Summary of key points

Financial markets’ reaction to the Covid-19 pandemic has drawn historical parallels with the global financial crisis (GFC) of 2008.

Key fundamental differences can be drawn between these events, both in the pace and timing of macroeconomic deterioration and the policy response.

The Federal Reserve’s rapid policy response is intended to alleviate short-term financial market liquidity challenges for TALF-eligible securities.

The full impact of the macroeconomic shock on credit performance has yet to be revealed.

We expect spread tightening in AAA-rated sectors to reverse and remain elevated as investor focus shifts from short-term liquidity considerations to rationalizing the depth and length of the ensuing slowdown.

A similar policy response to unprecedented events

Much like the Lehman Brothers bankruptcy in September 2008, the events of March 2020 will be forever etched into the memories of people all over the world. In a particularly nostalgic moment for financial professionals and, more specifically, securitization veterans, the Fed reacted to violent market movements by reintroducing the Term Asset-Backed Securities Lending Facility (TALF). The spread widening preceding both TALF announcements marked significant market dislocation. As highlighted in Exhibit 1, in both instances, high-quality, AAA-rated securitization sectors widened dramatically in the month preceding the policy response.

Exhibit 1: Change in spreads at TALF announcement vs four weeks prior

<table>
<thead>
<tr>
<th>Sector</th>
<th>TALF 1.0</th>
<th>TALF 2.0</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit Cards (3-year AAA)</td>
<td>+134</td>
<td>+177</td>
</tr>
<tr>
<td>Prime Auto (3-year AAA)</td>
<td>+59</td>
<td>+142</td>
</tr>
<tr>
<td>CMBS (10-year LCF AAA)</td>
<td>+477</td>
<td>+124</td>
</tr>
</tbody>
</table>

Source: Aegon AM, J.P. Morgan. TALF 1.0 reflects spreads four weeks prior to November 22, 2008. TALF 2.0 reflects spreads four weeks prior to March 21, 2020.

Comparisons are inexact

TALF 1.0 was preceded by gradual worsening in macroeconomic conditions that developed throughout 2007 and 2008. In a progression leading up to September 2008, investor focus had already begun to shift in succession from short-term liquidity demands, to fundamental implications of the looming recession, to the eventual onslaught of credit challenges that followed. By late 2008, structured product spreads had begun to widen in response to deteriorating subprime mortgage securitization performance and growing evidence of housing crisis-induced macroeconomic damage.

Macroeconomic deterioration is just beginning

In comparison, today’s market is just waking up to the credit risks that are in store. On May 15, 2020, investors got their first look at the economic damage wrought throughout April. April’s Employment Situation Report offered insight into the potential credit impact that securitization remittance reports are beginning to reveal. With U-6 unemployment reaching levels similar to the Great Depression, we expect the economic setback induced by the Covid-19 pandemic to manifest itself in securitization collateral performance at a pace and intensity that exceeds that seen during the GFC.

1. U-6 unemployment includes discouraged workers who have quit looking for a job and part-time workers who are seeking full-time employment. The U-6 rate is often considered to be the most revealing measure of unemployment.
As highlighted in Exhibits 2, 3, and 4, unemployment is a prognosticator for both consumer and corporate defaults. Against this backdrop, avoiding a repeat of GFC-level high yield corporate and consumer defaults would be contrary to historical precedent.

**Exhibit 2: Unemployment (U-6) & high yield defaults**

Fed response has eased liquidity conditions

FINRA TRACE ABS trading activity data exposes rising liquidity strains that are developing as investors come to grips with the impact of a global economic shutdown. Trading of near-cash assets such as short duration, AAA-rated, prime auto loan-backed ABS has risen as investors seek to reposition to meet liquidity demands (Exhibit 5).

**Exhibit 5: Weekly AAA prime auto trades by WAL in 2020**

The rush for liquidity has been most evident in short duration, AAA-rated ABS. Due to their short tenor, these bonds typically trade near par. However, in late March, many of these securities began trading at significant discounts as investors sought to raise cash by selling their most liquid assets at minimal dollar loss (Exhibit 6). As a result, spreads for short duration, AAA-rated ABS underperformed their longer counterparts despite the longer securities’ greater exposure to collapsing economic conditions. As the saying goes, cash is still king.

**Exhibit 6: Price of short prime AAA-rated ABS in 2020**
Credit risk continues to accrue

Early securitization credit indicators for April were released last week and, as expected, delinquencies, payment deferrals and forbearance were materially higher. Securitizations backed by prime consumer receivables fared best as borrowers with the strongest financial wherewithal and most resilient employment prospects will continue to meet obligations. Near-prime and sub-prime borrowers exhibited the greatest increases in stress given generally larger financial obligations, lower reserves and/or more variable income. Similar patterns are evidenced in securitizations backed by commercial assets such as CMBS. The divergence in performance between commercial real estate sectors is notable. While office and industrial loans have experienced little change in performance, preliminary May data suggest an increased level of stress in retail and lodging with 21% and 37% of loans reporting as delinquent or in grace period, respectively. CLOs exhibited significant increases in CCC-rated exposures as downgrades have pushed average portfolio concentrations up from 4-5% in February to 12-15% today. Additionally, expected defaults for the levered corporate credits backing CLOs are expected to increase significantly.

Monetary policy can ease the pain but cannot eradicate the problem

Securitization spreads rebounded following the TALF 2.0 announcement but remain wider than pre-Covid-19 levels.

<table>
<thead>
<tr>
<th>Sector</th>
<th>TALF 1.0</th>
<th>TALF 2.0</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit Cards (3-year AAA)</td>
<td>-30</td>
<td>-107</td>
</tr>
<tr>
<td>Prime Auto (3-year AAA)</td>
<td>-55</td>
<td>-42</td>
</tr>
<tr>
<td>CMBS (10-year LCF AAA)</td>
<td>-150</td>
<td>-5</td>
</tr>
</tbody>
</table>


The alphabet soup of monetary policy response has brought symptomatic relief to the markets’ liquidity concerns. But much like chicken soup for the common cold, the Fed’s alphabet soup, targeting market liquidity, does little to combat the underlying virus – in this case, deteriorating macroeconomic fundamentals. Direct payments to households help cover necessities in the short term, but do not alleviate the financial strains of extended under- or unemployment. Likewise, businesses are cutting back on capital expenditures and non-essential expenses, which will lessen the likelihood of a quick recovery.

Conclusion

Spreads across AAA-rated securitization sectors will likely remain elevated as market participants shift their mindset, re-pricing risks from near-term liquidity considerations to the economic contraction’s longer-term impact on credit performance.

Structured finance with Aegon Asset Management

The Structured Finance investment team at Aegon AM has navigated multiple credit cycles since the inception of the asset class in the late 1980s. The portfolio managers and research analysts have a repeatable process to evaluate creditworthiness and the relative value of investments in the structured finance universe. The research team covers all structured finance sub-sectors across the quality spectrum and collaborates with the firm’s global credit research analysts on the fundamental strength of issuers and leverages real estate professionals from Aegon Real Assets. Aegon AM employs a fundamental, research-driven investment process with a focus on total return. The portfolio management and structured research teams have the experience to understand collateral and complex deal structures, helping the team identify opportunities to oscillate risk at market inflection points.
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