AXA IM CLO Market Update – July 2024

For Professional Investors Only

CLO…

…summer vibes

Dear Investors,

July proved to be a momentous month with significant political and economic events shaping global markets. Anticipations of rate cuts by the European Central Bank and the Federal Reserve as early as September was driven by softening economic data, Europe's flash PMI numbers notably fell below consensus. Concerns grew regarding the economy losing momentum into Q3 as the Euro Area composite PMI printed at 50.1 versus an expected 50.9, amid disappointing readings in Germany.

The beginning of the earnings season was underwhelming, around a third of S&P 500 companies reported results which hinted towards a sales and revenues slowdown. The same pattern was observable with Large-cap companies, resulting in significant share price decreases.

Markets were also all ears on the recent ECB meeting and the notable rally of the JPY currency against the USD, amid speculations about a potential intervention of the BoJ in the FX markets. Softer U.S. economic data fuelled expectations for a Fed rate cut, resulting in the ongoing decrease in sovereign bond yields, noticeable stock rotations and tighter credit spreads.

In the political landscape, Joe Biden's withdrawal from the presidential race and the endorsement of Kamala Harris as Democrats' candidate against Donald Trump sparked chatters regarding her odds to become the first woman elected as POTUS and her potential impact on the county as opposed to Trump's program. Markets reaction was relatively muted, with the re-steepening U.S. yield curve trade experiencing only a slight unwinding.

In Europe, the French elections results provided markets some relief, equity markets rallied and the OAT-Bund spreads narrowed. The UK general election indicated less uncertainty than in France, as the Labour party's victory was a landslide.

With political uncertainties fading, investors are now expected to focus on earning, economic data and the assessment of Central Banks next moves.

Leverage Loan Markets

The European primary market remained highly active, driven primarily by repricing deals. The total launch volume for the first seven months of the year amounted to €70.8 billion, nearly three times the volume for the same period in 2023 and double that of 2022. Repricing and refinancing transactions continued to dominate the use of proceeds, accounting for over half of the volumes. Additionally, there was an uptick in M&A, representing 30% of the volumes as of July.

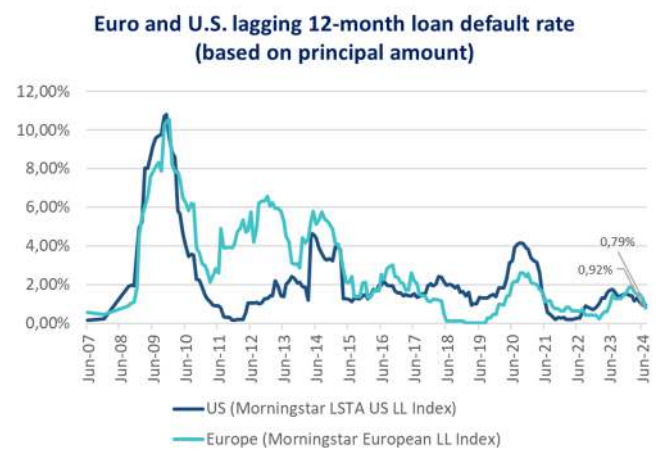
Technical stability was observed, with the average bid of the WELLI slightly increasing during July to reach 97.4. The market exhibited significant differentiation, with BB and performing B-rated credits hovering close to 100, while CCCs were in the low 70s.

In terms of fundamentals, default rates in Europe remained low at 0.79% by principal amount at the end of July 2024. The consensus is that a moderate increase by the end of 2024 will be observed, as corporates experience top-line pressure due to a mild recession and increased interest payments following base rate hikes. However, no uncontrolled acceleration is anticipated.

In the U.S. attention turned toward LBO and M&A financing as refinancing and repricing activity tapered off. Over the last three months, M&A and LBO activity accounted for $33.7 billion, marking the highest reading since June 2022. M&A-related activity for this month alone totalled $16.0 billion, a 10-month high, and comprised just under 50% of July's institutional new issue volume. Year-to-date, M&A-related volume has reached $73.1 billion, showing an improvement from the $31.8 billion last year, although still lagging comparable periods between 2013-2022.

July's institutional new issue volume amounted to $34.5 billion, compared to $24.7 billion in July 2023. Refinancing activity took a backseat, totalling $10.7 billion, marking the lowest reading in the last 12 months. The par amount outstanding fell by $1.2 billion in July, bringing the size of the index to $1.39 trillion. Over the last 12 months, the index has decreased by 0.6%, reflecting a supply shortage.

The Morningstar/LSTA Leveraged Loan Index gained +0.68% in July, with the weighted average bid remaining unchanged at 96.60. This represents a 39bps decrease from the intra-year high of 96.99 in May. By the end of July, the share of loans valued above 100 increased to 52%. BB loans (+0.80%) outperformed Single B loans (+0.73%) and CCC loans (-0.03%), indicating increased divergence in secondary prices, with higher-rated names rebounding despite lagging year-to-date performance.



CLO Primary Markets

The European CLO pipeline remained robust last month, with 22 CLOs priced, totalling €8.9 billion, comprising 12 new issues amounting to €5.2 billion and 10 refinancings amounting to €3.7 billion.

Year-to-date, 106 CLOs have been priced, totalling €42.2 billion, with 71 new issues amounting to €30.1 billion and 35 refinancings amounting to €12.1 billion. This marks a stark contrast to the 36 European CLOs priced during the same period last year.

Strong demand on the liability side has sustained the buoyancy of the European CLO pipeline throughout July. The investor demand, coupled with higher-than-expected amortizations and liquidations, has driven AAA spreads tighter. This trend has been further supported by robust demand from Japanese accounts. In July, AAAs hit record tight levels at +125 bps, marking a new low for AAA spreads this year.

Furthermore, there was a Static CLO in July that, due to robust investor demand, was upsized to €631.2 million, making it Europe's largest 2.0 CLO transaction. This deal boasted strong coverage ratios across the capital stack, and investor’s appetite for short-dated transactions was reflected by the pricing of the AAAs at +99.

The U.S. CLO market experienced a similar trend as tightening liability spreads reduced deal costs and enhanced the arbitrage opportunity. CLO issuance has continued at a record pace, with a remarkable 83% increase from last year's comparable figures, totaling $116 billion across 246 deals through July in the broadly syndicated market, on track to rival the record highs of 2021, and with record resets also reaching $93 billion year-to-date, compared to approximately $79 billion in the same period in 2021.

CLO issuance moderated in July with 29 deals pricing for $13.2 billion, which falls slightly below the monthly average of $17 billion seen in the first half of the year. In terms of spread, the U.S. market mirrored that of Europe, with AAAs tightening to +135bps above SOFR, marking a new low for the year for new issue.

Finally, CCC metrics have shown improvement since the beginning of the year, with the median CCC holding at 5.8%, down from the 6.3% peak in January 2024.

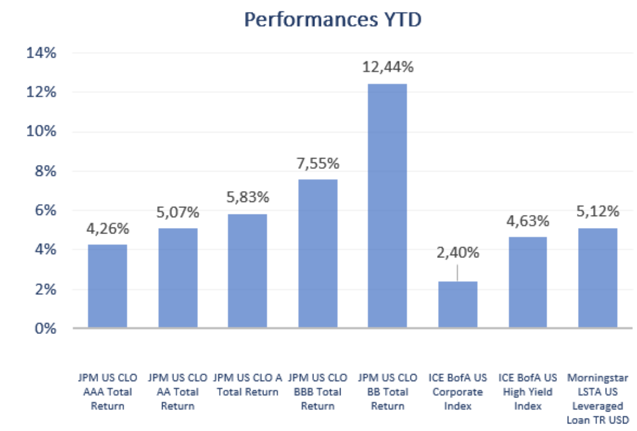
CLO Secondary Markets

Secondary market activity eased in July, reaching its lowest traded volumes and market supply of the year, albeit in line with the expected and seasonal pattern over summer. In the U.S., aside from the first week of the month, activity remained relatively stable, with approximately $3.5 billion of trading activity for $1 billion of BWIC supply per week. In the European CLO market, weekly BWIC supply ranged from €150 million to €250 million, with generally more limited flows than those observed earlier this year, which typically amounted to over €300 million per week.

Spreads remained stable at the top part of the capital structure after months of tightening. High yield tranches, which had previously lagged the rally, finally came in with superior BB profiles trading in the low-600bps to high-500bps discount margin. Despite this trend, no significant shift was observed in any particular part of the capital structure, as supply remained within average breakdowns: 70% of IG, 20% of Non-IG, and less than 10% of Equity.

Performance & strategy

In line with previous months, CLOs experienced strong returns across the capital structure in July, outperforming most other fixed income instruments of similar rating. The combination of high base rates, spreads, and some price appreciation has contributed to another strong month in terms of performance.



Source: Bloomberg as of July 31st, 2024

On the CLO equity side, July's Q2 distributions delivered an average 4.5%. Variations were observed between returns on reinvesting deals, which yielded 5%, and amortizing post-reinvestment period transactions, which yielded 4%, with both types representing consistent income following Q1 levels of 5%.

Regarding our view on positioning on the investment grade side, all tranches are perceived to offer both attractive absolute and relative value, with AAA being the preferred choice and BBB the less preferred due to a potential higher mark-to-market drop.

In the high yield sector, B-rated tranches are favoured over BB-rated tranches due to the additional convexity and the 300bps spread pick-up, which is particularly attractive in a low default rate environment.

When it comes to the equity part, primary transactions are valued for their long-term reinvestment ability through the credit cycle, while secondary deals with low costs of debt offer the highest cash distributions. However, the manager, structure, and portfolio selection remain paramount.

In conclusion, the CLO market in July continued to exhibit all the characteristics that investors increasingly view as strategic within their allocation: attractive forward returns based on high spreads and elevated base rates, diverse manager offerings, credit robustness, and high liquidity across ratings. Looking ahead, we expect volatility to pick-up due to uncertainty in Central Banks policies, geopolitical risks and macro slow-down.

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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