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The CLO market shouldn't fear inflation — in fact, 2022 could be a very good year indeed

Now that the Libor transition deadline has passed, what will be the next CLO conference hot topic? The global trillion-dollar CLO market has survived a taper tantrum, the Volcker rule, an energy crisis, an unusual one-month versus three-month Libor basis, the enactment and overturning of US risk retention, covid-19 and now a Libor-Sofr transition. This is all just the 2.0 era!

With record volumes last year and an estimated 200 warehouses open, the CLO machine seems poised for another robust issuance year. Inflation is certainly less than transitory, so the Fed will need to be firm in quelling fears of rampant price rises with a steady hiking cycle. But as long as the Fed doesn't have any significant policy missteps, we see this as an attractive environment for CLOs.

Technicals are in favour

Recalling the last rate hike cycle, between 2017 and 2019, CLO debt outperformed many fixed-rate securities due to its floating rate and very low credit expense. Many of the supporting technicals are similar to those we saw in 2018 — although possibly they are even better today.

Without risk retention funds and only a few captive funds issuing CLOs at uneconomic levels, the CLO equity arbitrage was balanced throughout 2021 and looks to be the same leading into 2022. That's because collateral managers and equity investors are not forcing CLO prints, which helps to avoid deterioration in loan credit quality. Many street research desks are forecasting default rates of 1% or less in 2022, which is well below long-term averages.

Loan retail inflows have picked up, with multiple rate hikes anticipated this year, but retail funds are still materially below the total size they were in 2018. While large retail inflows can lead to repricing activity, CLOs are still a majority of the loan market. CLO equity investors today are disciplined in only printing economic transactions, so there will be a need for commensurate CLO debt tightening, which will enable the CLO machine to take on loans at tighter spreads. The last rate hike cycle brought about the all-time tights for CLO debt spreads in the 2.0 market. In a rising rate environment, minimising rate duration is a chief objective of investors, and CLO debt provides floating rate exposure at a premium yield to corporates or other structured products.

CLO resets are in play

For CLO equity investors, the optionality remains attractive. Despite achieving record refinancing and reset volumes last year, approximately half of the CLO market is out of its non-call period and prepared to refinance or reset based on moves in spread and/or the basis between Libor and Sofr.

Admittedly, the spread savings will not be nearly as much as we saw in 2021 from refinancing 2020 vintage CLOs, but many of the CLOs out of their non-call period today have less than two years left in reinvestment. Resetting those CLOs and lengthening the reinvestment periods will unequivocally accrete value to the equity and set those CLOs up for the next bout of volatility. During 2020, we were not aware of any CLO collateral manager or CLO equity investors who wanted to have less reinvestment period left in their CLOs. While many are predicting a decline in resets this year, perhaps the decline will be less than anticipated.

Inflation and rising rates can be a scary environment for fixed income investors with duration. Thankfully, loans and CLOs are floating rate. They offer an appropriate hedge to inflation and rising rates. CLOs have outperformed in similar rising rate environments, so this is the CLO market's time to shine and prove once again that CLOs deserve to be a mainstream asset class.

We believe 2022 will be a very good year for CLO investors.

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