AXA IM CLO Market Update

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Floating rate CLOs

Navigate an evolving landscape

Dear Investors,

In recent days, political events have taken center stage, reshaping the geopolitical landscape and the economic outlook.

A “Red Sweep” scenario appears highly likely in the 2024 election, with Trump winning the presidency, Republicans gaining control of the Senate and retaining a slim majority in the House. We expect Trump to proceed with proposed tariffs, which could significantly

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boost to near-term inflation and modestly reduce growth.

Geopolitical dynamics affecting financial markets and economic outlooks are evolving. Trump repeatedly stated that he could settle the Russia-Ukraine conflict. The removal of military support in Ukraine could have implications for European security and impact European defense spending and public finances.

Trump should heighten trade tensions with China, impacting China's already fragile economic outlook. Meanwhile, European governments are not ideally positioned to provide reassurance or guidance, as both France and Germany face domestic political challenges, with German Chancellor Scholz recently calling for a confidence vote and snap elections anticipated next year.

On the economic data front, we have seen a dramatic swift from fears of a hard landing in August to a "no landing" scenario, with solid conditions in the Labor market, a low unemployment rate at 4.1%, an advance Q3 GDP estimate at 2.8% and a Core PCE at 2.7%. The Federal Reserve cut rates by 25bps to 4.5-4.75% and has adopted a data-dependent, meeting-by-meeting approach to guide its monetary policy path. Economists at AXA IM expect Trump's inflationary policies to constrain the Federal Reserve from easing policy. They forecast another 25bps rate cut in the December meeting, with only one additional cut for 2025 (in March) to bring rates to 4.00-4.25%.

Several of these developments are influencing financial markets. U.S. yields rose sharply, reflecting increased longer-term inflation expectations and potential concerns about fiscal sustainability. The dollar strengthened, U.S. equities indices reached new all-time highs like Bitcoin, and credit spreads resume the tightening trend.

Finally, escalation risks in the Middle East have decreased following a report indicating that Israel would limit its retaliation to Iran's military targets, rather than extending actions to Iran's oil facilities or nuclear installations.

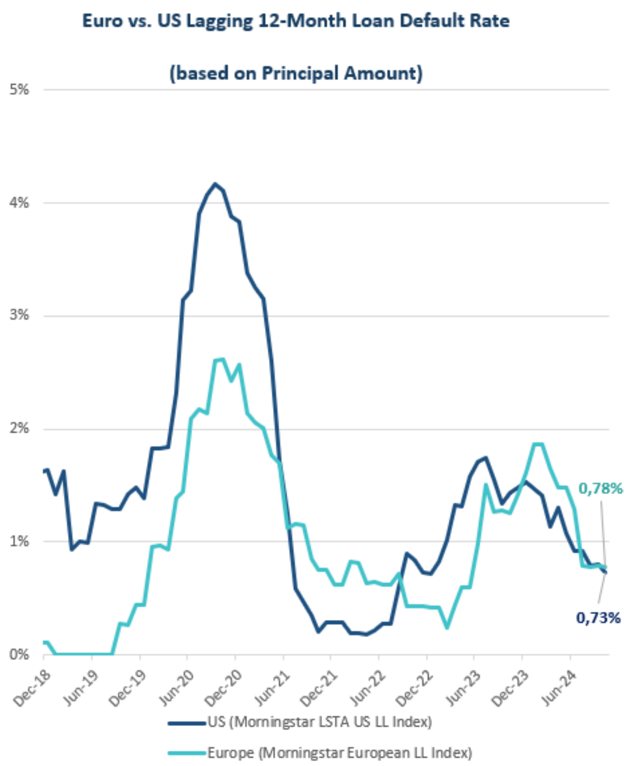
Leverage Loan Markets

Despite high level of activity, net loan supply remains elusive. In the U.S., leveraged loan activity reached an all-time high in 2024, with trading prices hitting two-year highs in the fourth quarter due to strong investor demand.

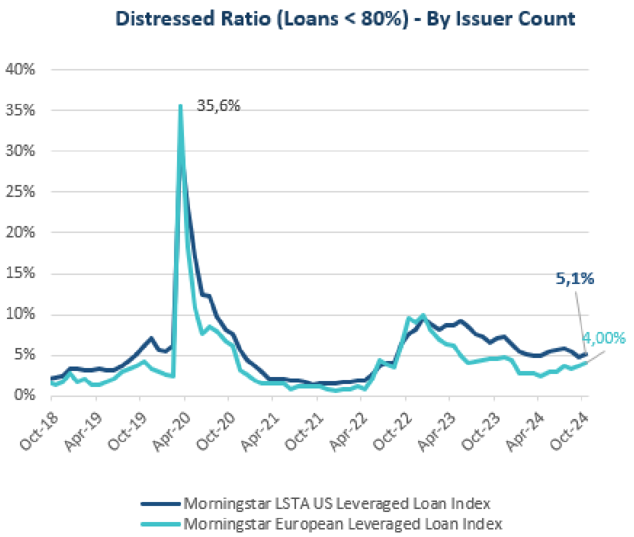
The wave of repricing, and increased risk appetite is largely driven by a persistent lack of net supply, alongside rising demand from CLOs and other loan investors. With a significant portion of U.S. leveraged loans trading above par in the secondary market, repricing and refinancing activities are expected to continue, helping borrowers alleviate their interest burdens.

Looking ahead to next year, we expect new money to pick-up due to rising M&A/LBO volumes driven by on-going loan spread compression and the considerable amount of uninvested capital on the sidelines and increasing pressure on Private Equity sponsors to monetize their existing holdings. Trump's administration could have 2 opposing effects: on one hand, inflationary policies may limit rate cuts creating headwinds for M&A/LBO activity, while on the other hand, the deregulation policies could act as a catalyst.

Regarding risk metrics, the lagging 12-month loan default rates (excluding distressed exchanges) remain low at 0.73% for the Morningstar LSTA U.S. Leveraged Loan index and 0.78% for the Morningstar European Leveraged Loan index, based on principal amount. Additionally, the percentage of distressed names (loans trading below $80 cash price) remains limited at 5.1% for the U.S. and 4.00% for Europe.



An improving macroeconomic outlook, and lower price tails suggest that default activity should be benign. Besides, continued manager sales of CCC and lower-priced loans as seen this year should drive lower default activity in CLOs.



Nevertheless, Trump's election is likely to get implications for the loan market. Fewer rate cuts could increase pressure on interest expenses, while Tariffs may lead to slightly slower economic growth, which could constrain earnings growth. Sectors that rely heavily on imported goods-such as retail, machinery, and building products-could face greater margin pressures. Additionally, sectors with a significant share of revenue from exports may experience earnings underperformance due to retaliatory tariffs.

CLO Primary Markets

This year, most of the activity has occurred in the primary markets, with investors focusing on investing increased prepayments, inflows, and coupons.

Since the start of the year, broadly syndicated loan CLO new issuance volumes have surged by 83% in the U.S., reaching $135.8 billion, and by 80% in Europe, totalling €39.7 billion. Additionally, the CLO market is recycling, with heightened reset and refinancing activity amounting to $222.8 billion in the U.S., and €22.5 billion in Europe.

Despite strong gross CLO issuance, the net CLO supply was limited and U.S. CLO market's growth at 3% YTD is much slower compared to market expansions of 10% and 18% growth in 2022 and 2021 respectively.

That is worth highlighting that the supply/demand dynamic for the U.S. CLO market is different from the EUR CLO market.

On the U.S. side, there is a negative net supply of -$3 billion for U.S. CLO AAA following the October repayments. That situation should continue in 1st half of 2025. Besides, the expectations of limited rates cuts keep base rates at elevated levels. As the result, the reinvestment demand is robust and puts downward pressure on AAA spreads. In addition, we expect new money to flow into the asset class.

While in Europe, the technicals are mixed, with positive net supply of €6.4 billion for EUR CLO AAA and recent push of CLO issuances ahead the U.S. elections maintain spreads above Euribor 3M+130bps. Despite the softness in Europe, we believe the strong dynamic in the U.S. can bring some support for Europe. Spreads-wise, there is still room vs. tights of 2021 at Euribor 3M+91-94bps.

This year, on the mezzanine part, AA to BBB tranches experienced an on-going appetite from U.S. insurance investors, deploying money primarily on the U.S. market and secondly on the European market.

For CLO BB tranches, given their strong performances over the past 18 months and the benefit of an elevated floating rate component, demand is exceptionally high, leading to 160bps compression in spreads to Floater +525-650bps through the year. The depth of bids is diverse across investor types, including asset managers, pension funds, insurance companies, and structured credit investors. As the spreads are at the tight end of the recent historical range, we do not expect significant spread tightening for mezzanine in the near term. We forecast the high carry to be the primary driver of returns going forward.

CLO Secondary Markets

Year-to-date saw significant activity in the secondary markets, with a trading volume of $171 billion in the U.S., according to TRACE, and approximately €42 billion in Europe, based on our estimates.

In October, there were supply waves driven by various reasons. First, we saw some profits taking ahead of the U.S. elections and tensions in the middle East. Then, we saw the typical seasonal equity supply post mid-October distributions. Finally, we noticed some U.S. investors rotating into U.S. agency RMBS which reached new wides.

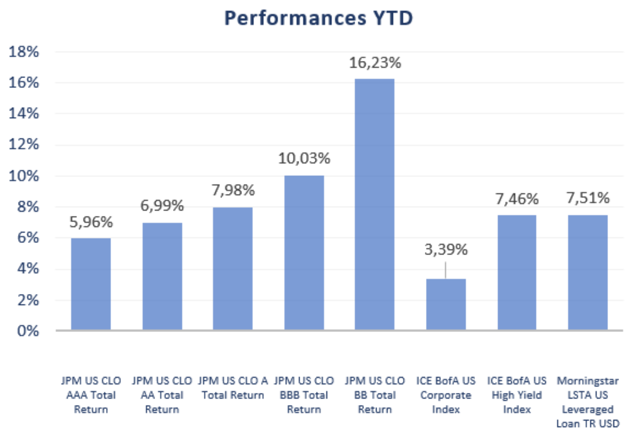
Overall, the supply has been well absorbed given the robust reinvestment demand fuelled by the elevated prepayments from U.S. amortizing and called CLOs. Then the U.S. CLO spreads are continuing to normalize and grind tighter across the capital structure. While the supply/demand dynamic in Europe is more balanced and EUR CLO spreads ended the month unchanged. Lately, we have even noticed some EUR CLO AAA secondary spreads in line with primary ones but with a shorter settlement period.

For CLO equity, demand is firm as the default rate of leveraged loans stays low, attracting investors seeking mid-teen returns, discounted prices, or optionality through extension scenarios. Supply is coming from maturing closed-end CLO equity funds or portfolio rotations by investors.

Overall, the market remains constructive with supportive technical factors from amortizations and inflows into the CLO asset class. The tiering between managers remains limited especially at the top of the capital structure. Sourcing large sizes in the secondary market is challenging, and secondary spreads are in general inside primary spreads.

Performance & strategy

In October, CLOs delivered solid performances and continued to outperform traditional credit markets. The combination of the credit premium and the floating rate component, benefiting from elevated interest rates, are powerful tools for generating income and superior returns.



Source: Bloomberg as of October 31st, 2024

We view CLOs as a strategic asset class in credit allocations, serving as diversifiers and offering attractive risk-adjusted returns.

3 Year Correlation Matrix	5Y Treasury	10Y Treasury	IG Bonds	HY Bonds	Loans
5Y Treasury					
10Y Treasury	95%				
IG Bonds	74%	74%			
HY Bonds	48%	47%	82%		
Loans	31%	32%	53%	70%	
CLO AAA	35%	32%	59%	58%	87%
CLO AA	34%	32%	49%	44%	85%
CLO A	37%	34%	51%	46%	83%
CLO BBB	42%	42%	58%	52%	85%
CLO BB	42%	42%	56%	52%	86%
CLO B	33%	35%	54%	56%	81%
CLO Equity (Prices)	-2%	6%	13%	8%	34%

Source: J.P. Morgan Research, J.P. Morgan PricingDirect as of September 30th, 2024

It is noteworthy that only a limited number of CLO mezzanine tranches issued pre-GFC experienced default, outperforming traditional corporate credit markets in that regard.

Regarding positioning on mezzanine risk, given the flattening of the CLO credit curve we remain neutral on Sub-IG tranches. We appreciate the high cash-on-cash nature of CLO equity and its short duration profile. Our preferred route for CLO equity is in the primary market, where we can select the right manager, benefit from tighter CLO liabilities and source sizes to target mid-teens returns. We also explore the secondary market to optimize our fund.

For investors seeking for double-digit returns and diversification, CLO equity is an attractive option.

Best regards

Risk factors

The list of risk factors as shown below is not exhaustive. Each prospective investor should carefully read the portfolio's final prospectus or portfolio management agreement (as applicable) in its entirety, including any of its amendments or supplements.

Liquidity Risk	▸ Low liquidity offered to investors during the life of the strategy.
CLO structure risk (leverage, maturity, subornation/rating migration)	▸ CLO are designed as leveraged exposure to a portfolio of loans. Depending on the rating of the CLO debt tranche, level of leverage varies and thinness of the tranche varies. Reaching a certain level of default and loss post recovery in the underlying portfolio could trigger a downward rating migration and even losses at tranche level. ▸ The subordination of any class of CLO securities will affect their right to payment in relation to the more senior securities. Interruptions in payments to subordinated classes may occur. Following acceleration of CLO securities, payments of interest proceeds and principal proceeds from the CLO issuer's assets will generally be applied on a strict seniority basis. ▸ The investment in CLO have an expected maturity that may be shorter or longer depending on market conditions and portfolio management. Market conditions may affect CLO tranche maturity and spread when for example there is a refinancing.
Underlying loan exposure risks	▸ CLO are exposed to performance of leveraged loans with inherent risks such as among other things default, recovery, prepayment, liquidity and interest rate risk.
Market Risk	▸ The investments contemplated herein may at any time be subject to significant price movements, which will impact negatively the valuation of the Portfolio and may lead to the loss in case of redemption.
Performance Risk	▸ The investment strategy's performance described herein may be lower than anticipated due notably but not limited to market drawdown, loss in underlying portfolio and forex impact.

Source: AXA IM

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