TCW

# INSIGHT

YEAR-END COMMENTARY

## ABS 2016 Review and Outlook

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As we begin to look toward 2017, it is helpful to note how stark the contrast in sentiment is from just less than a year ago. Global recession fears dominated the early year as the market was dealing with a growth slowdown in China and declining oil prices. Equity markets were down 10%, oil dropped to $26 a barrel, and 10yr Treasuries reached 1.66%. Markets were questioning the future outlook and prospects looked dim. While certain sectors in ABS exhibited strength, ABS as a whole widened during this turbulent time period. The growth slowdown in China had investors concerned about global trade, impacting containers used in the shipment of goods. Weak prices for commodities, such as oil, had consequences for railcars that transport petroleum. Global weakness also had an impact here at home for unsecured borrowers and in particular, for a new asset class that had emerged from the credit crisis – marketplace lending. Borrowing became more expensive as interest rates for these unsecured consumer loans rose.

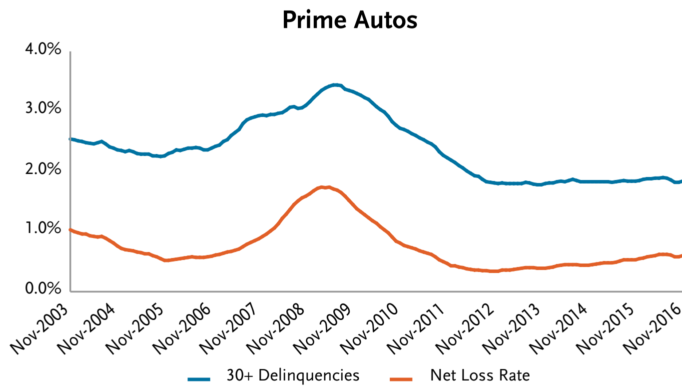
While fundamentals broadly came into question, trading challenges were also brought to light. Liquidity was difficult as many dealers had already reduced their balance sheets and were dealing with regulatory trading requirements. The newly implemented TRACE reporting, which required dealers to report trade prices, also added to the challenge, making dealers even more reticent to step into a down market. In times of uncertainty, all of these issues become even more acute and price movements become more volatile. The mindset of the market, however, can change quickly. The concerns that gripped the market in early 2016 began to ease as more moderate data trickled in. The first piece of news came from the U.S. consumer when data showed consumers had continued to spend during this volatile period. Markets began to turn around and shortly thereafter received further comfort as the ECB announced additional stimulus and the Fed capitulated on the pace of further rate increases (from 4 hikes to 2).

The fundamental concerns that existed in ABS gave way to compelling prices that lured investors back in and spreads moved tighter. Brexit reintroduced global recession concerns, but once the market came to believe that central banks would step in once again to counteract any negative consequences from a UK exit from the European Union, spreads continued to tighten. The sentiment remained encouraging heading into the Presidential election and the result, along with the potential for fiscal stimulus, only further strengthened the positive tone in spreads for ABS. Indeed, spreads in nearly all sectors in ABS ended 2016 tighter than where they began. Below are highlights of how the broader market dynamics and sector-specific fundamentals shaped the trading environment for some of the ABS sectors in 2016.

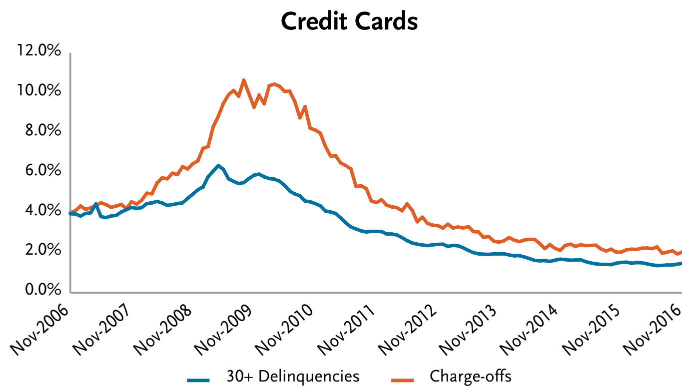
## Sector Themes

### *Prime Autos & Credit Cards*

Prime autos and money center bank credit cards have traditionally been recognized by the market as high quality assets. Despite concerns of a global recession early in 2016, spreads for prime autos and cards exhibited strength with prime autos tightening about 10 bps through the volatile period. As more positive sentiment in the broader markets picked up, spreads continued to grind tighter and only saw a brief pause following the Brexit outcome. Delinquencies for both prime autos and cards remain at post financial crisis lows as seen in the charts below. Currently, spreads are at +20bps for both 2yr prime autos and cards after beginning the year at approximately +50bps and +40bps, respectively. Through volatile times, prime autos and cards were resilient in the face of broader market volatility.



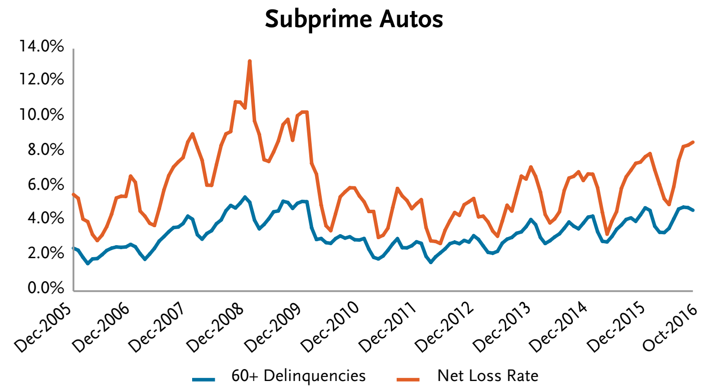

Source: BofA Merrill Lynch



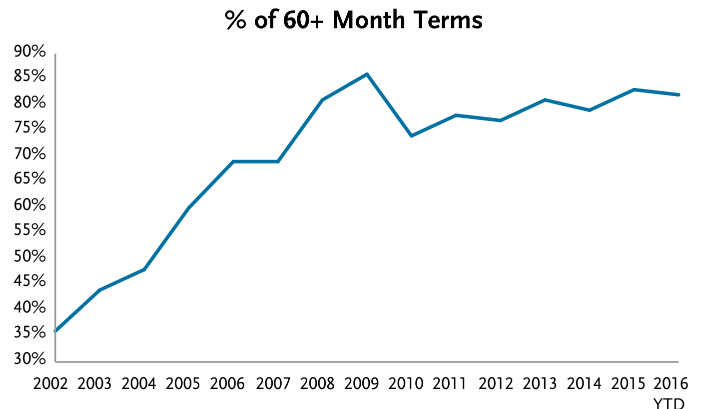

Source: BofA Merrill Lynch

### *Subprime Autos*

The performance for subprime autos continued to weaken further over the course of 2016. Net loss rates increased to the highest level since the credit crisis and delinquencies rose as well. The underperformance came as underwriting standards became more lax as can be seen in the rising use of term loans greater than 60 months. Even though performance weakened, this did not cause major alarm bells to ring for ABS investors. This is due to the fact that senior subprime auto ABS are short spread duration bonds with between 25-50% total credit enhancement and structured such that the bonds amortize quickly and credit enhancement percentages grow rapidly. Trading reflected this sentiment as well as 2yr subprime auto seniors tightened from +85 bps at the start of the year to +45 bps.




Source: Standard & Poor's




Source: Standard & Poor's

### *Student Loans*

Within student loan ABS, the Federal Family Education Loan Program (FFELP) makes up over 80% of the 191B outstanding amount. FFELP loans are guaranteed by the U.S. government at a minimum of 97%. Traditionally regarded as a high quality asset due to the government guarantee and additional structural enhancements, FFELP has been embroiled in a ratings battle that has left the asset class on an island of its own.

Back in the summer of 2015, rating agencies began to place this once predominately AAA rated asset class on downgrade watch. The action was based on the increased use of income based repayment plans which could cause the loans to extend which in turn could cause the bonds to extend past their legal maturity. This would be deemed a technical default years in the future by the rating agencies even though the full repayment of principal and interest of the bond would not be in question. Despite no change in the sanctity of the government guarantee, the FFELP market reacted quite negatively with fears of a potential flood of supply hitting the market should AAA FFELP bonds get downgraded to below investment grade. Entering 2016, FFELP remained at the widest levels since the credit crisis and largely remained at these wide levels until the market had a better grip as to how the ratings would transpire. After a year of being on downgrade watch, the rating agencies finalized their methodologies in the summer of 2016 and began to take action shortly thereafter. With the dark ratings cloud beginning to clear, FFELP spreads for AAA bonds began to tighten and normalize. Moody's completed taking action on all bonds they had placed on watch, while Fitch is expected to complete action in January 2017. In total, Moody's placed about 4% of the FFELP market below investment grade and another 12% at Baa. The FFELP market is now fragmented with bonds rated all across the ratings spectrum and trading levels reflecting this dispersion. For example, 5yr AAA trades at +80, while 5yr BBB/BB at +130.

### *CLOs*

Lower oil prices were certainly at the forefront of concerns for the CLO market. While anxieties for a pickup in defaults in energy credits were already present heading into 2016, they were further heightened by global recession fears and the continued drop in underlying loan prices. The market was also concerned with potential forced selling coming from accounts facing redemptions and a potential wave of downgrades from the rating agencies. All of these factors made secondary trading challenging as prospective buyers were pricing in further fundamental deterioration while sellers were reluctant to sell at such depressed prices and the stalemate resulted in many CLO mezzanine bonds not trading during the early months of 2016. However, the CLO market, much like other markets, began to recover as global recession fears receded and oil prices rebounded.

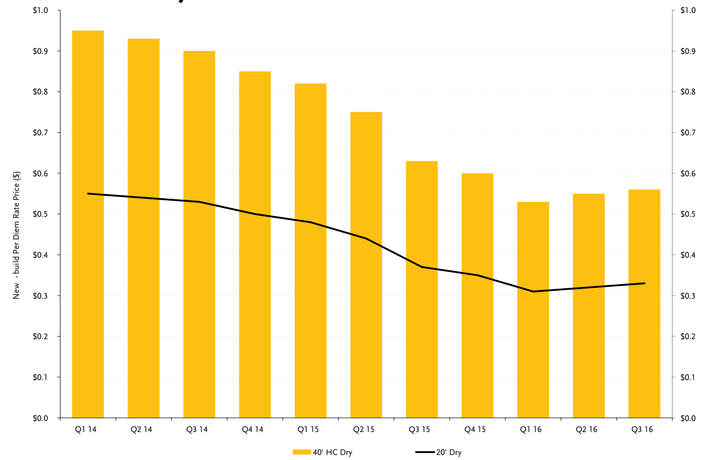
Brexit did cause spreads to widen, but only for a brief moment and what emerged were better buyers and few sellers. Spreads continued to tighten thereafter. In the background of the CLO market and certainly not forgotten was the risk retention rule that will be effective heading into 2017. The rule, which requires the CLO manager to retain 5% of the deal balance either through a horizontal first loss piece or a vertical pro rata slice of each tranche in the deal, has caused the number of CLO managers to decline and issuance volume to drop. Additionally, the lack of clarity on what structures will be risk-retention compliant has further complicated the issuance landscape.

***Containers***

The fundamentals for containers were challenging in 2016 as trade growth slowed while fleet capacity remained high. Adding to the trouble was the low price of steel through much of 2016 as the price of container boxes is highly correlated to the price of steel. The industry also dealt with the bankruptcy of Hanjin, the seventh-largest shipping line by twenty-foot equivalent units (TEU). While many of the larger container lessors had publicly stated that they expected to recover between 70-90% of these stranded containers, the bankruptcy, nonetheless, added to the challenging environment.

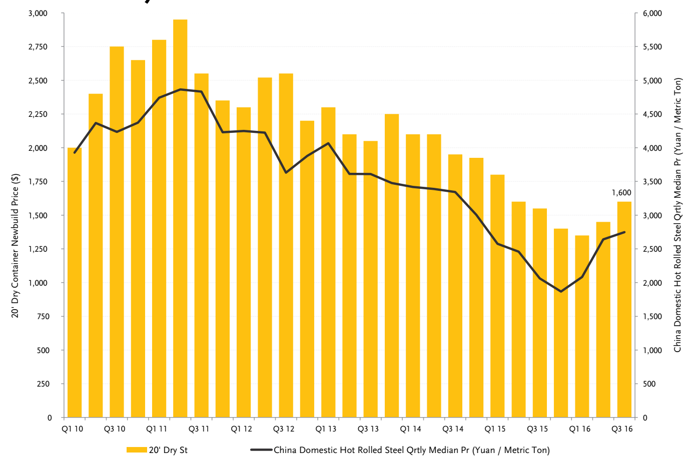
While a difficult environment, there were signs of stabilization in 2016. First, the production of new containers had slowed down and combined with the disposal of old containers, net production was close to 0. Second, as steel prices rose during the last quarter of 2016, so did prices of container boxes. These two factors had helped stabilize lease rates in 2016. Due to the volatility of fundamentals, among other reasons, spreads in 2016 remained at the widest levels in more than four years. Spreads began the year at +240, widened to nearly +400 during the bout of market volatility in Q1, and are currently around +290.

**20’ Dry Newbuild Container Per Diem Rates**




Source: Wells Fargo Securities
Data as of Q3 2016

**20’ Dry Newbuild Container Prices vs. Steel Prices**

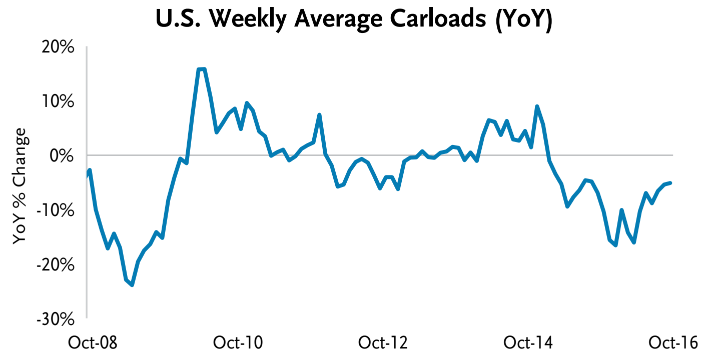



Source: Wells Fargo Securities
Data as of Q3 2016

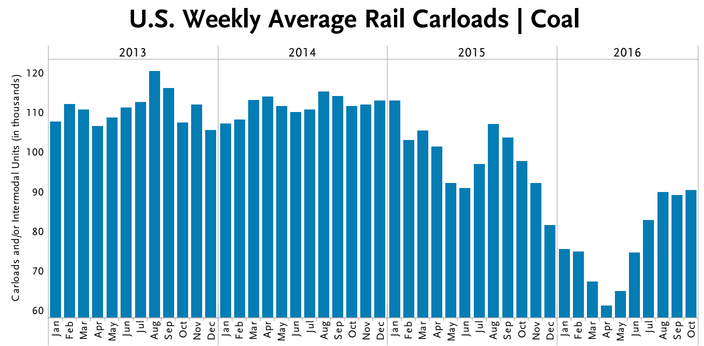
***Railcars***

Railcar fundamentals continued to deteriorate in the beginning of 2016 and remained weak closing out the year with total rail carloads down 10% from the prior year. Orders of new railcars also declined sharply. Perhaps the single most important factor was the secular decline of coal usage, which is the largest shipped commodity for railroads (18% of carloads in 2015). Coal consumption peaked in 2007 and has been on a decline since. Over 90% of coal's usage was for the generation of electricity and its decline came as the production of natural gas, another fuel used in electricity generation, increased. Advances in hydraulic fracking had provided new means to extract oil and natural gas and the abundance of natural gas had given electricity producers a cheaper fuel to use in electricity generation. Natural gas's share of electricity generation stood at 37%, up from 21% 5 years ago, while coal's share decreased from 45% to 33% over the same time span. This fundamental shift is likely to persist and given coal's limited use in other areas, the prospect for this segment of the rail industry remains dim.

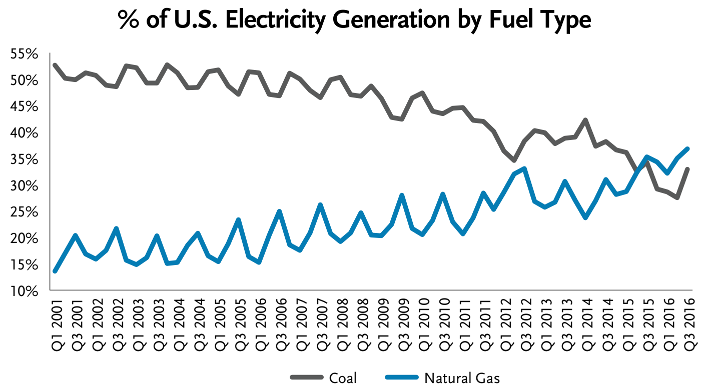
The industry also dealt with the low prices of oil, which in turn impacted the demand and lease rates for tankers that carry petroleum. Average weekly carloads for petroleum and petroleum products were down 15% from the prior year. While a challenging environment for some of the cargo that railcars ship, railcars remain an important method to ship goods around the country. This was evident in the utilization rates of railcars in securitization trusts remaining around 98%. Railcar ABS spreads were around +240 to start the year, widened to +350 during the first quarter, and tightened to +220 by the end of the year.




Source: BofA Merrill Lynch




Source: Association of American Railroads




Source: U.S. Energy Information Administration

***Marketplace Lenders***

Marketplace lending is a relatively new market, though there are already over a hundred companies operating in this space. Loan products vary, but the typical marketplace lender originates unsecured consumer loans to near-prime and sub-prime borrowers via an online process. The business model of many marketplace lenders is one of originate-to distribute and it was this model that contributed to the woes of marketplace lenders as funding began to dry up for many in 2016. Performance of the loans deteriorated as well, which was partially why some of the larger marketplace lenders raised interest rates on loans and/or stopped lending to the riskiest borrowers. Adding to the issues were the headlines surrounding LendingClub and its CEO who resigned due to abuses tied to a particular package of loan sales. This further heightened investors' concerns and as they pulled back, marketplace lenders began to cut jobs. The pullback from investors led to a slowdown in securitization of nonprime unsecured consumer loans. On the performance side, there were five deals that had breached loss triggers and delinquencies and defaults continued to rise. Trading levels painted a more positive picture as senior bonds have strong structural enhancements; a delevering structure with typically 30-50% of hard credit enhancement and 8-10% of excess spread . Spreads for 1yr bonds were +200 to start the year, widened to +400, and are now +150.

## Conclusion

2016 ended with the market in a remarkably different state of mind than where it began. The sentiment is positive and there is optimism that spreads will be buoyed by a new administration that may bring fiscal stimulus and less regulation. While the enactment of any potential fiscal policy is still to be determined, the mere possibility has already had a powerful impact on the market. There are still fundamental concerns, however, as data have shown signs of deterioration within certain sectors of ABS, emblematic of a maturing cycle. For now, those concerns have been muted and the technical environment is positive for spreads heading into 2017. ■

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