

SFA Research Corner

Confidence in CLOs Boosted by 2020 Resiliency and 2021 Economic Recovery

May 3, 2021



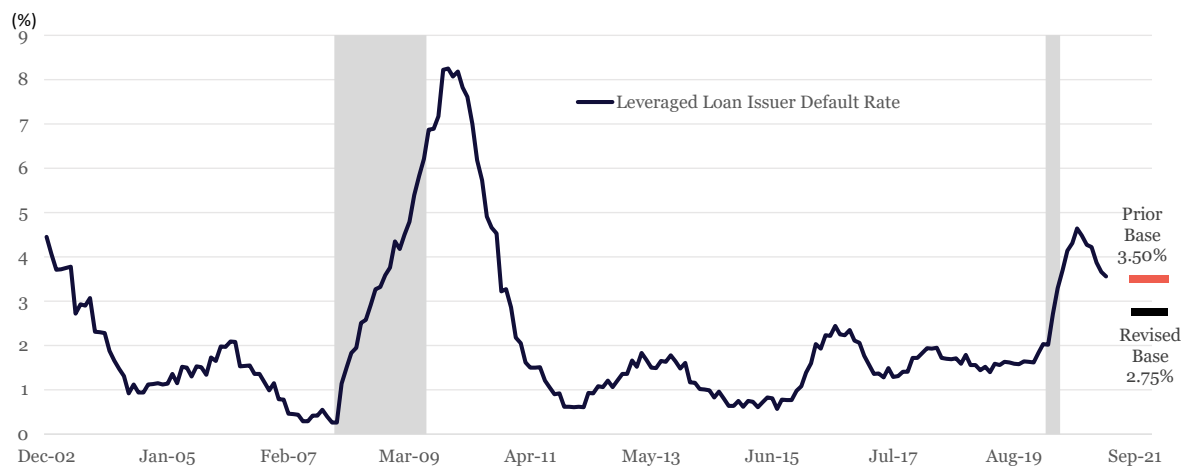
WHAT WE'RE WATCHING

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The nation's economic output increased for the third consecutive quarter, according to new data from the [Bureau of Economic Analysis](#). Real gross domestic product (GDP), which measures the value of U.S. goods and services, increased in the first quarter at a seasonally adjusted annual rate of 6.4%, following the 4.3% increase in the fourth quarter of 2020. The stronger first quarter activity and a pickup in vaccine distribution have resulted in more optimistic outlooks, according to the [Federal Reserve System's Beige Book](#) survey, which reports anecdotal information collected from bankers, market experts, economists, key business contacts and other sources.

Based on their improved outlook, [S&P Global Ratings](#) lowered its estimated year-end 2021 S&P/LSTA Leveraged Loan Index issuer default rate to 2.75% from 3.50%, which itself was a favorable revision from the rating agency's default forecast of 6.5% made in December 2020. The rating agency notes that "[t]he improved outlook comes as the pace of COVID-19 vaccinations in the U.S. has picked up and signs point to a faster and sustained reopening of the economy. [S&P] expect[s] fiscal stimulus passed since December 2020 to provide a tailwind for demand in the second quarter that continues into the second half of the year." A stronger and sustained economic recovery and lower default rates bode well for the credit performance of CLOs in 2021. We review the CLO sector below.

**S&P/LSTA Leveraged Loan Index Default Rate
Forecast Revised Lower to 2.75% by Year-End**

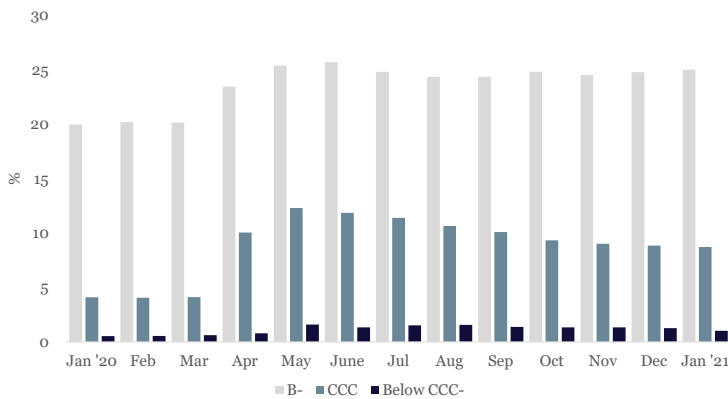


Source: LCD, an offering of S&P Global Market Intelligence, S&P Global Market Intelligence's CreditPro, S&P Global Ratings Research, Oxford Economics, Bureau of Labor Statistics, and Haver Analytics. Data as of March 31, 2021.

Corporate credit deteriorated rapidly at the onset of the pandemic. Drastically reduced corporate earnings and persistently sluggish economic activity - greatly exacerbated by uncertainty over the trajectory of the COVID-19 virus and what policy responses would be forthcoming - resulted in a wave of downgrades, particularly for issuers at the low end of the speculative grade range. According to S&P, in 2020, 25% of issuers rated 'B-' had their ratings lowered into the 'CCC' category. Whereas S&P expects issuers rated 'B-' to "[typically have the capacity to meet financial commitments](#)" and a sustainable capital structure, the rating agency considers an "eventual default" "highly likely" for CCC+ rated issuers and "increasingly likely" for issuers rated lower than 'CCC+'. In 2020, 47% of issuers with CCC/C credit ratings defaulted. As the economy recovers, vaccine distribution continues, and fiscal and monetary stimulus have made their way through the system, upgrades have become more common. By December 2020, the number of upgrades from the 'CCC' rating category surpassed downgrades.

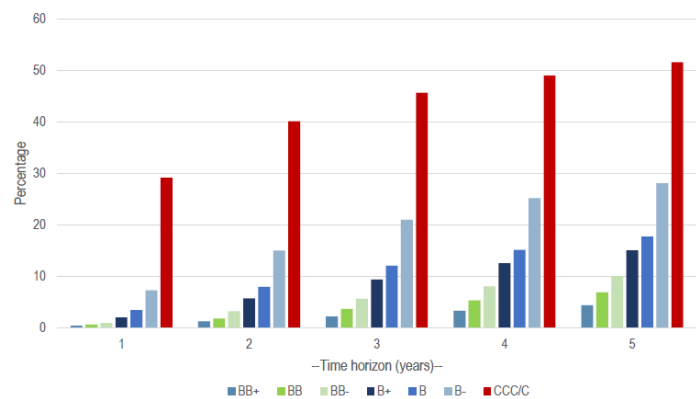
In addition to economic stimulus, highly diversified collateral pools, skilled, active management, and structural guardrails have mitigated the impact of corporate negative rating actions on CLOs. Nonetheless, the damage was evident. By May 2020, the share of loans in U.S. Broadly Syndicate Loans ("BSL") CLO collateral pools from companies rated 'CCC' by S&P had risen to 12.31%, three times the pre-pandemic level reported in January and well above the 7.5% 'CCC' ceiling dictated by most CLO structures. Exposure above this level may trigger a reassignment of cash flow from lower-rated tranche to senior tranches. By year-end the share of 'CCC' loans in CLOs had fallen to 8.73%, an improvement from the May high, but still more than double the pre-pandemic level. As the universe of 'CCC' loans shrinks, we expect the share of 'CCC' loans in CLOs to moderate.

CLO Collateral by Ratings - Share of Loans Rated Triple-C Has Moderated From Period High



Source: S&P Global Ratings

Average Cumulative Default Rates for Speculative-Grade U.S. Corporates (1981-2019) CCC/C Category Credits Default Much More Frequently



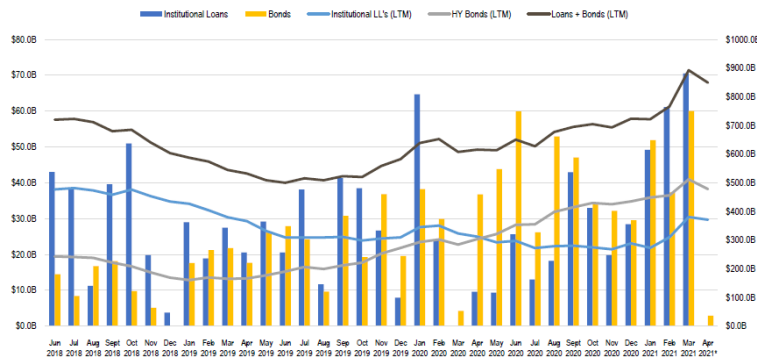
Sources: S&P Global Ratings Default, Transition, and Recovery: 2019 Annual U.S. Corporate Default Study and Rating Transitions, June 17, 2020, Table 14 and Table 28.

Lower default expectations and attractive financing have boosted activity in the leveraged loan market. U.S. leveraged loan sales are "off to the fastest start in at least eight years" according to Bloomberg, with \$173 billion sold year-to-date. Leveraged loan issuance is expected to crest \$400 billion in 2021, a new high for the sector.

The level of activity in the loan market drives new issue supply of CLOs. CLOs have historically held 50% to 70% of the outstanding leveraged loans made to more than 1,500 U.S. corporate borrowers, according to S&P.

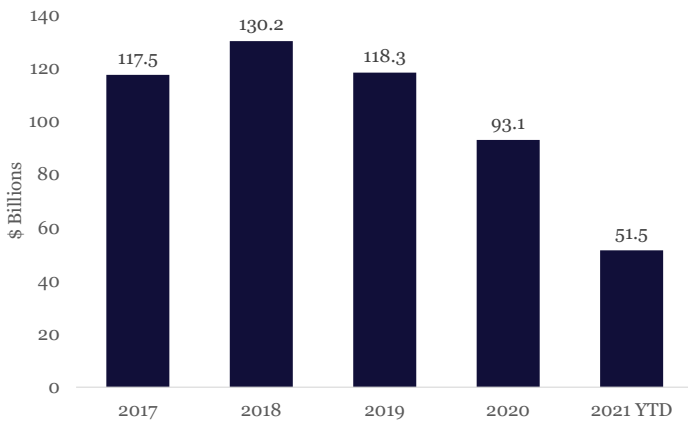
Through April 2021, CLO issuance year-to-date has reached \$51.5 billion, compared just \$21.4 billion during the same period in 2020. This represents more than half of 2020’s full-year volume of \$93.1 billion and is on track to pass 2019’s full-year level of \$118.3 billion. Despite having widened a bit in recent weeks, CLO new-issue spreads are currently near the tightest levels in the past two years. Triple-A CLOs backed by broadly syndicated loans are being issued at average spread levels near 115 bps, as triple-B tranches are pricing around 315 bp – down from their respective three-month averages of more than 190 bps and 460 bps in May of 2020, respectively.

**Leveraged Loan Issuance Rebounding
Monthly Leveraged Finance Issuance Volumes:
Jun 2018 through April 2021**



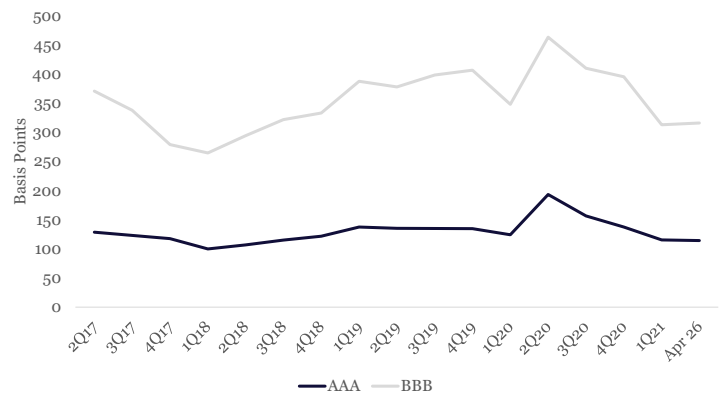
Source: LCD, an offering of S&P Global Market Intelligence

CLO Issuance 2021 YTD: \$51.5 BN



Source: LCD, an offering of S&P Global Market Intelligence

CLO New Issue Spreads Near Period Tights



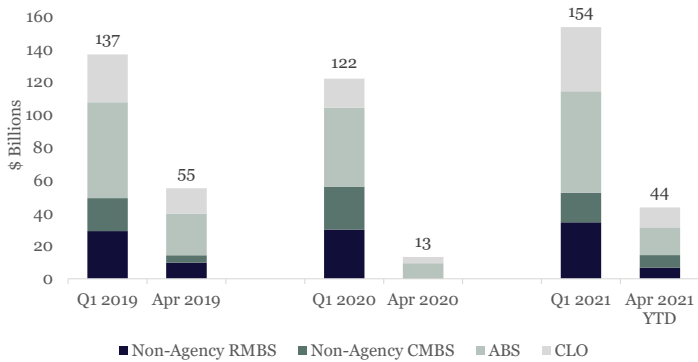
Source: LCD, an offering of S&P Global Market Intelligence

The strength of the investor demand for CLO notes scarcely more than a year out from the arrival of the COVID-19-driven downturn is impressive and owes to several factors, according to Steve Anderberg, Managing Director and CLO Sector Lead at S&P Global Ratings. “A global thirst for yield has brought new investors into the asset class; interest in floating rate assets has increased as investors perceive some risk of rising rates at some point; and, CLO tranches spreads offer attractive relative value against “comparable” assets such as investment-grade corporate bonds or CMBS senior notes.” “But above all,” Anderberg continues, “the theme we hear from investors in the asset class both new and old is that the resilience of CLOs through the 2020 downturn has bolstered confidence in the asset class. There are simply fewer CLO sceptics in Q1 2021 than there were a year ago.”

MARKET SUMMARY

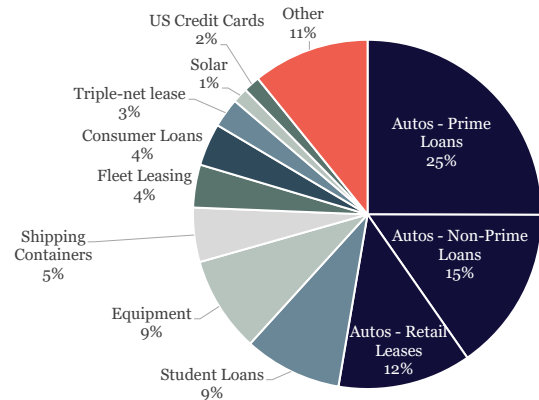
Issuance of Non-Agency RMBS, CMBS, ABS and CLOs in the first four months of the year has reached \$198 billion, 47% of 2020's full-year volume. Thus far, the ABS sector comprises 40% of the market, followed by CLOs with 26%. Year-to-date issuance of SOFR-based securitizations has reached \$22 billion. Freddie Mac has contributed 56%, or \$12.9 billion, to the 2021 total.

Issuance for Non-Agency RMBS and CMBS, ABS, and CLO 2021 YTD (\$190 Billion) Versus 2019, 2020



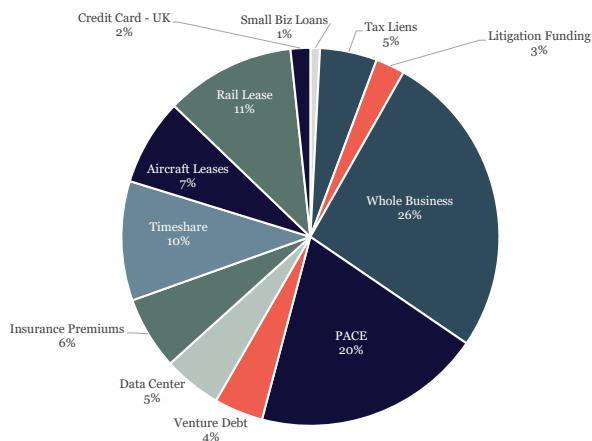
Source: Market Compilation

ABS Only - 2021 YTD: \$74.1 Billion



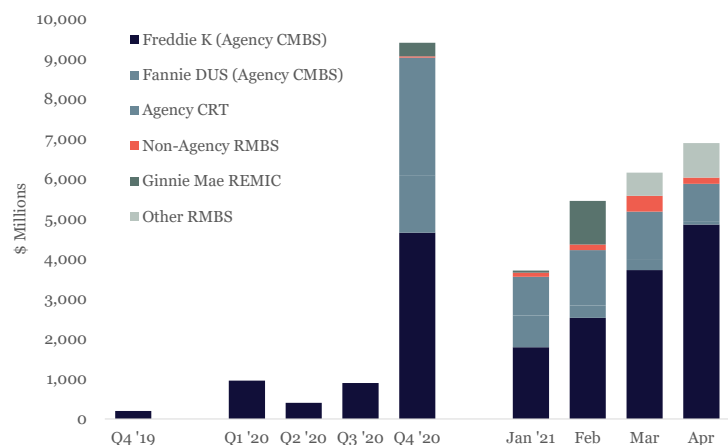
Source: Market Compilation

Other ABS Only - 2021 YTD: \$8 Billion



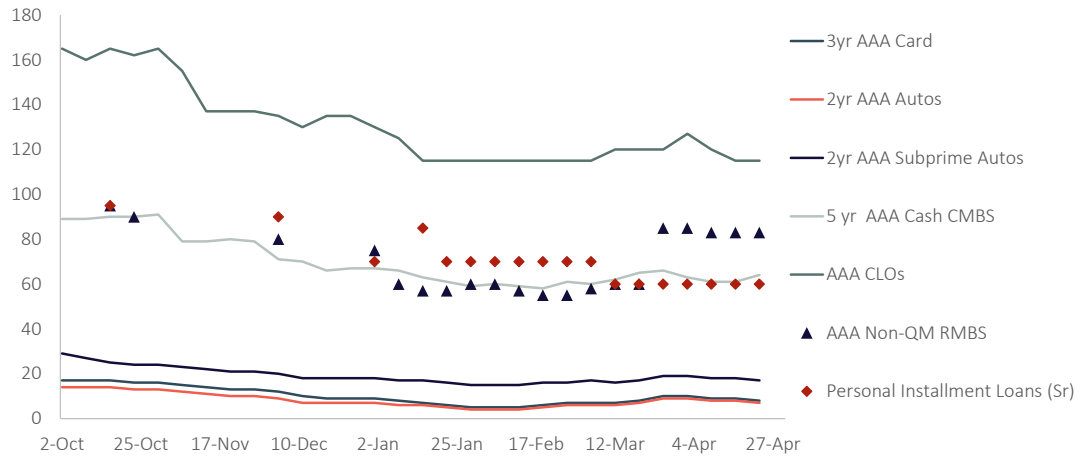
Source: Market Compilation

SOFR Securitizations - 2019 to 2021 YTD: \$34 Billion



Other MBS includes mortgage insurance-linked securities. Data begins Q3 2019. Source: Market Compilation

Secondary Market Bid-Ask Spreads (BP)



Source: Market Compilation

Secondary Market Bid-Ask Spreads		
(bps)	23-Apr	16-Apr
3yr AAA Card	8	9
2yr AAA Prime Autos	7	8
2yr AAA Subprime Autos	17	18
5yr AAA Cash CMBS	64	61
AAA CLOs	115	115