some extent by programs to help borrowers by allowing deferrals and extending loan payments. A side effect of this policy has been to make it difficult for lenders to assess the creditworthiness of new borrowers.

How should we gauge the weakness of the economy? The employment-population (EP) ratio provides a broad measure of the potential for economic growth. The EP ratio fell to a post-war low of 51.3% in April 2020 before rebounding to 54.6% in June. The recovery in employment in the past couple of months has been welcome, but the EP ratio remains below previous recession lows, not to mention the 61.2% recorded in January 2020. A gradual or halting emergence from lockdown likely means businesses will be slow to rehire workers. This translates into sluggish economic growth, at best.

Chart 2: Employment-Population Ratio



Source: Federal Reserve Bank of St. Louis

In a standard growth accounting framework, real GDP growth is driven by labor productivity, the proportion of the population that is employed, and the civilian population. In the near term, the population changes very little. That leaves productivity and employment to do the heavy lifting for economic growth. Even if labor productivity improves, lagging employment will produce a drag on growth. Watch real economic indicators, such as employment and income movements, for clues about the direction of the economy. Credit risk is likely to be elevated against the backdrop of high unemployment and slow growth.

Calibrating ABS Risk Pricing

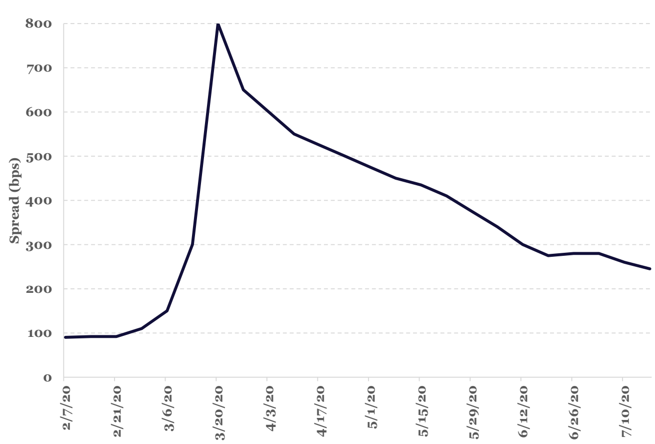
As mentioned above, the current economic crisis seems to be primarily a Main Street (growth/employment) problem as opposed to a Wall Street (financial/liquidity) problem. This differentiation seems to be playing a part in the way the ABS market is currently viewing and pricing risk.

The AAA segment of ABS (roughly 80% of annual issuance) has recovered from the market's liquidity freeze in March to such an extent that the Fed's TALF program has become almost an afterthought. Benchmark prime auto loan and credit card ABS are back near pre-COVID levels of February 2020 (Chart 1). This spread move suggests that the liquidity concerns that drove AAA prime auto loan spreads to +300 bps in the secondary market have been alleviated.

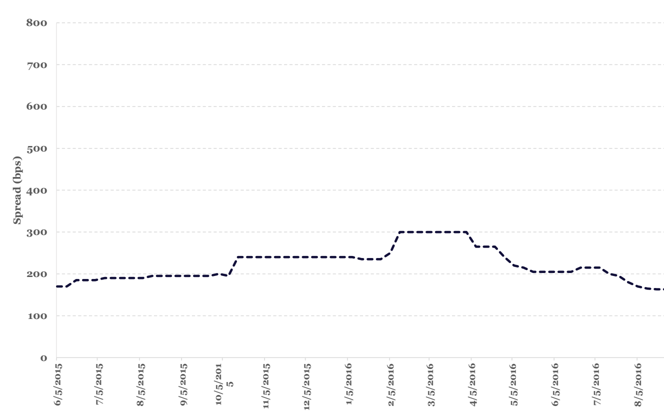
After an initial liquidity crunch in March 2020 that pushed spreads to +800 bps, ABS credit spreads recovered in a steady manner. The market is now pricing the risk of BBB subprime auto ABS risk at +245 bps, which is still double the level from February, but roughly in line with the peak of the 2015-2016 sell off. However, the outlook for the economy, as mentioned earlier, is considerably weaker than it was four years ago. It appears that Fed programs to support the fixed income markets have helped market sentiment, even as social lockdowns remain in place for much of the country, constraining normal economic activity.

Chart 3: BBB Subprime Auto Loan ABS Spreads

2020



2015-2016



Source: Wells Fargo Securities

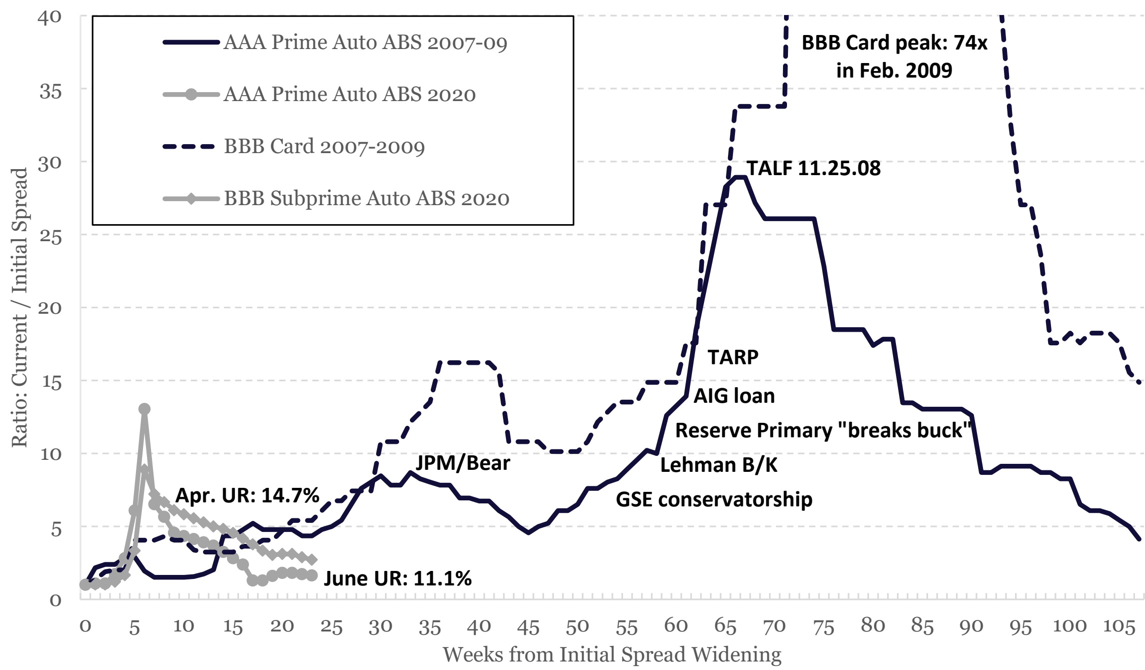
Compare 2020 to the pricing of risk and the economic backdrop in 2015-2016 (Chart 3). The market experienced an increase in liquidity premium along with a modest deterioration in auto lending credit fundamentals. Spreads widened to +300 bps from +170 bps, representing a significant sell off even as more investors added subprime auto ABS subordinated bonds to pick up yield. Auto loan ABS losses increased somewhat, but it was concentrated in the late 2015 and early 2016 vintages, and then primarily in certain lenders' ABS shelves. The economic outlook was still solid at the time, and interest rates were poised to rise based on an improvement in the market's expectations for growth and employment. This comparison indicates that current spread levels in at least some ABS sectors may be too low relative to embedded consumer credit risk.

Comparison to 2008-2009

What can explain the seemingly complacent outlook for spreads and risk compared to economic fundamentals? A brief, random walk down memory lane to revisit the financial crisis of 2008-2009 may prove instructive. It took the Federal Reserve, FDIC and Treasury Department most of 2008 to invent various programs to support the money and capital markets, while at the same time cobbling together lending facilities and mergers to stabilize the banking system. A list of key events and programs is listed below in the Appendix. Most of these programs had never been done before, and it pushed the boundaries of what the Federal Reserve System was intended to do to support the financial system.

In 2020, regulators merely had to dust off the previous playbook, while adding some new twists. The response for the programs to support the credit markets were implemented within about 10 days in March 2020. A list of the timing of these updated programs is presented below in the appendix.

Chart 4: Relative Spread Movements: 2020 & 2007-2009



Source: Wells Fargo Securities, Bank of America Merrill Lynch, First XV Partners

The result of the prolonged response in 2008-2009 produced a much sharper widening in ABS spreads as credit risk increased and liquidity became increasingly dear, especially in September and October 2008 when large financial institutions needed support from the government to stabilize the financial system. GSE conservatorship, Lehman's bankruptcy, the "breaking of the buck" by the Reserve Primary money market fund, the initiation of loans to banks from the TARP fund, and Fed lending to AIG were some of the events associated with the evaporation of liquidity in ABS in 2008. Spreads peaked and turned the corner with the announcement of the TALF fund around Thanksgiving 2008. Spreads tightened in a meaningful way, although lending from TALF did not commence until March 2009. As a point of reference for economic fundamentals, initial jobless claims hit a one-week peak in March 2009 at 665,000.

Chart 4 compares the spread widening of 2020 with the spread widening in 2007-2009. AAA prime auto spreads are used for both periods. BBB card spreads are used for the financial crisis, and BBB subprime auto spreads for the COVID recession. The data are indexed to the week before spread widening began as a ratio of the spread in each week over the initial spread.

The initial response of the ABS market in 2020 to the economic and social lockdowns was rapid and severe, but still not nearly as sharp as the response during the financial crisis. Spreads have gradually tightened as the trading recovered, and even as fundamental economic conditions have been deteriorating. ABS market moves and the pricing of risk appears more closely related to liquidity and sentiment as opposed to economic fundamentals. A reversal in spread movements that ultimately reflect underlying economic conditions cannot be ruled out as it is still early in the 2020 recession. However, fixed income markets have been trading as if government policy and Fed liquidity can overcome the stress on the consumer and the economy.

The lesson of the financial crisis is that unexpected turns should be expected. The policy induced nature of the current economic slowdown also suggests that it can be reversed. However, the consequences are likely to be far-reaching unless market forces can be unleashed and brought to bear on the problem. Government policy directives can only do so much.

"Nothing is so permanent as a temporary government program." – Milton Friedman

Appendix: Key Dates for the Financial Crisis and for COVID-19

Key Dates for the Financial Crisis	
2007	Jul 2007: Bear Stearns mtg hedge funds shut down
	Jul/Aug: Independent mortgage companies begin to file for B/K
2008	Feb 13: Economic Stimulus Act of 2008
	Mar 11: Fed announces Term Securities Lending Facility - $200 B
	Mar 24: JPM buys Bear Stearns
	Jun 5: BAC buys Countrywide; monoline bond insurers rating dropped to AA
	Jul 13: Fed authorizes lending to Fannie and Freddie
	Sep 7: Fannie and Freddie placed in government conservatorship
	Sep 14: Fed expands list of eligible collateral to PDCF and TSLF
	Sep 15: BAC buys Merrill Lynch; Lehman files BK;
	Sep 16: Fed lends to AIG; Reserve Primary Money Fund breaks "the buck"
	Sep 19: Fed creates Asset-Backed Commercial Paper MMMF Liquidity Facility (AMLF) to support money markets
	and Treasury creates Exchange Stabilization Fund to guarantee investments in MMMF's
	Sep 21: Goldman Sachs and Morgan Stanley become BHC's
	Sep 25: JPM buys Washington Mutual
	Sep 29: FDIC announces Citi to purchase Wachovia; House of Representatives rejects TARP legislation
	Oct 3: $700 billion TARP program signed into law
	Oct 7: Commercial Paper Funding Facility (CPFF) created by Fed; FDIC increases deposit insurance to $250,000
	Oct 8: Fed program to purchase securities from AIG
	Oct 12: WFC buys Wachovia
	Oct 14: TARP injects capital into 9 large financial institutions
	Oct 21: Fed creates Money Market Investor Funding Facility (MMIFF)
	Nov 10: Fed restructures lending facilities to AIG, and buys MBS and CDOs
	Nov 11: Treasury sets up new mortgage loan modification programs
	Nov 14: Treasury buys preferred stock in 21 banks under the Capital Purchase Program (CPP)
	Nov 18: Ford, GM and Chrysler request access to TARP funding
	Nov 21: Treasury buys preferred stock in 23 banks under the CPP
	Nov 23: Treasury, Federal Reserve and FDIC announce package to support Citigroup
	Nov 25: Fed creates the Term Asset-Backed Securities Lending Facility (TALF)
	Fed announces program to purchase direct obligtions of the GSE's, and MBS backed by the GSE's
	Dec 11: National Bureau of Economic Research announces that the recession started in Dec. 2007
	Dec 19: Treasury authorizes TARP loans to GM and Chrysler

Source: Federal Reserve Bank of St. Louis

Key Dates for Covid-19		Selection of Corporate Bankruptcies	
3/17/2020	Commercial Paper Funding Facility	April	Diamond Offshore
	Primary Dealer Credit Facility		Whiting Petroleum
3/18/2020	Money Market Mutual Fund Liquidity Facility		Frontier Communications
3/19/2020	Initial jobless claims 3.307mm	May	J.Crew
3/23/2020	Primary Market Corporate Credit Facility		Gold's Gym
	Secondary Market Corporate Credit Facility		Neiman Marcus
	Term Asset-Backed Securities Loan Facility		JC Penney
3/23/2020	State Stay-at-Home orders begin		Hertz
3/26/2020	Initial jobless claims 6.867mm	June	GNC
3/27/2020	CARES Act signed into law		24 Hour Fitness
4/2/2020	Initial jobless claims 6.615mm		Chuck E. Cheese
4/9/2020	Initial jobless claims 5.237mm	July	Lucky Brand
4/16/2020	Initial jobless claims 4.442mm		Brooks Brothers
4/16/2020	Paycheck Protection Program Liquidity Facility		
	Municipal Liquidity Facility		
4/23/2020	Initial jobless claims 3.867mm		
4/30/2020	Initial jobless claims 3.176mm		
5/8/2020	April Unemployment Rate: 14.7%		
6/5/2020	May Unemployment Rate: 13.3%		
6/8/2020	Main Street Lending Program		
7/2/2020	June Unemployment Rate: 11.1%		
7/14/2020	Banks stockpile loan loss reserves		

Source: Various news sources, First XV Partners