MARKETGRAPHIC

CDOs of ABS

Citigroup strategists suggest that AA tranches of CDOs of asset-backed securities may be more vulnerable to downgrade than BBBs

SUBPRIME HAS BEEN one of the main focal points during the recent sell-off, if not necessarily its cause. But we reckon the effect on CDOs of ABS may be more interesting than on subprime itself – and considerably less priced in.

Unlike CLOs, US CDOs of ABS seem to be relatively undiversified. Put better, the individual BBB and BBB ABS tranches within CDOs of ABS are actually quite well diversified.

Rather than being concentrated in particular regions, they tend to span several – even if there is still a preponderance of exposure to 'hot' states like California. This renders the individual ABS more stable. But from a CDO perspective, it actually makes the collateral more similar, thus *reducing* diversification. As we see it, this creates a classic 'ball in bowl' phenomenon, in which either no ABS tranches get downgraded, or else a great many do.

Translated into CDOs, widespread downgrades would, relatively speaking, be far worse for senior tranches than for junior ones. Indeed, preliminary analysis of some cash CDO of ABS deals confirms this. If 25% of BBB ABS tranches fall to B, for example, then on one deal which we analysed, the AA tranches would fall to A-, while the BBB tranches would only move to BBB-. Of course, the severity and timing of the actual number of downgrades remain extremely unclear at this stage. But a recent Moody's report reached a similar conclusion: that some AA CDO tranches might suffer more than those lower down the capital structure.

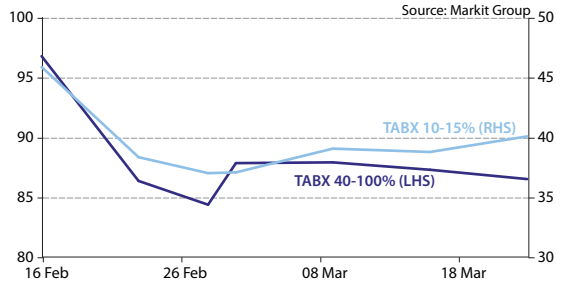
Such findings already seem comfortably priced into TABX, and indeed help to explain the otherwise absurd levels reached by its super-senior tranches (*see chart 1*). But the more liquid (if less transparent) CDS on CDOs of ABS market does not seem to share that pattern at all: to judge from new issues, BBB tranches have suffered far more than AAs (*see chart 2*).

We recommend that existing investors in high-quality tranches switch out in favour of (smaller) allocations to, say, BBB or even equity tranches instead, or consider using CDS on CDOs of ABS to effect the package. That requires choosing specific deals, of course, but if our thesis is right then we can't see that making a lot of difference.

Trade suggestion

Buy protection on the AA tranche of CDOs of ABS at roughly 150bp versus selling protection on (or buying outright) BBB tranches at roughly 800bp. A ratio of 8:1 should achieve a small net short. Note that levels will depend on the specific deals and may differ significantly from those shown on the charts as many tranches are being sold at discounted prices. On some deals, the bid/offer is very wide.

1. Prices for TABX-HE 07-01 06-02 BBB- tranches



2. Spreads for tranches of typical mezz ABS CDO