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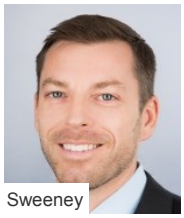
# CORONA AND TALF 2.0 – NEW OPPORTUNITIES AHEAD



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IN A NUTSHELL

- The Fed has expanded the Term Asset-Backed Securities Loan Facility (TALF) in an effort to improve financing for households and small businesses.
- Liquidity has improved dramatically for TALF-eligible assets now that both dealers and investors know the downside is relatively well protected.
- There is, however, a lot of nuance in investing in TALF and investor return could vary significantly.

The past weeks have been remarkable in the U.S. structured-finance market. On April 9, the U.S. Federal Reserve (Fed) expanded the Term Asset-Backed-Securities Loan Facility, otherwise known as TALF. It now includes existing AAA-rated commercial mortgage-backed securities (CMBS) and new-issue static collateralized loan obligations (CLOs), in addition to the existing new-issue asset-backed securities (ABS) that were included in the original program launched in late March. TALF was first deployed during the financial crisis in 2008 in an effort to stabilize markets by keeping loans flowing to households and businesses. As large chunks of economic activity have come to a halt during the outbreak of the pandemic, the Fed aims "to provide as much relief and stability as [they] can during this period of constrained economic activity, and [their] actions today will help ensure that the eventual recovery is as vigorous as possible."[1] On the back of this news, spreads rallied significantly across the U.S. structured market – with some sectors 50 to 60 basis points (bps) tighter overnight. We are now closer to the "tights" than to the "wides" in credit spreads in all but deep credit and sectors directly impacted by the crisis, such as retail, tourism and travel.

## TALF PROGRAM

To understand why TALF has had such a substantial effect on spreads in the structured market, let's briefly review the program itself. The TALF program allows investors attractive three-year nonrecourse financing of TALF-eligible assets, at anywhere from 85 to 95% loan to the value of the security. This would generally allow investors five to six times leverage on TALF-eligible assets. To give you a quick example of how powerful this is, an investor could buy 20 million dollars of a five-year ABS or CMBS yielding 2.2%, and then receive a loan on that for the next three years at a three-year overnight index swap (OIS) rate plus 1.25%, this currently amounts to approximately 1.4%. Essentially, this would mean levering the difference between the 2.2% yield on the pledged assets and the 1.4% financing yield five to six times for three years at no recourse. Even on an unhedged basis, assuming spreads remain somewhat flat, we think 4% to 6% returns for the next three years could be available.

That said, internal rates of return (IRRs) on leveraged TALF assets are heavily dependent on credit spreads at the time of entering and exiting the position, as well as on the decision whether or not to hedge rates. TALF loans are prepayable at any time. So if spreads were to rally significantly in the next year, while rates stay relatively low and an investor does not hedge the asset, the investor could easily see low double-digit returns on TALF-eligible assets.

The tail risk of higher pledged asset yields when the loan matures in three years, remains, however. If an investor did not hedge and spreads continue to stay at fairly wide levels or rates are significantly higher, an investor could potentially see flat, even significantly negative returns given the leverage provided. So, it is very important that investors have a view on the long-term effects of spreads and the evolution of the pandemic.

## SPREADS

To understand what happened to spreads, take the example of CMBS. A AAA-30%-enhanced (duper) CMBS was approximately 80bps over swaps pre-corona crisis, sold off

[1] https://www.federalreserve.gov/newsevents/pressreleases/monetary20200409a.htm

to 330bps-350bps at the lows and now sits at around 175bps. This is unprecedented for CMBS AAAs. Their previous post-2008-crisis wide was in 2016 at around 180bps. So 330bps-350bps is almost double the sell-off that we saw at the worst post-crisis sell-off. Sitting at around 175bps after the TALF announcement, we have more than rallied halfway back to where we were pre crisis.

This is possible since the Fed is essentially backstopping yields. If spreads were to sell off, the difference between the yield on the TALF-eligible asset and the financing yield on the Fed loan would increase, making TALF financing more attractive. This essentially limits the downside risk on TALF-eligible assets and presents a decent upside if spreads were to rally closely – or even not too closely – back to pre-crisis levels. Liquidity has improved dramatically now that both dealers and investors know the downside is protected. Dealers are actively making a two-way market and bid-ask spreads are rapidly declining for these assets.

Liquidity, however, did not only improve for TALF-eligible assets, but also for non-TALF-eligible assets for three main reasons. First, investors can use the increased liquidity in the market to move from TALF-eligible assets to non-TALF-eligible assets that are trading at a discount. Second, the Fed has already expanded the TALF-eligible asset universe once, they retain the option of further expansion and investors may be anticipating such a move. Finally, the Fed's action is a strong indication that it realized credit markets were severely dislocated, effecting credit creation. The market is now recognizing the Fed will do what it takes to protect credit creation in the United States.

## OUTLOOK

We continue to have a positive outlook on high-quality ABS and CMBS. From an investor perspective, knowing that there is a backstop bid is a favorable scenario due to the potential for significant upside and relatively low downside. Similarly, we like rolling into high-quality non-TALF-eligible assets like AAA-AA CLOs, existing ABS and single-asset-single-borrower (SASB) CMBS. That being said, the post-Covid-19 economic environment is likely to have changed for all assets, so strong credit-research capabilities should be a requirement for entering into any investment program.

The key question is whether the TALF program itself may be lucrative for investors. And that is where it gets a little tricky. Knowing how successful the TALF program was in 2008, there may be significant capital being raised outside to put to work in this market. We expect this to drive spreads of some TALF-eligible assets to non-economic levels, and to potentially do so for substantial portions of the eligible market. In our view, more esoteric ABS, equipment, subprime auto and legacy CMBS are likely candidates. In addition, some of the captive automakers may be active given recent downgrades.

So in our view, the TALF program's existence itself will do the heavy lifting in keeping spreads at certain levels. With regard to taking direct advantage of TALF, there is a lot of nuance and investor returns could vary significantly.

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