CLO Insider Newsletter
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Welcome to **CLO Insider**, a monthly commentary on the CLO Equity Markets from **Mike Kurinets**, CIO of Capra Ibex Advisors and Capra Credit Management.

This month's CLO Insider explores the impacts of June's CPI report and the Fed's 75 bp rate hike on the CLO and leveraged loan markets. Though the markets rallied at the start of the month,[1] the 8.6% CPI inflation rate announced on June 10 heightened fears of inflation and concerns over a recession, causing loan prices to drop. Five days later, the Fed announced a 75 bp rate hike – despite its May statement that it was not discussing rate hikes above 50 bps – which further rattled the markets. Through the end of the month, loan prices continued to drop.

In the CLO markets, CLO debt prices fell, CLO equity trading stalled, and new CLOs became increasingly difficult to issue.

CPI Print Halted Market's Rally

Credit Markets Rally at the Start of June

Though May saw leveraged loan prices drop and CLO debt tranches widen, the markets began to recover during the first week of June. Leveraged loan prices rose almost 0.75 points from the end of May, and CLO debt tranches traded at tighter spreads,

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[1] In early June, leveraged loan prices were up nearly 0.75 points and BB CLOs were two to four points higher than they were near the end of May.

with AAA spreads 10 to 12 bps tighter and BB spreads as much as 30 to 40 bps tighter than where they were at the end of May. For a few days, it felt as if May's sell-off had ended.

CPI Print and 75 bp Hike Rattle Markets

The mood turned on June 10, when the 8.6% CPI number printed. Suddenly, the market's fears of persistent inflation and concerns over the chance of a recession returned, with loan prices dropping[2] and retail investors pulling their money out of leveraged loan funds. Then, the Fed's decision to raise rates by 75 bps – a reversal from its indication a month earlier that it was not considering rate hikes above 50 bps — startled the markets and shook confidence in the Fed. **As the market responded to the combined shock from these two events, the price of assets in credit products declined through the end of June.**

Despite the selloff, the high CPI number does indicate a glimmer of hope for leveraged loan investors. Since the Fed will have to be more active in raising rates than the markets initially anticipated, the floating rates of leveraged loans will also increase, benefiting investors who will likely receive larger cash flows. However, the market's fears that a recession is unavoidable trumped optimism about the potential benefits of rising rates in June.

Despite Sell-Off, Markets Do Not Identify Idiosyncratic Risks

While June's loan sell-off was significant, it did not differentiate between industries or ratings. **All loan types moved down in near unison, implying that the market was worried about the future, but it did not know where problems would occur.**

In our May letter, we highlighted how loan prices at the end of May 2022 were, on average, in the same range as loan prices in September of 2020, but the loan market felt much riskier in September 2020 because Covid-19 left several industries in distress. **By the end of June, loan prices had dropped further and, on average, reached prices close to what we saw in March 2016 at the lows of the energy/commodity sell-off.** In March

[2] On June 13, the single day drop in loan prices was 83 cents.

2016, the dislocations in the negatively affected industries were significant, leaving credit tails in CLOs much larger than they are today. Because of this tail risk, Tier 1 CLO BBs traded in the mid-60s in March 2016, whereas at the end of June 2022, Tier 1 BBs were trading in the mid-80s.

The market's forward view suggests that even though the future may see a recession (or we are already in one), defaults will not jeopardize the money goodness of CLO debt or cash flows to equity,[3] a perspective that has allowed CLO BBs to trade 20 points higher today than in March 2016 despite the comparable average loan prices.

Prices of CLO Debt Drop

CLO debt continued to trade in June, but at lower prices than in May. **However, the prices of CLO debt tranches dropped significantly more in May than in June, even though the leveraged loan prices moved down by nearly same amount in both months.** According to Morgan Stanley, spread movements in June were as follows[4]

Tranche	End of June (bps)	End of May (bps)	End of April (bps)	Spread Widening in June (bps)
AAA	175 to 210	170 to 190	125 to 145	5 to 20
AA	250 to 275	250	190 to 210	0 to 25
A	300 to 350	300 to 350	225 to 250	0
BBB	385 to 500	450 to 525	325 to 360	-25 to -65[5]
BB	825 - 950	800 to 900	700 to 750	25 to 50

[3] Nevertheless, defaults are likely to rise in the future from the artificially low levels we saw during the stimulative period immediately following Covid-19 lock downs.
[4] Information from Morgan Stanley CLO Trading Desk, in "Morgan Stanley CLO Commentary" released July 8, 2022. Based on Capra observations.
[5] It is hard to see how BBBs spreads could have tightened in June, but the Morgan Stanley report nevertheless indicates that they did.

Price moves on BB CLOs were particularly dramatic, with many top-tier BBs down by over five points and trading in the mid-80s by the end of June.[6] Yields on well-performing and recently issued BBs from Tier 2 managers traded at 13% to 14% yields, while well performing BBs from Tier 1 managers traded at roughly 12% yields.

CLO Equity Trading Slows and New Issue CLOs Struggle to Print

While there were a few trades in CLO equity during the first week of June, trading essentially stopped after the publication of the June CPI report. From June 10 through the end of the month, relatively few CLO equity positions appeared on Bid Lists, and most of those failed to trade.

Meanwhile, the new-issue broadly syndicated loan CLO market seemed dysfunctional in June. It was hard to line up AAA buyers with spreads in the SOFR +180 to SOFR +240 range.[7] In addition, U.S. banks, which are large buyers of AAA CLOs, stepped back from the CLO market. Sprint to Print CLOs – in which a CLO manager tries to sell the entire debt stack before purchasing any loans into the CLO warehouse – seemed like a promising strategy to get deals done because the cost of creating equity is lower if the CLO ramps up collateral trading at a deep discount, but these deals are very difficult to arrange. **Only the largest CLO managers – who could find AAA buyers and bring most, if not all, of the money for the equity tranche – could do deals.**

In order to adapt to the higher cost of funding, many new issue CLOs adopted three- or four-year reinvestment periods and one-year non-calls. This structure provides a shorter waiting period before a refinance or reset can occur – as compared to regular CLOs that have five-year reinvestment periods and two-year non-calls – which may be more appealing to third party CLO equity investors.

[6] As a reminder, top-tier BBs were down nearly 10 points in May.

[7] While AAA spreads in the SOFR +240 range are higher than the table from "Morgan Stanley CLO Commentary" indicate, we did see deals issued with spreads in this range in June.

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