LSEG Yield Book

Mortgage Research Report

2024 CLO Outlook

December 2023

AUTHORS

Miles Li
miles.li@lseg.com

Luke Lu
luke.lu@lseg.com

Summary

We expect new issuance to remain strong in 2024 with an increase in loan supply and continued momentum of private credit CLO. We are forecasting an uptick of 5-10% in CLO issuance to $121-127bn under our baseline scenario vs. a drop of 10-20% to $92-104bn under the stress scenario.

Private credit CLO volume in 2024 is expected to grow to a range of $25-30bn.

With 45% of CLOs exiting RP by end of 2024, we estimate a total refinance/reset volume of $15-30bn depending on the future movement of new issue spreads.

Credit fundamentals are poised to weaken further into 2024 but at slower pace, and they may potentially bottom out by mid 2024 before rebounding in later 2024. Our baseline scenario projects a 10% CCC and 1.5% default rate in CLO portfolio, compared to 12% CCC and 2.5% default rate in stress scenario.

We expect to see increased manager consolidation and tiering. For 2024, we predict the Junior OC cushion to shrink to 2.1% - 3.3% (from 4.5% currently) amid rising downgrades and defaults, and the cash-on-cash yield for equity to decline to 9%-13% (vs. 15.8% in 2023).

CLO spreads may remain choppy at least through the 1st half 2024. We expect AAA spreads to tighten to 150-160bps over SOFR and BB spreads to stay steady at 750-850bps in baseline scenario, vs. a widening to 200-210bps and 1000-1200bps respectively in stress scenario.

Macro Scenarios

Looking forward into 2024, we think the major CLO themes are going to be tethered to the rate path and economic condition, where two scenarios are in focus:

1. baseline scenario which assumes inflation continues to cool down as Fed wraps up rate hikes and starts rate cuts later next year, with minimal or minor impact to the economy.
2. stress scenario which assumes inflation remains stubbornly high into 2024 and Fed ends up overtightening, causing a hard landing for the economy.

Issuance

It's fair to say that CLO vastly outperformed market expectation in 2023 despite a rocky year of Fed tightening and market volatility. YTD, the CLO new issuance totaled $109.45bn as of November, only 11% lower than that of the same period last year.

Major headwinds this year to CLO issuance include constrained loan supply, challenging arb, and pullback of US banks.

On the loan supply side, soaring borrowing cost, high volatility and sharp drop in M&A/LBOs resulted in a 22% decline in leveraged loan volume in 2023. 2024 will likely see a pick up of loan supply on the back of a more benign macro backdrop, providing more collaterals for CLO managers to choose from.

Loan spreads generally tightened in 2023 against elevated costs of funding for CLO debts, pressuring the arb throughout the year. However, we are seeing loan spreads to range bound or biased to widen amid increase of supply, improving the arb for new issuance.

Demand from US banks pulled back in the wake of regional bank failures and increased regulatory scrutiny. And we don't see things change significantly in 2024, though the Basel III endgame proposal to lower the risk weight floor can be a positive. Meanwhile, Japanese investors are likely to become more active next year on the back of a stronger yen prospect and lower FX hedging cost on BOJ rate hikes.

The private credit CLO issuance totaled $24.16bn YTD, accounting for a record high 22% market share. Rapid growth of Private Credit CLO issuance is another tailwind for CLO issuance volume next year and we expect this momentum to continue.

Overall, we forecast CLO issuance in 2024 to remain robust in our baseline scenario with a 5-10% uptick in volume from 2023's full year estimate of $115bn, for a total issuance of $121-127bn with Private credit CLOs accounting for around 20-25% of total market share (on par with 2023).

We see a major market downturn in our stress scenario, with a forecast of 10-20% decline of issuance volume to $92-104bn. The private credit CLOs may account for 25%-30% of the market, higher than this year given that borrowers will likely rely more on private lenders for financial support under distress.

Exhibit 1: 2024 CLO Issuance Forecast

Year	BSL Issuance ($bn)	Private Credit Issuance ($bn)	Refinance/Reset ($bn)
2021	156	20	235
2022	106	12	22
Est. 2023	87	25	18
Proj. 2024 (baseline)	94-98	27-30	25-30
Proj. 2024 (stress)	67-75	25-28	15-20

Source: Yield Book, LSEG LPC (November 2023)

Year to date, CLO refinance/reset volume totaled $16.92bn across 37 deals as a number of short-dated 2022 deals with wide spreads sought to reduce their funding cost. As more and more existing CLOs exit reinvestment period (RP) and start amortizing, we think CLO managers might be motivated to keep up AUM level by pursuing refinance/reset. 34% of outstanding CLOs are currently out of RP and there is another 11% by the end of 2024.

Out of these deals, 49 deals with a total volume of $22bn are currently in the money for a refinance/reset, by comparing the deal's Weighted Average Cost of Capital (WACC) with the recent new issuance WACC level of 2.19% in November. We estimate a total refinance/reset volume of $15-30bn depending on the future movement of new issue spreads.

Exhibit 2: CLOs Exiting Reinvestment Period

	Count	Par ($bn)	Par %
Total Outstanding US CLO	1830	913	100%
Exiting RP by end of 2023	652	306	34%
To exit RP in 2024	203	97	11%
Refi/Reset Candidate	**49**	**22**	**2.4%**

Source: LSEG LPC, Trepp, Yield Book (November 2023)

Credit Review

On the fundamental front, both CCC% and default rate increased significantly in 2023 but have showed signs of stabilization in recent months.

Rising interest rates are pressuring issuers with loans of near-term maturities as refinancing become more challenging for companies with weak cash flows and profit margin amid a slowdown of economy. We also saw companies from some industries such as healthcare, entertainment, and telecom suffering from waning consumer demand and soaring operating cost.

The default rate for CLO collateral started the year at 57 bps, ramping up to 1.04% in June (a new high in two years) before sliding down to 84 bps in October with signs of stabilization. To put it in the context of overall loan market, TTM institutional loan default rate started the year at 1.7% and rose to a 12-month high in July at 3.0% and stabilized at 2.9% in October (according to LSEG LPC).

Meanwhile, CCC% has gone up to 7.87% in September (before dropping slightly to 7.84% in October), from a low of 5.80% in March, amid asset downgrade waves throughout the year.

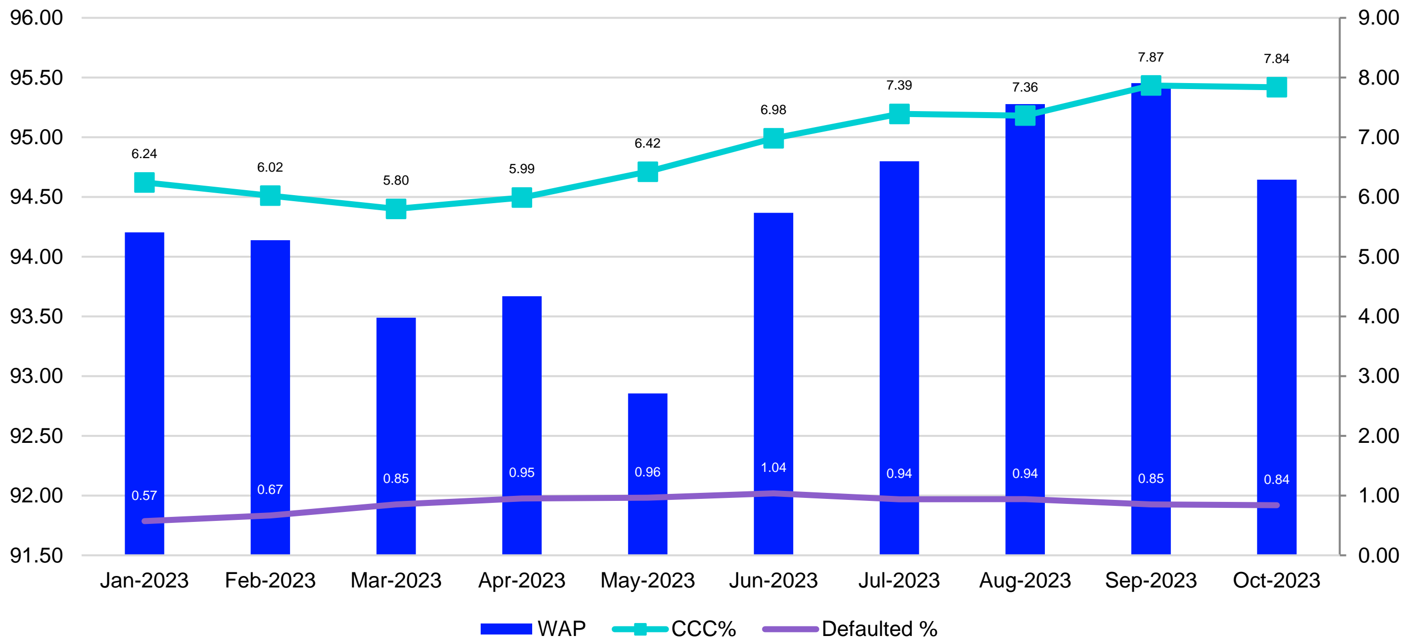
On the other hand, CLO loan price rallied in the 2nd half of 2023, to 94.65 in October, more than 2 pts higher than the end of 2022, reflecting favorable technical condition in the loan market as well as resilient financials of issuers in face of economic uncertainty.

However, we think the credit fundamentals are poised to deteriorate further into the 2024. As Fed keeps the rate hike option on the table, financing condition will remain tight and volatile. Persistent high interest rate and slower economic growth can burn cash reserve for many issuers, especially those with high leverage and lower rating, and cripple their capability to serve or refinance existing debts. In addition, as many CLOs are exiting reinvestment period, the trading restrictions for amortizing deals will limit CLO's ability of trading out CCC or default assets, contributing to elevated CCC and default exposure.

Nevertheless, we look for the pace of credit deteriorating to continue slowing down, and potentially bottom out by mid-2024 before rebounding in later 2024 as macro backdrop improves.

In the baseline scenario, we forecast the CLO CCC% to peak at 10% in 2024, and the CLO default rate to rise to 1.5% (roughly 1/3 of the peak TTM loan default rate of 4.5% in 2020), while we see CCC% reach 12% and the CLO default rate climb to 2.5% in the stress scenario.

Exhibit 3: Weighted Average Price, CCC %, Defaulted % of CLO collateral in 2023



Source: LSEG LPC, Trepp, Yield Book (November 2023)

Manager Performance

In the primary market, manager tiering exacerbated in 2023 due to challenging market conditions, with an average AAA spreads dispersion of 50bps between top managers and new entrants/smaller managers. We tracked 40 CLO managers with new issuance in 2021-2022 have not yet issued a deal in 2023. The majority of these managers are trailing behind the market average on AUM, Junior OC cushion and Equity NAV.

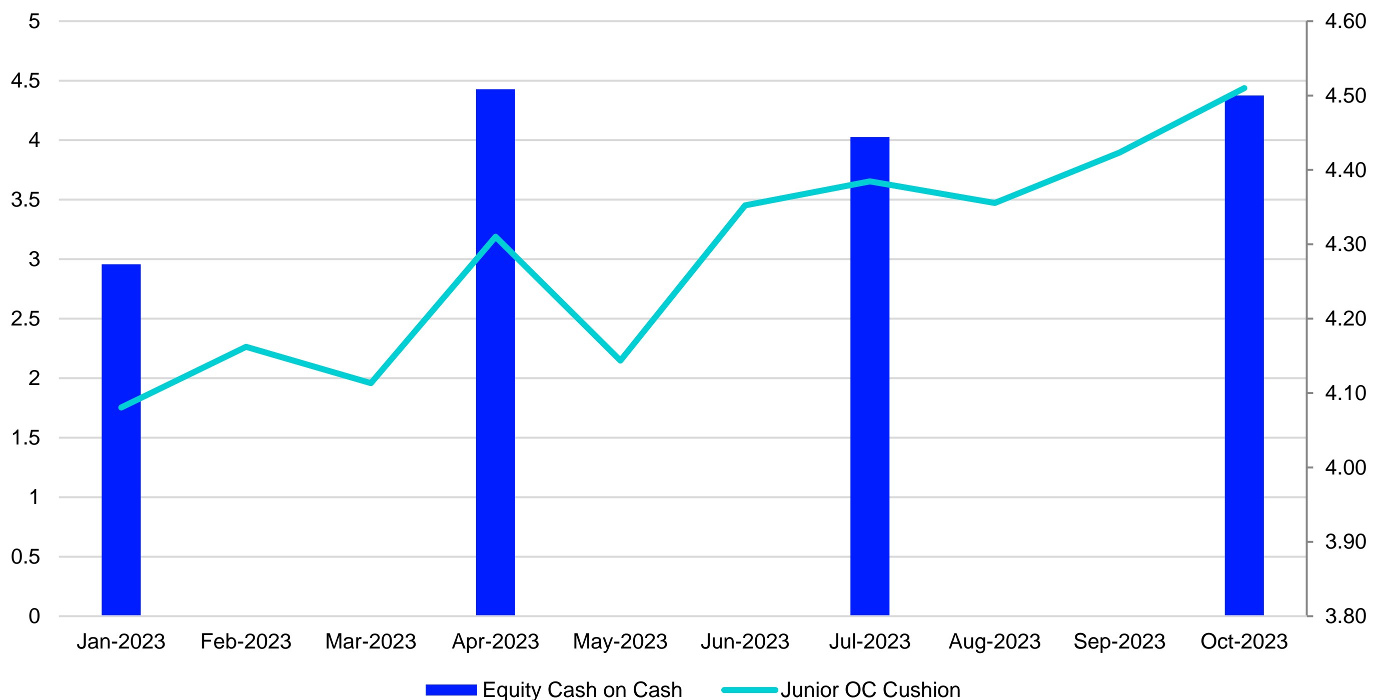
In 2023, CLO managers have focused on maintaining a healthy collateral portfolio through active management and discretionary trading. They also ramped up the bond bucket at discount price to rotate out of CCC loans and to improve asset credit profile. Their performance has resulted in better debt structural protection, especially for deals within RP, as the average Junior OC cushion improved from 4.1% in January to 4.5% in October. Only 5.2% of deals in RP failed the Junior OC test in October (vs. 18.6% for deals out of RP).

Separately, equity performance remained robust as the cash-on-cash yields add up to 15.8% for the full year 2023, just a tad lower than the 17.2% last year.

On the other hand, managers have struggled with par build amid high market volatility and limited liquidity. The cumulative par build YTD averaged at -0.3% at the end of October. The par burn is also a result of rising asset defaults coupled with plunging loss recovery, which has declined to below 40% (vs. a historical average of 60%).

We expect to see increased manager consolidation and tiering in manager performance in 2024. Smaller managers may continue to struggle to print new deals. As a large portion of deals exit RP, managers with less capital will be facing more difficulty in deal resets and maintaining AUM.

Exhibit 4: CLO Junior OC Cushion and Equity Cash on Cash in 2023



Source: LSEG LPC, Trepp, LSEG Yield Book (November 2023)

In our baseline scenario with a CCC% of 10% and a default rate of 1.5%, the excess 2.5% CCC assets (on top of the 7.5% haircut threshold) will result in a par burn of 0.75% (assuming the CCC asset average market price of 70). After adding the erosion from the default rate increase of 0.66% (over current 0.84%) with 33% loss recovery reflected by default loan market price, the Junior OC cushion would likely drop to 3.3% from the current level of 4.5%. In the meantime, the equity cash-on-cash yield, according to our latest projected profit margin, will likely stay around 4% in 1Q24, while distribution of later quarters might be softened by the rising default/downgrade and decline to 2.5-3% area. Overall, the full-year 2024 equity distribution is expected to be around 12-13%, moderately lower than this year.

Under our stress scenario with 12% CCC and 2.5% default rate, the Junior OC cushion could drop to 2.1% from current 4.5%. We expect more deals to fail junior OC test with equity cash distribution diverted to senior tranche paydown. The quarterly equity payment might weaken to 2% in certain periods but still sum up to 9%-10% for the full year.

Exhibit 5: 2024 CLO Junior OC Cushion and Equity Cash-on-Cash Forecast

Scenario	Junior OC Cushion	Equity Cash on Cash
Current Level	4.5%	15.34%
Baseline Scenario	3.3%	12 - 13%
Stress Scenario	2.1%	9 - 10%

Source: Trepp, LSEG Yield Book (November 2023)

Spreads Outlook

While CLO spreads have tightened for the year, they were choppy over the course, driven by inflation/jobs data and macro conditions. And we expect them to be subject to persistent market volatility at least through the 1st half 2024.

Across the capital stack, AAAs continue to look cheap relative to IG and AAAs of alternative securitized products, and the increase of Japanese bank demand may help tighten the spreads. BBs offer attractive total return at current level, specifically for deals with sufficient structural protection and muted asset downgrades and defaults. The potential rate cuts and rebound of credit fundamental in later 2024 may trigger spreads compression for BBs, as clear signs of a soft landing of the economy emerge.

On the flip side, we would caution about a potential negativity for the spreads, which is floating rate products may lose some appeal in a falling rate environment, tampering CLO demand to some degree, though we don't consider it to become a major headwind.

For the BSL AAA spreads, we expect them to tighten to 150-160bps over SOFR by the end of 2024, as a result of declining market volatility and robust investor demand in baseline scenario. The BB spreads will likely stay steady in the 750-850bps context as investors remain wary of the tail risk. Under our stress scenario, we would look for AAA spreads to widen to 200-210bps over SOFR, and BB spreads to blow out to 1000-1200bps area amid severe market distress.

Exhibit 6: 2024 BSL CLO Spreads Forecast

Year	BSL AAA spread (bps)	BSL BB spread (bps)
2021	112	662
2022	241	829
2023 (as of November)	178	794
Proj. 2024 (baseline)	150-160	750-850
Proj. 2024 (stress)	200-210	1000-1200

Source: LSEG Yield Book (November 2023)

About LSEG Yield Book

Yield Book is a trusted and authoritative source for fixed income analytics that enables market makers and institutional investors to perform complex analysis of their portfolios, benchmarks, trading decisions, historical performance, and risk. Yield Book products offer analytical insight into an extensive range of financial products in the fixed income space including governments, agencies, corporates, high yield, emerging markets, mortgages, ABS, CMBS, CMOs, CLOs, and derivatives. The platform utilizes dedicated centralized servers that help ensure reliable, prompt data delivery. Yield Book forms part of London Stock Exchange Group (LSEG)'s Data and Analytics division.

To learn more, contact us at sales@yieldbook.com or visit our website: yieldbook.com

Americas
+1 646 989 2200

EMEA
+44 20 7334 8963

Asia-Pacific
Tokyo +81 3 6441 1015
APAC +886 2 8729 5130

© 2023 London Stock Exchange Group plc and its applicable group undertakings (the "LSE Group"). All rights reserved.

"The Yield Book®" is a trademark and/or service mark owned or licensed by The Yield Book Inc., and all other trademarks and service marks used herein (whether registered or unregistered) are trademarks and/or service marks owned or licensed by the applicable member of the LSE Group or their respective licensors. Microsoft and Excel are trademarks of the Microsoft group of companies.

All information is provided for information purposes only. All information and data contained in this publication is obtained by the LSE Group, from sources believed by it to be accurate and reliable. Because of the possibility of human and mechanical error as well as other factors, however, such information and data is provided "as is" without warranty of any kind. No member of the LSE Group nor their respective directors, officers, employees, partners or licensors make any claim, prediction, warranty or representation whatsoever, expressly or impliedly, either as to the accuracy, timeliness, completeness, merchantability of any information or of results to be obtained from the use of the Yield Book products, including but not limited to data and analytics or the fitness or suitability of the Yield Book products for any particular purpose to which they might be put. Any representation of historical data accessible through Yield Book products is provided for information purposes only and is not a reliable indicator of future performance.

No responsibility or liability can be accepted by any member of the LSE Group nor their respective directors, officers, employees, partners or licensors for (a) any loss or damage in whole or in part caused by, resulting from, or relating to any error (negligent or otherwise) or other circumstance involved in procuring, collecting, compiling, interpreting, analysing, editing, transcribing, transmitting, communicating or delivering any such information or data or from use of this document or links to this document or (b) any direct, indirect, special, consequential or incidental damages whatsoever, even if any member of the LSE Group is advised in advance of the possibility of such damages, resulting from the use of, or inability to use, such information.

No member of the LSE Group nor their respective directors, officers, employees, partners or licensors provide investment advice and nothing contained herein or accessible through Yield Book products, including statistical data and industry reports, should be taken as constituting financial or investment advice or a financial promotion. Past performance is no guarantee of future results. Charts and graphs are provided for illustrative purposes only.

This document may contain forward-looking assessments. These are based upon a number of assumptions concerning future conditions that ultimately may prove to be inaccurate. Such forward-looking assessments are subject to risks and uncertainties and may be affected by various factors that may cause actual results to differ materially. No member of the LSE Group nor their licensors assume any duty to and do not undertake to update forward-looking assessments.

No part of this information may be reproduced, stored in a retrieval system or transmitted in any form or by any means, electronic, mechanical, photocopying, recording or otherwise, without prior written permission of the applicable member of the LSE Group. Use and distribution of the LSE Group data requires a licence from Yield Book and/or their respective licensors.

TO THE EXTENT THAT ANY INDICATIVE PRICING INFORMATION IS PROVIDED HEREUNDER (THE "VALUATION") AS PART OF THE DATA AND/OR MODELS, SUCH VALUATION IS BEING PROVIDED AT CUSTOMER'S REQUEST FOR CUSTOMER'S INFORMATION PURPOSES ONLY AND IS NOT INTENDED AS AN OFFER OR SOLICITATION FOR PURCHASE OR SALE OF A SECURITY OR A CONTRACTUAL OBLIGATION (COLLECTIVELY, THE "FINANCIAL INSTRUMENTS"), INCLUDING THE FINANCIAL INSTRUMENTS SPECIFIED HEREIN. ANY VALUATION IS ONLY AN ESTIMATE AS OF THE DATE PROVIDED AND THE ACTUAL MARKET PRICE OF THE FINANCIAL INSTRUMENTS CAN BE DETERMINED ONLY WHEN AND IF EXECUTED IN THE MARKET; CONSEQUENTLY, ANY VALUATION MAY NOT REFLECT LEVELS AT WHICH:(A) ACTUAL TRANSACTIONS MAY OCCUR OR HAVE OCCURRED OR (B) COLLATERAL CALLS MAY BE MADE. THERE MAY BE NO OR MAY NOT HAVE BEEN ANY SECONDARY TRADING MARKET FOR ANY SUCH FINANCIAL INSTRUMENTS. ANY VALUATION MAY INCORPORATE INFORMATION FROM THE MOST ACTIVE MARKETS TO WHICH A SOURCE HAS ACCESS AND, CONSEQUENTLY, MAY NOT REPRESENT AN ESTIMATE OF THE VALUE OF THE PARTICULAR FINANCIAL INSTRUMENT IN THE MOST ACTIVE MARKET TO WHICH OTHERS MAY HAVE ACCESS.

Any Valuation is only an estimate of LSE Group or third-party data providers as to the general value of the specified Financial Instruments, as of the dates indicated, and are subject to change at any time without notice. Each Valuation is only one view as to the estimated general value of a particular Financial Instrument at a particular point in time.

Any Valuation may take into account a number of factors including, but not limited to, any one or more of the following: (a) general interest rate and market conditions; (b) macroeconomic and/or deal-specific credit fundamentals; (c) valuations of other financial instruments which may be comparable in terms of rating, structure, maturity and/or covenant protection; (d) investor opinions about the respective deal parties; (e) size of the transaction; (f) cash flow projections, which in turn are based on assumptions about certain parameters that include, but are not limited to, default, recovery, prepayment and reinvestment rates; (g) administrator reports, asset manager estimates, broker quotations and/or trustee reports, and (h) comparable trades, where observable. LSE Group's view of these factors and assumptions may differ from other parties, and part of the valuation process may include the use of proprietary models. Any Valuation is based upon information derived from sources believed to be reliable; however, LSE Group have not independently verified such information. In addition, reports may be available only periodically and with a delay and accordingly, where any Valuation relies upon the most recently available information in such reports for a transaction, any Valuation may be based on information that may not be current as of the valuation date.

LSE Group is not acting as your advisor, agent or fiduciary in providing any Valuation to you. To the extent permitted by law, LSE Group expressly disclaim any responsibility for or liability (including, without limitation liability for any direct, punitive, incidental or consequential loss or damage, any act of negligence or breach of any warranty) relating to: (a) the accuracy of any models, market data input into such models or estimates used in deriving any Valuation, (b) any errors or omissions in computing or disseminating any Valuation, (c) any changes in market factors or conditions or any circumstances beyond LSE Group's control, and (d) any uses to which such Valuation is put. You are responsible for your own independent verification and should consult with your own auditors and other advisors with respect to any Valuation and before deciding the uses to which any Valuation may be put. Specifically, LSE Group does not assert that any Valuation is appropriate for the purposes of valuing particular Financial Instruments in your financial statements in accordance with the requirements of your local accounting framework (for example FASB Statement No. 157 "Fair Value Measurements" under US GAAP or International Accounting Standard No. 39 "Financial Instruments: Recognition and Measurement").LSE Group and any third-party data provider may make a market in or engage in transactions in the Financial Instruments referred to herein. Any Valuation may be affected by those parties' own transactions and own quotations.