Consumers to the rescue

ZAIS Insights

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Bernhard Eschweiler, PhD
Senior Economic Advisor

Bernhard advises ZAIS on macroeconomic risks and prospects related to credit markets and is a regular contributor to ZAIS Insights.

Consumers to the rescue

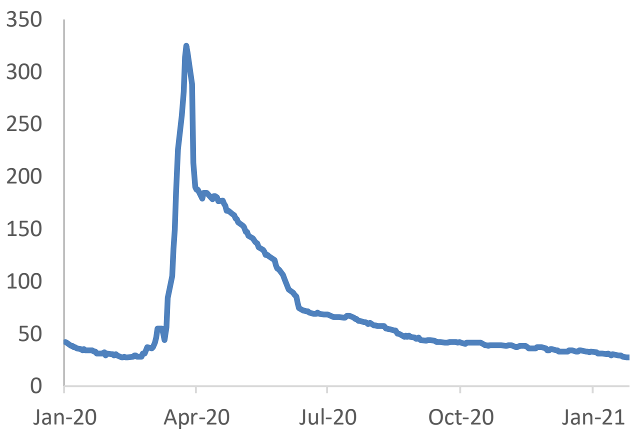
- Consumers are in good financial shape for recovery in 2021
- Yet consumers are prudent and unlikely to spend it all at once
- Public ABS markets already reflect the positive outlook
- But we see good risk rewards in less crowded market segments

Consumption is the backbone of the US economy. We think consumers are in good financial health and should drive the expected economic recovery this year, as vaccination progress allows a gradual return to normal.

In our opinion, the prospect of a solid consumption recovery without excesses should be good news for consumer ABS. Spreads of consumer ABS have largely returned to pre-pandemic levels (see Chart 1 below) and we doubt they will tighten much further.

Chart 1: US consumer ABS index

Basis points option-adjusted spreads



Source: Barclays[1]

However, we think consumer ABS will remain robust and offer good risk rewards in less crowded segments. As discussed below, new lenders like market-place lenders (MPL) have overcome the crisis well and we believe these credits are likely to expand further in size.

Consumption has the most potential

While economic activity recovered in the second half of last year, real GDP in the fourth quarter was still 2.5% below the level of Q4 2019 (see Table). As the table shows, the main factor holding down GDP last year was depressed consumption.

The Table shows further that the drag came from services consumption, which accounted for 60% of all consumption in 2020. Goods consumption, in contrast, actually rose last year, especially for durable goods.

The sectors most affected by the pandemic have been transportation, recreation and hospitality services, which together accounted for 80% of the negative contribution from services consumption to real GDP growth.

Table: US real GDP in Q4 2020

Percent

	Growth from year ago	Contribution to real GDP growth	Share of GDP
Real GDP	-2.5	-2.5	100.0
Consumption	-2.6	-1.8	69.2
Durables	11.9	1.1	10.8
Non-durables	4.3	0.7	16.8
Services	-6.8	-3.0	41.7
T-R-H*	-25.5	-2.4	7.1
Housing	13.7	0.4	3.7
Business investment	-1.3	-0.2	14.6
Government	-0.6	-0.1	17.7
Net trade		-1.3	
Inventories		0.2	

* Transportation, Recreation and Hospitality

Source: U.S. Bureau of Economic Analysis[2]

The current high levels of coronavirus infections are still undermining mobility and consumption, but we believe that vaccination progress will reduce the threat of the virus and allow for a gradual return to normality over the course of the year.

Consumption, in our opinion, should be the biggest beneficiary of that normalization, especially in the areas most depressed by the pandemic.

We think consumers are well positioned to drive the recovery for two reasons:

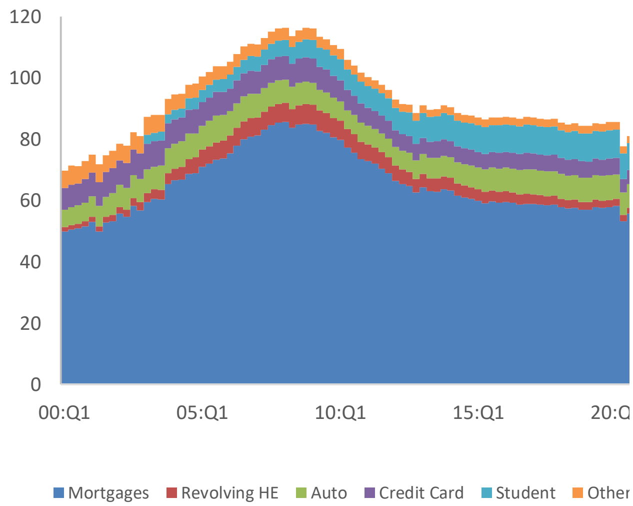
1. Consumers were in good financial condition before the pandemic, and
2. Consumers have received unequaled fiscal support and have managed their finances prudently during the pandemic.

Household finances improved before …

Households have been successful lowering their debt burden since the 2008 financial crisis. The overall ratio of debt to disposable income dropped from 116% in early 2008 to 81% most recently (see Chart 2).

Chart 2: US household debt

Percent of disposable income



Source: N.Y. Federal Reserve[3]

The biggest debt declines were in mortgages (-30% points) followed by revolving home-equity loans (-4% points) and credit card loans (-3% points). The ratio of auto loans to disposable income remained relatively unchanged; only the ratio of student loans increased (+3% points).

The low interest rate environment was undoubtedly helpful, but households made a substantial effort to raise their savings rate from about 3% in the mid-2000s to above 7% over the past ten years before the pandemic[4].

The combination of lower interest rates and higher savings has reduced debt service payments from more than 13% of disposable income at the end of 2007 to less than 10% just before the pandemic.[5]

The quality of household debt has also improved. The share of new mortgages with credit scores above 760 increased from an average of around 25% before the financial crisis to above 70% most recently.[6]

We think the improvement in household balance sheet health is positive for housing (see also ZAIS Insight "*Housing staying on positive growth track,*" November 2020[7]) as well as consumption, since mortgages are the largest share of household debt.

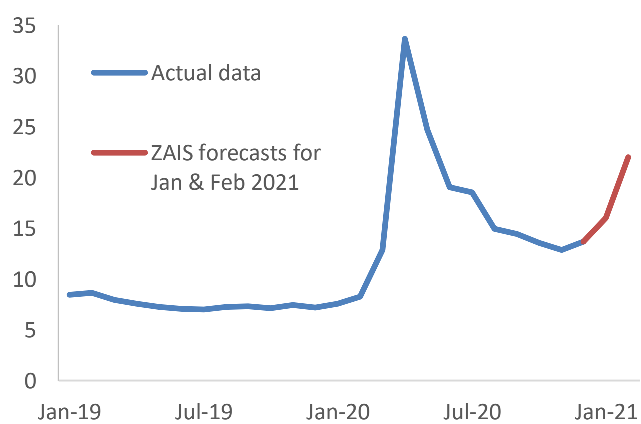
… and remained healthy in the pandemic

The pandemic-driven recession has not derailed household finances. First, the labor-market dislocation was unprecedented, but also concentrated in the service areas that were hit hardest by the pandemic.[8] Most employees with higher educational qualifications kept their jobs.[9]

Second, the US Government provided households with fiscal support, much of which went into savings (see Chart 3).

Chart 3: US household saving rate

% of disposable income



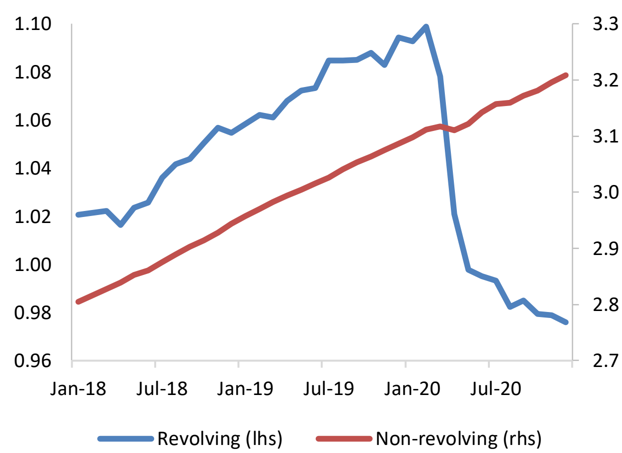
Source: U.S. Bureau of Economic Analysis and ZAIS estimates[10]

Factoring in the second relief-package passed at the end of last year and some of the Biden administration's proposed additional measures, we believe households accumulated additional savings worth at least 10% of disposable income over the 12 months since the start of the pandemic.

Third, households opted to modify debt service payments and sharply reduce higher interest-bearing revolving consumer credits (see Chart 4). As a result of these efforts and in striking contrast to the financial crisis, households credit delinquencies and foreclosures declined during the course of the pandemic (see Chart 5).

Chart 4: US consumer credit outstanding

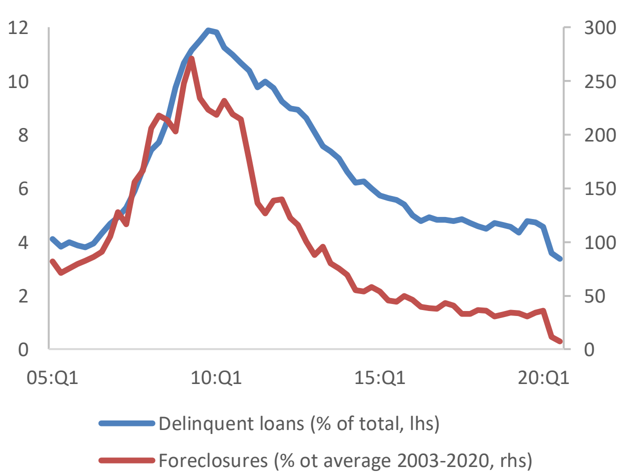
USD trillion



Source: Board of Governors of the Federal Reserve System (US)[11]

Chart 5: US household credit status

Percent



Source: Board of Governors of the Federal Reserve System (US)[12]

Solid recovery but no fireworks

We are optimistic that vaccination will change the course of the pandemic this year leading to rising mobility and consumption.

However, we think a sudden burst in consumption is unlikely.

- First, we expect the improvement in the health situation to be gradual.
- Second, we think that many people who lost their jobs in the hardest-hit service sectors will be re-employed over time, but we do not expect a quick return to pre-crisis conditions.
- Third, given their cautious behavior so far, we doubt consumers will spend their extra savings in a rush.
- Fourth, leisure, hospitality and travel have the most upside potential, but we believe people will not return to their pre-pandemic habits and activity levels immediately. Indeed, some people may never return to their old habits and preferences.
- Fifth, we expect demand for some of the durable goods that benefitted from the pandemic will probably moderate.

Good for consumer loan ABS

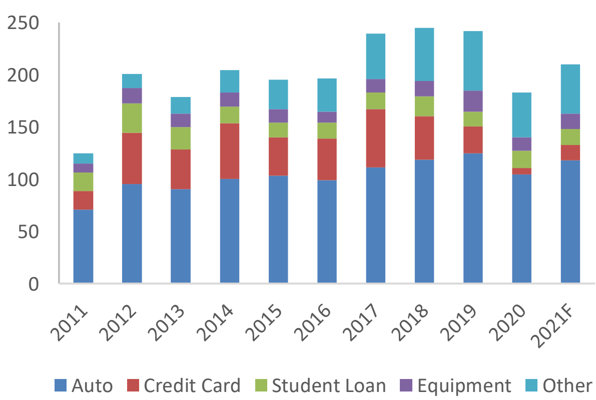
We expect a solid consumption recovery without excesses, supported by sound household finances and lingering fiscal stimulus, should be good news for consumer loan ABS.

We believe the Fed's large injection of monetary liquidity helped to quickly tighten consumer ABS spreads. However, we also think the tightening of spreads is justified, given the amount of fiscal support and favorable household balances and credit records.

In our opinion, issuance of consumer ABS is likely to rise this year after the decline in 2020 (see Chart 6), but we do not expect a surge, given the high level of household savings. Moreover, we think banks will rely more on deposits to fund consumer loans, especially for credit card balances.

Chart 6: Consumer ABS gross issuance

$ billion



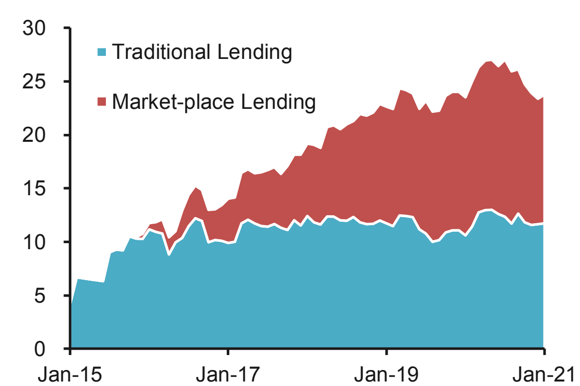
Source: BofA Global Research[13]

We believe monetary policy will remain supportive for consumer loans this year, but the big spread compression in consumer ABS is over, in our view. Thus, searching for single credits with still-attractive valuations will become more important.

New entrants have managed crisis well

Chart 7: Personal loan ABS outstanding

USD billion



Source: INTEX, Barclays Research [14]

A large growth area within personal loans over the last few years has been the so-called "Market-Place Lenders" (MPL) that offer unsecured installment loans connected to online platforms. Within a few years, the outstanding balance of MPL ABS has reached the same level as traditional personal loan ABS (see Chart 7).

The pandemic is the first stress test for the MPL sector. We have seen some lenders struggle over the last year, but MPLs have, overall, managed the crisis well despite their rapid growth in recent years.

Losses at MPLs fell on average in 2020, similar to the performance of traditional lenders (see Chart 8). While the pandemic provided a unique boost, we think online-shopping will continue to grow rapidly and offer interesting growth and investment opportunities in the MPL ABS space.

Chart 8: Annualized net losses by segment

% of loan balances

Source: INTEX, Barclays Research[15]

No rally but selected opportunities

To sum it all up, we believe consumption will drive the expected recovery, and healthy household balance sheets will support solid ABS credit fundamentals. Spread levels in the public ABS markets already seem to reflect that outlook with limited upside from here.

However, given our view on US consumer fundamentals, less crowded segments like the off-the run issues and private ABS debt continue to offer very compelling risk rewards. We are focused on uncovering attractive value propositions in these areas for our clients.

More information

As always, we are available to discuss our views with you. Please contact your Client Relations representative at +1 732 978 9722 or zais.clientrelations@zaisgroup.com

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[1] Barclays Agg ABS Avg OAS; Bloomberg code LUABOAS.

[2] U.S. Bureau of Economic Analysis; https://www.bea.gov/data/gdp/gross-domestic-product

[3] Federal Reserve Bank of New York Consumer Credit Panel/Equifax; Quarterly Report on Household Debt and Credit, November 2020, page 3.

https://www.newyorkfed.org/medialibrary/interactives/householdcredit/data/pdf/HHDC_2020Q3.pdf

U.S. Bureau of Economic Analysis, Disposable Personal Income [DPI], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/DPI

February 3, 2021.

[4] U.S. Bureau of Economic Analysis, Personal Saving Rate [PSAVERT], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/PSAVERT

February 3, 2021

[5] Board of Governors of the Federal Reserve System (US), Household Debt Service Payments as a Percent of Disposable Personal Income [TDSP], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/TDSP

February 3, 2021

[6] Federal Reserve Bank of New York Consumer Credit Panel/Equifax; Quarterly Report on Household Debt and Credit, November 2020, page 6.

https://www.newyorkfed.org/medialibrary/interactives/householdcredit/data/pdf/HHDC_2020Q3.pdf

[7] https://www.zaisgroup.com/housing-to-stay-on-positive-growth-track.html

[8] Employment in recreation and hospitality in December 2020 was 23% below the level before the pandemic and contributed 40% to the overall decline in non-farm payrolls.

U.S. Bureau of Labor Statistics, All Employees, Total Nonfarm [PAYEMS], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/PAYEMS

February 2, 2021

U.S. Bureau of Labor Statistics, All Employees, Leisure and Hospitality [USLAH], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/USLAH

February 2, 2021.

[9] Employment (25 years old and over), which accounted before the pandemic for 42.3% of the total was down 1.9% in December compared to the pre-pandemic level, while employment of all lower educational levels was down 8%.

U.S. Bureau of Labor Statistics; Table A-4. Employment status of the civilian population 25 years and over by educational attainment

https://www.bls.gov/news.release/empsit.t04.htm

[10] U.S. Bureau of Economic Analysis, Personal Saving Rate [PSAVERT], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/PSAVERT

February 3, 2021

ZAIS estimates for January and February 2021.

[11] Board of Governors of the Federal Reserve System (US), Total Revolving Credit Owned and Securitized, Outstanding [REVOLSL], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/REVOLSL

February 9, 2021.

Board of Governors of the Federal Reserve System (US), Total Nonrevolving Credit Owned and Securitized, Outstanding [NONREVSL], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/NONREVSL

February 3, 2021.

[12] Federal Reserve Bank of New York Consumer Credit Panel/Equifax; Quarterly Report on Household Debt and Credit, November 2020, page2 11 and 17.

https://www.newyorkfed.org/medialibrary/interactives/householdcredit/data/pdf/HHDC_2020Q3.pdf

[13] Bank of America Global Research, Consumer ABS gross issuance, January 31, 2021

[14] Barclay's Research, based on data from Intex, Personal Loan ABS Performance 2015-2020, January 1, 2021

[15] Barclay's Research, based on data from Intex, Personal Loan ABS Performance 2015-2020, January 1, 2021

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