Investment Managers

VOLTA FINANCE

AXA IM CLO Market Update

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

Could the last quarter... bring Vol back?

Dear Investors,

The Federal Reserve (Fed) sent a strong signal to the world with a 50bps cut in October. The decision was nearly unanimous and reflected the determination and solidarity across the Federal Open Market Committee as they stepped into a new monetary policy phase. Inflation and employment have been Powell's key focus and with the former close to be classified as under control, protecting jobs has become the priority. As a matter of facts, although GDP growth projections were unchanged slightly above 2% in 2025 and 2026, unemployment forecasts were up at 4.4% for 2025 and 4.6% for 2026.

September 2024

Although the Fed's move was significant, the path forward does not appear as straightforward as what the nearly unanimous rate cut decision suggested. Maintaining a restrictive stance for too long could prove dangerous and the anticipated soft landing could turn into a harder one. On the other end, the US economy – notably the payroll report for September – offers wiggle room to the Fed to keep the easing cycle going at a pace calibrated accordingly to the dataflow. Similarly in Europe, Christine Lagarde's reaffirmed at the European parliament the ECB's commitment to engage in back-to-back cuts should the situation requires them. Here as well, the deterioration of the real economy will be the key catalyst for future cuts. We assign a high probability for repeat 25bps cuts until the ECB reaches the neutral rate of 2% in June next year; a more aggressive approach would only be justified by the materialisation of a clear recession.

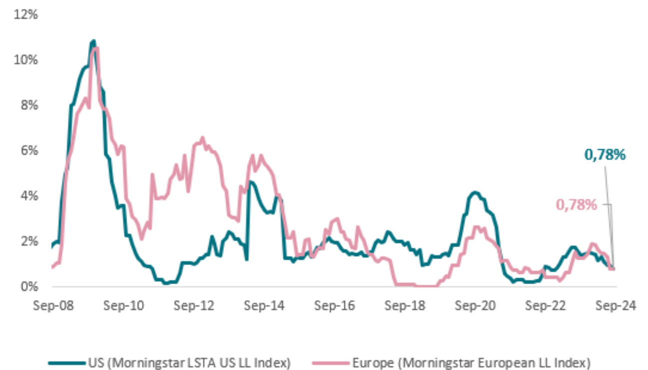
One fundamental piece of the US jigsaw is missing though: the Fed does not have any guidance on the country's fiscal policy path for 2025 and 2026. The general elections in November do appear key in that instance, and there are still major unknowns regarding either Kamala Harris or Donald Trump's plans on this topic. It is understood that Harris's plans to keep the 2017 tax cuts plans untouched for most of the US population whilst keeping Biden's Inflation Reduction Act stimulus in effect. This would classify as a neutral to slightly expansionary stance. Should Trump win the elections, it is conceivable to witness large tax cuts in order to smoothen the impact of his well-documented tariff hikes. In a context of trade wars and expansionary fiscal policy, inflation would likely pick-up.

Leverage Loan Markets

The European loan market recorded a positive return of +0.44% in Europe, taking its YTD total return at +7.02%. The main driver of the performance was the carry of the asset class which totally offset a slight decline in price: Euro loans moved from 97.85px to 97.58px (Morningstar European Leveraged Loan Index).

On the other side of the pond, US Loans were up +0.71% on the month, and +6.54% on a YTD basis. There as well, loan prices were generically slightly lower as the Morningstar LSTA US Leveraged Loan Index was down around 5 cents at 96.71px.

In terms of fundamentals, the Loan Upgrade vs. Downgrade ratio was relatively stable with c. two times more downgrades than upgrades over the course of the month. Default rates though remained well under 1% in both the US and Europe, respectively at 0.79% and 0.80%. US Loan recoveries continued to trend up reaching $63.09 while monthly Loan repayment rates established at 26% in the US and 14% in Europe.



Liability Management Exercises

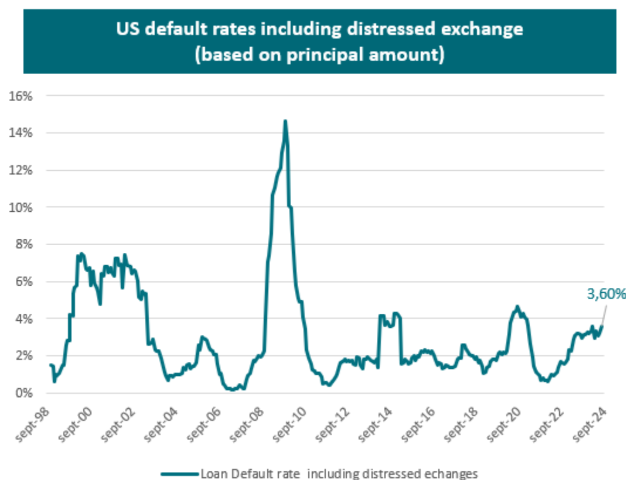
A growing concern regarding default rates has been the surge of Liability Management Exercises ("LMEs" aka "soft default") in the Loan markets due to the high rates environment and the subsequent pressure this has put on corporate balance sheets and cash flows. In a few words, LMEs encompasses any attempt from a company to reset their debt. LMEs can take various shapes and forms such as below-par tender offers, exchange offers, lender up-tiering, maturity extensions, consent solicitations, covenant

amendments and so on. Using LMEs is usually a matter of survival as companies look to preserve their business via this out-of-court mechanism, de facto avoiding bankruptcy.

LME volumes reached $28bn, ahead of last year's level of $17bn. LMEs also accounted so far for 67% of the combined defaults and distressed volumes of the year, significantly up from 32% in 2023, 45% in 2022 and 25% in 2021. Including LMEs to Loan Default Rates on an Issuer count basis, the "combined default rate" climbed to 3.60% in September 2024.

The "soft default" terminology emanates from the fact that a great proportion of LMEs do ultimately default, and defaults keeps going up: 27% of 2020's LMEs defaulted within the next three years, 33% of 2022's LMEs defaulted to date and c. 10% of 2023's LMEs already defaulted. In the absence of significant base rates drop, businesses implementing liability management exercises still face elevated interest rate costs on their floating-rate debt as well as an expensive access to liquidity when renegotiating terms due to their financial weakness.

A pivot in global rates will certainly help alleviating some of the pressure on that front, lower rates being a tailwind to risky assets. On the bright side, recoveries on asset defaults including LMEs used to trend down over the last couple of year are now up, from lows of 48% last year to c. 55% in 2024.



US Regulation Update

You may remember that the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation released last year a proposal that would substantially increase the capital requirements applicable to Banks in order to better reflect their risks' exposure ("Basel III"). The proposal was anchored around the philosophy of a standardized approach, and de facto implied moving away from internal models for both Credit and Operational risk assessment. In absence of clarification, and since the process was bound to take quite a long time to run, we had noticed a sensible pull-back of US banks from the US CLO market. After many months of consultation, Fed Vice Chair for Supervision Michael Barr outlined on the 10th of September the new Basel III endgame proposals. We noted especially that although CET1 capital requirements for global systemically important banks would increase by 9% compared to current levels, the increased is much lower than the 19% increase initially proposed last year. This piece of information is key since circa 90% of the CLOs held by banks are actually held by systemic banks, and any change in capital requirements may affect these banks' demand for the asset class.

Overall, the CLO community expected limited impact of the new Basel III proposal on their home market, which can be considered a strong positive given where we stood a year ago. Barr's speech did not allude to changes in securitization haircuts or specific capital requirements against holding AAA CLOs, although it is understood that those should remain unchanged (conservative case) or even reduce (base case). As a result, we do not anticipate AAA CLOs to lose ground in terms of RV vs. other AAA-rated assets and expect Banks demand for the asset class to remain strong.

CLO Markets

It was again a very productive month for global CLO Primary markets in September, which was the

fourth busiest month of the year in terms of issuance volumes.

The US CLO market recorded 25 New Issues for a total of $12bn, and 64 Reset/Refi for $30bn. This took the total amount of Primary issuances to 751 transactions and volumes to $345bn. New Issues had the biggest share with over 300 transactions closely followed by Resets with 296 transactions.

On the European side, 17 CLO priced totalling €7.5bn, comprising 6 new issues and 11 Resets. Overall, 82 New Issue deals printed since January 1st, alongside 10 Refis and 41 Resets, totalling Eur 345bn.

The weighted average cost of capital was slightly wider in both Europe and the US, driven by wider IG Mezzanine tranche spreads due to the strong supply pipeline. This was not enough to stop the New Issue machinery although Resets represented indeed most of the product supply over the month. We noticed increased Managers Tiering as well as an increase of the discount applied to Reset transactions vs. New Issue ones, which gave fuel – to some extent – to the slight widening momentum (130bps vs 135+bps on AAAs). This proved that end-accounts valued the fact that New Issue deals offer higher protection than repackaged vintaged portfolios and that the later should offer investor some kind of spread compensation.

Secondary markets followed a similar pattern, we noticed an increased trading activity going into month-end especially on non-investment grade tranches as dealers lightened their inventories to limit their end-of-quarter capital charges. Spread-wise, while the first half of the month was relatively strong, the second half saw weaker prints as the large supply and competition in Primary offered many alternatives to investors.

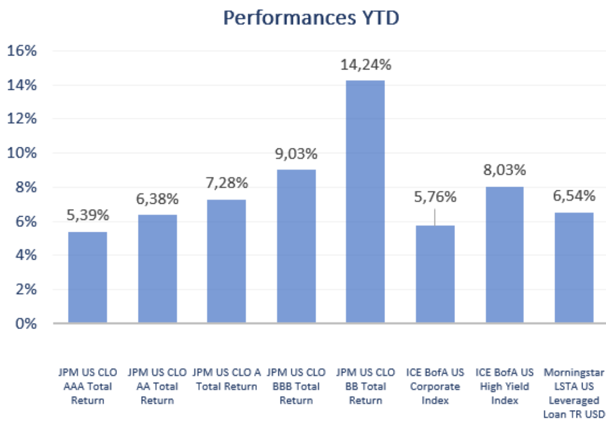
Performance & strategy

Looking ahead, we believe that Q4 2024 could bring some volatility on CLO spreads as there are still unresolved issues on the macro front as well as on the political front notably with the US elections and their implications regarding global trades, domestic fiscal plans and the wars currently raging in Europe and the Middle East.

Looking at CLOs, we see a strong CLO supply into year-end fuelled by Refinancings and anticipate higher tiering between managers and transactions. We estimate that a large chunk of the market is still eligible for a Reset, especially the 2021-issued deals and the 2022-2023 vintages that will exit their non-call period by year-end. We already started to see some pressure on senior spreads which should filter through mezzanine tranches, especially on deal-Resets which by nature present slightly more risky collateral portfolios.

On the fundamentals side, although default rates have remained contained at historically low levels, we are conscious of the increased presence of LMEs and believe they could weight on spread as well, until the easing rate cycle is properly engaged by Central Banks. Those remain 'data dependant' for now and we expect forward guidance to gain visibility into the new year, as the first few cuts filter through the economy.

In terms of positioning, we continue to feel very strong about the Primary markets since they give exposure to fresh collateral portfolios that have no default and limited CCCs. Primary also offer a significant spread pick-up compared to Secondary, and organically contribute to increase the portion of reinvesting CLOs in our portfolios which we like. Deep mezzanine tranches from top tier Managers make sense especially if base rates remain elevated and the loans default pattern does not deviate from its current path, although we shall need to see some softening on that part of the capital structure especially in the US (current levels in the +520 bps). In terms of CLO Equity, we are still keen on the combined investment Warehouse + Equity to benefit from the carry and pick the right window to convert the Warehouse into a syndicated CLO.



Source: Bloomberg as of September 30st, 2024

As a conclusion, CLOs returns remain strong across the capital structure, with year-to-date returns of 5.39% to 14.24% from AAA tranche to BB tranche. As we enter the last leg of the year, we are convinced that investors should remain extremely diligent when purchasing assets: trade origination has been and will remain key to future performance.

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

AXA Investment Managers

VOLTA FINANCE

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.