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Covid-19 impact: Consumer and Mortgage Finance

It's 2008 all over again – or is it?

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- The initial market reaction that "it's 2008 all over again" does not stand up to scrutiny, in our view. It is far too simplistic to assume that investment strategies that worked post-2008 can be replicated successfully in the coming months and years.
- While the past decade favoured corporations over individual taxpayers, we expect the opposite in this decade.
- Patience will be rewarded, but opportunities to invest both tactically and strategically in consumer and mortgage credit are already visible and we are executing selectively on them.
- In the long run, we see an acceleration of European bank deleveraging, potentially catalysed by greater M&A activity and consolidation – resulting in greater opportunities to position as an asset acquirer of performing bank loan portfolios from capital-strapped banks.

The value of investments will fluctuate, which will cause prices to fall as well as rise and you may not get back the original amount you invested. Where past performance is shown, please note that this is not a guide to future performance.

We are all cognitively wired to recognise patterns. Pattern recognition occurs when new information is associated with old, causing automatic activation of linkages drawn from long-term memory of prior incidents.

What is true in life is also true in approaches towards investing. So, the last few weeks of market movements have resulted in innumerable references to "it's 2008 all over again", with the unwritten conclusions that one can and should make investment decisions in the post Covid-19 environment by:

1. looking back at which sectors were hardest hit,
2. identifying what opportunities are deemed to be 'rich' and 'cheap' now by reference to price points post-2008 of similar instruments,
3. implementing investment strategies that performed well in the post-2008 era, and
4. doing so with investment professionals that experienced (and thrived in) the aftermath of the 2008 global financial crisis (GFC).

While this initial instinctive reaction is understandable, and certainly reinforced by the immediate actions of the central banks and governments in dusting off some of the monetary and fiscal tools used post 2008, we believe that such reactions reveal more about cognitive bias than the reality of investing in a post Covid-19 world.

In our view, it is far too simplistic to believe that drawing on the same investment strategies that worked post-GFC can be replicated in the ensuing months and years, with the same success. The world today is very different to that in 2008. While a severe economic crisis is a common thread running through both of these crises, we believe that the aftermath of the Covid-19 pandemic will play out quite differently. While the past decade was the decade of the corporation, we believe the coming one will be the decade of the consumer.

We examine the reasons why we believe this to be the case in this paper and discuss what that means for investing strategies.

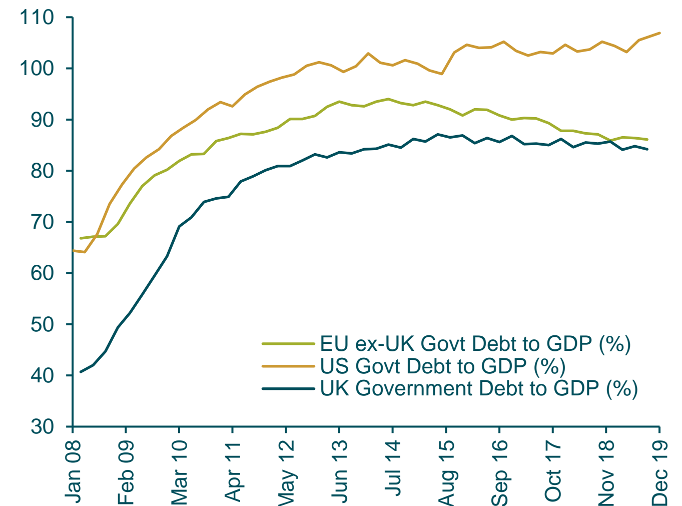
The past decade revisited

The period since 2008 saw a considerable rise in government debt relative to GDP, the size of central bank balance sheets (see Figures 1 and 2) and a lowering of interest rates, resulting in an impressive appreciation in asset prices and compression of yields (see Figure 3). Valuations also appeared stretched on several measures including price-earnings (P/E) ratios (see Figure 4) and high yield bond spreads per unit of leverage (see Figure 5).

One sector has deleveraged through the past decade, however, and that is the consumer. Perhaps helped by low interest rates and forced by a tightening of credit standards, consumer debt-to-disposable income ratios have fallen consistently post-GFC. This has happened at a time when disposable income itself has barely grown so consumers, in aggregate, have paid down debt rather than spent their earnings (see Figure 6). Attempts to boost global aggregate consumer spending have, in effect, proved insufficient, with the result that the unprecedented stimulus failed to lift global GDP growth above the trend growth observed in the decade preceding 2008. Instead, what this did was provide companies with the ability to leverage their balance sheets, borrow significant amounts from lenders, and increase their leverage debt burden at attractive yields, both from the public and private credit markets, and undertake share buybacks – resulting in significant increases in outstanding corporate debt (see Figures 7 and 8).

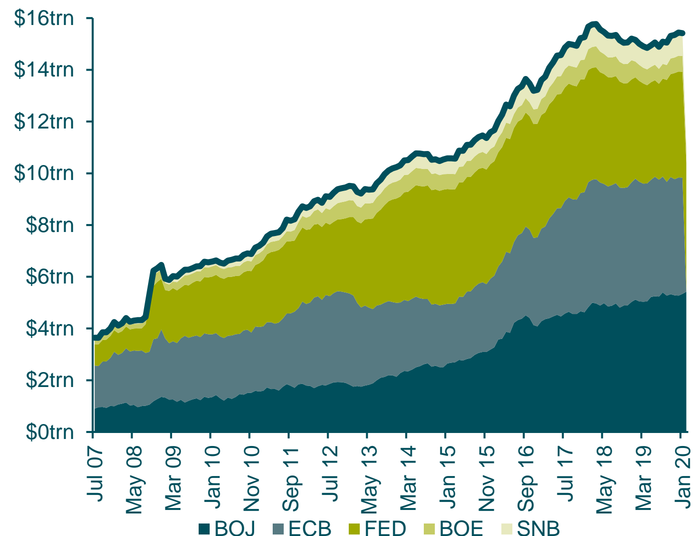
The past decade nevertheless saw much economic progress, particularly technological progress, and the living standards for many people have improved. However, the divergence of asset prices from underlying fundamentals has led to wider income disparities, with owners of capital getting richer relative to the owners of labour. Governments have increasingly recognised this. In the past couple of years, we have seen governments starting to declare hard won victories over the crisis and a promise to begin the easing of austerity measures imposed on the population. This has coincided with a resumption of investment in public services and social welfare. As governments reasserted themselves, central banks gradually began to unwind the monetary policy decisions of the past decade. Covid-19 effectively ended this, with both monetary and fiscal stimulus returning at a scale not seen even post-GFC.

Figure 1. Government debt-to-GDP ratios



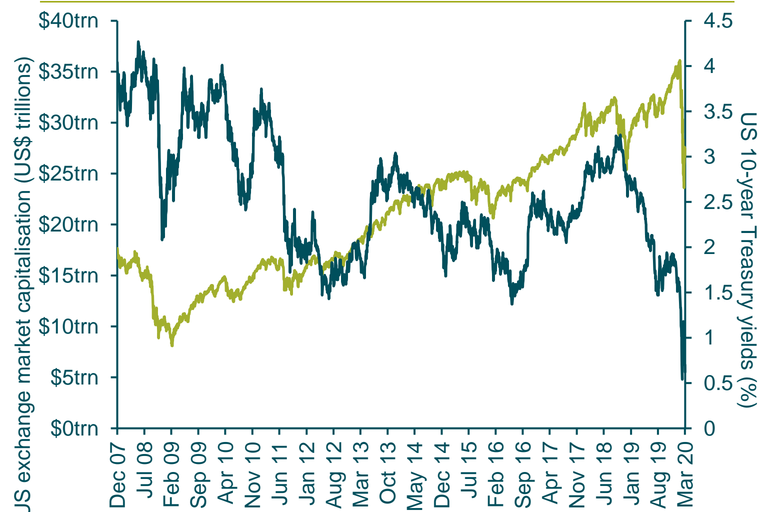
Source: M&G, Bloomberg EUR EUQDG , US FDTGATPD, UK EUQDG, as at October 2019.

Figure 2. Central bank balance sheets



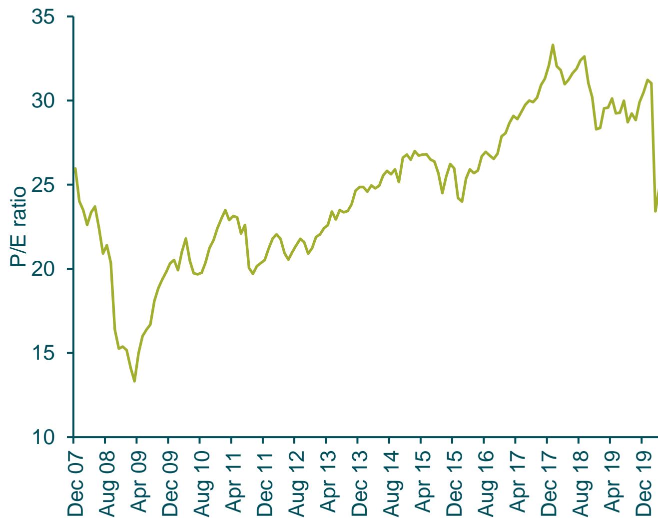
Source: Thomson Reuters Datastream, as at January 2020.

Figure 3. US equity market capitalisation (LHS) versus US 10-year Treasury yields (RHS)



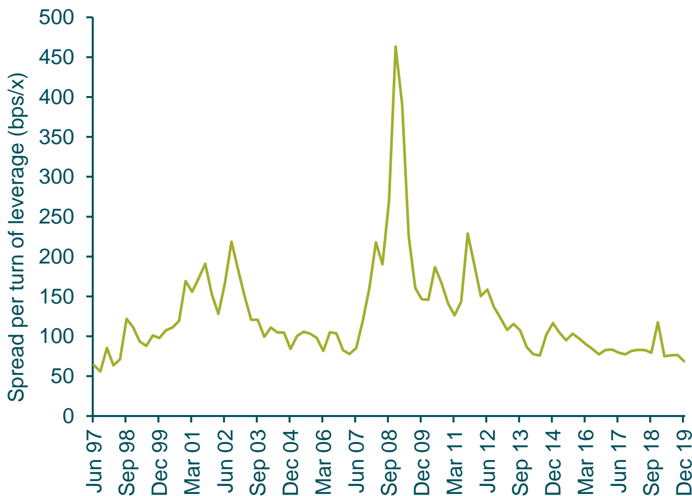
Source: M&G, Bloomberg WCAUUS Index & US H1510Y, as at March 2020.

Figure 4. US cyclically-adjusted total return price-earnings ratio



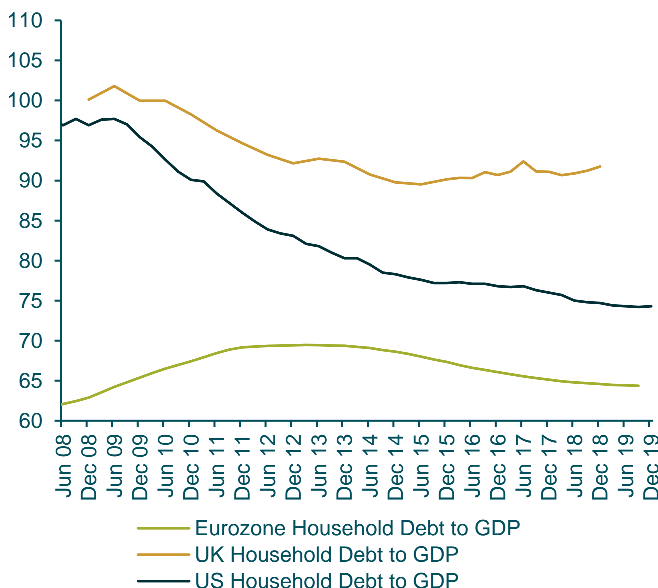
Source: M&G, S&P 500 Index CAPE, as at April 2020.

Figure 5. US High yield spreads per turn of leverage



Source: M&G, Bloomberg BofA Merrill Lynch Global Research, as at December 2019.

Figure 6. Household debt-to-GDP



Source: M&G, Bloomberg: EU (FALIEU/ENGCEMU), UK (FSI HGGB) & US(HHLDHDGD), as at December 2019.

Why consumers matter

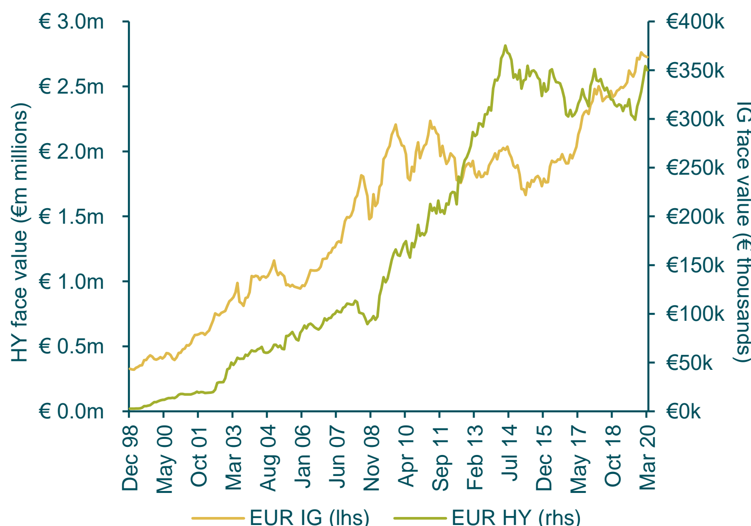
Underneath the political and human aspects of stopping and unwinding austerity measures lies a simple fact that developed economies are increasingly service-driven economies with consumer spending (rather than corporate investment) the bulwark of GDP growth.

Consumers can either borrow and spend or they can earn and spend. In any event, spend they must. If they don't, GDP growth suffers, and asset prices that might have been elevated by financial engineering must eventually revert to a more sustainable trajectory. So, keeping the economy growing requires the engine of the economy (the consumer) to be in good financial health and/or feel optimistic about their future financial prospects.

The Covid-19 pandemic has clearly had a significant negative exogenous shock on consumers and their financial outlook, resulting in the prospect of exactly the opposite, ie a further slowdown of consumer spending. An immediate focus of governments has been on preventing this demand-side shock from turning into a self-fulfilling spiral of: consumers not spending, businesses going bust and laying-off employees (also consumers), leading to a significant destruction in employment, wealth and welfare until the result is a permanently smaller economy. Preventing this involves vast sums of money promised to effectively 'backstop' the consumer. Wage guarantees, making up lost income, forcing or cajoling lenders to exhibit forbearance on loans, encouraging banks to roll over debts and continue lending to consumers and small businesses at affordable rates, are all part of the near-term actions being taken, particularly in Europe. Ensuring that the consumer remains solvent and central to the functioning of the economy is likely to be the key economic priority for governments in the post Covid-19. It also matters that it is a politically necessity to do so. A democratic government that presides over a significant increase in unemployment cannot expect to be re-elected.

Please refer to the Appendix for a summary of some of the measures that have already been enacted by governments.

Figure 7. Growth of the Euro high yield bond market



Source: M&G, BBG BofA Merrill Lynch Global Research, as at March 2020.

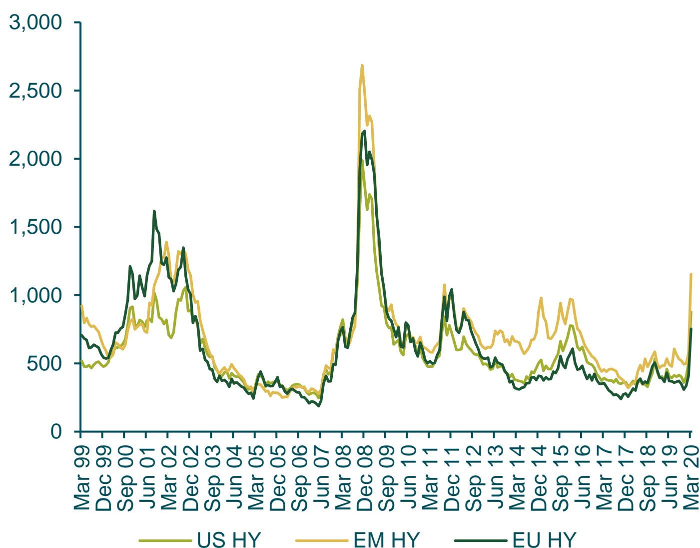
The question that needs to be asked is: who will pay for this?

Answering this is where the notion that "it's 2008 all over again" starts to feel challenged. The bank bailouts post-GFC were eventually paid for by individuals (ie the consumer) and the benefits reaped by the corporate sector and banks that avoided insolvency. 'NINJA (no income, no job, and no assets)' loans in the US, property speculation in Ireland, for instance, facilitated by irresponsible banks and inadequate regulation were viewed to be the causes of the crisis back then.

The current crisis cannot, however, be pinned on the 'average' consumer. As we have discussed, they have been busy in the past decade repairing their balance sheets, being subject to ever more stringent regulation and affordability testing on borrowing. This time round, we expect the favour to be returned by the beneficiaries of government policies and bailouts post-2008 – banks, the corporate sector, particularly large businesses. Already, share buybacks have had to be suspended as a pre-condition for receiving government aid, and banks have been asked to defer bonuses and dividends in order to maintain capital to lend and support the consumer. De-facto nationalisation (even if temporary and by stealth) of certain sectors of the economy is in process. Higher corporate taxes may follow as a price for the rescue financing.

Overall, we expect that, this time round, government resources will be focused on supporting the solvency of the average consumer. How will this be paid for? This could come via higher taxes on high earners and by shareholders of large enterprises through a repositioning of the corporate sector, through burden sharing in the near term and a decisive shift (and most would agree welcome) away from purely targeting profit, instead also including social and customer responsibility as a key corporate performance metric. Valuations have fallen but only from extremely stretched levels at the start of the year. Nevertheless, more challenges and a potential paradigm shift lies ahead. Arguably, this does not bode well for already over-valued equities, commercial property or leveraged corporate credit, at least until a significant retracement of values has occurred – either organically or through a default driven re-organisation.

Figure 8. Selected High Yield Spreads



Source: M&G, BBG Bofa Merrill Lynch Global Research, as at March 2020.

Does anyone need to pay?

You could challenge the assertion that someone has to pay for this on the premise that government or central bank interventions can appear to be costless (or at least inexpensive) so that no one really has to pay. Expansion of central bank balance sheets through a resumption of quantitative easing allows governments ample room to undertake cost-effective and cheap borrowing. This money-printing machine with no negative externalities appears tempting at the moment but, borrowing – unless permanently monetised – must eventually be repaid or at least be refinanced cost effectively. In addition, a sustainable debt trajectory is important to the ability to roll over borrowing at affordable rates (various sovereign debt restructurings are illustrative). In the euro area, growing calls from weaker economies for some form of debt mutualisation is a recognition that heavily-indebted euro area economies do not believe they

can afford this spending without a collective backstop to guarantee their perceived solvency. If the European Central Bank (ECB) were so powerful as to grant large-scale debt relief as part of the magical world of central bank accounting, that would not be the case.

Investing in the post Covid-19 world

If you agree that preserving the solvency and supporting the spending power of consumers will be a key focus of the recovery from the current crisis, you can start to develop an investing framework that does not fall into the potential "it's 2008 all over again" trap.

Our framework for the post Covid-19 world involves "follow the government" and to support the consumer (whom the government and private sector backstops). Low interest rates, an increase in unemployment benefits, relaxation of forbearance and bankruptcy laws all support the case for an outperformance of prudently-underwritten consumer credit relative to corporate credit or equities in the coming decade (once the economy starts to function again).

Is it the right time to invest?

Successful investing involves picking the right investment theme and the right timing. It is easier to do the former than to do the latter. The next best way to time your investment is to deploy capital over a long-enough horizon that makes timing less of a consideration.

We have previously written that consumer credit broadly defined is a large and diverse sector. Residential mortgages, consumer loans, auto loans, credit cards, certain SME loans is a €26 trillion market in the US and Europe. So, there is ample opportunity to be highly selective. We believe our strong and established presence in the market, specialised focus on this sector, highly developed analytical resources and an ability to react quickly are key strengths.

In the near term, our focus is:

1. To manage the risks within our existing portfolio investments. Our insistence on prudent long-term non-recourse financing and patient locked-up capital has been invaluable in letting us focus on managing credit rather than liquidity.
2. Opportunistic secondary market purchases from forced sellers – we have selectively acquired debt instruments backed by consumer loan portfolios with double-digit IRR potential. We have used the opportunity through these investments to increase the diversity of our portfolio across regions and risk profiles where we have previously been priced out of by competition from repo-leveraged hedge fund buyers. While liquidity interventions by the central banks has limited repo margin-driven liquidations, fund redemption-driven sales have not yet commenced so we would expect this theme to continue for a while yet, to the potential benefit our patient capital.
3. We also remain able to capitalise on and react quickly to any sizeable strategic portfolio opportunities (including rescue financings).

With an eye on the medium term:

1. We are intensifying our conversations with experienced consumer loan and mortgage originators (including banks) that are seeking strategic partnerships for their upcoming portfolio of originations with patient capital partners such as ourselves – and are prepared to pay a considerable premium for it. We have a diverse set of discussions already ongoing in Europe and further afield, in this regard. One observation is that platform value in a number of non-bank originators has been severely impaired (which will likely lead to considerable losses for private equity or venture capitalist investors that have backed them and/or public market shareholders in them), but those that survive will pay for the privilege of being able to continue to originate so as to eventually recoup the lost enterprise value.
2. Opportunities may arise to acquire stakes in lending platforms at depressed valuations, although our focus remains on assets.

We remain focused on consumer credit that is realised through repayments rather than non-performing loans (NPLs) relying on asset liquidations, and would expect to see the supportive measures of governments and the private sector providing support to the performance of affordable consumer credit. Unemployment shocks will ease and consumers with delayed debt will eventually repay, even if some debt is rescheduled. In contrast, we expect to see NPL-focused loan portfolios (especially in Southern Europe) experience considerable stress in their investments, and would anticipate that stress to continue or even intensify (as the value of the security is impaired), timelines for cashflow realisation lengthen considerably and financing of acquisitions becomes scarcer and more expensive.

What about the longer term?

Once the dust has settled and the capital adequacy of the European banking sector, in particular, again becomes an area of concern, we see an acceleration of the trend towards bank balance sheet deleveraging, potentially catalysed by greater M&A activity and consolidation. This could result in opportunities to acquire performing bank loan portfolios in our sectors of focus.

Appendix: Summary of consumer support measures (as of 31 March 2020)

Jurisdiction	Measures
United Kingdom	The government has passed emergency legislation to ban evictions / repossessions and protect renters, while the FCA and UK Finance have introduced three-month mortgage payment holidays with no penalties for those financially impacted by Covid-19, including those with buy-to-let mortgages. HM Treasury and HMRC have announced various measures to defer tax payments and business rates to help SMEs and their owners, including the introduction of a Coronavirus Business Interruption Loan Scheme (CBILs), which will offer government guarantees to lenders providing loans to SMEs, helping their consumer owners. A Coronavirus Job Retention Scheme has been created for the Government to reimburse employers for 80% of wage costs, up to £2,500 per month, of furloughed employees. This is intended to reduce redundancies or lay-offs during the crisis, allowing consumers to return to their jobs when the crisis subsides. Statutory Sick Pay rules have been extended in instances of Covid-19-related absence and SMEs with less than 250 employees are able to claim refunds from the Government. The PRA has written to the largest UK banks' CEOs asking them to suspend dividend distributions and conserve capital, primarily in order to be able to lend more to support small businesses and consumers.
Ireland	The five Irish retail banks, many non-bank lenders and many credit servicing companies have agreed to adhere to a voluntary scheme where flexible arrangements, including payment breaks, will be available to customers affected by Covid-19. Emergency legislation has been introduced to prevent rent increases and evictions / repossessions.
Italy	The Decreto Cura Italia (the Covid Decree) allows "first home" mortgage holders to suspend payment of mortgage payments for up to 18 months. The decree also allows for a suspension of payments if the borrowers' working hours fall, turnover for self-employed borrowers falls or other adverse effects occur. Further, the decree supports SMEs and micro-enterprises and their owners by suspending all payments until 30 September 2020 if the borrower self-certifies a temporary lack of liquidity. Extraordinary relief has been introduced to cover a proportion of the salary of employees temporarily suspended or whose working hours are reduced. Employers are prohibited from making redundancies until 15 May 2020. Sick pay provisions have been extended to include those in mandatory self-isolation, even if asymptomatic, and any Covid-19-related time-off does not count towards the 12 month statutory maximum to be entitled to keep their job.
Spain	The Royal Decree-law 8/2020 and 11/2020 provides for protection in favour of mortgage debtors and consumer loan borrowers, respectively, in a "vulnerable" situation, which includes (i) unemployment or substantial loss of income, (ii) if family aggregate income does not exceed 3x an adjusted Spanish monthly minimum income amount, (iii) if the mortgage payment plus basic supplies is greater than 35% of net income, (iv) if a health emergency has altered a family economic situation. Further benefits have been granted to SMEs, eg insolvency protection, government insurance and government guarantees. New measures improve conditions for employees' access to unemployment benefits, including exemption of social security contributions, if working hours have been reduced. Employees who are self-isolating, regardless of symptoms will receive sick pay commensurate with other types of medical sick pay.
Netherlands	While no direct government forbearance legislation has been introduced, the largest domestic banks have agreed to introduce a relief measure which gives certain SME clients a six-month postponement of repayment obligations, and in some cases, interest payments, helping their consumer owners. Most banks have also announced relief to consumer mortgage borrowers who are financially affected by Covid-19. New emergency fund for bridging employment has been introduced by the Government to compensate up to 90% of wage costs for employers who expect a loss of turnover of 20% or greater. This will apply

	for three months and may be extended. Employees infected by Covid-19 will receive the same sick pay as those on others types of medical sick leave, typically up to 70% of their salary up to a cap.
United States	The Families First Coronavirus Response Act has been passed to provide emergency paid sick leave and extended family and medical leave rights to employers with fewer than 500 employees. This will give employees the right to two weeks' paid sick leave, subject to caps, if they are subject to quarantines restrictions or are caring for a family member due to Covid-19. Under the Federal Economic Stimulus Bill 'stabilisation loans' can be granted to eligible US businesses. While it is not currently government enforced, America's five largest banks have agreed to defer mortgage payments for up to 90 days for homeowners impacted by the coronavirus outbreak.

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