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SFA Research Corner

Time to Take Off the Training Wheels?

November 23, 2020

The idea of training wheels is to teach balance with a "safety" system to catch the child when their balance is off. In reality, most kids simply rely on the training wheels and never practice balance at all.
– families.com

WHAT WE'RE WATCHING

On November 18, the Office of Financial Research (OFR) submitted its Annual Report to Congress. The 177-page report concludes that "significant downside risks to financial stability persist amid high uncertainty." The report asserts that there is a difference between "'organic liquidity,' which reflects the ongoing competitive market buying, selling, and risk bearing by private actors," and "'synthetic liquidity,' which is dependent on large official interventions and public absorption of financial risk." OFR posits that it is synthetic liquidity that has "induced financial market recoveries" as it provided "safe passage" through pandemic-related lockdowns. Moreover, "[t]here remains a striking contrast between the quick recovery of financial markets and the slower recovery of the economy."

The question of whether 'organic liquidity' has returned and the issue of the unevenness in the recovery has moved to the forefront as Treasury Secretary Mnuchin and Federal Reserve Chair Powell negotiate the fate of pandemic-related Federal Reserve lending facilities. These facilities, which were put in place to stabilize the equity, debt and funding markets following widespread lockdowns, provided approximately $2 trillion in loans and are slated to end on December 31. One such program is the TALF, which by and large supported the recovery of the securitization markets.

OFR summarizes the risks as follows:

1. Macroeconomic risk is high
2. Credit risk is high
3. Market risk is elevated
4. Liquidity and funding risks are moderate
5. Leverage in the financial system has been restrained since the last crisis
6. Insolvency and contagion risks appeared contained
7. Cyber risk grows both in volume and sophistication
8. Pandemics can be added to the list of additional financial stability risks

We take a brief look at some of these risks in our discussion below and the potential impact on consumers, corporations, and securitization. The OFR was established to support the Financial Stability Oversight Council and its member agencies by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

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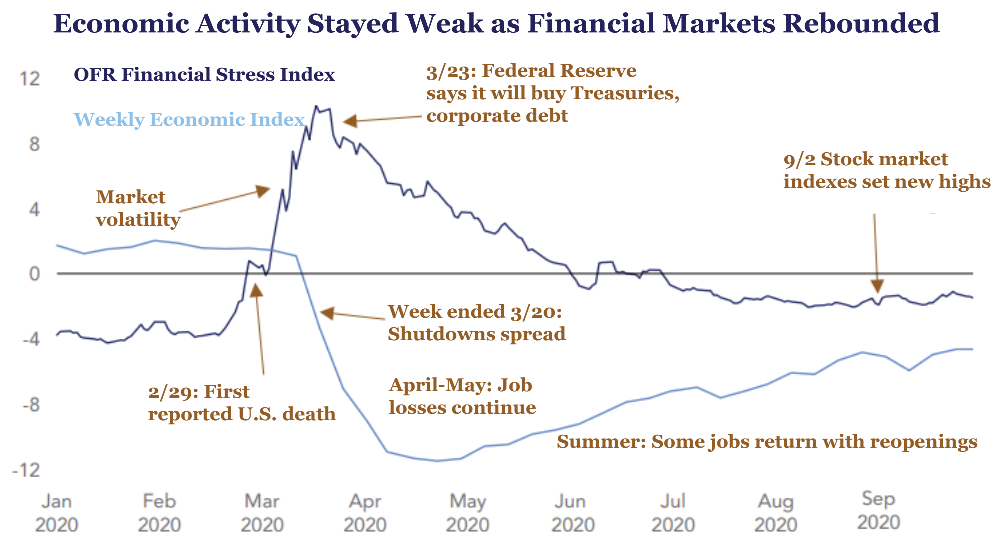
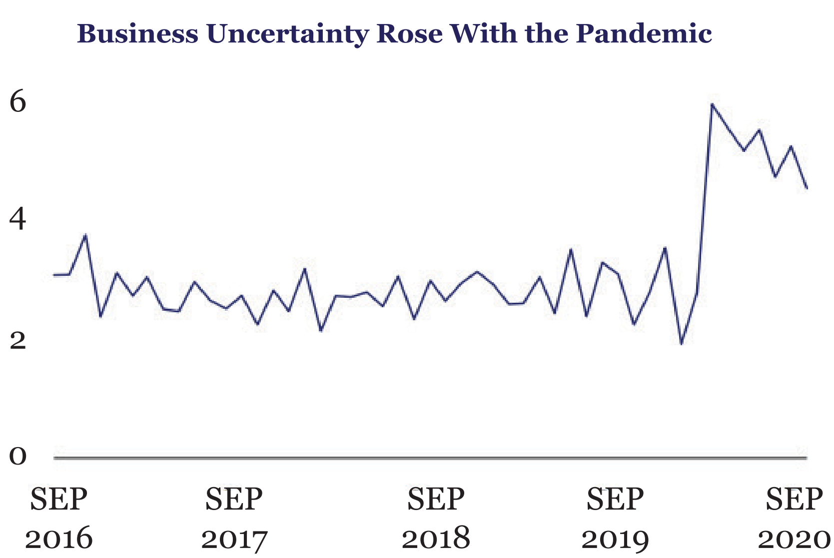


Note: The Weekly Economic Index is an index of ten daily and weekly economic indicators. It reflects what the annualized percent change in gross domestic product would be if conditions persisted for a quarter. The OFR Financial Stress Index measures systemwide stress. It is above zero when stress levels are above average, and below zero when stress levels are below average.

Sources: Federal Reserve Bank of New York, Office of Financial Research

The OFR warns that macroeconomic risks remain high even as some market valuations near or exceed historical highs. The report notes that "[d]ue to the novelty of the virus, the unknowns of its course and the response of health policy, many businesses are unsure when or even if they will resume normal operations and what new safeguards they must erect. Considerations like these have contributed to an environment of high uncertainty for businesses." Macroeconomic risks impact all markets as a slowdown in economic activity results in lower corporate earnings, raising the likelihood of joblessness, and, subsequently, tighter access to credit and lower consumer and business spending.



Note: The Business Uncertainty index is based on Altig, Barrero, Bloom, Davis, Meyer, and Parker (2020). This index reflects a survey of firms' uncertainty as measured by the sales-weighted average standard deviation of the probability distributions of each of the firms' own next-four-quarter sales expectations.

Sources: Altig and others (2020), Atlanta Fed/Chicago Booth/Stanford Survey of Business Uncertainty, Office of Financial Research

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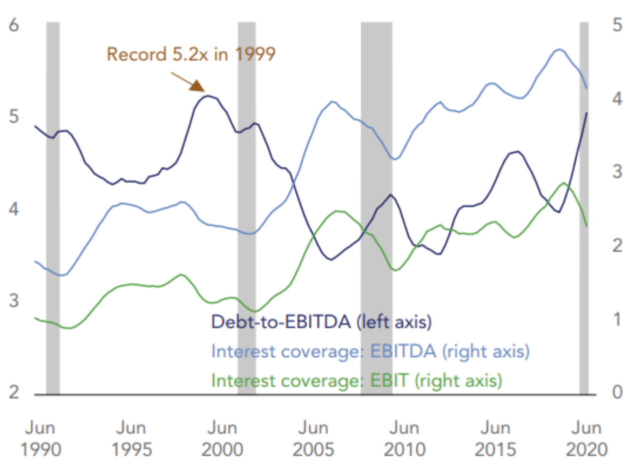
Credit risk, or the risk that borrowers may not be able to meet their financial obligations, is high among high-yield companies according to the OFR report. High-yield companies that were highly leveraged coming into the crisis and were not able to access credit sufficiently through a Federal Reserve lending facility have been particularly challenged. Given the sharp decline in earnings this year, some of these companies may soon face difficulty servicing outstanding debt despite near-zero interest rates. The OFR expects that the debt-to-EBITDA (earnings before interest, taxes, depreciation, and amortization) ratio for high-yield companies will exceed the 1999 all-time median peak of 5.2 times EBITDA. In terms of securitization, high leverage ratios and high corporate bankruptcies have a direct and negative impact on CLO cash flows. The extent of which will depend on a specific CLO tranche, structure and pool composition. The report also discusses the risks in the commercial mortgage market as lockdowns, working from home arrangements, and reduced economic activity have resulted in rising delinquencies and losses for certain property types. The report points out "CMBS investments at highest risk of principal losses are those backed largely or exclusively by higher-risk properties, such as hotels and shopping malls."

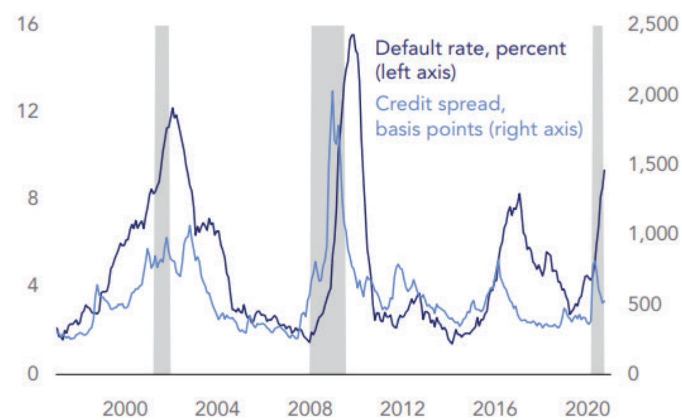
Median Leverage and Interest Coverage For BBB-Rated Companies (Ratios)



Note*: Data as of June 30, 2020. Shaded areas are U.S. recessions. Leverage is gross debt-to-EBITDA (earnings before interest, taxes, depreciation, and amortization). Coverage is EBITDA and EBIT divided by interest expense. Leverage and coverage are four-quarter moving averages of the median.*

Sources: Compustat, Haver Analytics, [Office of Financial Research]

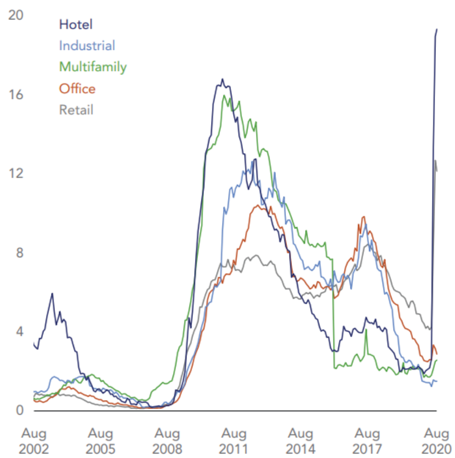
U.S. Corporate Bond High-yield Default Rate vs. Credit Spread (Percent, Basis Points)



Note: *Shaded areas are U.S. recessions. Credit spread is monthly average (daily peak exceeded 1,000 basis points in March). Defaults reflect high-yield bonds (excludes loans).*

Sources: Moody's Investors Service, Haver Analytics, [Office of Financial Research]

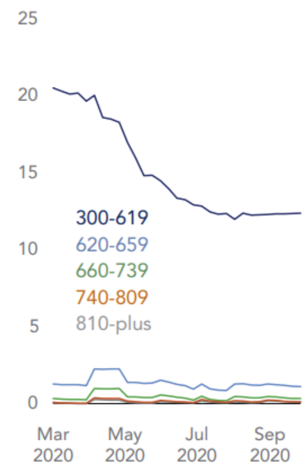
Commercial Mortgage-Backed Securities 60+ Day Delinquency Rate (Percent)



Note: *Data as of August 2020. Moody's conduit DQT defines delinquent loans as loans that are 60 or more days in payment arrears; performing matured; nonperforming matured; foreclosure in progress; or real estate owned.*

Sources: Compustat, Haver Analytics, Office of Financial Research

Household Delinquency Rates by Credit Score Category (Percent)

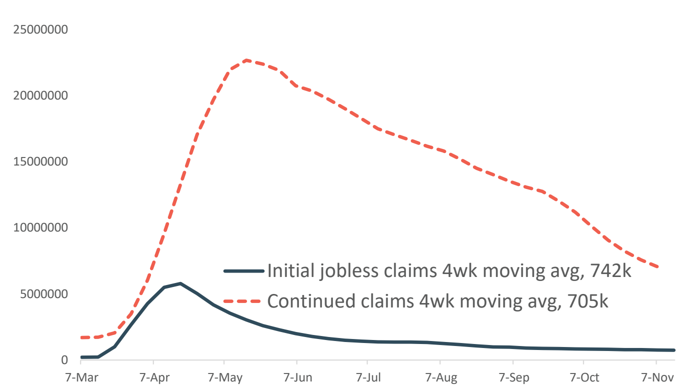


Note: *Delinquency rate is calculated as the fraction of balances 30-plus days past due, by credit score category.*

Sources: Moody's Investors Service, Haver Analytics, Office of Financial Research

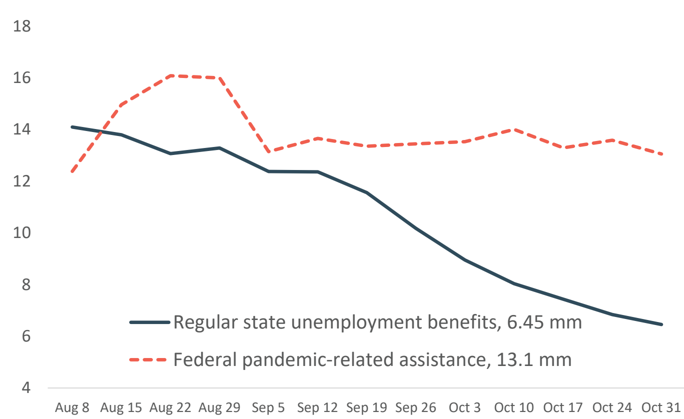
The OFR also looks at the state of the consumer. Unlike corporations that entered the pandemic with high levels of leverage, household leverage had been declining since the 2007-09 crisis, providing for a stronger financial footing coming into the pandemic. Furthermore, households benefitted from an unprecedented level of policy initiatives, such as supplemental unemployment benefits, and a myriad of lender accommodations, which kept delinquencies and loss rates low for consumer loan products despite high levels of joblessness. OFR warns, however, that it is this same support structure that keeps households exposed to "vulnerabilities" once government stimulus and lender accommodations come to an end. Indeed, faced with a slowing labor market recovery and the spectre of rising delinquencies and losses, banks have remained cautious, keeping lending standards tight and access to credit more difficult. See our discussion here.

Jobless claims 4-week Moving Average Inch Lower



Source: Department of Labor

Persons Claiming Federal Pandemic-Related Assistance Stays Elevated as the Number of State Benefit Claimants Fall



Source: Department of Labor

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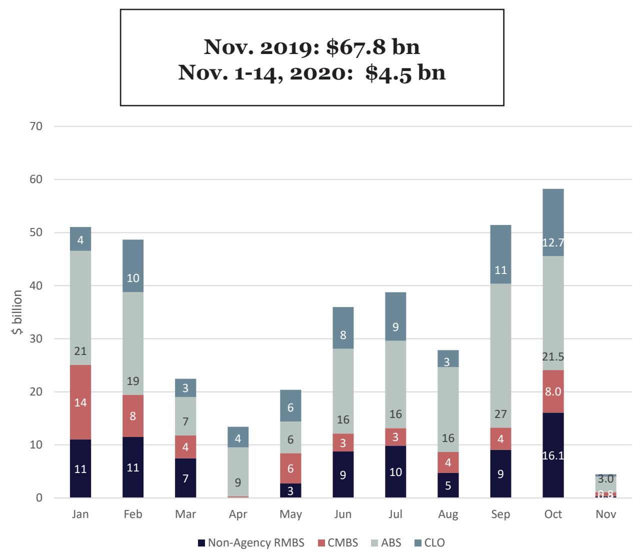
MARKET SUMMARY

Activity in the new-issue market remains muted. For the week ending November 14, a total of $1.5 billion of new securities backed by consumer and commercial loans, as well as residential and commercial mortgage loans, were issued. Total annual new-issue supply now stands at $373 billion, which is 35% below the volume recorded for the same period in 2019. Investors continued to turn to the secondary markets for inventory, pushing bond prices higher and bid-ask spreads tighter across highly-rated and higher-yielding products such as ABS backed by subprime autos, non-agency RMBS and CLO products.

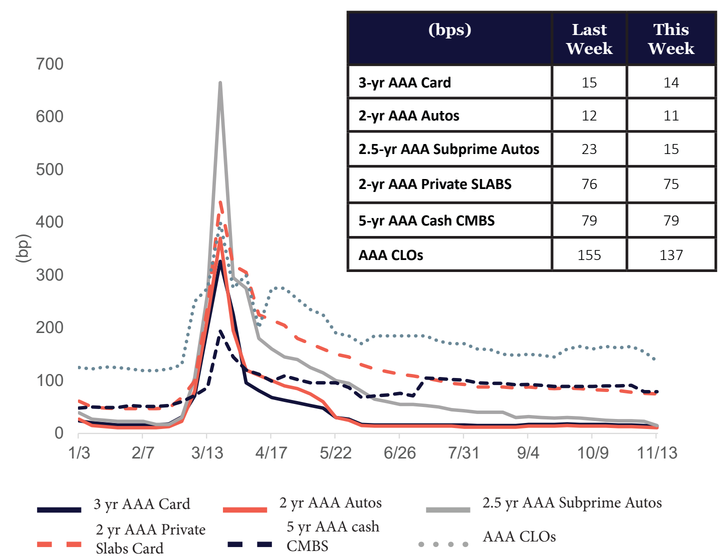
NEW ISSUE ACTIVITY

New-Issue Activity Slows to a Crawl



Source: Bloomberg, Deutsche Bank Research

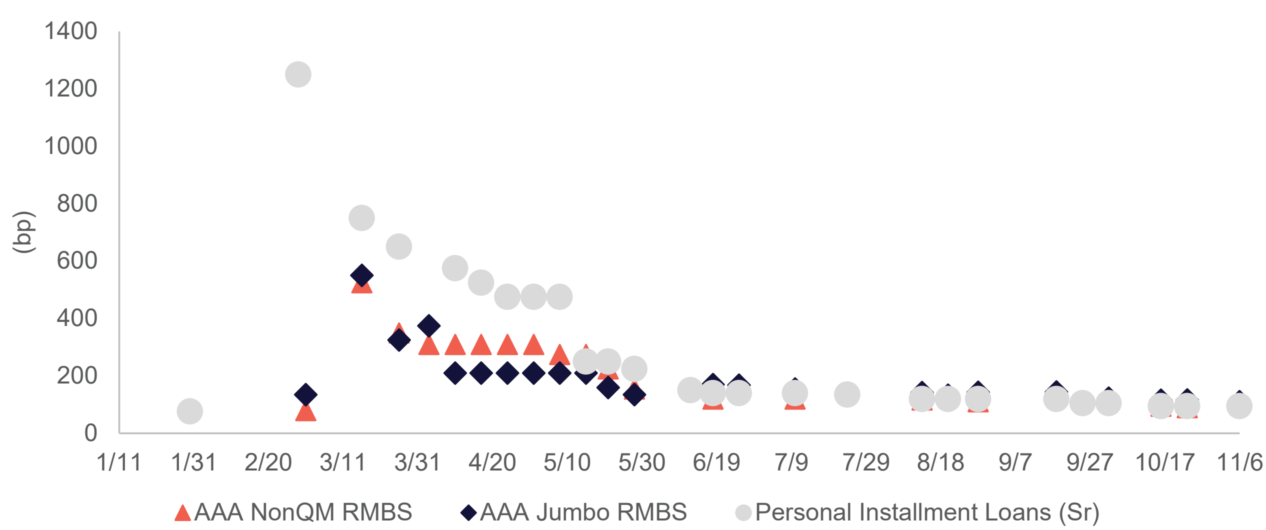
Secondary Market Spreads



(bps)	Last Week	This Week
3-yr AAA Card	15	14
2-yr AAA Autos	12	11
2.5-yr AAA Subprime Autos	23	15
2-yr AAA Private SLABS	76	75
5-yr AAA Cash CMBS	79	79
AAA CLOs	155	137

Source: Bloomberg, Deutsche Bank Research

SECONDARY MARKET SPREADS



Source: Market Compilation