AXA IM CLO Market Update

CLO -
the trade that keeps on giving

Dear all,

The US Federal Reserve Chairman, Jay Powell, recently made a statement indicating that the US central bank was taking a cautious approach to cutting interest rates. While there have been calls for rate cuts, Powell noted that more evidence of sustainable disinflation is needed for the central bank to start making cuts. The announcement surprised markets which expected a different outcome from the Fed given the strength of the US economy although risky assets & Equities continued to perform as US S&P 500 and Nasdaq traded near their all-time highs.

In the Eurozone, the latest GDP prints indicated the need for a perfect data flow in order to see the European Central Bank start cutting rates. Overall, market consensus was for the first cut in interest rates to be implemented in June, although a cut in May was also be in scope. The Euro area inflation rate decelerated again in January, both for the headline and underlying data. Although supply-side factors may have driven the inflation shock in Europe, demand-

side factors cannot be ruled out, with labour market tensions still presenting as potential triggers of inflation. Monetary policy has not yet had a significant dampening impact on the economy, which suggests that it makes sense for central banks to take their time before making policy changes.

Leverage Loan Markets

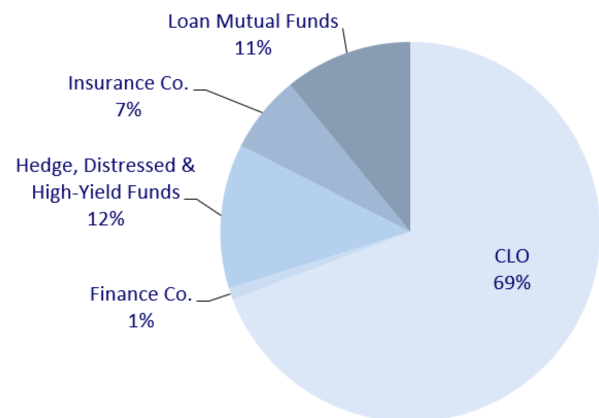
Expectations were high for the Leveraged Loan markets since they achieved last year their best performance since 2009 and established themselves as one of the top liquid asset class. With a total returns of +1.72% (SPBDEL Index) for January, Euro Loans continued to deliver. This represented a move of circa 1% up in terms of cash price, from 96.00% in December to 97.00% as of the end of January (European Leveraged Loan Index).

In terms of Primary volumes Eur 16.0bn of Loans printed in January, the busiest month in Europe since July 2021. It was interesting to note that Repricings – as opposed to New Issues - took centre stage with €12.3bn / 77% of the total issuance volumes. The largest transactions in the market were Kohler Energy ($1.6bn-equivalent cross boarder Financing), Merlin (Eur 1.0bn Repricing), Cognita (Eur 1.2bn Repricing) and Kantar (Eur 1.2bn A&E). Forward pipeline was looking healthy at the end of January with 7 Primary transactions being marketed for an aggregated amount of Eur 5bn.

In terms of fundamentals, default rates remained sub 2%. Looking at rating agencies predictions, Fitch Ratings anticipated both High-Yield and Leveraged Loans default rates to reach 4% by December 2024.

In the US, the Leveraged Loan market delivered a positive total return of +0.65% (SPBDAL Index). This compared lower than their Europeans peers, prices did not see a shift upwards in January and were flat month-on-month closing at 96.27%. The main reason for this relative under performance was the gigantic supply from the Primary market, totalling USD 171bn of issuance (largest amount issued on a single month since January 2017). For comparison, the total issuance volumes for January 2023 stood at USD 22bn. With only USD 18bn of non-Refinancing issuance, Repricings, Refis and A&Es captured most of the activity. New loan supply is expected to remain limited in the near-term, potential rate cuts in 2024 could drive a pickup in M&A/LBO volume although continued uncertainty in equity valuations remains a headwind.

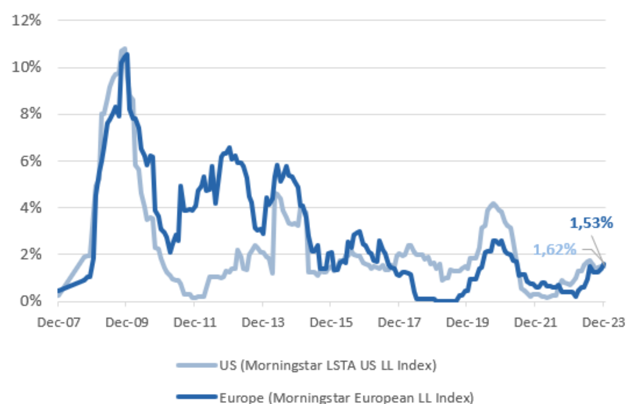
US: Lev Loan Market Investors (Primary)



While default rates have remained low, the trend in terms of recovery rates has been downwards since 2022 for both bonds (now around 30% recovery rate according to MS Research) and loans (around 55% recovery rate). A key element to understand the relationship between default rates and recovery rates is the concept of distressed exchanges. Distressed exchanges have been increasingly used in debt restructuring processes instead of conventional bankruptcy filings to preserve equity and save on expenses. Various types of distressed exchanges are employed including up-tiering, maturity extensions, debt buybacks at a discount and debt-for-equity swaps.

Distressed exchange volumes have picked up since 2022, outpacing conventional defaults. Since a predominant share of distressed exchanges consist of issuers recently downgraded to CCC+/lower, ultimate recovery rates vary greatly from one situation to the other. According to Nomura's research, approximately 20% of

issuers experiencing a distressed exchange eventually filed for chapter 11 bankruptcy. This usually happened within 8 to 15 months of the initial distressed exchange, resulting in recovery rates of 35%, i.e meaningfully lower than the historical market recovery average.



CLO Primary Markets

We recorded Eur2.2bn of CLO issuance in Europe for the month of January, split across three New Issue transactions and two Resets. This was roughly twice as much as the same period last year, and just shy of the Eur 2.5bn issued in 2022. AAA spreads dropped significantly from +175bps (last December) to +150bps (BB spreads tightened by 155bps to reach +670bps from +825bps in December) driving CLOs' weighted average cost of capital lower. Although those drops should have boosted the CLO arbitrage, Loan spreads also tightened significantly - single-B Loans traded in the 400bp context and BBs in the low 300bps context - whilst price discount in Primary eroded. As a result, although improving, the arbitrage remained under pressure. In terms of forward issuance, the near-term CLO Primary pipeline was 15+ transactions strong at the end of January, hinting to a potential stabilisation in spread levels.

On the other side of the Atlantic, total New Issue volumes reached USD 12.5bn from 29 individual transactions (BSL & MML), i.e. the highest-ever amount of issuance for a January month. Managers were also active repricing older vintages as eight outstanding CLOs were Reset totalling USD 3.6bn, while another USD 1.0bn were refinanced with lower coupons. The tightest New Issue transaction broke the +150bps mark with a +148bps print on AAAs while BBs managed to print inside 600bps at +590bps (standard 5nc2 structure). This move was driven by surging investor demand, including US banks returning as major AAA buyers.

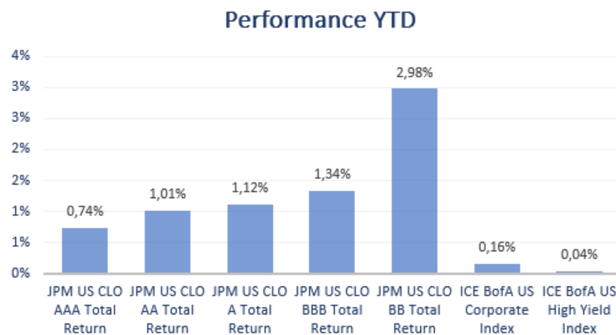
CLO Secondary Markets

Secondary markets were extremely busy in January as demand for bonds pushed spreads tighter and triggered significant trading volumes. As the month progressed, we noticed that activity shifted from a focus on Investment Grade tranches towards non-Investment Grade risk since the sharp tightening in deep Mezzanine spreads incentivised fast money accounts to take profits. Spread-wise, we saw AAA tranches trading +130bps context in Europe and +135bps context in the US. At the other side of the capital structure, BB-rated tranches traded inside +700bps in Europe while superior US profiles were in the +600bps context.

Performance & strategy

CLOs delivered solid returns in January once again and continued to outperform traditional credit markets. We have been advocating for some time now that a substantial benefit of CLOs when building a multi-assets portfolio is that they introduce diversity in terms of risk profile and income generation. While imminent rate cuts were priced-in, market was caught off-guard by economic data and the subsequent uncertainty regarding near term monetary policy. Floaters such as CLOs fully benefited from the repricing of the rates curve, capturing more income from their benchmark leg while credit margins tightened due to the increased demand for the asset class. With US High Yield yielding in the 8% context, CLOs offers a stronger risk/reward

profile and should continue to attract significant demand.



Looking at CLO Equity, we closely monitor Loans dynamics and specifically the current repricing action taking place both in the US and Europe. We expect this trend to live on given the elevated proportion of Loans currently trading above par. Together with loan repayments ticking up, we anticipate those elements to impact Equity distributions potentially negatively, especially for vintaged Equity tranches.

In terms of management, most our portfolios were positioned to benefit from a January market rally. View back in December was that there was too much optimism in the market regarding rates direction and that CLOs had generally lagged the credit risk tightening. We consequently came into January fully invested and used the January strength to consistently reduce risk, focusing on lower collateral quality assets. This enabled us to create tactical pockets of cash that can be deployed when volatility picks-up since we expect the macro momentum to deteriorate over the coming months as the full impact of aggressive rate hikes over the past two years sinks in.

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.

Risk	Description
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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