April 2024

AXA IM CLO Market Update

CLO wave still rolling

Dear Investors,

The Federal Reserve on 1st of May emphasized that inflation has remained stubbornly high in recent months and said it doesn't plan to cut interest rates until it has "greater confidence" that price increases are slowing sustainably to its 2% target.

Despite the uncertainty of the current economic moment, Powell's characterization of rate hikes as "unlikely" has relieved investor's concerns.

The Fed kept its key rate at a two-decade high of roughly 5.3%. Several hotter-than-expected reports on prices and economic growth have recently undercut the Fed's belief that inflation was steadily easing.

The Fed also announced that it would slow the pace at which it's unwinding one of its biggest COVID-era policies: Its purchase of several trillion dollars in Treasury securities and mortgage-backed bonds, an effort to stabilize financial markets and keep longer-term rates low. Instead of allowing $60 billion in Treasuries to roll off each month, it will allow just $25 billion starting in June. At the same time, it will continue letting $35 billion in mortgage-backed bonds mature each month.

The step is meant to ensure the financial system does not run short of reserves, as happened in 2019 during the Fed's last round of "quantitative tightening."

While the move could loosen financial conditions at the margin at a time when the U.S. central bank is trying to keep pressure on the economy, policymakers insist their balance sheet and interest rate tools serve different ends.

This 'higher for longer' policy in the US doesn't apply for the rest of the world though. In Europe we are getting closer to the expected June cut. Markets are now pricing in 70bp in ECB rate cuts, expecting therefore 2-3 cuts for this year. But with the Fed only likely to cut late in the year, and some ECB members showing discomfort at the prospect of consecutive cuts, the path for rate cuts beyond June will now be the key question.

Leverage Loan Markets

With the fed funds rate in a holding pattern as inflation persists above the Fed's target for initiating cuts, demand for loan debt, reflected by robust CLO issuance, has been outstripping supply by a record amount. And while this demand has resulted in tighter spreads, the elevated base rates continue to underpin strong returns for investors.

The US leveraged loan secondary market rally stalled in April as investors confronted a hawkish tilt in rate progressions and intensifying global conflicts. Despite weaker performance in April, year-to-date returns remain above average thanks to higher base rates. US loans have gained 3.07% through the first four months of the year, lower than the 4.31% at the same period last year but higher than 2020-2022 levels.

Staying on trend with the first quarter, loan refinancings and repricings dominated issuance in April, leaving net supply limited.

Euro leveraged loan supply has picked up, with supply of around €29bn during the first four months of the year, significantly exceeding the first 4 months of 2023 (~€10bn) and 2022 (~€21bn), mainly coming from refinancings and repricings as well.

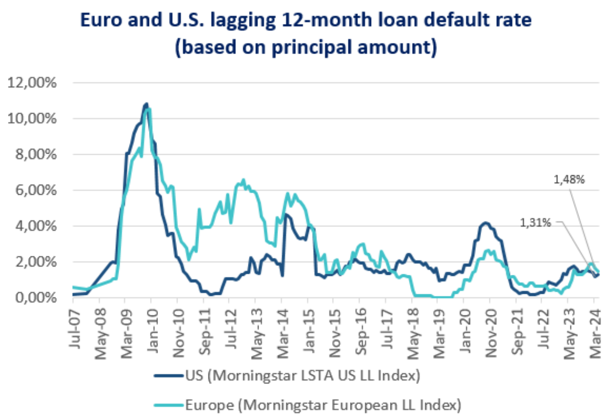
The Morningstar ELLI TR has returned 0.87% in April, and total return YTD is 3.38%.

Approximately 26% of the ELLI is trading at or above par compared to 17% in late January 2024.

Loan fundamentals should also benefit from incoming rate cuts from ECB that will help loan funding costs, easing Interest Coverage ratio pressure.

Altice France is no longer the most widely held asset in European CLO portfolios, having slipped from its long-held position at the top of the chart to 3rd place, behind MasOrange and Verisure.
As of May 1st, 89.14% of European CLOs rated by Fitch referenced Altice France in their portfolio, down nearly 3% versus 92.07% at the beginning of April. The average exposure within CLOs to Altice France has also decreased from 1.21% to 1.15%.

Despite an increase, the lagging 12-month loan default rates remained well below the historical average of 2%. The Morningstar LSTA US Leveraged Loan index stands at 1.31% and 1.48% for the Morningstar European Leveraged Loan index.



CLO Primary Markets

The wave of CLO supply continues its way with $65bn and €14.8bn Gross issuance YTD. But CLO amortization and liquidation are almost offsetting these figures, bringing Net Issuances respectively at $2bn and €6.4bn.

CLO markets are still benefiting from a strong and sustainable demand. Banks have been actively redeploying principal payments into the CLO primary market, supporting the strong issuance both in Europe and in the US. CLO holdings held by the top 6 Japanese banks represents around 20% of the CLO AAA tranches, and we expect them to continue investing as both US and EUR CLOs are offering ~ 2% yield post currency hedging to Japanese investors, which is still attractive compared to 10-yrs JGB yield of 0.9%.

CLO ETFs also provide a source of new retail demand. There is currently 9 CLO ETFs in the market, with current total assets slightly over $10bn since the first one was launched in 2020. While it remains small relative to the overall CLO market, it is growing rapidly, and it could attract new demand from retail investors, family offices or small insurance firms.

While it remains to be seen whether this amount of primary activity will be enough to put upward pressure on CLO liabilities, so far, demand for CLOs has held firm and spreads have continued to grind tighter. Even despite heightened volatility in the broader markets, as well as the downgrade to CCC of the widely held debt of Altice France serving as a reminder of the idiosyncratic risk in CLO portfolios.

As expected, after the recent loan downgrades including the full debt stack of Altice France, the median CCC exposures in CLOs have increased – 6.4% Moody's and 5.1% S&P in the US, and 4.8% Moody's and 3.2% S&P in Europe. But the impact on OC cushion was limited and they remain healthy.

CLO Secondary Markets

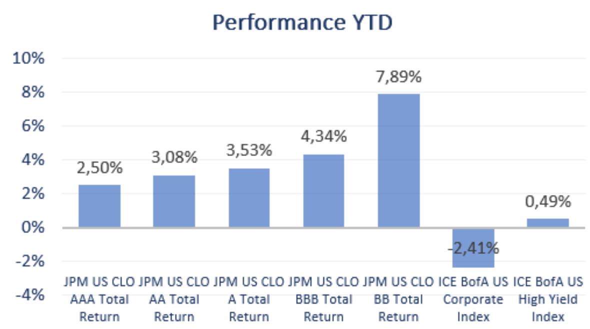
In April, secondary market activity stabilised to more normal volumes after a busy month of March. And the market remained resilient to the different macro-economic event causing volatility in global markets.

In the US, trade volume slowed down from USD 5bn to reach the average volume of USD 3-4bn per week. 75% of the flow were at the investment grade level, where dealers ended net seller showing a good appetite in IG from end-accounts. Similarly, in Europe, BWIC volume slowed to EUR 250m per week, with demand well distributed across the capital structures, with still significant activity in BB and B-rated tranches as well as CLO equities.

Overall, spreads continued to tighten on the whole capital structure. The end of April saw spreads of AAAs reaching 110-105bps for some long profiles which were in the 120bps a month ago. While more and more CLOs reach the end of their reinvestment period and spreads tighten in the primary. Short profiles on tranches at discount callable anytime, or high coupon ones trading above par continue to be a key interest from market participants. We observed a significant premium for those profiles, and whereas March saw more interest in short-dated AAAs, we noticed more willingness from buyers to source short-dated mezzanine and deep mezzanine tranches.

The end of the month saw a strong momentum on all tranches especially in the US with spreads 10bps to 20bps tighter. While Europe was more restrain with all IG tranches tightening 10bps, whereas buyers were more selective on sub-IG with spreads overall unchanged but dispersed across the various profiles and qualities.

Performance & strategy



source: Bloomberg as of April 30th, 2024

CLO continue to out-perform traditional credit markets. As of end of April, CLOs tranches both in EUR and US markets were showing returns ranging from 2.50% to 13% from AAA tranches to single-B tranches.

For our Senior funds, the focus is still on investments on primary market as the premium versus secondary market remains significant, and we tend to prefer investing in brand new transactions with clean portfolios. The sizes of our investments also allow us to negotiate attractive spreads, longer Non-Call periods, and defensive documentation.

For our mezzanine funds, we think BBs currently provide better relative value than BBBs now. Given the recent widening on single-B, we will also look at opportunistic purchases on primary market where portfolios are clean.

Equity returns are again beginning to look better than single-B CLO tranches. The IO part of the return - the distributions to equity - has been strong recently with average payments around 5% in April for EUR CLOs and 4.3% for US CLO. The downgrade of Altice has had minimal impact on OC tests and equity distributions so far. The PO part of the return - upside from resets and liquidations - is more in the money for some CLOs. The rationale to buy equity is therefore getting stronger.

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

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