Spring surge

US CLO rally riding into summer

The rally in the US CLO market is being reflected in new issuance, with investors witnessing some of the tightest spreads so far in 2016. Questions remain over the resilience of the sector, however.

A strong second half of April was followed by a more subdued start in May for new issue US CLOs, but a healthy pipeline began to bear fruit, with a flurry of issuance as the month progressed. This enabled the month to close out with the second highest monthly issuance total this year, at US$4.9bn.

A mid-month trio of deals worth over US$1.3bn underlined a shift towards spread tightening, particularly the York CLO-3 transaction, whose class A tranche priced at Libor plus 157bp. The senior notes of THL Credit Wind River CLO 2016-1 priced marginally wider at plus 165bp (see SCI's new issue database).

However, Deutsche Bank securitisation analysts suggest that the precedent was firmly set by Apollo Management International's deal at the beginning of the month, which priced at some of the tightest spreads across the US CLO capital stack to date this year. For example, ALM XIX's C tranche priced at a 300bp spread, the tightest single-A rated tranche since October 2015. Similarly, the deal's D tranche - rated Baa3 by Moody's - priced at 450bp, reportedly the tightest in this rating category since September of last year.

Last week's Octagon Investment Partners 27 print raised the benchmark even further at the top of the stack. The US$310m triple-A rated notes produced a 153bp coupon, while the B notes priced at a solid 225bp.

Mike Terwilliger, global portfolio manager and md at Resource America, says that a number of factors are continuing to play into this rally, including the broader supply and demand dynamic in the markets. "There's a lack of opportunity for yield in other global markets, so on a relative basis the US corporate market provides an attractive proposition right now," he explains. "I'd expect this yield-grab to continue, which should reel more investors into the market and further prop up demand."

The turning point for the market can be traced back to February after wider market volatility that spilt over from last year initially prompted spread widening in the early weeks of 2016 (SCI passim). However, a disappointing supply figure this year has since coincided with a growing appetite among investors.

"Eventually CLO investors believed prices dropped low enough that it made sense to buy, even if they were bearish on credit fundamentals," says Berkin Kologlu, senior portfolio manager at Angel Oak Capital Advisors. "This demand intensified, together with a broader rally across other markets, with spreads tightening up from improving macroeconomic conditions."

The April FOMC minutes signalled a shift to a more hawkish attitude from the US Fed and Fed Chair Janet Yellen last week expressed her support for another hike soon. But sentiment remains split, with the market currently projecting a 50% chance for a rate hike in June, according to JPMorgan CLO analysts.

In addition, the approaching start date of CLO risk retention is weighing on supply. The Loan Syndications & Trading Association recently estimated that 69% of US CLO managers that have issued deals in 2016 are compliant or have plans to deal with the upcoming retention requirements.

"It is making it more challenging to put deals together and certainly dampened supply," says Terwillinger. "It's difficult to predict a spread floor, but as long as supply continues to underwhelm, the potential is there for them to go lower."

However, Kologlu warns that the effect risk retention has on CLO spreads should not be overstated, with retention-compliant supply expected to pick up as the market moves into the summer. He states that the biggest impact from the rules will likely come through manager consolidation.

"The top issuers are already figuring out how to structure a deal to fit compliance measures," Kologlu explains. "If you compare two similar deals, one being compliant and the other non-compliant, there isn't much difference in the spreads at which they trade."

Nonetheless, recent trends spurred the JPMorgan analysts to lower the midpoint of their primary US CLO triple-A spread target for end-2016 by 10bp to 155bp. But Kologlu explains that despite the rally that started in March, spreads remain wide from both a relative and historical basis.

"In comparison to flow credit, for example, CLO spreads are still cheaper. One should expect structured credit to trade wider than flow credit as an asset class," he says. "However, this gap is at historically wide levels, given the huge rally in flow credit spreads including investment grade, high yield bonds and high yield loans. CLO spreads are still lagging behind when you compare them relatively."

He continues: "If economic conditions improve, it is possible that there could be a reduction of this gap between the spreads in the two markets."

Meanwhile, lower down the capital stack, mezzanine and subordinate spreads are still pricing in a wide range, leading to significant deal tiering. For example, triple-B spreads from the most sought-after issuers and cleanest deals are coming in at around 450bp, while weaker-branded issuers are pricing at around 600bp to 700bp. Some of the worst quality triple-B tranches are coming as wide as 900bp, adds Kologlu.

"It's reflective of the quality issue currently dominating investor demand," he says. "Investors have become very selective and are looking for cleaner portfolios. They've not forgotten that they were burned in the market just earlier this year."

Another issue also surrounds the fragility of the spread rally. The energy sector - in particular oil and gas credits - has proven to be unpredictable, while a slowing of the Chinese economy is adding to investor wariness. These concerns have left spreads vulnerable to a reversal if volatility re-emerges.

"Although [the energy sector] will have a more weighted impact on the high yield bond market than the loan market, it's still a big X-factor," Terwillinger concludes. "An up-tick in defaults could be a real issue, especially if it causes deterioration in the underlying fundamentals of the market."

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This article was published in Structured Credit Investor on 2 June 2016.