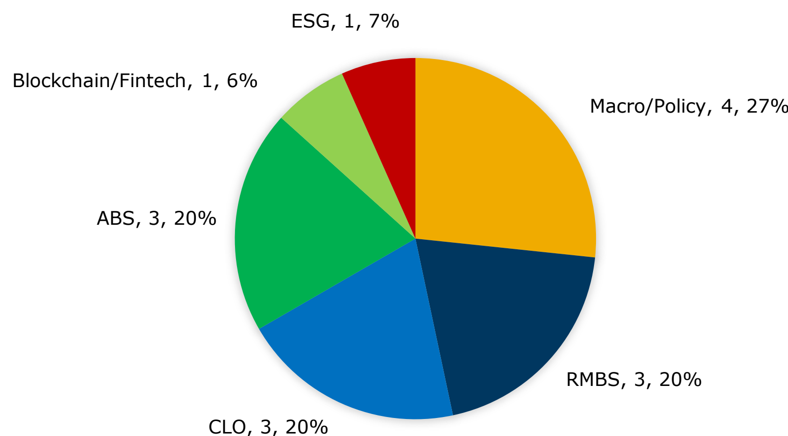
SFVegas 2023 Conference: Monday Recap

Structured finance market professionals assembled at the Aria in Las Vegas for the annual SFVegas 2023 conference held on February 26-March 1. Against a backdrop of elevated market volatility and rising economic uncertainty, this year's attendance soared back to pre-pandemic levels. As of Monday morning, there were 8,300 registered attendees, a 30% jump over last year's numbers and slightly above the number logged in February 2020.

Following a number of 101 sessions on a variety of structured finance segments and topics, Monday began with opening remarks from Michael Bright (SFA CEO), followed by a discussion focused on the outlook for macroeconomic and geopolitical trends. Later in the morning, Securities and Exchange (SEC) commissioner, Mark T. Uyeda, and the former Commander of U.S. and International Forces in Afghanistan, General Stan McChrystal, each participated in fireside chats. The afternoon was allocated to a number of breakout panel sessions, with topics ranging from CLO, ABS, and RMBS market outlooks, to panels focused on environmental, social, and governance (ESG) and macro/policy discussions.

Figure 1: Breakdown of Day 1 Conference Panels



Sources: KBRA, SFA

From our discussion with investors and issuers, there appears to be a general lack of conviction about where the market goes in the coming months. That said, it appears the primary market will remain relatively active, as investors have plenty of money to put to work and issuers continue to view the securitized market as an attractive source of funding.

Below we provide a brief recap of some of Monday's panel discussions.

CLO and Leveraged Loan Market

While the CLO and leveraged loan market still face uncertainty with respect to interest rates and inflation, strong recent economic data and labor market activity has led to some compression for CLO spreads. Despite some tightening since late 2022, panelists remarked that, at an all-in rate of nearly 7%, broadly syndicated loan (BSL) AAAs look cheap on a relative value basis, currently offering an all-in yield commensurate with CLO mezzanine tranches, historically speaking. On the other end of the capital structure, BBs are now exhibiting equity-like returns, and given their historically low default rate, offer a highly attractive risk-adjusted return. Panelists agreed that so long as investors continue to be prudent with respect to CLO security selection, there is value to be found up and down the capital structure.

As for supply, new issuance expectations were in the $115 billion-$125 billion range for 2023, with an additional $50 billion in refinance and reset activity. Refinance and reset activity will likely be limited so long as AAA spreads remain above 150 basis points (bps). Panelists predicted a continued surge in middle market and private credit activity, which has experienced a boon in recent years given higher risk-adjusted returns, lower volatility, and lower correlation with public markets. Middle market CLO spreads still command a premium relative to BSL, with a Q4 2022 AAA average of 250 bps over secured overnight financing rate (SOFR).

As for topical issues, one panelist noted that the LIBOR-to-SOFR transition has proceeded in a relatively orderly manner except for recent hiccups related to underlying loan amendments. CLOs have "dutifully" moved over to SOFR and adopted the recommend credit spread adjustment (CSA) of 26 bps. Further, while new leveraged loans have adopted SOFR as the replacement, there remains some disagreement between borrowers and lenders on the CSA, which some have argued should be 10 bps. A lower CSA for CLO assets than liabilities could squeeze the deal's economics and create some headwinds to issuance. Still, the panelists were constructive on their outlook for the year, noting that optionality with respect to credit selection and reinvestment is key for CLO managers going forward.

State of the U.S. Consumer

Panelists noted that consumer credit fundamentals benefited tremendously from federal stimulus payments, increased savings, and a rise in net wealth for many borrowers throughout 2020 and 2021, which helped push consumer loan delinquencies to historically low levels. However, beginning in 2022, consumer delinquency rates began to rise and are now meaningfully higher year-over-year across the vast majority of loan products and along the consumer credit spectrum.

Much of the recent deterioration in credit can be explained by a "normalization" in credit performance as the effects of stimulus dissipate. However, an erosion in real wages for many borrowers (as inflation remains elevated) and more aggressive underwriting in 2021 and 2022 (as lenders looked to ramp up loan production) have also been major contributors. The non-prime sector has seen the largest increase in delinquencies, with the percentage of delinquent non-prime borrowers at or above pre-pandemic levels for most loan types at the start of 2023. Prime delinquency rates are up, but still below 2019 and early 2020 levels, as this borrower type is likely more insulated from the effects of inflation due to higher income and levels of net worth in the aggregate.

Panelists also debated the current consumer "priority of payments" and how it is different from the global financial crisis (GFC). Unlike the GFC, where many mortgages were underwater and borrowers chose to walk away, the house price appreciation seen over recent years has likely pushed mortgage payments toward the top of the consumer "waterfall." Panelists also noted that compared to the GFC, consumer credit fundamentals are on much stronger footing, with household debt-to-income (DTI) ratios and debt service as a percentage of disposable income both at multi-decade lows.

CLO Investor Roundtable

Against the backdrop of continued uncertainty, elevated interest rates, and rising recessionary risks, CLO investors stressed the importance of tactical investing. Investors often look at risk stratification across asset classes by comparing the spread offered at the same rating category for different products. From this perspective, CLO AAAs appear cheap.

As for fundamentals, investors expect defaults in the 3%-5% range in 2023. To account for this, new issue CLO mezzanine tranches are being structured with additional credit enhancement by having even higher attachment points than those structured during the depths of the pandemic. Panelists viewed these lower levered BBBs and BBs, with current all-in yields at 10% and 14%-15%, respectively, as especially attractive.

Investors will continue to scrutinize the defensive position of CLO collateral managers, noting that the strategy that worked in the past may need to be tweaked for this current environment. Should interest rates remain elevated for several years, managers may have to grapple with prolonged (and higher) CCC exposures compared to the past downturn. Distress is also not likely to be sector-driven (as it was during the pandemic and even the GFC) but may be more idiosyncratic in nature. With this, manager selection is a key consideration for CLO investors.

Non-Agency RMBS Market

Panelists noted that the current macroeconomic environment was challenging for the U.S. consumer, who they described as continuing to be stretched due to the combined effects of inflation and housing affordability. With respect to home prices, panelists acknowledged and described the declining price environment, but noted the decelerating pace of declines and, in some cases, the fact that homebuilders were rolling back incentives. National home price predictions by panelists ranged from flat to down 10% in 2023. Some panelists noted that certain private-label RMBS have recently exhibited somewhat higher weighted average DTIs and loan-to-values (LTV). The combination of those trends and a generally challenging macroeconomic outlook led certain panelists to expect higher losses for recent RMBS issuance. That said, panelists noted that loan performance in government-sponsored enterprise credit risk transfers and prime jumbo to date has been strong overall, which reflects generally tight underwriting standards.

Expectations by panelists are for depressed origination volumes throughout 2023, though many expect to see growth in home equity lines of credit (HELOC) and second lien origination as homeowners unlock built up home equity. Panelists also discussed the rising interest among borrowers for interest-only loans, adjustable-rate loans, and loans with 40-year maturities to help with affordability. Panelists noted the largest opportunities in 2023 were likely in the non-qualified mortgage (QM) space and highlighted the emergence of new originators or existing players. Other trends discussed were related to debt

service coverage ratio (DSCR) loans, where panelists noted an increase in the prevalence of low ratio (<1.1x) DSCRs and the variety of structures seen in the second lien space that are yet to coalesce around a market standard.

Aircraft ABS

The panel opened by recapping the ups and downs of aviation ABS new issue activity over recent years. The sector saw record issuance volumes in 2019 ($10.1 billion), followed by a sharp reduction in 2020 due to COVID ($2.6 billion), then a rebound in 2021 ($8.5 billion) as travel restrictions were lifted and consumer demand rose. However, rising interest rates and the onset of the Russia-Ukraine war caused volumes to plummet once again in 2022 ($1.1 billion). One panelist noted that secondary market trades ($3 billion of notional) surpassed primary market activity in 2022.

As carriers seek to expand their fleets to meet rebounding travel demand, and with production delays still ongoing, the panelists have seen aircraft values rise in the secondary market in recent months. Meanwhile, aircraft lease rates are slowly beginning to rise, as leases originated when interest rates were low, are beginning to roll off, and re-price at higher levels. The repricing of lease rates will lead to more cash flow available for outstanding transactions and improve the economics for future transactions, which should lead to a partial recovery in primary market activity in 2023, with a mix of 144A and private placement (smaller number of investors and more execution certainty) transactions expected.

Non-QM

This panel discussed how rising interest rates have created challenges for non-QM originators. Non-QM origination volumes were depressed in 2022 and there were a few notable closures of non-QM originators. However, panelists noted that credit performance has remained strong, with delinquencies remaining low and losses near zero.

The increase in the concentration of investor loans in non-QM transactions was also discussed. Panelists also pointed to changes in collateral trends, which include a reduction in the average DSCR for non-QM loans, a lower percentage of full documentation loans, and growth in bank statement underwriting. However, panelists noted that lenders also tightened underwriting by originating higher FICO and lower LTV loans to mitigate these risks. Going forward, panelists expect to see more HELOCs and closed-end seconds, buydown loans, and adjustable-rate loans, given the current rate environment.

ESG Trends and Outlook in Structured Finance

Panelists agreed that sustainable bonds remain a nascent market within structured finance. Indeed, sustainable bonds totaled only about 5% of all U.S. bond issuance in 2022, compared to about 30% in Europe and 15% in Latin America. However, this newness brings with it opportunity for today's participants to have a hand in shaping the future of this market. The industry remains in a learning and cooperative phase that brings together working groups of investors, issuers, arrangers, and other market participants to share information and ideas.

There were some key developments around ESG in structured finance during 2022. For example, Fannie Mae launched new social disclosures in November 2022 for its single-family MBS, which include the Social Criteria Share (SCS) and the Social Density Score (SDS). The new disclosures are designed to respond to investor feedback and aim to provide single-family MBS investors with insights into socially-oriented lending activities. Arrangers on the panel also noted that 2022 was characterized by a higher level of issuer motivation around exploring the potential for issuing sustainable bonds. Further, investment managers observed a higher level of inquiry by investors into ESG characteristics of specific investments.

The primary challenge that limits the pace of sustainable issuance in structured finance continues to be data and common standards. Issuers are asking investors what data they need, and investors are asking issuers what data they have. There is no standardized definition of what constitutes a green or sustainable U.S. structured finance security. Confidentiality concerns to protect borrowers pose another challenge related to standardizing disclosures and the types of data tracked. Especially for smaller pools, the existing paradigms of loan- or pool-level data disclosure standards could result in revealing specific income information. Revealing certain types of data such as carbon footprints may serve to hurt borrowers rather than improve access, the latter being the primary goal of social and sustainable investing.

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