

The Strength of the Consumer Balance Sheet and How it Relates to ABS

Vanderbilt Avenue Asset Management
Emad A. Zikry, Chief Executive Officer

A hallmark of a strong economy is consumers who are employed and spending. A strong consumer sector points to strengths within investment sectors of the economy that are linked to consumer spending. Specifically, we find that a high performing consumer is showcased in the loans he/she is able to borrow and repay. **In particular, we look at asset backed securities collateralized by consumer credit cards and consumer auto loans.**

Asset Backed Securities (“ABS”) are bonds whose income payments are collateralized by pools of underlying assets. These assets may include auto loans, credit card loans, student loans, home equity loans, and other esoteric loans that a financial institution securitizes and sells to investors. As borrowers of these loans pay their monthly interest and premium payments, the ABS passes these payments along to investors. Timely, stable, pass through interest and premium payments result in well performing ABS. As the economy has recovered over the course of the last decade, so too has the performance of ABS.

The performance of ABS is measured by the delinquency of the underlying loan borrowers. Since their peak in 2009, delinquency rates in Credit Card and Consumer Loans have been declining and are now stable. Charts 1 and 2 below show that the current levels of delinquencies are well below the troughs from previous recoveries, as demonstrated by the level of delinquencies following a shaded recessionary period.

Chart 1: Credit Card Loan Delinquency Rate

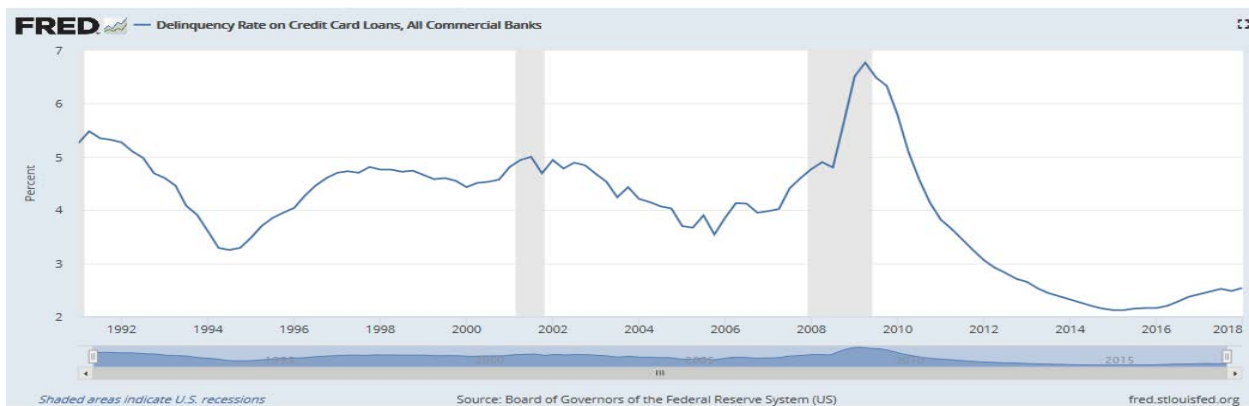
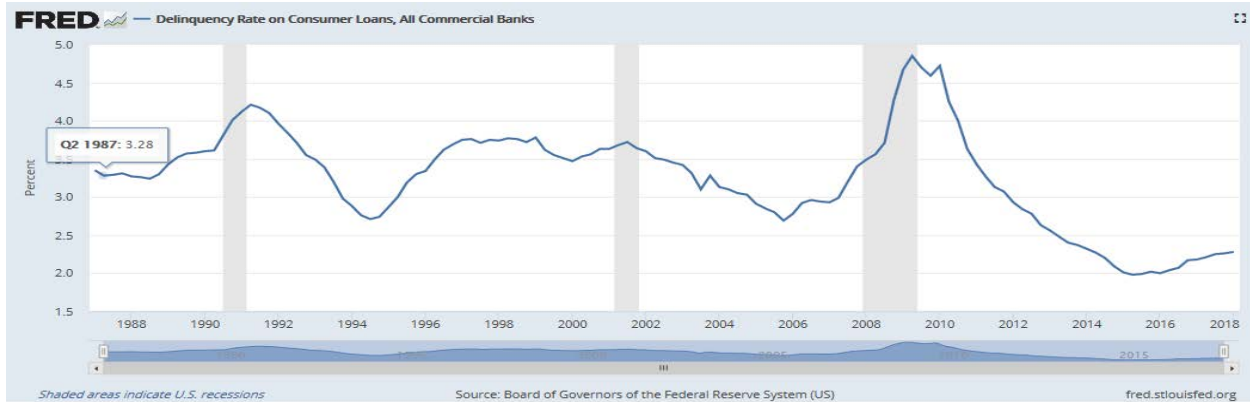
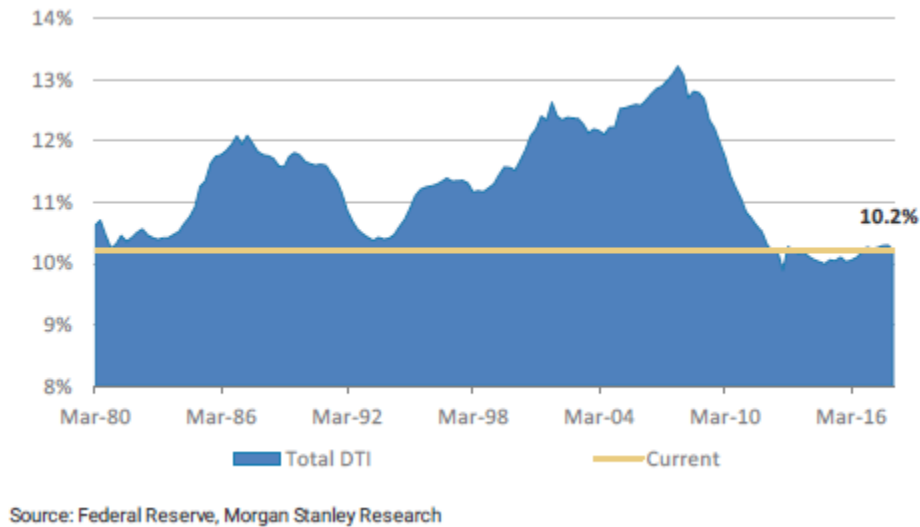


Chart 2: Consumer Loan Delinquency Rate



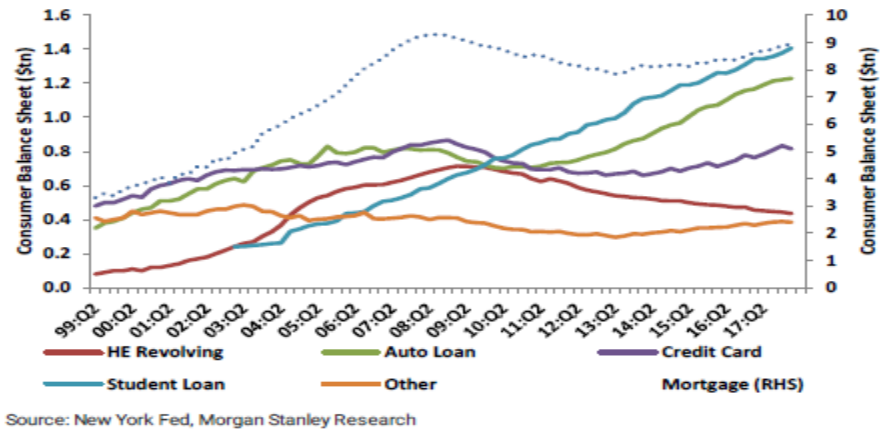
Along with an improving economy, lower delinquency rates can also be attributed to stricter lending guidelines by banks. Specifically, lenders analyze borrowers’ debt-to-income ratios (“DTI”) for loan approval. While this rate continued to increase throughout the 20 years prior to the great recession, it then rapidly declined, and has hovered at 10% ever since (Chart 3). Borrowers with lower DTI are naturally less delinquent in their loan payments. From the perspective of investors, loans collateralized by borrowers with lower DTI are more attractive because they should perform better.

Chart 3: Debt-to-Income Ratio



Yet despite lower DTI, some consumer balance sheet sectors have been rising (Chart 4). If it were coupled with increasing DTI, a rising consumer balance sheet could trigger concern from investors. However, these consumer balance sheets have been growing while borrowers’ DTIs have simultaneously remained low. All of this points to a strong consumer.

Chart 4: Consumer Balance Sheet



In the current strong economy, an increase in consumer spending, coupled with less debt, has signaled lower delinquency rates. It clearly follows that ABS backed by better loans should be performing well and continue to do so going forward. Depending on your risk tolerance, there is value in these highly liquid, well performing securities to investors at all levels of the capital structure. The table below lists spreads over treasuries for a variety of investment grade Credit Card and Auto ABS.

	Rating	Spreads
1 year Credit Cards	AAA	24
2 year Credit Cards	AAA	30
3 year Credit Cards	AAA	34
5 year Credit Cards	AAA	37
5 year Credit Cards	A	59
5 year Credit Cards	BBB	79
1 year Prime Auto	AAA	27
2 year Prime Auto	AAA	33
3 year Prime Auto	AAA	39
3 year Prime Auto	A	60
3 year Prime Auto	BBB	112

For our short duration clients, we recommend investing in 1 – 3 year AAA rated ABS backed by credit card or auto loans. These securities take advantage of strong consumer borrowers while providing a healthy yield over short treasury and Agency bonds.

Suzanne Saurack
 Managing Director