March 2024

AXA IM CLO Market Update

CLOs entering a Phase of Stabilization

Dear Investors,

Central banks' recent actions have significantly influenced the market in March.

The Federal Reserve confirmed expectations for rate cuts in 2024 but emphasized the need for more evidence of inflation dropping toward its 2% target. Meanwhile, the European Central Bank maintained its policy rates, revised down Eurozone growth and inflation forecasts and hinted at a possible rate cut in June. The Bank of Japan raised rates for the first time in 17 years, marking a significant shift in policy stance.

The Fed's unexpectedly dovish tone, along with the Swiss National Bank's rate cut, caused global risk assets to rally as investors weighed up resilient economic growth versus a weakening earnings outlook for the remainder of 2024. Overall, the mood was bullish, with numerous assets, such as equities, high yield, gold, and cryptocurrencies, reaching historic highs.

The more dovish tone from major central banks also caused bond markets to retrace some of the previous sell-offs, while implied rates volatility settled at two-year lows.

Looking ahead, we anticipate that central banks will remain the primary drivers of market activity, with minimal downside currently factored into prices.

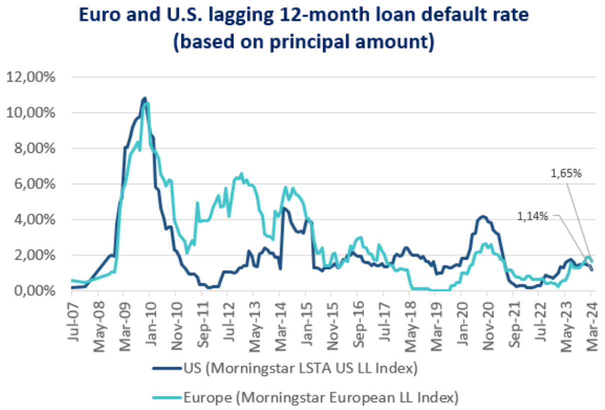
Leverage Loan Markets

The Leveraged Loan market was abuzz with the c.60 billion USD debt of French telecoms group Altice.

Following the company's annual investor call on March, Altice loans and bonds declined significantly. The decision to relocate disposal proceeds outside the restricted group and lower leverage targets created heightened uncertainty and price volatility, leading to lenders to increase scrutiny. Analysis points to event-driven potential recoveries and a wide range of outcomes, driven by negotiations aimed at retaining control of Altice France while seeking debt reductions. Price contagion affected Altice International and Altice USA to a lesser extent. Rating agencies downgraded Altice France to CCC or equivalent. The situation continues to evolve, with implications for various stakeholders in the market as potential recovery rates play a mitigating role.

One of the consequences was that the Morningstar European Leveraged Loan index dropped by -0.17%, while the Morningstar LSTA US Leveraged Loan index stood at +0.31%, despite its floating rate component and the risk-on mood among investors. Gross issuance of Leveraged Loans in the US and Europe reached a two-year high, mainly driven by refinancing and repricing. M&A activity has remained sluggish but there is strong support for Leveraged Loan prices due to new CLO creation.

Regarding risk metrics, the lagging 12-month loan default rates remained well below the historical average of 2% and is grinding lower specially in US. The Morningstar LSTA US Leveraged Loan index stands at 1.14% and 1.65% for the Morningstar European Leveraged Loan index.



CLO Primary Markets

The global CLO new issue supply remains robust and close to historical highs, contributing to spread stabilization across the capital structure.

In the European CLO primary market, the first quarter was marked by exceptional activity, with new issue volume reaching approximately EUR 0.6bn excluding re-issues and EUR 11.5bn including re-issues. This represented a record-breaking quarter for the CLO 2.0 market, surpassing Q1 2021. February and March stood out, with around EUR 4bn and EUR 5bn of new issue supply respectively. Furthermore, a surge in delayed draw Class F tranches sales was observed, with 11 such transactions in Q1 following the flattening of the CLO credit curve. Europe has shown less impact from expected waves of refinancing compared to the US, where roughly half of the USD 75bn CLO supply originated from repricing.

Significant appetite for short-dated and static CLOs has been evident, with a steepening of the credit curve at the AAA tranches. Short-dated new issue AAAs were priced in the 120bps range, while long-dated were well anchored at 150bps, with some adjustments depending on the CLO manager tiering. The rest of the capital structure remained relatively unchanged compared to last month, lagging behind the rally observed in other asset classes this month.

A new trend has emerged in Europe and is expected to continue: the refinancing of all rated tranches except AAA. This involves transactions priced in Q1 and Q2 2022, with relatively tight pricing of AAA tranches and heavily discounted mezzanine tranches, allowing CLO managers to increase arbitrage by reducing the cost of debt on the mezzanine tranches while maintaining a tight spread on the AAA.

Looking ahead to Q2, elevated primary activity is anticipated to persist. Deals in the post-Reinvestment Period are expected to continue amortizing, offering further opportunities for additional repricing.

CLO Secondary Markets

In March, secondary market activity picked up after a lull in February.

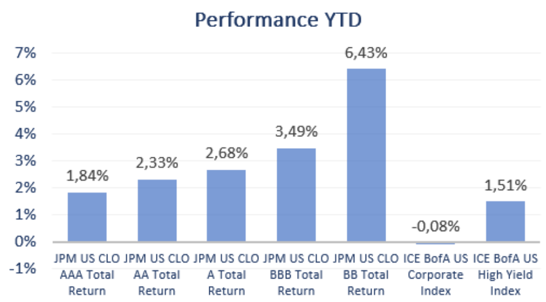
In the US, trade volume hit around USD 5bn in some weeks, notably higher than the USD 3-4bn average. 75% of the flow was at the investment grade level, evenly split between dealers and end-clients. Similarly, in Europe, BWIC volume peaked at EUR 500m in some weeks, with demand well distributed across the capital structures, including BB and B-rated tranches.

Overall, spreads tightened and showed a significant premium over primary, with notable traction for short-dated and amortizing transactions, particularly in Europe. Short-dated AAA traded inside a 100bps, and BB inside a 500bps, highlighting the appetite for defensive profiles in the short term amidst dwindling discounted opportunities elsewhere.

It's worth mentioning that investors have not yet factored in the Altice component within the CLO, as the Overcollateralization test only triggers when CCC exposure exceeds 7.5%. 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

CLO once again stood out as a top performer across the capital structure, especially compared to traditional credit. Floating rate as well as high carry laid the foundation for robust year-to-date performance.



source: Bloomberg as of March 28th, 2024

As observed, March saw a stabilization of spreads, particularly in the primary market. Consequently, CLOs continue to present appealing forward yield and income generation opportunities across the capital structure, contingent on investor appetite. However, it's evident that discounted prices, especially for the High Yield tranches, have largely disappeared, offering limited upside potential.

In our senior funds, we maintain a preference for the primary market to capture the substantial new issue premium compared to the secondary market. Additionally, we value the ability to acquire a significant portion of the senior part of the transaction, enabling us to influence transaction terms. For our mezzanine funds, we opt for a defensive stance by overweighting short-dated BBB and BB-rated tranches, allowing us to benefit from an attractive carry while prioritizing mark-to-market drop protection.

In conclusion, as we embark on Q2, CLO tranches continue to be a robust income generator, relatively insulated from potential rate volatility. While systemic risks in the leverage loan market appear subdued thus far, we have observed a rise in specific situations that, if accumulated, could more severely impact the market. Despite the absence of significant adverse scenarios on the macroeconomy or geopolitics currently, our focus remains on agility and risk management for the remainder of the year.

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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