CLO Markets: Opportunities Amid Risks in 2019

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The fourth quarter of 2018 witnessed an uptick in credit market volatility, as investors grew increasingly risk-averse in the face of falling equity markets, ongoing U.S.–China trade tensions and geopolitical risks such as Brexit. Broader market weakness spilled over into CLO (collateralized loan obligation) markets during November, as CLO managers and arranging banks struggled with a rapidly shrinking investor base.

Then December, typically a quiet month given the holidays, proved instead to be a roller coaster ride: Indices for U.S. stocks, high yield bonds, bank loans and CLOs fell sharply. Bank loan mutual funds experienced the highest investor outflows ever, according to the J.P. Morgan High Yield Bond and Leveraged Loan Market Monitor. New CLO issuance slowed to a trickle, and bid-ask levels for low-rated CLO debt and equity widened sharply, reflecting a growing gap between market demand and supply.

In light of these dramatic developments, what is the outlook for CLOs in 2019? In our view, while a range of risks continue to confront CLO markets and investors, several pockets of opportunity have opened that may intrigue investors who can tolerate risk and volatility – including secondary market investments, CLO warehouses, short turnaround CLOs, bespoke securitizations and distressed corporates.

MACRO BACKDROP PRESENTS CHALLENGES

Although credit markets staged an impressive rally in early January, a slowing global economy could potentially exacerbate market volatility in the coming year, particularly for already fragile credit markets. For details, please read our latest Cyclical Outlook; here are the key uncertainties:

- **China–U.S. trade tensions:** The conflict between the U.S. and China is deep-rooted and extends beyond trade, potentially prolonging uncertainty even if a tentative trade deal is reached.
- **Brexit:** While we believe that a chaotic no-deal Brexit is a very low probability, the lingering uncertainty may increase market volatility.
- **European peripheral risk:** We expect economic uncertainty in Italy to create periodic spikes in market volatility; we are also monitoring the potential for longer-term risks to the eurozone more generally in the next recession.

- **The Fed:** Although a more dovish Federal Reserve is opting to pause rate rises for now, will this be followed by a resumption of rate hikes, or will the next move be down? The former outcome could have negative implications for corporate credit, while the latter could lead to negative investor sentiment toward floating-rate assets such as bank loans.

INVESTMENT IMPLICATIONS: TACTICAL OPPORTUNITIES IN CLOS

Despite these macro headwinds, we believe that in 2019 the CLO market will offer compelling opportunities for tactical investors with patience, a contrarian mindset and the fortitude to withstand market swings. Here are five potential approaches:

1. **Opportunistic secondary market investing in CLO debt and equity:** The coming year may bring opportunities to buy CLO debt and equity at steep discounts in the secondary market. In December, bank loans were under pressure due to outflows from retail bank loan funds, leading to volatility as these funds became forced sellers into an illiquid market. While CLOs generally outperformed relative to bank loans, they were not immune to the volatility. Bid-ask spreads widened up to 10% in sectors such as CLO equity, as expectations of buyers and sellers diverged. December's volatility demonstrates that liquidity remains fragile in these sectors, suggesting that 2019 could bring additional bouts of volatility. Record-breaking CLO issuance in recent years has greatly increased the size of the market, but secondary market liquidity does not appear to have expanded commensurately. **Bottom line:** *In the coming year, weakened secondary market liquidity could create opportunities for investors if market volatility causes CLO prices to overshoot to the downside.*

2. **Capitalizing on the backlog of CLO warehouses:** If bank loan prices fall again and lead to underwater CLO warehouses, CLO managers and arranging banks with exposure to these warehouses (see appendix below for details) will have a limited range of options. One option would be simply to wait out the current volatility, try to avoid defaults and hope for a quick reopening of the CLO new issuance window. Another option would be to push deals through the pipeline at any cost – either through deep discounts on CLO debt and equity, higher liability costs, and/or lower management fees. CLO managers may also push to issue "static" deals that have simplified structures and no reinvestment optionality, increasing their attractiveness to prospective debt investors. **Bottom line:** *While many managers and banks will likely opt for the "wait and see" approach, if volatility persists we may see near-term opportunities for tactical investors willing to offer liquidity to help them de-risk – for a price.*

3. **Investing in short turnaround CLOs:** During December, bank loan prices fell to levels which made the CLO equity arbitrage attractive in deals that did not have legacy underwater warehouses. If bank loan prices fall again, there could "print and sprint" CLOs that raise debt and equity without warehouse portfolios, hastily assembling discounted bank loan portfolios after the CLO debt and equity have been placed. This approach mitigates the risk of getting stuck with an underwater warehouse, but can be challenging given the reluctance of CLO debt investors to step into a falling market. Given how expensive liability costs have become, this also curtails much of the upside that comes from locking in term funding for a CLO. **Bottom line:** *CLO managers assembling CLO portfolios in a volatile loan market could have an easy time finding attractively priced assets, but liabilities may be a challenge.*

4. **Investing in bespoke securitizations:** If credit markets unravel again in 2019, this could open the door to off-the-run opportunities driven by motivated sellers and banks looking to securitization markets to offload risk. As an example, banks may be stuck with private equity bridge loans that are no longer appealing to debt investors, but which can be bundled into bespoke CLOs with third-party equity investors and banks holding the senior risk. In a sustained risk-off

market, banks may be strongly incentivized to bundle together “scratch and dent” debt securities and offer attractive term financing as they move to clean up balance sheets. Depending on the severity and the duration of the volatility, investors following this approach would need to carefully manage their own downside to avoid potentially joining a future wave of forced sellers. **Bottom line:** *Investors with a long-term investment horizon may be able to reap benefits from negotiating and assembling complex transactions that solve headaches for overextended market participants.*

5. **Investing in discounted/distressed corporates directly:** Ongoing dislocations in high yield credit markets could open up potential opportunities for contrarian investors if unlevered yields increase to high single digits for BB/B credits and low- to mid-teens for more distressed names (source: J.P. Morgan Leveraged Loans Index as of 4 January 2019), as they did in December. **Bottom line:** *Valuations in the broader credit markets could become more attractive, although investors should be prepared to be patient in the event that market volatility persists.*

Amid these opportunities, there are also risks to keep in mind. CLOs employ leverage, which increases the potential downside for investors – particularly in the lower rungs of the capital structure. Manager selection and careful structural analysis is key to reducing this risk. In addition, a “buy on the dip” approach has inherent risks since market downturns can sometimes go on far longer than expected. For this reason, prospective CLO investors should be prepared to follow a patient approach with a long-term investment horizon.

Regardless of the approach, flexibility will be key – opportunities could manifest themselves in the primary market (e.g., if arranging banks begin to panic and fire sale new CLO issuances), as well as in the secondary market (e.g., if hedge funds dump CLO assets in a scramble to meet redemptions). Tactical investors deploying flexible, stable pools of capital may well be poised to benefit.

APPENDIX: UNDERSTANDING CLO WAREHOUSES

Prior to launching a new CLO, banks extend credit to CLO managers so that they can accumulate “warehouse” portfolios of bank loans, effectively lending money with the expectation of being repaid when the CLO is ultimately issued. When the CLO is issued, this warehouse portfolio typically transfers into the CLO based on the original purchase price of the underlying bank loans.

In periods of steady or rising bank loan prices – as was the case for 2017 and much of 2018 – this is an easy proposition, since many CLO investors are happy to invest in a portfolio of bank loans that has appreciated in value (and may continue to do so). But falling bank loan prices present a problem by creating “underwater” warehouses with embedded losses, requiring CLO investors to effectively absorb the losses sustained during the warehouse period. Given that CLO warehouses are typically four to five times leveraged, these losses are magnified for CLO equity investors. They also imply less “cushion” before CLO debt investors begin to incur losses.

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