AXA Investment Managers

September 2023

AXA IM CLO Market Update

CLOs closing Q3 in style

Dear Investors,

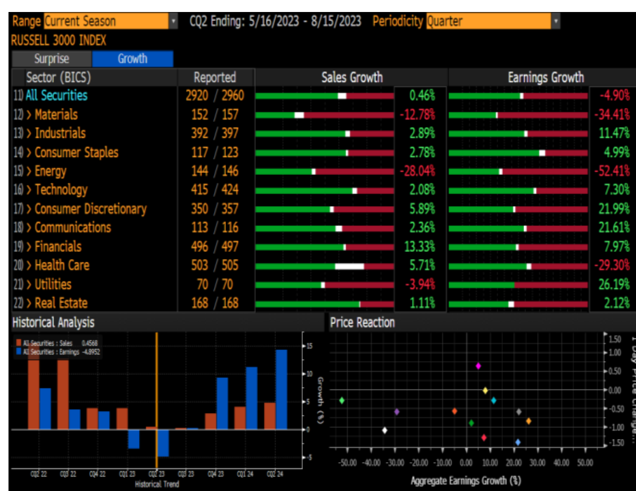
After an eventful summer in terms of data releases all the major western central banks provided markets with some clarity regarding their intentions on the rates policy front. Although they consider themselves at or close to policy rate peak, the FED, the ECB and the BoE adopted a rather hawkish narrative in order to keep their options open. They did not give markets clues towards an imminent rate pivot and seemed to diligently take steps to ensure that markets did not price this too soon – keeping rates higher for a longer period may be the path forward in beating inflation down.

The US economy continued to show resilience, supported by strong consumer spending largely fuelled by excess savings (saving rate down to 3.5% in August from 4.8% in May). With employment and wage growth slowing down and increased oil prices, disposable income will be under pressure and we anticipate consumers spending to adjust accordingly. In terms of rates action, the FED left Fed Funds unchanged at 5.50% this month although we still anticipate one extra hike by year end. Amid some disconnect between hard and soft data plus shutdown treats, global markets closed the month of September on

a weaker note as 10y Treasury yields moved towards 5%.

In Europe, the Eurozone Q2 GDP growth was revised down 0.2pp to 0.1% q/q while power economies such as Germany felt the pain of their externally driven growth model. The ECB hiked rates by 25bps to 4.0% in September with little anticipation for near term further changes.

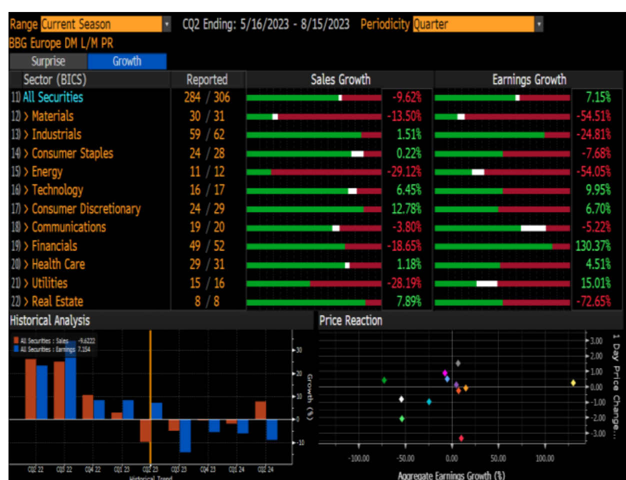
Q2 earning did not surprise either on the upside or the downside and were largely in line with expectations, confirming that sectors such as Energy, Construction or Healthcare are indeed struggling in terms of EBITDA growth. Financials, especially in Europe, seem to benefit from the high-rate environment.


Range Current Season | CQ2 Ending: 5/16/2023 - 8/15/2023 | Periodicity Quarter

RUSSELL 3000 INDEX

Surprise | Growth

Sector (BICS)	Reported	Sales Growth	Earnings Growth
11) All Securities	2920 / 2960	0.46%	-4.90%
12) > Materials	152 / 157	-12.78%	-34.41%
13) > Industrials	392 / 397	2.89%	11.47%
14) > Consumer Staples	117 / 123	2.78%	4.99%
15) > Energy	144 / 146	-28.04%	-52.41%
16) > Technology	415 / 424	2.08%	7.30%
17) > Consumer Discretionary	350 / 357	5.89%	21.99%
18) > Communications	113 / 116	2.36%	21.61%
19) > Financials	496 / 497	13.33%	7.97%
20) > Health Care	503 / 505	5.71%	-29.30%
21) > Utilities	70 / 70	-3.94%	26.19%
22) > Real Estate	168 / 168	1.11%	2.12%


Range Current Season | CQ2 Ending: 5/16/2023 - 8/15/2023 | Periodicity Quarter

BBG Europe DM L/M PR

Surprise | Growth

Sector (BICS)	Reported	Sales Growth	Earnings Growth
11) All Securities	284 / 306	-9.62%	7.15%
12) > Materials	30 / 31	-13.50%	-54.51%
13) > Industrials	59 / 62	1.51%	-24.81%
14) > Consumer Staples	24 / 28	0.22%	-7.68%
15) > Energy	11 / 12	-29.12%	-54.05%
16) > Technology	16 / 17	6.45%	9.95%
17) > Consumer Discretionary	24 / 29	12.78%	6.70%
18) > Communications	19 / 20	-3.80%	-5.22%
19) > Financials	49 / 52	-18.65%	130.37%
20) > Health Care	29 / 31	1.18%	4.51%
21) > Utilities	15 / 16	-28.19%	15.01%
22) > Real Estate	8 / 8	7.89%	-72.65%

Primary CLO Markets

20 New Issue transactions priced in Europe taking YTD volumes to c. EUR 16bn. Four deals priced in June, five in July and August then another six in September. While established and highly praised platforms such as Spire Partners came to the market, it was interesting to note that newcomers also took a share of the pie. Pemberton and their first "Indigo Credit Management" installment achieved respectively +178/+260/+350/+540/+800 & +1100bps for their AAA/AA/A/BBB/BB & B tranches.

In the US, market remained fluid with over 70 new Issue transactions priced since June, taking YTD volumes to c. USD. 75bn (MML + BSL). Golub Capital Partners placed an impressive USD 1.3bn MML transaction late September, AAAs coming at +235bps.

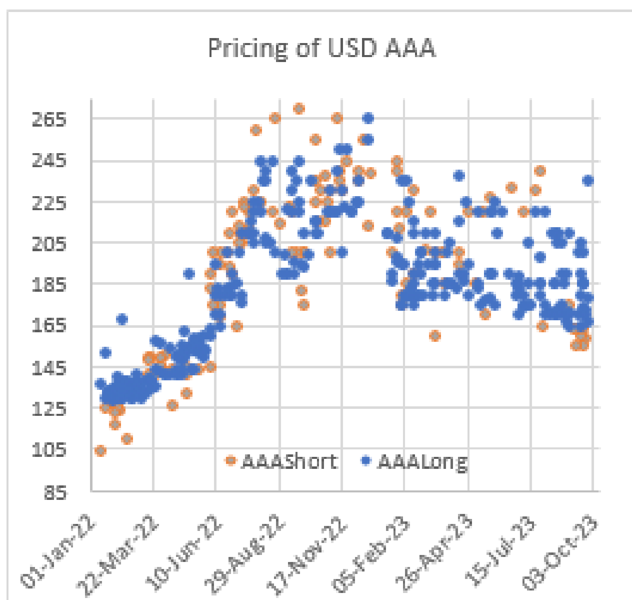
The Refi/Reset machinery was working in the US with over 20 transactions coming to the market. September alone saw eight of those pricing, tightest being BallyRock 20 Refi with AAAs achieving +163bps (1yr non-Call) while longer Resets (2yrs Non-Call) were in the 185-205bps range.

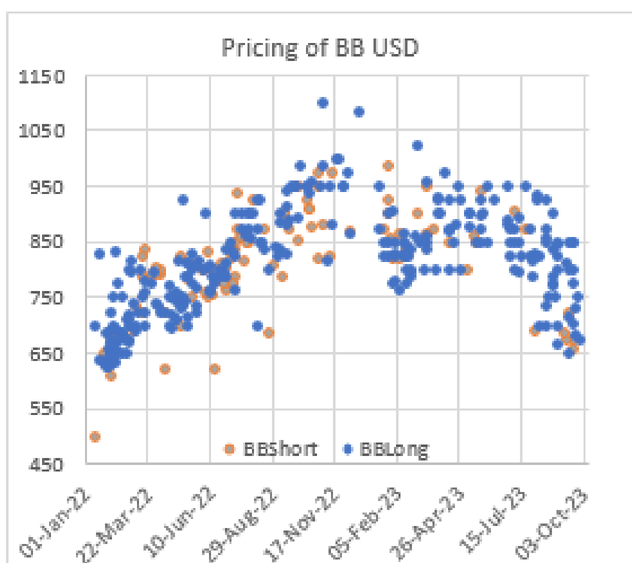
In Europe, the Refi/Reset pipeline built up as many of 2022' vintages - with higher costs of capital - will be coming out of their non-Call periods towards the end of 2023. We identified nine transactions following this pattern.

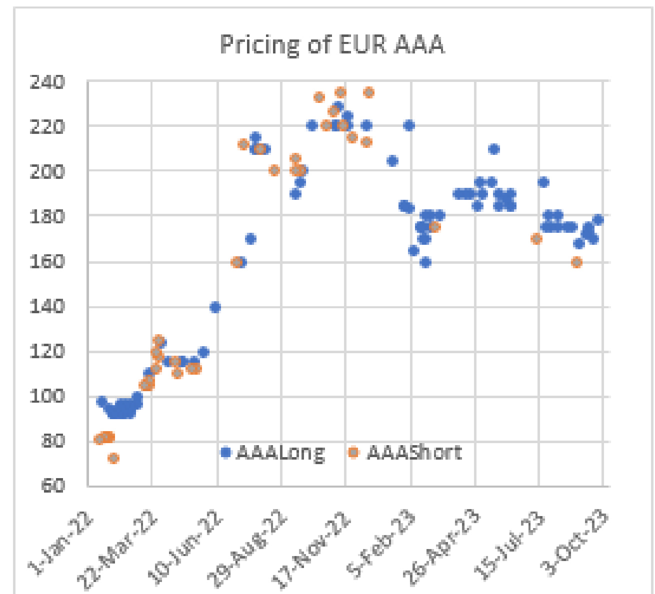
In terms of supply/demand dynamics, the positive momentum observed in the broader markets during summer coupled with low CLO supply levels provided CLO Managers with the perfect landscape to print favorably. While transactions were issued in the +190bps context on AAAs/MH+800bps on BBs pre-summer, prints tightened down to +170bps/MH+700bps into September. This was driven by a strong demand from continental accounts while some arranging banks were happy to hoover some AAAs into their treasury books to properly anchor transactions at the appropriate level. We also understand that a few Japanese buyers were

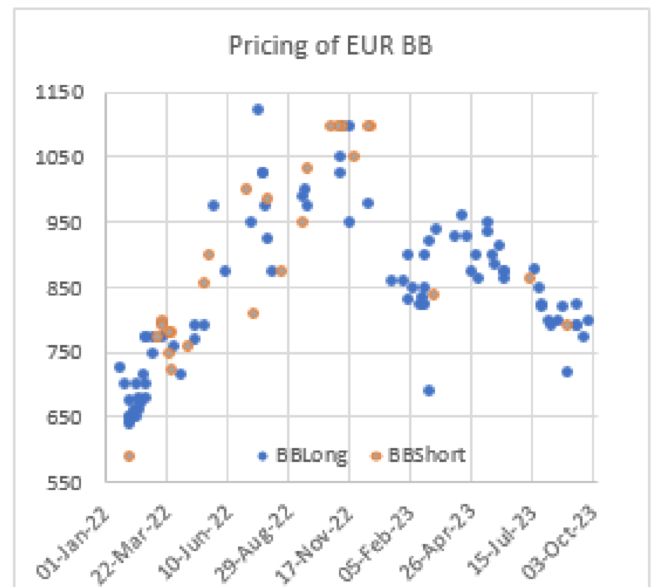
actively purchasing substantial AAA stakes – sometimes full tranche –, contributing to the strong momentum. Mezzanine and Sub-IG risk were syndicated across the globe as demand from the UK, the US and Europe was decent.

In terms of volumes, with USD 64bn of Primary Issuance YTD, the US BSL market was 40% down vs. same period last year. Same pattern in Europe with issuance levels down 30% year-on-year and a total Primary volume close to EUR 16bn.









Source: AXA IM, LCD, Bloomberg

Secondary CLO Markets

Secondary CLO markets were carried through summer by the positive momentum observed in broader markets. Trading volumes remained in line with seasonal average although we noticed increased activity in August with close to EUR 1bn of bonds offered via bid lists (vs. EUR 700mm for July). The increased volatility observed from mid-September triggered portfolio rebalancing strategies and consequently drove the total amount of bid lists close to EUR

1.5bn, amid spreads widening throughout the capital structure.

In terms of relative value, we continue to favour European IG CLOs vs. US CLOs since they offer a significant spread pickup after considering the EUR USD Swap costs (up to 55bps on BBBs). On the non-IG side though, we frame US spread wider than their European peers and see some US profiles offer substantial value to investors due to the higher tiering that market offers. MML CLOs also look attractive since they offer diversification and an attractive spread pickup.

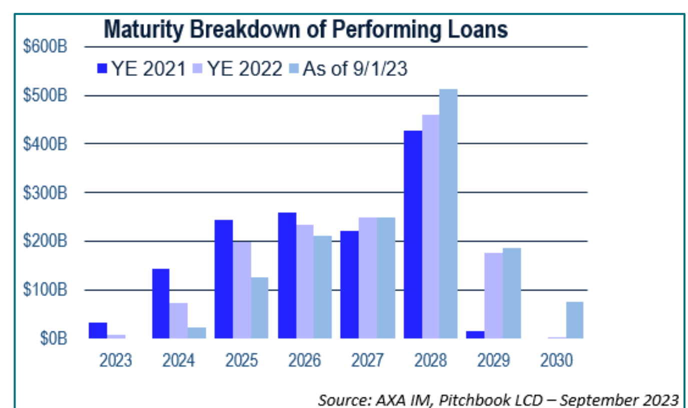
Leverage Loan Markets

In contrast to a relatively busy CLO Primary market, Leveraged Loan Issuance was slow over the summer period and only one transaction priced in August for less than EUR 500mm. Private credit disintermediating syndicate markets remains a point of discussion (and concern) for the asset class though. Finastra secured a EUR 4.8bn private package in August to refinance cross boarder loans, making the operation the largest take out of syndicated credit into private markets. The Loan pipeline is nonetheless slowly building, and some LBO and M&A financing activity is expected. Amend & Extend have been the favoured tool in securing financing over the past year and we expect this dynamic to persist.

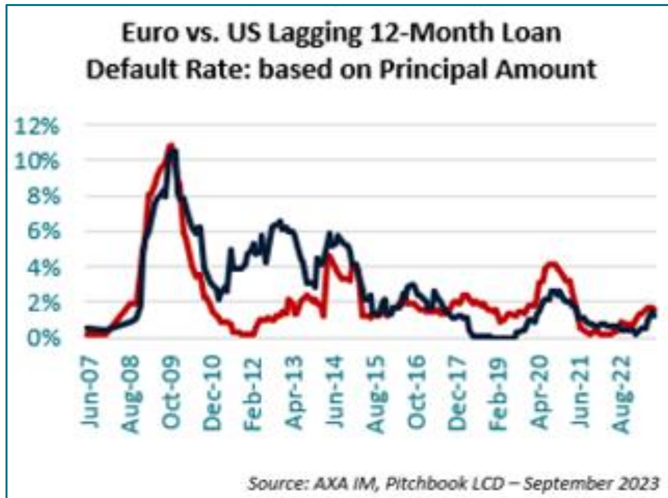
In terms of defaults, both the European and US Leverage Loan rolling 12-months default rates fell for the first time of the year, the European rate sits currently at 1.27% down from 1.5% in July while the US one sits at 1.55% down from 1.75% in July. Market's three largest exposures to defaulted names in Europe consisted of Genesis Care, Casino Guichard-Perrachon and Wittur. Those three names alone represented almost 2/3rd of the total 2023 defaulted exposure. The defaults predictions we established at the end of 2022 for 2023 (2-2.5% defaults in Europe, 3-3.5% in the US) were somehow bold and in contradiction with rating agencies forecasts. We were happily surprised to see Fitch cut its Euro Lev Loans default rates forecast for 2023 to 3.0% from 4.5%, yesterday.

Loan prices rallied through summer and currently trade at 96.60px in Europe and 95.70px in the US. Higher valuations enabled CLO managers to enact switch trades at a lower cost to cure asset pools from certain credits or simply take profits and realize par. Indeed, we noticed only minor deteriorations in the average CLO pools in August, for instance median Junior OC cushions were unchanged MoM for US 2020' 21' and 22' vintages while they were lower by just 0.1% in Europe. In the meantime, median CCC assets in CLO portfolio were down MoM in the US at 5.5% for August (from 5.9% in July) and unchanged at 3.7% in Europe.

Recovery rates continued to trend lower with US Loan Recoveries around 57% from 60% on the previous reading (Moody's) while average recovery rate for bankruptcy related defaults has declined meaningfully to c. 25% (BofA). To mitigate this, "60% of Bankruptcy filings this year have occurred in borrowers who are either filing for bankruptcy the 2nd (even 3rd time) or have gone through an out of court restructuring earlier" (BofA). Our view is that CLO managers will be in a position to mitigate par burn through thorough documentation negotiation, taking an active approach in workouts, their relationships with Private Equity sponsors as well as being busy on the asset trading side. With maturity walls successfully pushed further away, we still see long term average of 50-60% recovery the norm going forward.

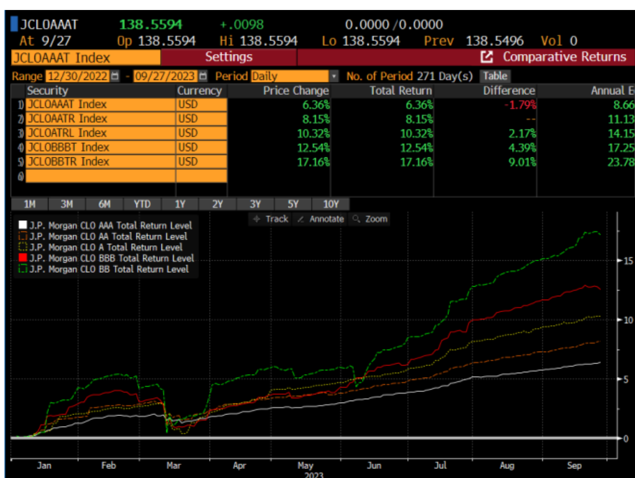


Source: AXA IM, Pitchbook LCD – September 2023

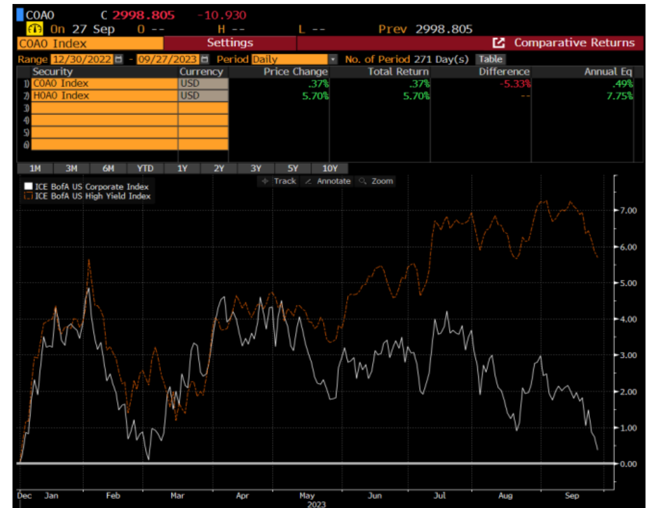


Performance and stategy

In terms of performance, the year remains very solid for all CLO tranches which have been benefiting from the strong carry offered by their floating benchmark:



Given attractive projected yields there is still plenty of juice left in the asset class, which by the way, is substantially outperforming traditional Credit:



CLO Equity NAV naturally benefitted from a lift in asset prices, and Equity payments continued to improve compared to last year. The reduced mismatch between 1m Libor and 3m Libor certainly helped, we also believe that the wave of Amend & Extend activity improved CLOs' WAS and consequently Equity distributions. According to MS research, Median NAV for US transactions moved from 10.6% as of Jan-2023 to 44% in Aug-2023, while Median European NAVs moved from -18.5% to 34.1% over the same period. Since we expect the default pattern to remain manageable despite higher rates and the A&E activity to continue, we remain constructive on future Equity cashflows generation.

Jitters in the broader markets and macro concerns will surely induce volatility in the coming weeks and months. Although we are confident of the ability of CLO structures to withstand episodes of volatility, we are also conscious that such an environment will offer great opportunities and entry points. In that sense we have actively taken profits over the summer rally and created pockets of liquidity whilst staying invested by moving slightly up in ratings or quality via switches from Secondary towards Primary. We estimate that c. 40% of the CLOs will be out of their reinvestment period by year end, as a result more structures are bound to deleverage which – in a low supply market – could be the spark for a move tighter in terms of spreads.

Best Regards,

Risk factors

The list of risk factors as shown below is not exhaustive. Each prospective investor should carefully read the portfolio's final prospectus or portfolio management agreement (as applicable) in its entirety, including any of its amendments or supplements.

Risk	Description
Liquidity Risk	▸ Low liquidity offered to investors during the life of the strategy.
CLO structure risk (leverage, maturity, subornation/rating migration)	▸ CLO are designed as leveraged exposure to a portfolio of loans. Depending on the rating of the CLO debt tranche, level of leverage varies and thinness of the tranche varies. Reaching a certain level of default and loss post recovery in the underlying portfolio could trigger a downward rating migration and even losses at tranche level. ▸ The subordination of any class of CLO securities will affect their right to payment in relation to the more senior securities. Interruptions in payments to subordinated classes may occur. Following acceleration of CLO securities, payments of interest proceeds and principal proceeds from the CLO issuer's assets will generally be applied on a strict seniority basis. ▸ The investment in CLO have an expected maturity that may be shorter or longer depending on market conditions and portfolio management. Market conditions may affect CLO tranche maturity and spread when for example there is a refinancing.
Underlying loan exposure risks	▸ CLO are exposed to performance of leveraged loans with inherent risks such as among other things default, recovery, prepayment, liquidity and interest rate risk.
Market Risk	▸ The investments contemplated herein may at any time be subject to significant price movements, which will impact negatively the valuation of the Portfolio and may lead to the loss in case of redemption.
Performance Risk	▸ The investment strategy's performance described herein may be lower than anticipated due notably but not limited to market drawdown, loss in underlying portfolio and forex impact.

Source: AXA IM

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