DYNAMIC CREDIT

9 April 2020

# European ABS market Update

## COVID-19 curves may be flattening, but markets are at a crossroads

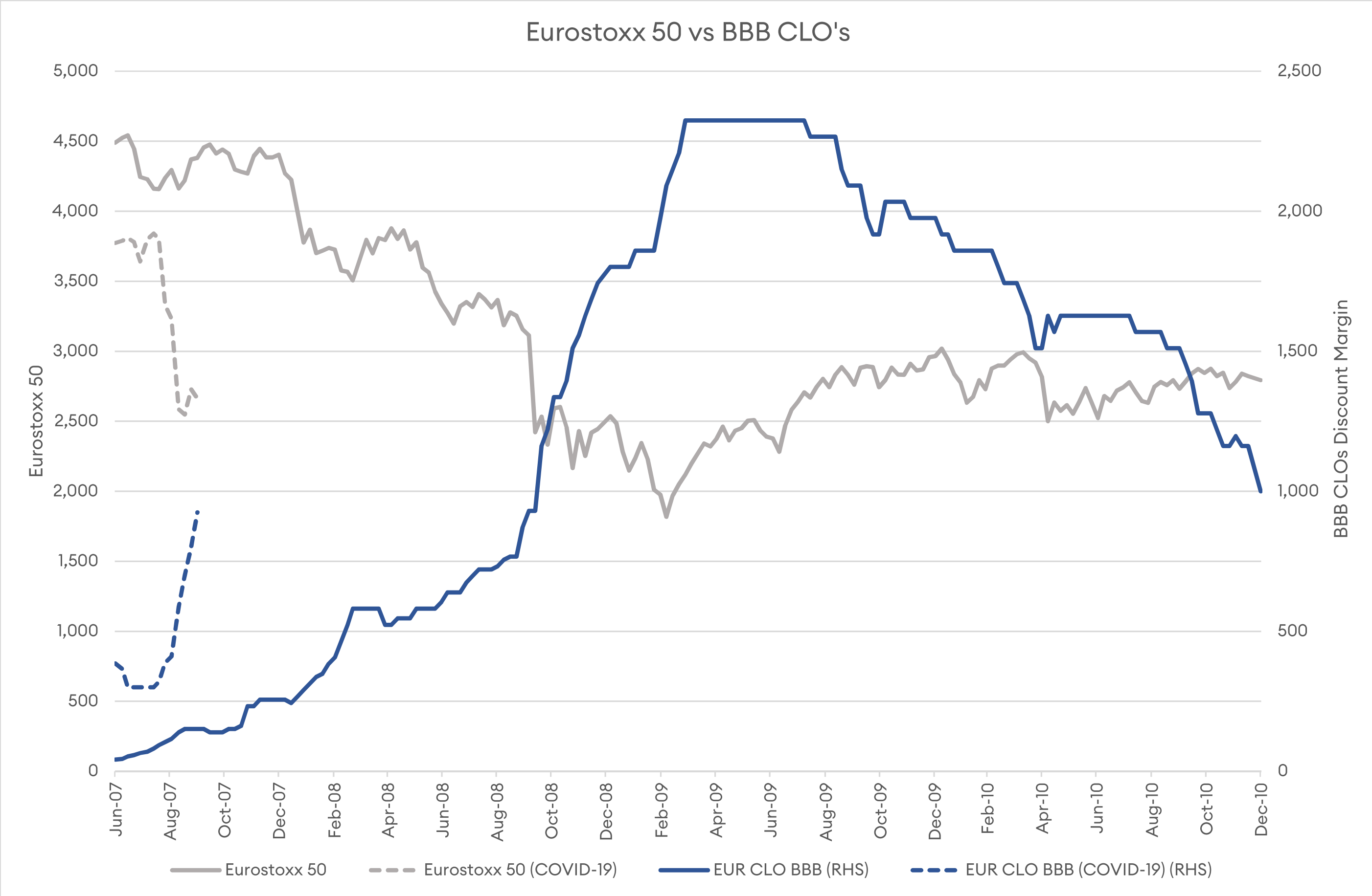
Markets remained volatile last week, with soft economic data driving a decline in equity markets. On a more positive note, data on the coronavirus published over the weekend included some green shoots in the form of indications that curves may be flattening in some countries. The numbers of new confirmed cases, deaths, and people needing to be hospitalized are coming down in several countries, providing signs that extreme policy measures taken to contain the virus are bearing fruit.While this is hopeful news, in our view, the 'COVID-19 crisis' will consist of three distinct phases:

1. the **'pandemic'** phase, when the virus spreads exponentially;
2. the **'shutdown'** phase, when quarantine measures are introduced, causing new case growth to peak and then fall towards manageable levels; and
3. the **'aftermath'** phase, when policy makers must strike a balance between restarting the economy and preventing subsequent waves of the new cases.

We optimistically see most of continental Europe in the 'shutdown' phase of the crisis, while other regions, most notably the US and UK, are still likely several weeks behind.

In previous updates, we noted that in order to call a bottom, the market would need to see both a peak in new cases as well as signs that the post-pandemic economy remains relatively intact. While we do not take the underlying health crisis lightly, the resulting economic damage from policy measures taken in response may be just as damaging. In our view, the recovery path will be a slow and unpredictable one. As quarantine measures are slowly lifted, impediments to normal economic activities will likely continue for at least 12-18 months until a vaccine has been developed. With governments wary of re-importing new cases, international air travel volumes are not likely be revived any time soon. Furthermore, post-epidemic consumer behavior may be slow to normalize considering the enormous shock to public, private, and household balance sheets. Service sectors such as tourism, leisure, and gastronomy will likely be the last to recover. In our view, this process will take time and there will likely be aftershocks once the initial impact of the virus has been mitigated.

It remains up for debate whether equity markets have bottomed, as we see valid arguments from both sides. However, even if equities have turned the corner, in our experience credit both lags equities in materialization of downside risk and takes significantly longer to recover to pre-crisis levels (see chart below). Comparing the Euro Stoxx 50 and BBB CLO spreads during the financial crisis, we note that although equity markets clearly bottomed in March 2009, they had already come close by September 2008, with limited downside from that point. In contrast, BBB CLOs saw credit spreads triple from already elevated levels over the same period, with no clear reversal until the second half of 2009. In fact, we did not observe a normalization of credit spreads for years(!) afterward (although this was compounded by the Eurozone crisis). While it remains early days, the chart below highlights the unprecedented speed at which this crisis has unfolded. Credit is already showing signs of continued deterioration, even as equities show signs of stabilization.




**Source: Bloomberg, JPMorgan. Please note that the dotted lines have a different time scale and start as of March, 2020**

This week in the credit space we saw most asset classes trading stable to slightly better compared to last week. The exception being mezzanine CLOs, which traded wider again. BWIC execution held to this pattern, with AAA CLOs trading well (80% execution rate) while mezzanine CLOs traded less frequently (40% execution rate) as buyers and sellers were further apart. Below is an overview of the one week spread change in various ABS segments, compared to investment grade and high yield corporate credit as of April 3, 2020. We also added the year-to-date spread movement as well as the peak level reached in the financial crisis period of 2007-2009:

| | Friday 20-2 | Friday 13-3 | Friday 20-3 | Friday 27-3 | Friday 3-4 | 1 Week Change | Ytd | Peak 2007-2009 |
|---|---|---|---|---|---|---|---|---|
| Iboxx Eur Corporate | 100 | 186 | 247 | 256 | 251 | -5 bps | 147 bps | 470 bps |
| Iboxx EUR HY | 338 | 661 | 895 | 802 | 770 | -32 bps | 420 bps | 1930 bps |
| | | | | | | | | |
| Prime/Auto Senior ABS | 16 | 25 | 50 | 60 | 60 | 0 bps | 44 bps | 400 bps |
| Spanish Senior RMBS | 38 | 85 | 200 | 215 | 215 | 0 bps | 102 bps | 750 bps |
| Auto ABS Mezzanine | 60 | 140 | 250 | 275 | 275 | 0 bps | 199 bps | 1150 bps |
| CLO AAA | 105-125 | 210-225 | 300-400 | 200-300 | 200-300 | 0 bps | 80-180 bps | 550 bps |
| CLO BBB | 265-375 | 575-600 | 600-800 | 750-850 | 800-1050 | 50-200 bps | 415-665 bps | 2300 bps |

**Source: Bloomberg**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