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Closed End Funds

Why Have CLOs Prospered Since The Pandemic?

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Summary

- Collateralized Loan Obligations (CLOs) are frequently confused by all but the most sophisticated investors with Collateralised Debt Obligations (CDOs), which were seen by many as the cause of the Global Financial Crisis ((GFC)).
- US CLO markets re-opened after a brief slowdown in March and April 2020, with issuance gradually increasing amid tightening liability spreads.
- The COVID shock for CLOs can be characterized as sharp but short, due to the unprecedented and swift response in fiscal and monetary stimulus including QE and TALF.

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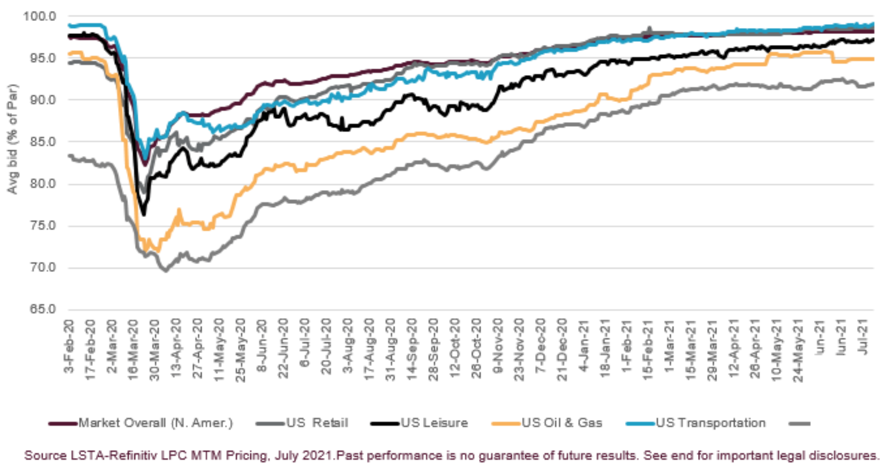
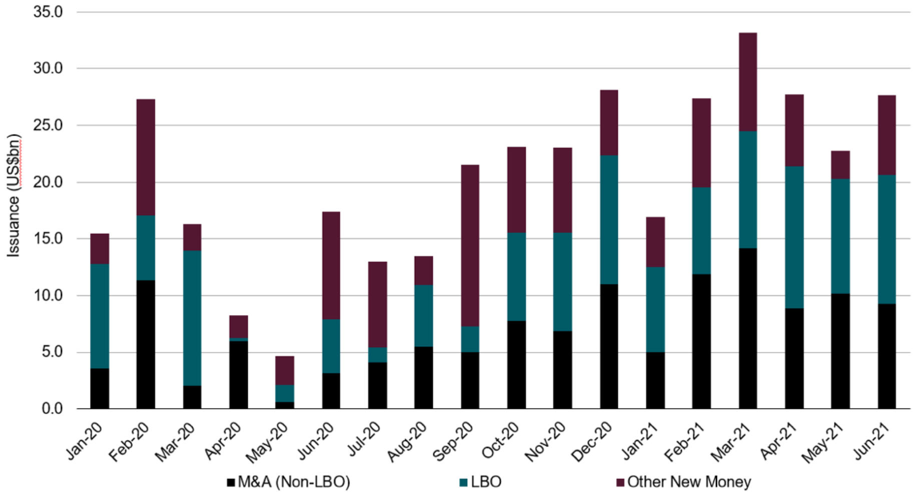
By Luke Lu, Yield Book CMBS/CLO research, Elizabeth Han and Hugo Pereira, Refinitiv LPC market analysis

Collateralized Loan Obligations (CLOs) are frequently confused by all but the most sophisticated investors with Collateralised Debt Obligations (CDOs), which were seen by many as the cause of the Global Financial Crisis (GFC). As market confidence took a nose-dive last year during the COVID pandemic, many observers feared that complex-sounding products, with complex or opaque-sounding names, would be the first dominos to fall in a repeat of the systemic problems of 2008.

As we set out in our paper, CLOs have proven to be resilient: leveraged loan secondary markets recovered quickly from the turmoil in March 2020, led by a rally in higher quality credits before extending to lower-rated and COVID battered sectors beginning in 4Q20. Below are loan price movement for some sectors hit hardest by COVID, including Retail, Leisure, Oil & Gas, and Transportation, as well as for loans rated below B3/B-.



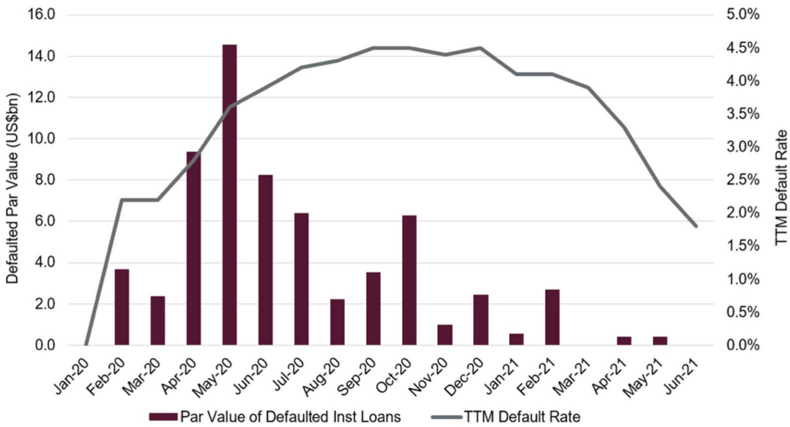
New issuance has also been resilient: the leveraged loan primary market slowly re-opened as joint monetary and fiscal stimulus stabilized and propelled deal-making and market activity, and new-money US Institutional loan issuance began to recover in the last quarter of 2020 and into 2021. M&A activity also returned in 2Q21. Fueled by rising demand for floating rate assets from large fund inflows from retail loan investors in 1H21, US loan fund AUM increased for the first time in years, as the economic outlook improved and investors seeking to hedge against possible rising rates. Below is a chart for new US Institutional loan issuance and dollar amount breakout.



Source: Refinitiv LPC as of June 30 2021. Past performance is no guarantee of future results. See end for disclosures

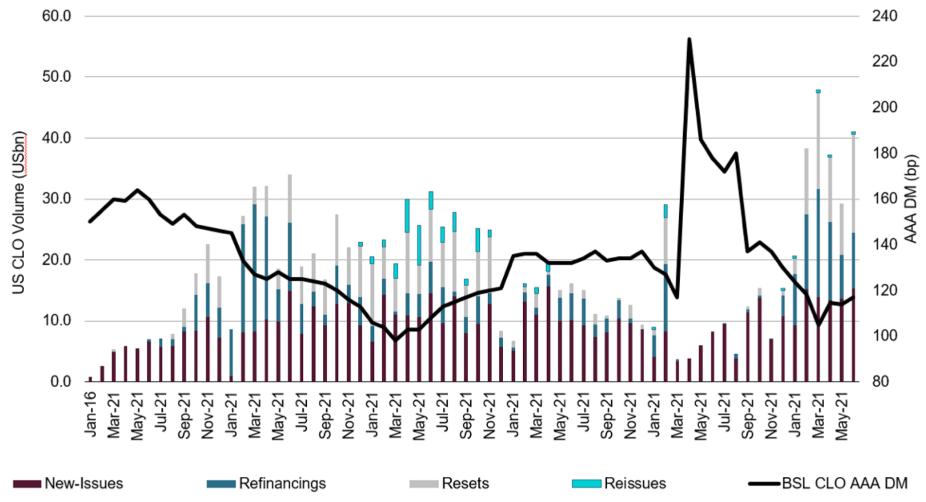
Fundamentals have continued to improve, with loan defaults continuing to fall after peaking in mid-2020, as the chart below shows.

Fitch Trailing Twelve Months (TTM) US Institutional Leveraged Loan Defaults



Source: Fitch U.S. Leveraged Loan Default Index. July 2021. Past performance is no guarantee of future results. See end for disclosures

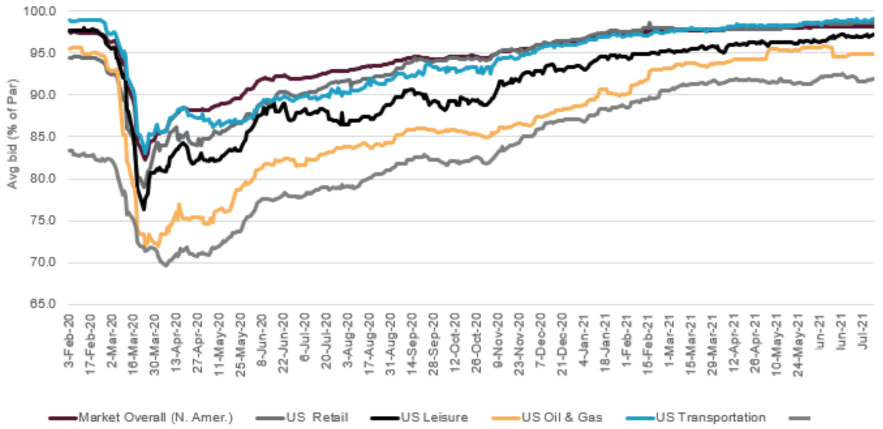
US CLO markets re-opened after a brief slowdown in March and April 2020, with issuance gradually increasing amid tightening liability spreads. Refi/Reset issuance volume spiked in the first half of 2021 as the market rallied and equity holders/managers looked to lower capital costs. Market participants have since recalibrated their estimates for 2021 CLO new-issue volume which is on track for a record year.



Source: Refinitiv LPC as of June 30 2021

The COVID shock for CLOs can be characterized as sharp but short, due to the unprecedented and swift response in fiscal and monetary stimulus including QE and TALF. This recovery, which took less than a year, is also much shorter comparing to that of the GFC when recovery took two years. The reopened economy in the US, following a rapid vaccination rollout during the last 7-8 months, has stabilized and improved CLO credit fundamentals and greatly boosted market confidence.

The CLO market may grow further as investors increasingly pivot towards floating-rate debt this year to protect against the prospect of rising rates amid inflation concerns. CLOs are one of the few scalable floating rate asset classes and is well positioned for a rising rate environment.



Source LSTA-Refinitiv LPC MTM Pricing, July 2021.Past performance is no guarantee of future results. See end for important legal disclosures.

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