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 addresses the intra-month volatility in AAA CLO spreads and its impact on the CLO market and on CLO equity. We also review consolidation among CLO managers and suggest two possible rationales behind it.

In March, concerns over inflation emerged as a larger concern than the war in Ukraine. Leveraged loan prices moved 0.37 points lower during the month, while the HY index and oil futures were roughly unchanged. CLO equity prices were essentially unchanged from the previous month.

Widening AAA CLO Credit Spreads Fluster CLO Market

Credit spreads on CLO AAAs abruptly widened.

Over the course of just five business days in the middle of March, CLO AAA tranches widened out by 15 to 25 basis points in the secondary market [1]. The magnitude of spread widening itself was surprising. Yet, it was made even more dramatic by the fact that it was accompanied by a rising S&P and tightening HY credit spreads.

What was behind the sudden and significant move for CLO AAAs in March?

As the 10-year US Treasury rose from 1.73% on March 1, 2022, to 2.48% on March 25, 2022, prices of fixed-rate, high-quality [2] credit products (like CMBS AAAs and investment-grade corporate bonds) dropped by several points. In the first week of March, CLO AAAs appeared unaffected by the Treasury move, as their price remained steady. CLO AAAs are considered to also be high-quality securities, but they are indexed to floating–rates [3]. **However, by the middle of March, CLO AAAs began to look "rich" relative to other high-quality products.** As a result, the third week of March saw US$ billions of CLO AAAs become available for sale, and the volume of paper sold drove prices down. **This downward pressure did not cease until the market perceived that the appropriate relative value between CLO AAAs and other similar products had been restored.**

How did the widening of credit spreads on CLO AAAs impact the overall CLO market and CLO equity?

The effects of these widening spreads were readily apparent in the secondary market since secondary market activity is visible to all market participants. In March, the widening in the secondary market was so rapid that market participants were caught off-guard.

However, the new-issue CLO market is much less transparent until those CLOs are officially issued, and pricing details become publicly available. We saw that, when CLO AAA spreads suddenly widened in the secondary market, a similar adjustment began taking place in the new-issue market. CLO managers [4] and investors began discussing the new and wider spreads at which new-issue CLOs would be brought to market. **Dealers, whose job it is to syndicate CLO debt [5], became uncertain about the spreads at which CLO liabilities could be sold and, as a result, many CLO managers seemed to slow down purchases into CLO warehouses.**

Because of this slow-down, prices on leveraged loans dropped significantly. By March 15th, prices of leveraged loans were down 1.9 points since March 1st. At the same time, the S&P 500 was rising and credit spreads on HY bonds were tightening. Therefore, the price declines in leveraged loans were not related to overall concerns in credit markets, but instead were a direct response to lower demand for leveraged loans by CLO managers.

In response to lower prices of loans, credit spreads on CLO debt tranches widened and CLO equity effectively stopped being offered. The CLO equity market temporarily froze with widened bid-offer spreads.

How did order in the CLO markets get restored in second half of March?

Once market participants agreed that CLO AAAs finally widened sufficiently and were no longer “rich” to other high-quality credit products, dealers gained comfort that continued widening of CLO AAA spreads would not continue. **CLO AAA spreads stabilized, and dealers were again able to understand where new-issue CLOs could be issued.**

As a result, CLO managers again had the green light to continue buying leveraged loans into CLO warehouses, which facilitated the rebound of loan prices. **Ultimately, by the end of March, loan prices regained most of the ground they lost during the first half of the month, ending the month down only 0.37 points.**

The rapid recovery in loan prices was likely also a consequence of both the 25-basis point Fed hike (vs. the 50 basis points some had predicted) and the appearance of a possible de-escalation of the war in Ukraine.

A Flurry of M&A Activity in the CLO Market

What is behind the recent wave of consolidation among CLO managers?

In recent history, we have seen a change in ownership in six CLO managers.

1. WhiteStar buys Carlson Capital
2. First Eagle buys Napier Park [6]
3. Carlyle buys CBAM
4. Blue Owl buys Wellfleet
5. Nuveen buys Symphony
6. AllianceBernstein takes over CarVal [7]

This recent wave was significant enough that it was noticed and reported by Bloomberg News. We suspect the motives behind the consolidations were a combination of desired liquidity events for the smaller managers as well as improved access to Captive Capital [8].

Do recent market events rattle your outlook on CLO equity returns in 2022?

We continue to believe that market volatility will present interesting opportunities to buy CLO equity. Like last month, we still believe that elevated market volatility should reduce the prices of CLO equity in secondary markets while also making CLO managers work harder to sell their new-issue CLO equity positions. In addition, we believe that the probability of a significant spike in leveraged loan defaults remains low. However, we may experience periods of mark to market volatility.

Footnotes:

1. Spread widening in the new-issue market is visible with several weeks of delay because the negotiation on spreads between CLO managers and investors becomes visible to the market only after CLOs price.
2. In this case, high-quality means low credit risk.
3. All CLO AAAs issued prior to 2022 are indexed to 3-month LIBOR while those issued in 2022 are indexed to 3-month SOFR.
4. CLO managers and the dealers they hired were together negotiating with investors in CLO debt tranches about how to respond to the spread widening in the secondary market.
5. Including the AAA tranches of CLOs.
6. Napier Park will continue to issue CLOs under its own brand.
7. CarVal is expected to remain independent.
8. Captive Capital refers to pools of money that CLO managers raise with the primary goal of investing in their own new-issue CLO equity.

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