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 how leveraged loan markets are reflecting growing concerns over the possibility of a "hard landing." As consensus views suggest that the Fed is too far behind in managing inflation, and that aggressive policies - like significantly larger rate hikes and a reversal of quantitative easing[1] - are inevitable, credit markets have become bearish.

In May, leveraged loan prices fell significantly. The CLO markets responded in turn, with CLO equity trading volumes effectively disappearing and spreads on CLO liabilities widening substantially.

Markets Turn Bearish as Macro Concerns Take Hold

Leveraged Loan Prices Plummeted as Fears of a Hard Landing Grew

From the first trading day in May, loan prices began to move meaningfully lower. On May 3, when the Fed hiked rates 50 basis points, as the market had anticipated, every trading session saw loan prices drop lower. By the middle of the

[1] A reversal of quantitative easing means that the Fed will not continue to reinvest maturing T-bills and agency paper on its balance sheet but will instead simply retire that paper, thus taking money out of circulation.

month, loans had sold off by nearly 2.5 points. At the month's lows, loan prices were down over 3.5 points, but they recovered some ground during the last three trading days in May. **On the whole, loan prices finished the month down approximately 2.9 points.** The only month in recent history that saw loan prices fall farther was March 2020 when Covid-19 hit and the government started to shut down the economy.[2]

Interestingly, while the selloff in loans was significant, it did not differentiate between industries or ratings. **Throughout the month, as loan prices dropped uniformly across all industries and rating sub-categories, the market did not indicate that it expected future defaults and losses to be concentrated in any particular types of loans**. As such, there seemed to be no sign of a flight to safety, with all loan categories down roughly the same amount.

This trend seemed to demonstrate that the market is worried that the future will bring problems, but has no idea where it expects the bulk of those problems will occur.

The loan market at the end of May offers an interesting comparison to the loan market in the middle of September 2020. While the average prices in the loan market were similar in both months, in September 2020 the loan market was significantly more risky than in May 2022. In September 2020, many of the industries directly impacted by Covid-19 were still far from recovering, and the market expected a significant number of defaults in those industries.[3] **However, in May we witnessed a generalized market selloff with no industry-specific risk, which implies that as the broader markets recover, so too will the loan market. As such, a significant spike in defaults beyond historic averages is far less likely.**

The CLO Markets Responded to Leveraged Loan Price Moves

[2] In March of 2020, loan prices were down 12.5 points.

[3] As a reminder, some of the industries that were affected by Covid-19 were airlines, hotels, and restaurants.

CLO markets may ignore relatively small changes in loan prices but they cannot ignore significant moves like we saw in May.

CLO equity markets froze as the bid-offer gap grew

Because loan prices dropped rapidly from the start of the month, CLO equity in the secondary market effectively stopped trading. Buyers immediately repriced paper lower in response to the reduced price of the collateral, but sellers continued to offer CLO equity at pre-selloff levels**. As the gap between buyers and sellers increased to over five points - it typically hovers around three points - trading essentially stopped.** During Q2 of 2020, we saw similar spread gaps slow the CLO equity markets.

After the first few days of May, CLO equity did not trade on Bid Lists and the market received little color about the bid levels that sellers saw.

All CLO equity profiles were lower in May. **However, CLO equities that had less time remaining in their reinvestment periods significantly underperformed CLO equities with more time remaining in their reinvestment periods.**[4]

CLO debt continued to trade though prices fell

CLO debt also sold off but continued to trade. While there were many trades at each part of the capital structure -- ranging from the senior-most AAA tranche down to the BB tranche[5] -- all tranches traded significantly lower.

According to Morgan Stanley, spread movements in May were as follows[6]

[4] There is no specific market consensus on what is considered short and long CLO equity, but generally speaking CLOs with more than three years remaining in their reinvestment periods can be considered to be long and those with less than one and a half years can be considered to be short.
[5] Less color was available on the single-B tranche.
[6] Information from Morgan Stanley CLO Trading Desk, in “Morgan Stanley CLO Commentary” released June 3, 2022.

Tranche	End of May (bps)	End of April (bps)	Spread Widening in May (bps)
AAA	170 to 190	125 to 145	45
AA	250	190 to 210	40 to 60
A	300 to 350	225 to 250	75 to 100
BBB	450 to 525	325 to 360	125 to 165
BB	800 to 900	700 to 750	100 to 150

Price moves on BB CLOs were particularly dramatic. Many top-tier BBs were down by over 10 points so that they were trading in the high-80s or very-low-90s. By the end of May, yields on tier-1 BBs reached over 10%.

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