The Current State of the Asset-Backed Securities Market

Q&A | **June 2020**

In an effort to provide greater insight into the asset-backed securities (ABS) space, as well as to answer some timely questions regarding these securities, we conducted the following Q&A session with James Sims, CFA. James is a senior portfolio manager who focuses on securitized products at PFM and manages multi-sector investment-grade (IG) fixed-income portfolios for state and local governments across the country.

Why invest in ABS? What are the advantages right now, if any?

Sims: Historically, ABS offers an attractive risk/return profile for high-quality fixed-income portfolios. These securities also offer yield advantages when compared to government bonds. It should also be noted that the majority of ABS carries AAA ratings on their senior tranches and benefit from a variety of structural credit enhancements designed to protect bondholders. So, they are typically a high-quality alternative to both government and corporate bonds.

Another important benefit is on the diversification front since ABS have a lower correlation relative to other sectors. In short, the combination of high-quality, strong risk-adjusted returns and diversification in ABS has led us to view investing in ABS as a core part of most bond portfolio strategies.

With all of that said, ABS has been under a lot of pressure recently due to the fallout from the novel coronavirus pandemic and the resultant plunge in economic activity. It is possible that the stability of ratings within the asset class could be challenged in the near-term. In fact, the corporate sector has seen a growing number of downgrades and many corporates remain on "watch" for future declines. We have not yet seen the same trend in ABS and, taken as a whole, we are not expecting a significant drop in ratings unless the economic downturn is more severe or prolonged than expected.

What impact does the novel coronavirus/ economic downturn have on the ABS market?

Sims: To stem the spread of the novel coronavirus, many state and local governments have issued "shelter in place" orders. This has, not surprisingly, led to a dramatic slowdown in economic activity and caused a spike in unemployment. As a result, there is now heightened uncertainty around the consumer's ability and willingness to pay certain items, including rent, mortgages, auto loans and other obligations.

Given this marked slowdown in economic activity and the growing unemployment numbers, we expect to see an increase in delinquencies and defaults in the coming months, even as many lenders are allowing their customers to participate in payment deferral plans to stave off default. We are still in the early stages of how this will play out, but we are monitoring the situation very carefully.

In response, policymakers have acted boldly and quickly to help stabilize the financial markets and the economy. The Federal Reserve (Fed) cut rates to near zero and has been very actively rolling out programs to provide liquidity. The U.S. Treasury is backstopping many of these programs, and Congress passed the CARES Act and other programs to help mitigate some of the damage to the economy. But, uncertainty regarding the duration and severity of the economic shutdown, and by extension, the broader ABS space remains.

Unlike the market for new issue corporate bonds, the new issue ABS market has been very slow to restart. As we see more issuers come to market, it will assist in the price discovery process and also reveal additional useful information as to the health of the sector.

What data points or metrics are you paying attention to given the current economic environment?

Sims: At PFM, we conduct regular surveillance on all of the ABS securities that we own. That surveillance includes analyzing metrics on prepayments, delinquencies, charge-offs, payment rates, changes in used car values (for auto deals) and changes in credit enhancement support balances, among many others.

In addition, we have expanded our range of scenarios for stress testing tranches we own to incorporate more dire potential economic outcomes. We continue these efforts to look for signs of deterioration in either borrowers' behavior or the performance of the underlying collateral.

How is the liquidity in the ABS market?

Sims: In a more normal environment, the ABS market, and specifically AAA-rated senior tranche securities backed by auto and credit card receivables, is considered to be quite liquid. Right now, however, yield spreads are wider than normal and liquidity is somewhat impaired, not unlike what occurred during the 2008-2009 financial crisis. This likely is the primary reason why the Fed has responded so aggressively by dusting off most of its liquidity support programs from that era.

Specifically, they are supporting the short-term commercial paper market, money market funds, primary dealers, the ABS market and others. Taken together, these programs help ensure access to credit and have already begun to reduce yield spreads and improve liquidity in ABS and other sectors.

Long-term, what is your view on the ABS market?

Sims: While the challenges in this sector are formidable today, the structural features discussed earlier should provide enough protection to avoid significant impairment on most senior tranche issues, even if losses accelerate to prior recession levels. Then, as the economy recovers, we would expect ABS to perform well as the market improves. But, we are appropriately cautious right now.

Longer-term, we maintain the view that ABS are a core asset class appropriate for use in high-quality bond portfolios.

For further questions, please feel free to reach out to your PFM representative.

To learn more or discuss in greater detail, please contact us:

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