AXA IM CLO Market Update – June 2024
For Professional Investors Only

CLO markets – A phase of normalization

Dear Investors,

The past month has been eventful for the markets, largely driven by political developments in France and central bank actions globally.

Following the European Parliamentary elections, the surprise announcement of a snap legislative election by French President Macron triggered market sell-off across various asset classes. This political uncertainty widened the spread between French 10-year OAT and German Bund yields to levels unseen since 2016. Consequently, French bank stocks suffered a significant drop in price.

In contrast to Europe, US equity markets performed well, driven by tech giants like Nvidia, Microsoft, and Apple, each exceeding a market cap of $3 trillion.

On the monetary policy front, the European Central Bank lowered rates by 25 basis points, as anticipated. This decision marks a departure from nine months of stable rates, following a significant inflation decline of over 2.5 percentage points since September 2023. The

ECB aims to keep policy rates sufficiently restrictive and will continue to take a data-dependent approach. The latest Euro system staff projections have revised up headline inflation forecasts to 2.5% for 2024, 2.2% for 2025, and 1.9% for 2026. Economic growth is projected to improve, reaching 0.9% in 2024, 1.4% in 2025, and 1.6% in 2026.

In the U.S., the Federal Reserve still considers inflation too high relative to its 2% target, despite recent slowdowns. Although economic growth has sharply declined to 1.4% compared to the expected 2.5% for the first quarter, the Fed sees the job market as quite resilient. A weakening in employment would likely be required to prompt any action from the Fed.

Volatility in both US and EUR interest rates has been decreasing over the past six months, indicating increased market confidence in the trajectory of rate cuts.

Elsewhere, the Reserve Bank of Australia and the Bank of England both held their rates steady, with the latter hinting at potential future cuts. The Swiss National Bank, however, cut rates unexpectedly due to upward pressures on the Swiss Franc.

Looking ahead, the investors are closely monitoring the U.S. political landscape and the ongoing depreciation of the Japanese Yen against major currencies.

Leverage Loan Markets

This year has seen a surge in demand for leveraged loans, resulting in record-breaking activity. Despite this high level of activity, net loan supply remains elusive. In the U.S., leveraged loan activity has hit an all-time high in 2024, with trading prices reaching two-year highs in the second quarter due to strong investor demand. Renewed risk appetite has driven opportunistic repricings and loans for dividend payouts, even in lower-rated market segments.

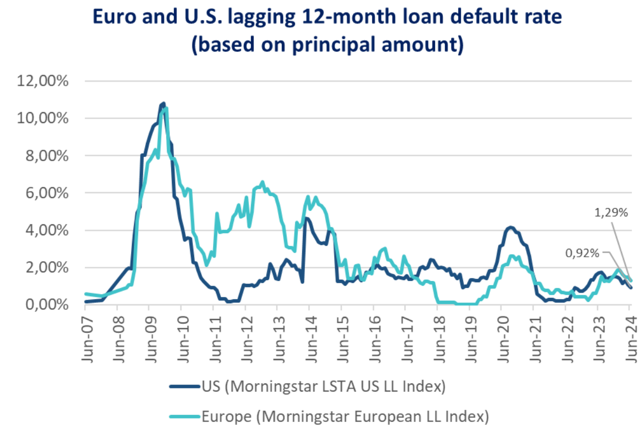
Overall, primary market activity for leveraged loans has been unprecedented, totalling $736 billion through June 30, surpassing the previous post-Global Financial Crisis peak of $584 billion in 2017. However, the issuance of new loans not related to refinancing or amending existing debt fell to 13% of total activity this quarter, down from 18% in the first quarter, the lowest level in the post-GFC era.

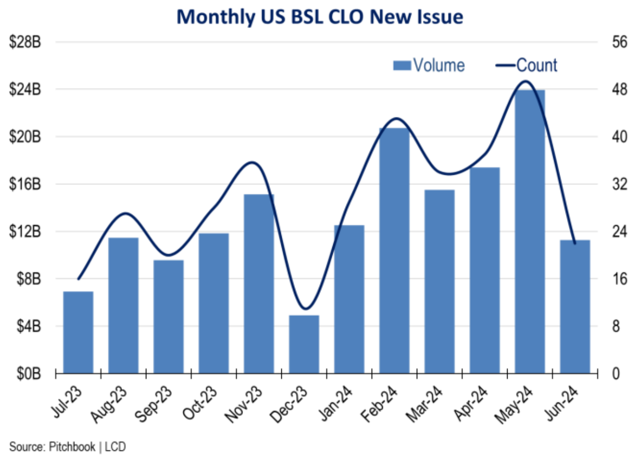
This massive repricing wave and increased risk appetite are primarily driven by the persistent lack of net supply, amid surging demand from CLOs and other loan investors. With 40% of U.S. leveraged loans trading above par in the secondary market, repricing and refinancing activities are expected to continue, helping borrowers reduce their interest burdens.

M&A activity is expected to recover as private equity firms face strong pressure to invest. M&A volumes reached $10 billion in June, the highest since February, but remain low compared to historical averages. High base rates and election uncertainty continue to impact deal prospects.

The maturity wall for institutional term loans continues to be pushed back. As of June 28, $36.6 billion of institutional term loans are due by the end of 2025, a 61% decrease from year-end 2023. Similarly, 2026 maturities fell by 48% to $90.1 billion, while 2027 maturities decreased by 28% to $181 billion.

Regarding risk metrics, the lagging 12-month loan default rates remain low at 0.92% for the Morningstar LSTA U.S. Leveraged Loan index and 1.29% for the Morningstar European Leveraged Loan index, based on principal amount. Additionally, the percentage of distressed names remains below 5%, at 4.42% for the U.S. and 3.06% for Europe.





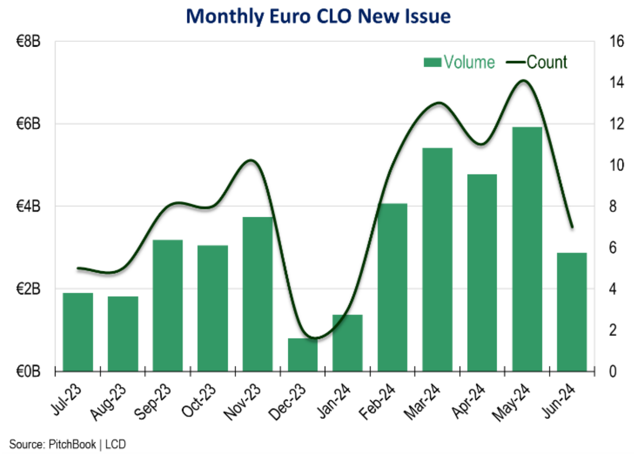
CLO Primary Markets

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 88% in the U.S., reaching $80.5 billion, and by 119% in Europe, totalling €25.6 billion compared to H1 2023. Additionally, the CLO market is recycling, with heightened reset and refinancing activity amounting to $104.5 billion in the U.S. and €7.4 billion in Europe.

Despite strong gross CLO issuance, the net supply has been limited for US BSL at $19 billion and on the low side for European CLO at €10 billion.

In June, despite a tightening of -10bps in primary AAA spreads, the pace of new CLO issuance slowed sharply due to limited loan supply, with most activity focused on refinancings and resets. This trend is expected to continue into the second half of the year. A lack of new loans is likely to slow CLO new issuance globally and record high amortization rates in the U.S. should lead to negative net AAA issuance in H2. July payments for U.S. CLOs will provide substantial prepayments for reinvestment, driving U.S. CLO AAA spreads tighter, which will also support EUR CLO AAA spreads.



We expect the increasing reset activity to drive elevated CCC leveraged loan sales and put downward pressure on CCC prices. Through a reset process, that is common to see the CLO manager cleaning the tail risk of their portfolios to make the reset issuance less risky for mezzanine investors.

Given the strong performance of CLO BB tranches in 2023 and the benefit of an elevated floating rate component, demand is exceptionally high, leading to a 175bps compression in spreads to Floater +590-675bps through H1. 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

The first half of the year saw significant activity in the secondary markets, with a trading volume of $114 billion in the U.S., according to TRACE, and approximately €26 billion in Europe, based on our estimates.

In June, during the annual Global ABS/CLO conference in Barcelona, the US and EUR CLO secondary markets experienced a slight dip in activity compared to May, but trading volume remained high at $14.28 billion. The tone at the conference was bullish, particularly for EUR CLO AAA levels, though there is still room to reach pre-Ukraine war levels. The market appears to be tightening, with the rest of the European investment-grade sector following the trend set by AAA securities.

Secondary EUR CLO BBs tightened by -20bps in June, reaching Euribor 3M +530-690bps, depending on quality. Hedge funds were primarily selling BBs to buy single-B and equity tranches for higher returns, while asset managers were buying, deploying income from their portfolios.

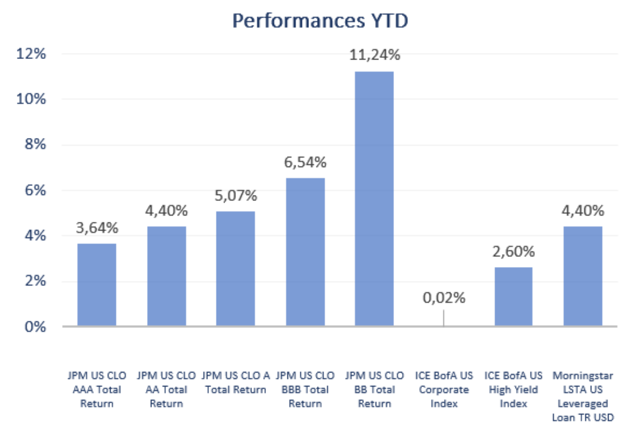
In June, tiering between transactions re-emerged for BB/B tranches. High demand persisted for top-tier deals, while appetite for lower-tier deals softened due to macroeconomic concerns around the French elections.

For CLO equity, demand remains strong 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-ended 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. Sourcing large sizes in the secondary market is challenging, and secondary spreads are well inside primary spreads.

Performance & strategy

In June, CLOs once again returned 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 June 28th, 2024

With regards to CLO equity, returns in H1 totalled 10-25% across profiles according to Nomura, driven by elevated distributions and increased optionality. There is a large dispersion due to the increase in both portfolio tails and equity NAVs.

Regarding positioning for our mezzanine funds, given the flattening of the CLO credit curve, we keep our neutral stance in terms of allocations across ratings, avoiding any overweight on Sub-IG tranches. CLO BBB is rather the core of our investments. In the primary markets they offer an appealing carry at Floater+350-400bps and a credit premium of circa. +75bps compared to the traditional high yield market.

For our CLO opportunity fund, we appreciate the high cash-on-cash nature of CLO equity and its shorter duration profile. Our preferred route for CLO equity is in the primary market, where we can select the right manager and source sizes to target mid-teens returns. We also explore the secondary market to optimize our fund. Besides, on the primary market, EUR CLO single-B can complement the fund allocation and brings diversity. The high carry, the convexity and the credit enhancement make them attractive.

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

In conclusion, our outlook for the year is unchanged with the CLO market pursuing its normalizing given the strong technicals, and any episode of volatility or temporary oversupply could present buying opportunities. With half of the year remaining in 2024, the broader markets face various challenges such as issues in commercial real estate, recurring geopolitical tensions, stocks at all-time highs, elections, and further monetary policy adjustments. To navigate through this evolving landscape, we maintain a rather neutral stance within our portfolios and favour high-carry positions. Once again, the CLO structure has proven to be resilient and designed to withstand market cycles.

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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