Takeaways from SFIG Vegas 2019

How CLO Markets Are Responding to Recent Volatility

Feb. 28, 2019

Morningstar Perspective

After forced selling from retail fund flows contributed to a drop in loan prices by approximately 5 percentage points in the fourth quarter of 2018, the leveraged loan market has seen a strong snapback rally of approximately 3 percentage points year to date, according to Gretchen Lam, a senior portfolio manager at Octagon Credit Investors. Lam believes there will be a "relatively modest" amount of leveraged loans originated over the next few months, after the market absorbed approximately $50 billion of loan issuance in January, as a result of the volatility and other technical factors. While year-to-date 2018 versus 2019 issuance volumes for the collateralized loan obligations market are relatively in line, CLO liability spreads have not recovered from the whiplash. In Tuesday's afternoon panel on the leveraged loan and CLO marketplace, Lam described the three ways portfolio managers handled December's volatility in the market. The first type of reaction was managers "hiding under their desk" for the first two weeks, trading a little bit during the third week, and then taking the next week off. The second type of managers were more prudent, according to Lam; they reduced risk by selling the lower rated assets in their portfolios. Lam believed the third type of managers were the smartest; they sold the riskier assets but also built par and made gains by buying higher rated assets that experienced outsized benefits of the rally experienced since January.

All of this activity has led to net loan spreads tightening from the fourth quarter, while CLO liability spreads have remained wider, putting pressure on the CLO market. A significant number of new managers have entered the market or plan to enter the market, said Scott Snell, a portfolio manager at Tetragon Financial Management. "Those managers typically bring their own equity, and they have support from their parent companies… They're somewhat willing to accept wider spreads [on their liabilities] as a cost to entering the business."

Market difficulties "always lead to some sort of innovation," said John Nagykery, a team lead for CLOs at Morningstar Credit Ratings, LLC. Nagykery described several bespoke structures that Morningstar has received inquiries on, including shorter reinvestment period CLOs, principal protected notes, collateralized fund obligations, and collateralized bond obligations (bonds and leveraged loans in the same transaction). Because the Volker Rule prohibits certain investors from purchasing certain securitizations with bonds in them, it shows that there is appetite from nonanchor CLO investors in collateralized bond obligations. Finally, Morningstar has seen CLOs that are looking to take advantage of a future market sell off in the leveraged loan market, if one were to occur.

Nagykery emphasized the importance of being hypervigilant of developing trends when monitoring CLOs, especially for ratings purposes. For this reason, Morningstar conducts sensitivity analyses for new issuance and during surveillance to determine how sensitive the ratings are to a downgrade and to what extent the ratings will drop. This analysis includes lowering recoveries and raising defaults. "Since we're using Intex," Nagykery said, "we can actually run our analytics on a monthly basis." The hope is to quickly respond to individual transactions and avoid massive downgrades all at once for specific sectors.

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