Market Insight

Outlook for 2010: Should we be spread betters after all?

London, 9 December 2009, by Mike Nawas

As another eventful year – or, more accurately, a relatively uneventful year compared with the disasters of 2008 and an eventful one in its surprise April-to-October rally – draws to a close, we pause to consider what spread environment our debt issuing clients should be expecting for the next 12 months in European securitised credit.

'Spread betting is … wagering on the outcome of an event, where the pay-off is based on the accuracy of the wager, rather than a simple "win or lose" outcome … Spread betting has been a major growth market in the UK in recent years … In the UK, spread betting is regulated by the Financial Services Authority rather than the Gambling Commission.' (Wikipedia).

Stop right there! Spread Betting is not within the scope of approval that the FSA granted us here at Bishopsfield Capital Partners. Indeed it is not, and, for the avoidance of doubt, neither did we ask for it. But reading Wikipedia's definition, only barely can we suppress a smile, because when commentators of the securitisation market write about spread outlook it often appears as no more than 'wagering on the outcome of an event'. Point in case: few market participants foresaw the huge April-to-October rally in the credit markets. And while we chose the title of this Market Insight somewhat tongue-in-cheek, there is a serious undertone to that choice: with markets as volatile as they have been in the last two years, getting it right on where spreads will be heading could be a major benefit to our clients. So while we certainly will not stray into the territory of spread betting, we will consider what spread environment our clients may expect for European securitised credit in 2010.

Let us start with a small but telling historical dataset of credit spreads in basispoints:

Bull market spreads	**Sharp spread widening begins**	**ABS spreads peak**	**Recent spreads**
Up to Jun 07	**Oct 08**	**Apr-Aug 09**	**Oct-Nov 09**
AAA 3y-5y RMBS:			
10-20	100-200	350-650	170-400
AAA 3y-5y CMBS:			
20	280	1200	900
AAA 1y-4y Auto ABS:			
8	120	420	200
AAA 1y-4y Credit Card ABS:			
8	200	700	220
BBB 3y-5y RMBS:			
70-90	600-1000	2200-4700	1100-3200
BBB 3y-5y CMBS:			
80	900	5500	4200
BBB 1y-4y Auto ABS:			
80	600	2800	1650
BBB 1y-4y Credit Card ABS:			
65	900	3400	1300
			Source: AFME/ESF

We selected time buckets such that they reflect what we consider to be four distinct periods in the spread environment: the first column shows the bull market up to June 2007; the second column marks the start of sharp spread widening after the Lehman collapse in October 2008; the third column shows when spreads peaked; and the fourth column shows current levels. None of the data-points above should come as a surprise to our readers. But this overview, in its simplicity, supports a number of important statements:

First, the pattern is familiar: stability and low spreads in 2006 and early 2007 followed by gradual spread widening from mid 2007 onwards when the sub-prime mortgage crisis started in the US and impacted liquidity in the massive Asset Backed Commercial Paper market that until that time served as a major buyer of European ABS. The collapse of Lehman marks an inflection point after which the market widened dramatically. This continued for about 6-9 months, until the market gradually bottomed out and eventually the post-summer rally of 2009 gathered steam.

Second, the magnitude of the volatility stands out, with spreads widening to the unprecedented levels quoted by the trading desks, more reflective of their 'no-buy' stance than backed-up by any significant real trades.

Third, although this cannot be seen from the dataset in isolation, the 2009 rally in the structured credit market lagged the rally in equity markets. Whereas the equity market bottomed out in March 2009, it took more time for the ABS market to bounce back. Asset backed spreads peaked in April 2009 for AAA RMBS, in May 2009 for AAA Autos and Credit Cards, in June 2009 for AAA CMBS and in July/August 2009 for all BBB classes. Investor confidence only came back on staggered basis with the lowest risk RBMS paving the way for recovery of other asset classes.

Fourth, tiering is back in the structured credit market. In the days of the bull market, credits with similar maturities and ratings showed little price differentiation notwithstanding different asset classes, credit history or sponsor quality. In the post-crisis world, these differentials have returned and are likely to remain.

Finally, across all categories asset backed spreads are still significantly wider than in the pre-crisis days. So despite the massive rally that took the market by surprise in 2009, there still is a long way to go if we are to get back to 2007 levels.

The question is: will we? To find the answer to this question, we took several approaches.

Our review of market research and syndicate desk commentary revealed that there is little market consensus about what 2010 will look like. Most forecast a break in the rally for the remainder of 2009 as investor books close and the street seeks to offload its (given the recent history, what we may call a surprisingly considerable) inventory, followed by a gradual re-emergence of the market in 2010. Early signs of success by top sponsors such as Lloyds/HBOS, VW and Delta Lloyd during 2009 fuel this hope. At Bishopsfield Capital Partners we agree that this is a likely scenario, although we add that volumes remain incredibly low (less than €15 Bln of new issuance in European securitisation in 2009 compared to €400 Bln in the bull market) so deals will be bespoke in their marketing and caution will continue to dominate lead managers' placement advice.

Another important factor is the comparison between secured (i.e., asset backed) and unsecured credit spreads. Although in this Market Insight we will not delve into the unsecured market, we only note that it rallied to a far greater extent than the asset backed market. And, importantly, its spread tightening was backed up by very significant new issue diversity and volume. So as investors weigh up their allocation plans for 2010, they will bear in mind the relative value of secured compared with unsecured credit. Provided their concerns about securitised credit can be overcome, the comparison bodes well for the prospects of spread tightening of securitised credit in 2010.

And that brings us to our final consideration: what are those concerns for securitised credit? Essentially they boil down to three factors: extension risk, underlying credit performance and liquidity.

Extension risk has been a major investor concern ever since secondary credit spreads widened to levels exceeding the step up margins that apply in case issuers choose not to exercise their call option on the expected maturity date of their legacy securitisations. This proved to be a legitimate concern as many issuers indeed chose not to call their bonds notwithstanding warning signals from investors that such an action could jeopardize their ability to issue new deals in the future. And indeed the success of the recent Arena securitisation for Delta Lloyd can partly be explained by their investor friendly behaviour to date. The likely successful new issuers of 2010 will be sponsors with similarly strong credentials. Key factors will be issuers' ability to demonstrate multiple funding sources, willingness to pay market price for new issuance, performance of underlying collateral and quality of investor information.

Underlying credit performance is reclaiming its importance in determining appropriate spread levels of securitisations. Rightly so, we believe: even in the heyday of the bull market, your humble Bishopsfield Capital Partners warned against the lack of spread tiering of securitisations. This lack of tiering distorted the balance between risk and reward that should underpin equilibrium pricing of credit spreads. The re-appearance of spread tiering depending on maturity, asset class, sponsor, jurisdiction, credit performance and investor disclosure is a welcome stabiliser for the market. Investor scrutiny is now deeper than ever and successful issuers will be the ones who can demonstrate excellence across these drivers of the fundamental credit story.
Generally, however, so far underlying credit indicators for most European securitisations, e.g., delinquencies, repossession rates, have not been improving yet. Fortunately, the pace of deterioration is decreasing. So prospective issuers should carefully time a new issue off of their ability to evidence that underlying credit deterioration has bottomed out.

Finally, liquidity remains a concern for most investors who have now had first hand experience of the difference in liquidity of the unsecured high grade market versus the secured high grade ABS market. Arrangers will be seeking to lead successful deals by pre-securing orders from real money investors with a buy-and-hold investment thesis. With favourable capital treatment of AAA rated ABS under Basel II expect banks to be meaningful buyers and help to fill the void left by the demise of SIVs.

In conclusion, while it remains a bit of a bet as to what the spread outlook will be, based on relative value and expectations for bottoming out of underlying credit deterioration, we are cautiously optimistic about the 2010 spread environment for issuers in the European securitisation market, especially if they can mitigate the main investor concerns set out above. Volumes are likely to remain low as will the number of deals. But prudent issuers may be well-advised to capture any likely positive sentiment: as the mountain of five to seven year debt originated in 2006-2007 across virtually every credit asset class (unsecured/secured, highly/lowly rated, OECD / emerging markets) comes closer to maturity in 2011/2012, the year 2010 may be a smart time for prudent issuers to tap the market.