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 why the leveraged loan markets turned bullish in July after bearishness in May and June. Earlier this summer, high inflation data and the Fed's steep rate hikes sparked sell-offs as concerns about the likelihood of a recession emerged. By July, the market seemed to have accepted and expected high inflation and aggressive Fed policy. Therefore, leveraged loan prices rallied in the face of worrying macroeconomic indicators. The market appeared to view this summer's dramatic sell-off as an overreaction, as corporate earnings seem to be on track despite some economic data (e.g. two quarters of negative GDP reports and an inverted yield curve) suggesting that we may already be in a recession.

The Market's Recession Concerns Fade

Despite the Negative Macro Outlook, the Leveraged Loan Sell-Off Reversed

For much of 2022, fears of persistent inflation dominated the conversation, as market participants worried that the Fed had acted too slowly in taming inflation and would therefore have to adopt aggressive policies – such as steep rate hikes – that risked triggering a recession. With inflation indicators reaching 40-year highs in May and June, the Fed began to raise rates more sharply than the market had expected, seeming to validate the growing concerns over the possibility of a "hard landing."'

In response, the leveraged loan market sold off dramatically throughout May and June. The price of leveraged loans dropped 5.25 points, reaching levels not seen since the bottom of the energy/commodity dislocation in Q1:2016. Additionally, it seemed as if the market – though it expected a recession – could not identify which pockets of the U.S. corporate landscape would be harmed most, as the sell-off was relatively uniform across corporate industries and across the rating spectrum.

These signs of a possible impending recession continued in July, and the month even saw some indications that a recession had already arrived – since both Q1 and Q2 posted negative GDP reports and the slope of the US Treasury curve was negative[1] – but the market seemed to expect that the economic impact of this recession would be manageable, especially since corporate earnings appear to be on track. As a result, even though July saw another high CPI print and the Fed raised rates by 75 bps, the leveraged loan sell-off had ended and the market actually rallied.

Though there were no specific industries that vastly underperformed or outperformed during the loan sell-off and subsequent July rally, there have been a handful of names across healthcare, retail, media, and telecom where underperforming issuers are facing one of two underlying challenges:

1. Structural changes in their industry (most of these changes happened during the pandemic) that have resulted in permanent declines in client demand (and revenues), or
2. Margin compression due to a combination of labor availability and supply chain challenges on the cost side, coupled with an inability to pass through cost increases or where price increases cause a material decrease in revenues.

We continue to closely monitor issuers with these profiles, especially in light of continued Fed tightening and increased floating interest expense paid by leveraged loan issuers.

Prices Rose for CLO Equity, as Well as CLO Debt Towards the Top of the Capital Structure

Prices for CLO equity seemed to have bottomed out in the middle of July and rose through the end of the month. Not only were offers higher, but a greater volume of CLO equity traded. **Prices of CLO debt also increased, but these higher prices were more visible towards the top of the CLO capital structure, in the single-A tranche and above.** There was less clarity among BBB and BB tranches, since buyers were more reluctant to step back into the market after the sharp sell-off in June.

[1] The market generally perceives two quarters of negative GDP as a sign of a recession. Likewise, the market views situations in which the 2-year Treasury is higher than the 10-year Treasury, termed an "inverted curve," as a reliable guide to predict recessions.

According to Morgan Stanley, spread movements in July were as follows:[2]

Tranche	End of July (bps)	End of June (bps)	Spread Tightening in July (bps)
AAA	160 to 205	175 to 210	-15 to -5
AA	240 to 280	250 to 275	-10 to 5
A	290 to 365	300 to 350	-10 to 15
BBB	400 to 600	385 to 500	15 to 100
BB	800 to 950	825 to 950	-25 to 0

[2] Information from Morgan Stanley CLO Trading Desk, in "Morgan Stanley CLO Commentary" released July 29, 2022.

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