January 2009

MJX Asset Management

January Review - RMBS, CMBS, ABS and Leveraged Loans

Market Commentary

Summary Comments

A question we ask ourselves daily: "Are current observable market levels driven by fundamentals, technicals, liquidity or fear?" The short answer is "yes" to all the above, and leads us to the next question, how much does each factor contribute to these observable levels? The answer to that is harder to measure but each has contributed meaningfully to the results we see in the markets.

Spreads across all asset classes are being influenced not only by credit, liquidity (i.e. lack thereof), deleveraging, cost of funding and the cost of capital, but also by a new factor which is the uncertainty regarding federal policy initiatives and the much talked about "cram-down" issue. Although we touched on Loan Modifications in our November 2008 edition (on web-site) we continue to update our view as federal policy develops.

Market Developments

Loan modifications, cram-downs, TARP, TALF, it is difficult to have a discussion about any consumer ABS asset class without these topics popping up. Our view is that loan modifications and cram downs are difficult to predict and will play out over the next two years. However, the bottom line is that loan modifications and cram downs do and will continue to impact securitized mortgage pools. The effect of Loan Modifications may be more subtle and will affect different structures in unique ways depending on the structure's waterfall and documentation. On the other hand, cram downs, once applied, will have a blunt impact on securitized mortgage pools causing immediate realized losses to the structure.

More downgrades are inevitable, but from a credit and cash flow perspective current or future ratings are irrelevant to the knowledgeable investor. However we are very much aware of the fact that this may cause another round of "forced selling" by rating sensitive holders of these securities, so we would put the risk of downgrades into our technical outlook, and take this into consideration for more efficient price entry.

All of these structures are unique, and are not created equal, some tranches are very likely to suffer large impairments while others will not suffer any impairment at all, and it is unclear how the Rating Agencies plan to deal with this. We feel this dynamic offers tremendous opportunities to those who can tell the difference among the tranches.

TARP and TALF are the two potential elephants in the room. There is plenty of positive sentiment in the market about TALF with some would-be sellers holding off until they see how the TALF unfolds. The goal of the TALF is to get consumer lending flowing again. To achieve this, the government is going to inject leverage into the system enticing investors with 15% IRRs for what are perceived to be safe, top of the capital structure, consumer assets. The power of cheap, locked in, matched funding from the government is the biggest driver behind this trade. The TALF is intended to be available only for new or recently issued collateral and it is our view that this will cause a disconnect in prices and spreads between the new issue market and the much larger secondary market.

Whether or not the TARP uses the remaining $350 billion to buy distressed securitized mortgage bonds directly remains to be seen. Anxious investors who attempted to act quickly on this premise in 2008 did not perform well and the talk about TARP this time is not causing any significant spread tightening. The "fool me once, shame on you, fool me twice…." rule of investing appears to apply here.

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The Commercial Mortgage asset class is a possible beneficiary of government programs designed to help financial market recovery. While we believe there will be some political fallout from helping commercial real estate developers/trusts, a program of this nature benefits the economic recovery as a whole. Most CMBS conduit deals contain a sizeable percentage of retail and lodging debt. Retail exposure alone could be a reason to assist this sector as consumer spending is a necessary function of a recovering economy. Empty malls and vacant stores certainly do not contribute to the goal of stimulating the economy.

As it is, CMBS delinquencies continue to climb, and concentration risk has not yet been fully priced. And similar to the residential crisis, the current story in CMBS is all about vintage. As cash flow valuations are generally expected to decline, newer vintage transactions are much more susceptible to refinance risks. The Portfolio Managers at MJX note from their experience that it can take several years for commercial real estate markets to de-lever and recover. While we see opportunities and look for potential government programs to help stabilize asset prices, we are significantly more cautious for the time being.

Leveraged Loans

The end of 2008 did not bring an end to the challenges in the leveraged loan market. One of the most telling aspects of the past year's leveraged loan market has been a lack of refinancing and paydowns. Leveraged loans have traditionally maintained a near-par bid, an asset class characteristic that was partially supported by their recovery rate and partly by their turnover.

The average per annum repayment rate for leveraged loans from 1997 through 2007 was 45% as reported by Standard & Poor's Loan Commentary and Data ("LCD"). The slowest repayment year had been 2001 when 23% of leveraged loans were repaid. The next slowest repayment rate was 36% in 2007, and then came the credit crash of 2008. During 2008 the average leveraged loan repayment rate was 8.8%, cutting leveraged loan investor cash flows to 1/3 that of the worst previously experienced levels and raising average loan duration more than four-times historical levels.

The negative effect on loan prices has been significant. If repayment rates rose to 2001's 23% rate, having an additional 14% prepay at par would raise the average bid price a comparable amount, 12.6 points to a 77.15 average price. If repayments were running at the 45% average rate, the 36% greater percentage returning to par would again result in a comparable rise in the average bid price, 24.7 points to 89.5 average price. So, borrower's access to the credit markets for refinancing is key to improving price performance in the leveraged loan market.

December's S&P/LSTA Leveraged Loan Index reported a negative (2.95%) total return according to LCD and bringing the 2008 total return loss to (29.10%). The S&P 500 return was 0.78% in December and 2008's loss was (37.3%). The Merrill Lynch HY Index reported a December gain of 7.5% and 2008 loss of (26.4%). The Merrill Lynch High Grade Index recorded a 5.6% return in December and 2008 loss of (6.8%). Ten-year Treasuries reported a December return of 6.4%.

Index sub-categories reported negative returns as follows: Double-B issuers (1.77%) monthly and (24.21%) 2008 loss; Single-B issuers (3.72%) monthly and (34.89%) 2008 loss; first-lien loans (2.57%) monthly and (28.07%) 2008 loss; cov-lite loans (4.05%) monthly and (33.25%) 2008 loss; and second lien loans down (11.79%) in December and (47.69%) in 2008.

Trading data points

A very heavy cross wind confronts the debate between deteriorating fundamentals, and the buzz emanating from Government policies, resulting in observable price levels which continue to wax and wane. RMBS, CMBS and CLO cash bonds are trading with parallel similarity in that any tranche below the most senior tranche is trading at credit I/O like levels. Consumer ABS (autos, credit cards and student loans) have traded tighter from their wides in Q4 2008, perhaps in anticipation of the TALF. Senior tranches of structured products and senior leveraged loans are generally trading at prices that generate un-levered returns anywhere from 8% to 25%.

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