DECEMBER 2019

BOND iQ

Intra Quarter Update

Cracks Emerging in CLO Markets

In a world starved for yield, many investors have turned to Leveraged Loans as a way to supplement traditional Core Fixed Income portfolios. The combination of attractive yields, floating interest rates, and capital structure seniority has caused the size of the Levered Loan market to boom. In fact, according to the Bank for International Settlements ("BIS"), the market for Leveraged Loans just crossed the $1.2 trillion mark, surpassing the size of the traditional high yield market for the first time in history. The trouble is, this tidal wave of demand has put the ball squarely in the court of the issuers. According to S&P Global, a new record of 80% of outstanding leveraged loans are categorized as "covenant-lite", meaning investors are willing to accept little or no covenant protection for owning loans issued by low quality companies. Historically, this has been a dangerous combination. As the market for loans has boomed, so too has the securitization machine. In fact, the BIS estimates that nearly half of the leveraged loan market has been securitized into an investment known as a Collateralized Loan Obligation ("CLO"). Reminiscent of the CDO's created in the mortgage market heyday, CLO's buy Leveraged Loans and create separate tranches that offer varying degrees of cushion against losses. In theory, CLO investors are banking on the diversification benefits of CLO's to shield them from adverse outcomes. Recently, however, cracks have begun to emerge in low quality CLO's. In this month's BondiQ, we examine the weakness in the low-quality CLO market and what it might mean for bond investors going forward.

	Total Return (YTD)			Excess Return (YTD) *		
	CLO	*Bonds*	*Difference*	*CLO*	*Bonds*	*Difference*
AA	4.7%	9.6%	-4.9%	2.2%	2.0%	0.2%
A	5.4%	12.5%	-7.1%	2.8%	3.7%	-0.9%
BBB	3.7%	15.2%	-11.5%	1.2%	6.2%	-5.0%
BB	0.9%	13.5%	-12.6%	-1.6%	8.1%	-9.7%
B	0.5%	12.1%	-11.6%	-2.0%	7.3%	-9.3%

*Excess Return is defined as performance relative to a duration matched treasury
Performance is through 10/31/2019
Source: Citigroup

As the table above highlights, low quality CLO's have meaningfully underperformed similarly rated High Yield Bonds this year. In fact, BB rated High Yield bonds have outperformed duration matched treasuries by over 800 bps, while BB rated CLO's have underperformed duration matched treasuries by nearly 200 bps. What, then, is causing this stark contrast between High Yield and CLO performance? The most notable explanation is ratings deterioration. At the end of September, the downgrade/upgrade ratio in leveraged loans rose to 4.86x according to Citigroup – the highest in over a decade. This is particularly important for CLO managers and investors, as a vast majority of CLO's are contractually obligated to limit their exposure to CCC rated loans to just 7.5%. Further ratings deterioration would jeopardize CLO managers' ability to maintain these contractual ratings limits and could spark a wave of forced selling in the lowest quality Leveraged Loans.

As bond investors, we have always been firm believers that there is no substitute for high quality, investment grade bond portfolios during times of market stress. For investors who have used Leveraged Loans or CLO's as a way to enhance portfolio yields, we would urge you to take a second look at the ratings breakdown of your managers. What is your manager's current exposure to CCC rated Loans? What is your manager's exposure to B- rated bonds that may be susceptible to downgrades? While we certainly acknowledge that not all Leveraged Loan funds or CLO's are created equally, further ratings deterioration in the Leveraged Loan space could have material implications for market liquidity. A liquidity seizure in the Leveraged Loan space due to forced liquidations could in turn risk contagion in other areas of low-quality credit, including fixed rate High Yield Bonds. Despite the still tranquil economic environment, the dramatic underperformance of low-quality CLO's this year should serve as a stark reminder that the additional yield of popular "plus" sectors often come with additional risk.

Brandon Zureick, CFA, Portfolio Manager & Strategist
Dale Coates, CFA, Vice President & Portfolio Manager