Thomas Majewski

Founder & managing partner

Eagle Point Credit Management

The drop in loan and CLO prices today is unlike any previous downturn — but again it will pay to be agile

Entering 2022, bank research desks were predicting a year of low, rates-based, volatility with a rather benign outlook for credit. Everyone seemed concerned about the Fed's ability to raise rates and manage increasing inflationary pressures without causing bumps. Otherwise, most expected covid rebounds to continue and markets to finally stabilise after the volatility of the past two years.

Then Russia invaded Ukraine and the western world accessed its full might in economic warfare.

We have watched the events in Ukraine unfold with much sadness and horror. And while we all wish for an expeditious resolution, it also leaves us, as investors, trying to ascertain the best way to address the effects of this regional conflict with its potential worldwide impact. But the CLO 2.0 market is ripe with comparisons, and it has had an eventful trend upward since the great financial crisis of 2008.

What is clear is that what we are experiencing is not like 2008, or March 2020's covid-19 lockdowns, despite a blip of loan decline by multiple points in mid-March. Despite some coronavirus upticks, the world seems significantly more prepared for variant resurgences without the broad-based lockdowns we observed in 2020, and the current warfare is not leading to talk of significant financial market contagion similar to 2008. Instead, the concerns seem idiosyncratic but accelerated due to the persistence of supply chain and commodity disruptions. The broad policy of "moving up in quality or rating" — which was often recommended during the past few years' stresses — is probably not on the table this time.

> Having tighter CLO debt costs will not be enough for brand names to outperform more agile competitors

A different kind of crisis — a similar strategy

As tenured investors, commodity disruption brings memories of the pronounced oil and gas concerns of 2015-16. During that period, credit stress emerged due to currency imbalances, oil overproduction and general economic slowdowns, which caused commodity prices to drop quickly. Of course, now the prices of certain commodities are rising precipitously.

Instead of being worried that producers and procurers won't be able to hit sales figures, CLO collateral managers are reviewing their credit exposures for persistent increases in input costs for commodity users — something that can lead to the failure of companies that aren't agile.

So, as different as today is from 2015-16, in many ways it is much the same. CLO collateral managers are re-underwriting their portfolios for a new, less cooperative world and are being pressed to make decisions that will lead to some outperforming and some hitting a wall — which is yet another reason underscoring the importance of CLO collateral selection. Tighter debt costs alone will not be enough for all the brand names to outperform agile competitors.

Secondary market stifles primary

One additional parallel from the mid-2010s is the secondary market triple A technical gumming up the CLO primary market. Recently, primary CLO triple As have seen undue widening despite increasing data on their unshakable nature. This seems solely due to sellers emerging in the secondary market in efforts to briefly rotate into other, more volatile areas of credit. In 2015, it was the unwind of some levered triple-A CLO trades with tight market-value triggers that caused similar sales. Those sales were due to price declines and credit concerns. Nowadays, this blip is related more to rate stress and portfolio positioning.

As investors, we can be informed about which managers have put the work into having broad debt distribution channels to issue in all markets. We can also remind ourselves of the bulletproof nature of CLO senior notes, and expect this technical will abate soon as rotations slow.

CLO investing requires constant re-evaluation of collateral and market opportunities. We don't believe today is like any other time, but previous cycles can inform the present. They can help us identify the best game plans to employ, and enable us to remain calm and act decisively.