CAPRA IBEX
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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.

The war in Ukraine ended up as the dominant force driving markets in February. CLO Equity prices were lower in February by 1 to 3 points on deals that had longer reinvestment periods and by 2 to 5 points on deals that had shorter reinvestment periods. For the month, leveraged loan prices moved 0.85 points lower, while the HY index moved 1.6 points lower.

This month's CLO Insider addresses key investor questions related to Russia's invasion of the Ukraine.

Russia/Ukraine Conflict Rattles Markets Creating BUY Opportunity in CLO Equity

Describe the trading environment prior to the war in Ukraine.

February started as a relatively uneventful month. Markets focused on inflation and various policy responses designed to keep inflation from rising, or worse, turning into stagflation. Some members of the Fed hinted at a 50-basis point hike in March [1] and Goldman Sachs suggested that there would be a total of 7 rate hikes this year. Discussions around these views were the only sources of volatility in the first half of the month.

At the same time, the CLO market was busy issuing new CLOs now that there was clarity on the spread adjustment for SOFR. CLO managers and investors in AAA tranches largely agreed on a level in the 17 to 20 basis point range. As a reminder, the lack of transparency on the SOFR spread adjustment was a sticking point in January, which kept new-issue volumes low at $4.3 billion. **In February, CLO new-issue volume rebounded to $14.3 billion, which is comparable to monthly issuance levels we saw in the first half of 2021.**

What was the immediate impact of the war in Ukraine on the CLO market?

When Russia invaded Ukraine mid-month, credit markets, including leveraged loans and CLOs, repriced lower almost immediately as liquidity began to quickly disappear. **Credit spreads on CLO tranches widened out across the entire CLO capital structure.** AAA CLOs widened by 5 to 10 basis points, while BB CLOs widened to as much as 50 basis points.

CLO Equity also repriced lower. For CLOs that have 3 or more years remaining in the reinvestment period, CLO Equity became offered 1 to 2 points lower and was bid 3 to 5 points lower. For CLOs that are shorter and have less than 18 months remaining in the reinvestment period, offers were 2 to 4 points lower, while bids seemed to disappear from the market. Some Bid Lists for CLO Equity were canceled, while other lists saw nothing trade and did not release any color.

The sell-side stopped trying to buy CLO Equity for their books and dealers began to show more willingness to reduce their existing exposure. This behavior means that they became much less sticky with their offers and encouraged buy-side investors to show bids several points below the offers.

Some investors on the buy-side, including us, began to hunt for bargains. Other investors became more motivated sellers. **The situation quickly became a “buyer’s market”. This was a strong contrast to January when dealers were coming to us with unsolicited inquiries to see offers on our CLO Equity positions.**

Should we see a spike in defaults of US companies?

We believe that this war will not significantly affect corporate earnings in the US. We also think that higher energy prices, while inflationary, will be managed with higher interest rates, increased production, and lower demand as the cold weather fades and natural demand for energy decreases.

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

We think that this is likely to be a very interesting time to buy more CLO Equity.

1. **We do not believe that the war in Ukraine will cause either a spike in defaults among US issuers or an increase in severities. It will, however, cause a dislocation in the markets which will allow for more attractive entry points.**
2. CLO Equity is available at lower prices in the secondary market from sell-side and buy-side accounts that are not set up to hold CLO Equity through periods of volatility.
3. CLO managers have an opportunity to improve existing CLOs by buying new loans at lower prices and, therefore, build par – a behavior that mainly benefits CLO Equity.
4. In the new-issue market, CLO managers are likely to lower management fees and show increasing flexibility on price since it is harder to attract capital to CLO Equity during periods of market volatility.

Footnotes

[1] Including James Bullard, president of the Federal Reserve Bank in St. Louis

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