

CDOs knocking at the door, as Junk bond sales zoom

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CDOs of 2006 and 2007 are knocking at the door, as junk bond sales are zooming up. An article in [Business Week](#) shows the narrowing yields, and rising volumes of junk bonds. From an upwards-of-20% yield around 2009, junk bond yields are shown to have come down to as low as 5% towards end of Q1, 2003. Quite intuitively, this has ushered in huge issuances of high yield bonds in the market as corporate take advantage of low yields. The global issuance volumes in 2012 ended up with over \$ 400 billion. In the first quarter of 2013, the sales have already reached \$ 133 billion, says a story in [New York Times](#). Index returns have also fallen - the Bank of America Merrill Lynch U.S. High Yield index yielded 5.7 percent at the end of the Q1, 2003, down from 6.1 percent at the end of 2012, and from 8.3 percent at the end of 2011.

As the high yield market becomes attractive, CDOs have started knocking at the door. An article on [Knowledge@Wharton](#) goes overboard to warn- the bad boys of 2008 crisis are back.

Deutsche Bank brought two synthetic CDOs, one each denominated in Euro and USD, very early this year. Both the CDO have underlying pools consisting of a mix of ABS, RMBS, CMBS and CDOs of ABS. Particularly remarkable is the sizeable proportion of CDOs of ABS in the US deal. Therefore, the CDO is effectively a structured finance CDO, or the so-called CDO², which became highly infamous during the crisis. That Deutsche Bank could successfully market the CDO evidences the readiness of the market to wipe out the reactive memories of 2007-8, and look at structured finance CDOs - something that looked so very unlikely until recently.

Notably, structured finance CDOs were at their Himalayan peak in first half of 2007 when the market completely crashed. A structured finance CDO references asset-backed securities. As the underlying ABS is itself leveraged, a structured finance CDO becomes a double-leveraged product.

Vinod Kothari comments: While the excessive layers of leverage present in CDOs of 2006 and 2007 can take any instrument into a ditch, there is nothing wrong in the economic argument of CDOs, or structured finance for that matter. In my post-Crisis book co-authored with Frank Fabozzi (*Introduction to Securitization*, Fabozzi and Kothari), we had contended that the economic rationale of all structured finance, CDOs included, is in integration and differentiation, and this argument is secularly valid. If there was no differentiation, corporate finance will

be all equity. While we are glad to see the market turning back to rationality, we only hope that exuberance does not overtake caution.

Forthcoming workshop on CDOs/structured finance: For details please visit: <http://vinodkothari.com/secwork.htm>

[Reported by: Vinod Kothari]