AXA Investment Managers

February 2024

AXA IM CLO Market Update

CLOs entering a Phase of Normalization

Dear Investors,

The prevailing market sentiment remains bullish, with the soft-landing scenario viewed as the most likely path, while recession fears dissipate.

For the U.S., the ongoing strong economic data challenges market anticipations of an early Federal Reserve rate cut. The February release of Core CPI at +3.9% year-on-year surpassed expectations at +3.7% and led to a sharp rise in the 10-year Treasury yield from 3.84% to 4.30%, partially offsetting gains from January. It is noteworthy that market volatility was limited, as the Q4 earnings season yielded positive results, driving stocks to their all-time highs, fuelled by Tech giants.

In Europe, recent economic indicators suggest a soft-landing scenario characterized by a blend of disinflation and sluggish growth. Europe avoided a technical recession with Q4 GDP growth stagnating at zero versus an anticipated -0.1% contraction. Although the German manufacturing sector continues to exhibit signs of weakness, positive French services and manufacturing data suggest economic resilience.

While each economic region experiences different dynamics, there is a general market consensus anticipating rate cuts in the U.S., Europe, and the UK starting in June. However, ongoing trends in economic data will remain crucial to monitor.

Looking ahead, the year carries various market risks, including persistent geopolitical tensions, challenges in the commercial real estate sector, and equities reaching all-time highs, which could trigger periods of market turbulence.

Leverage Loan Markets

In February, the momentum in loan markets persisted, driven by a positive tone, improved fundamentals, and supportive technicals. Year-to-date total returns for the Morningstar LSTA US Leveraged Loan index stood at +1.64%, and the Morningstar European Leveraged Loan index recorded +2.18%. The average bid reached 96.89% for U.S. loans and 96.82% for European loans.

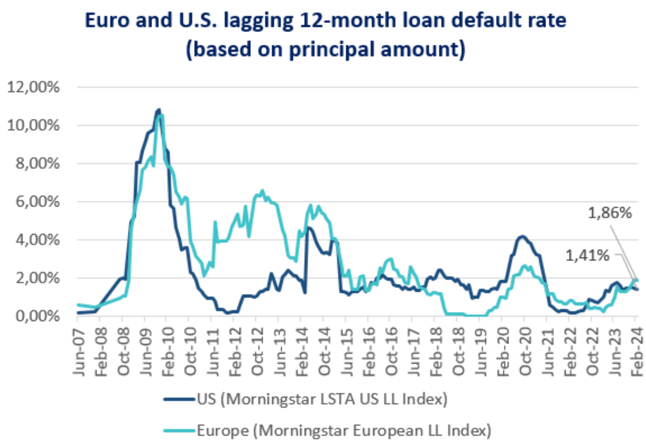
The tightening spread in the leveraged loan market enabled some issuers to refinance and alleviate their interest burden. Notably, refinancing activity accounted for 61% of U.S. leveraged loan issuances year-to-date. This trend is expected to continue as the percentage of loans trading above par rose from 13% at the end of January to 21% by the end of February, as reported by PitchBook LCD.

In February, the U.S. market saw an increase in new acquisition-related supply and dividend recaps. Additionally, CLO issuance reached its second-highest level on record for the month, contributing to the highest measurable demand for loans since the Fed began raising rates. Finally, the size of the loan market expanded for the first time in five months.

In Europe, new-money supply in loans surpassed expectations in February, driving total new issuance in that market to €12 billion—the highest monthly figure since January 2022 and up from €7.9 billion in January. Despite underwhelming M&A activity, add-ons, refinancings, and sporadic buyouts bolstered supply, with year-to-date volume nearing €20 billion, triple the issuance compared to the same period last year. However, total bond issuance in February declined sharply to €3.3 billion from January's €8.8 billion, primarily due to reduced bond refinancings, a significant supply driver in the previous year.

Still on a positive note, it's important to note that last year, issuers on both sides of the Atlantic successfully extended their short-dated debt maturities by three years to 2026-2028.

Regarding risk metrics, the lagging 12-month loan default rates remained low, standing at 1.41% for the Morningstar LSTA U.S. Leveraged Loan index and 1.86% for the Morningstar European Leveraged Loan index based on principal amount. Furthermore, the percentage of distress names remained below 4%. Looking at predictions from rating agencies, Fitch Ratings anticipated default rates for both High-Yield and Leveraged Loans to reach 4% by December 2024, while their forecasts of 4-5% for 2023 did not materialize.



CLO Primary Markets

The primary markets have fully reopened, and momentum is surging within these markets. Issuance volumes have surged by +48% in the U.S., reaching $33.66 billion, and by +12% in Europe, totalling €5.84 billion compared to year-to-date figures for 2023. The overall tone is optimistic, reflecting investors' eagerness to move forward with transactions.

With one-third of the CLO market entering its amortization phase, investors are going to face repayments and proactively positioning themselves for new CLO issuances. It's common to observe AAA tranches already preplaced in the primary markets, indicating heightened demand from banks across regions including the U.S., Japan, and Europe.

In the race to secure allocations ahead of repayment waves, CLO debt spreads have compressed with minimal differentiation between CLO managers. Year-to-date, CLO spreads have tightened by 20-30bps to Floater+148-157bps for AAA and by 40-60bps to Floater+205-220bps for AA.

Given the strong performance of CLO BB tranches in 2023, demand is exceptionally high, leading to a 150bps compression in spreads to 625-690bps. The depth of bids is diverse across investor types, including asset managers, pension funds, insurance companies, and structured credit investors, with significant appetite coming from U.S.-based accounts. Following the conflict in Ukraine, these investors are increasingly seeking European assets offering spread pick-ups compared to dollar assets.

The CLO rally persists and has gained momentum this year, supported by favourable supply/demand dynamics. However, the tightening trend is expected to moderate as the primary pipeline materializes, and the basis spread between CLO managers should build-up.

In terms of CLO manager activity, we anticipate managers focusing on maintaining assets under management. For seasoned CLO transactions entering amortization, managers will prioritize resets to prolong the life of these transactions. For instance, Nomura CLO research forecasts $80 billion in resets this year.

CLO Secondary Markets

The U.S. and European CLO secondary markets exhibited reduced activity in February compared to January, as investor attention shifted towards the fully reopened primary markets. During January, investors and bank trading desks began to capitalize on early profits, while others chasing for any convex profiles. As CLO tranche prices surged, finding discounted assets became increasingly challenging, and sellers also hesitate as they need to replace sales to maintain income.

The secondary markets are normalizing and trading inside the primary markets across the CLO capital structure. AAAs trade at Floater+110-120bps, 30bps inside primary and clean BB names trade at Floater+600bps, 50bps inside primary.

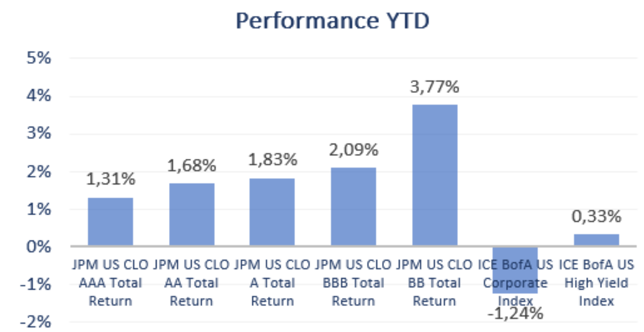
The market is constructive, with significant demand observed across ratings, and particularly for short-dated profiles, high coupon names priced to call, and sub-IG mezzanine tranches with clean pools.

Trading volume for CLO equity has increased for several reasons: January distributions have been processed, the loan rally has improved CLO Equity NAV, and CLO equity prices have caught up with the rally experienced by CLO debt tranches. Investors chasing yield or discounted assets are focus on equity, particularly with long reinvestment periods, top-tier managers, and clean portfolios. In this context, the access to the market is crucial for sourcing opportunities.

Overall, it is becoming increasingly challenging to find substantial sizes in the secondary markets, and levels appear rich compared to the primary markets. Nevertheless, secondary markets still present opportunities, such as potential call candidates.

Performance & strategy

CLOs once again delivered solid returns in February 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 February 29th, 2024

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.

Regarding positioning for our mezzanine funds, given the flattening of the CLO credit curve, we adopt a more neutral stance and favour BBB names over BB, which tend to be more volatile. Additionally, CLO BBB tranches in the primary markets offer an appealing carry at Floater+400bps and a credit premium of +100bps compared to the traditional high yield market.

For our CLO opportunity fund, we currently see more value in equity over BB/B. 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 opportunistically explore the secondary market to optimize our fund.

In conclusion, our outlook for the year is that the CLO market is normalizing, given the strong technicals, and any episode of volatility or temporary oversupply could present buying opportunities. With 10 months 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 the need for adjustments in monetary policies. To navigate through this evolving landscape, we maintain a rather neutral stance in 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,

The Secured Finance team

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

Disclaimer:

Not for Retail distribution: This document is intended exclusively for Professional, Institutional, Qualified or Wholesale Clients / Investors only, as defined by applicable local laws and regulation. Circulation must be restricted accordingly.

This document is for informational purposes only and does not constitute investment research or financial analysis relating to transactions in financial instruments as per MIF Directive (2014/65/EU), nor does it constitute on the part of AXA Investment Managers or its affiliated companies an offer to buy or sell any investments, products or services, and should not be considered as solicitation or investment, legal or tax advice, a recommendation for an investment strategy or a personalized recommendation to buy or sell securities.

Due to its simplification, this document is partial and opinions, estimates and forecasts herein are subjective and subject to change without notice. There are no guarantees forecasts made will come to pass. Data, figures, declarations, analysis, predictions, and other information in this document is provided based on our state of knowledge at the time of creation of this document. Whilst every care is taken, no representation or warranty (including liability towards third parties), express or implied, is made as to the accuracy, reliability or completeness of the information contained herein. Reliance upon information in this material is at the sole discretion of the recipient. This material does not contain enough information to support an investment decision.

Before making an investment, investors should read the relevant Prospectus and the Key Investor Information Document / scheme documents, which provide full product details including investment charges and risks. The information contained herein is not a substitute for those documents or for professional external advice.

The products or strategies discussed in this document may not be registered nor available in your jurisdiction. In particular units may not be offered, sold or delivered to U.S. Persons within the meaning of Regulation S of the U.S. Securities Act of 1933. The tax treatment relating to the holding, acquisition or disposal of shares or units in the fund depends on each investor's tax status or treatment and may be subject to change. Any potential investor is strongly encouraged to seek advice from its own tax advisors.

Past performance is not a guide to current or future performance, and any performance or return data displayed does not take into account commissions and costs incurred when issuing or redeeming units. References to league tables and awards are not an indicator of future performance or places in league tables or awards and should not be construed as an endorsement of any AXA IM company or their products or services. Please refer to the websites of the sponsors/issuers for information regarding the criteria on which the awards/ratings are based. The value of investments, and the income from them, can fall as well as rise and investors may not get back the amount originally invested. Exchange-rate fluctuations may also affect the value of their investment. Due to this and the initial charge that is usually made, an investment is not usually suitable as a short-term holding.

Information concerning portfolio holdings and sector allocation is subject to change and, unless otherwise noted herein, is representative of the target portfolio for the investment strategy described herein and does not reflect an actual account. The performance information shown herein reflects the performance of a composite of accounts that does not necessarily reflect the performance that any particular account investing in the same or similar securities may have had during the period. Actual portfolios may differ because of client-imposed investment restrictions, the timing of client investments and market, economic and individual company considerations. The holdings shown herein should not be considered a recommendation or solicitation to buy or sell any particular security, do not represent all of the securities purchased, sold or recommended for any particular advisory client, and in the aggregate may represent only a small percentage of an account's portfolio holdings.

Representative Accounts have been selected based on objective, non-performance-based criteria, including, but not limited to the size and the overall duration of the management of the account, the type of investment strategies and the asset selection procedures in place. Therefore, the results portrayed relate only to such accounts and are not indicative of the future performance of such accounts or other accounts, products and/or services described herein. In addition, these results may be similar to the applicable GIPS composite results, but they are not identical and are not being presented as such. Account performance will vary based upon the inception date of the account, restrictions on the account, along with other factors, and may not equal the performance of the representative accounts presented herein. The performance results for representative accounts are gross of all fees and do reflect the reinvestment of dividends or other earnings.

Issued by AXA INVESTMENT MANAGERS PARIS, a company incorporated under the laws of France, having its registered office located at Tour Majunga, 6 place de la Pyramide, 92800 Puteaux, registered with the Nanterre Trade and Companies Register under number 353 534 506, and a Portfolio Management Company, holder of AMF approval no. GP 92-08, issued on 7 April 1992. In other jurisdictions, this document is issued by AXA Investment Managers SA's affiliates in those countries.