RBC Global Asset Management

In focus: US Primary CLO AAA securities

January, 2023

In this piece, we draw attention to the attractiveness of CLO AAA securities, and in particular, US CLO AAA bonds issued in the primary market (floating rate, SOFR +mid 200s spread, all-in yield of ~6.5%).

We believe this is one of the most attractively priced securities (on a risk-adjusted basis) available in IG credit markets today. US Primary CLO AAA securities are structured with ~36%-40% credit enhancement, meaning that nearly 75%-80% of the collateral pool would have to default (assuming a 50% average recovery rate on defaulted assets) for a AAA bond to take a principal impairment. In fact, collateral defaults would need to be even higher as there are other structural protections, such as excess cash trap, that provide additional credit enhancement. Consequently, investors benefit from a very significant cushion against a rise in defaults (no CLO AAA security has ever taken any impairment).

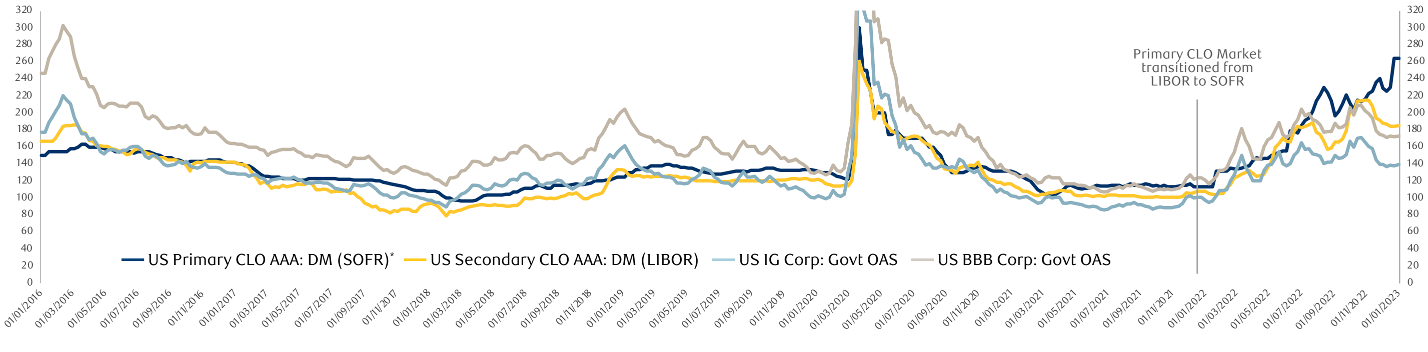
> “The attractive opportunity in Primary CLO AAA exists largely due to a mismatch in supply vs. demand.”

Technical pressures provide opportunities

We have recently seen a divergence between US Primary CLO AAA spreads (which widened into year-end) and other comparable spreads (which saw considerable tightening in Q4 2022). Figure 1 depicts the appeal of CLO Primary AAA, which in the mid-200s is not just wide to US Secondary CLO AAA (h100s) but is also wide to US IG-rated corporate bonds ('US IG Corp') at ~140. Further, US Primary CLO AAA is even attractively priced vs. US BBB-rated Corporate Bonds ('US BBB Corp') in the 170s. Given the credit remoteness of CLO AAA bonds, the recent widening is in our view the result of technical pressures, as some large buyers have been forced to be absent from the market and thus supply has not been absorbed with demand in the way it has been in the past.

Versus US IG Corp, an investor in a Primary CLO AAA can currently receive: i) higher rating (AAA vs. A3 composite rating); ii) higher spread (m200s vs. ~140); and iii) lower spread duration (5-year to maturity vs. 7-year to maturity)—and still maintain excellent liquidity, as CLO AAAs are part of the USD 1 Trillion Global CLO Market.

Figure 1: Spreads: US CLO AAA vs. US Corp

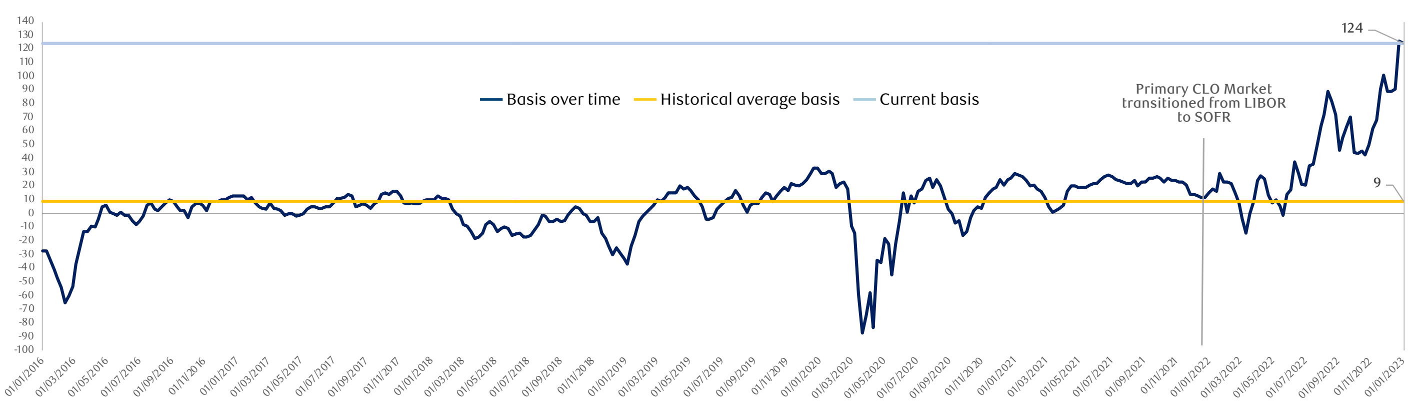


*Represents the spread over LIBOR before 1 January 2022 and the spread over SOFR after 1 January 2022 (the date on which the US CLO Primary Market transitioned from LIBOR to SOFR). Source: Bloomberg, BofA US Corporate Index, Palmer Square CLO Index, Barclays CLO Research.

Current spread basis is historically wide

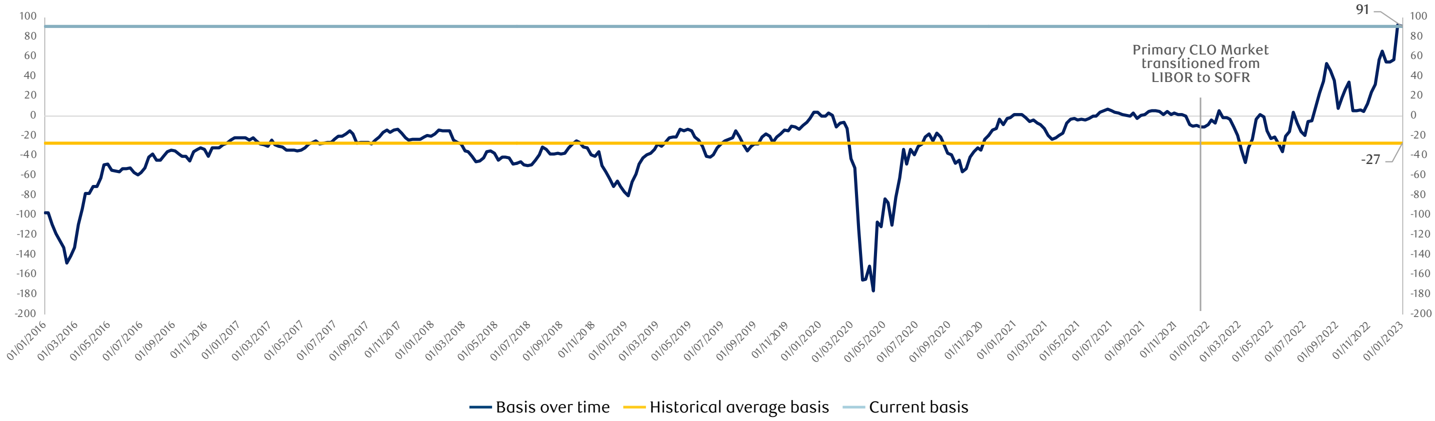
We can dig deeper to observe that the current spread basis between US Primary CLO AAA and US IG Corp is historically wide, at 115 bps higher than the historical average basis (Figure 2). The current spread basis between US Primary CLO AAA and US BBB Corp is similar (118 bps) but perhaps even more impressive given that historically this basis has been negative (as recently as Q2 2022) and is now 91 bps wider in favour of Primary CLO AAA (Figure 3). Note that the Primary CLO market transitioned from LIBOR to SOFR at the start of 2022, but the basis actually decreased for some period of time at the beginning of 2022. The basis widening has picked up in recent months as a result of technical pressure and supply and demand imbalance.

Figure 2: Spread Basis: US Primary CLO AAA (DM SOFR)* – US IG Corp (Govt OAS)



*Represents the spread over LIBOR before 1 January 2022 and the spread over SOFR after 1 January 2022 (the date on which the US CLO Primary Market transitioned from LIBOR to SOFR). Source: Bloomberg, BofA US Corporate Index, Barclays CLO Research.

Figure 3: Spread Basis: US Primary CLO AAA (DM SOFR)* – US BBB Corp (Govt OAS)

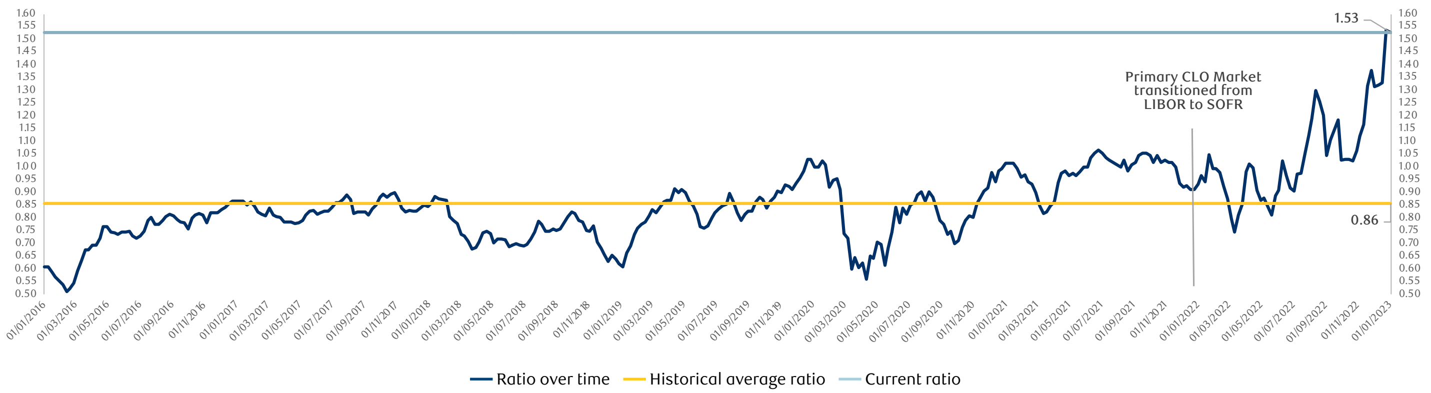


* Represents the spread over LIBOR before 1 January 2022 and the spread over SOFR after 1 January 2022 (the date on which the US CLO Primary Market transitioned from LIBOR to SOFR). Source: Bloomberg, BofA US Corporate Index, Barclays CLO Research.

Spread ratio has increased

Sticking with US BBB Corp, one final metric we can observe is the ratio between US Primary CLO AAA and US BBB Corp spreads. Whereas the historical spread ratio has been under 1.0, US CLO Primary AAA now provides more than 1.5x spread vs. US BBB Corp (Figure 4).

Figure 4: Spread Ratio: US Primary CLO AAA (DM SOFR)* / US BBB Corp (Govt OAS)

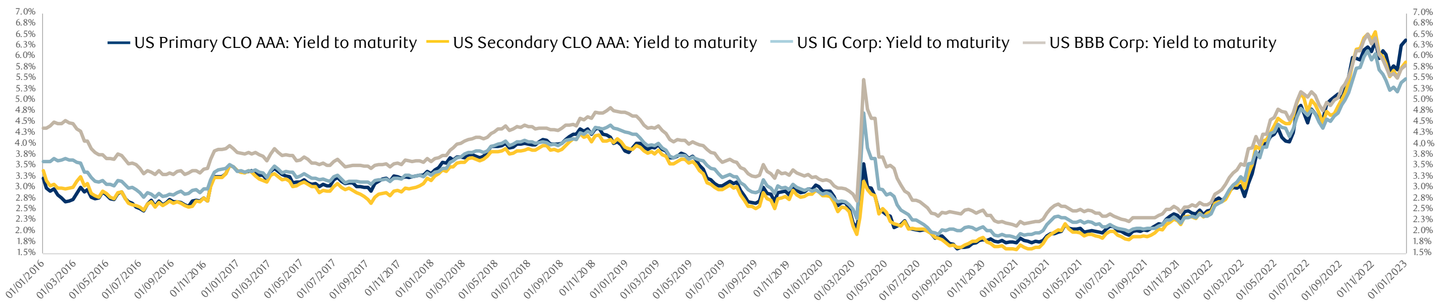


* Represents the spread over LIBOR before 1 January 2022 and the spread over SOFR after 1 January 2022 (the date on which the US CLO Primary Market transitioned from LIBOR to SOFR). Source: Bloomberg, BofA US Corporate Index, Barclays CLO Research.

Attractive yields

The same conclusions can be drawn by comparing these indices on an all-in yield basis (Figure 5). US IG Corp, US BBB Corp, and US Secondary CLO AAA yield between 5.5%-6.0% while US Primary CLO AAA yield closer to 6.5%. US Primary CLO AAA are typically structured with a 2-year non-call period, and given the historically wide coupons now being issued we expect these bonds will be in the money for refinancing at the conclusion of that 2 years. Because of the higher short-end of the SOFR curve compared to that of the US Treasury curve, a call scenario yields nearly 7.0%. US Primary CLO AAA effectively captures the more attractive shorter end of the rate curve, so this results in more yield pick-up on less spread duration vs. US IG Corp or US BBB Corp. Factoring in the original issue discounts that many recent primary market CLO AAA feature, underwritten yields can exceed 7.0%. This is in stark contrast to the return profile available on lower-rated US corporate bonds.

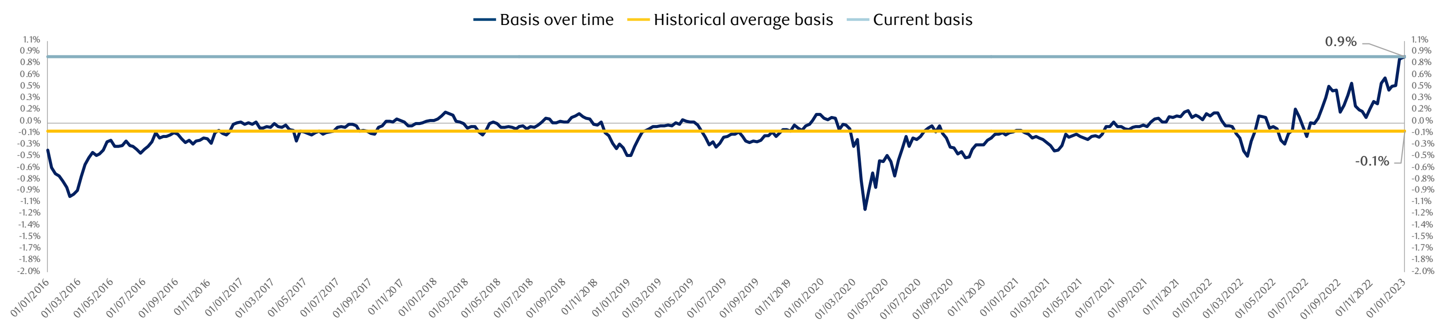
Figure 5: Yields: US CLO AAA vs. US Corp



Source: Bloomberg, BofA US Corporate Index, Palmer Square CLO Index, Barclays CLO Research.

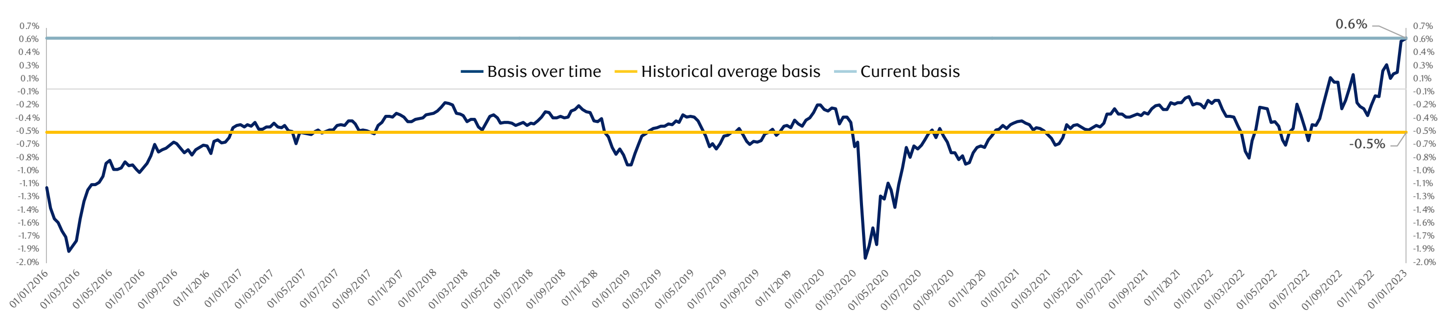
Just as we observed the historically attractive spread basis for US Primary CLO AAA, the same conclusion can be drawn by looking at the yield basis: both are historically wide (US IG Corp in Figure 6 and US BBB Corp in Figure 7).

Figure 6: Yield Basis: US Primary CLO AAA Yield – US IG Corp Yield



Source: Bloomberg, BofA US Corporate Index, Barclays CLO Research.

Figure 7: Yield Basis: US primary CLO AAA Yield – US BBB Corp Yield



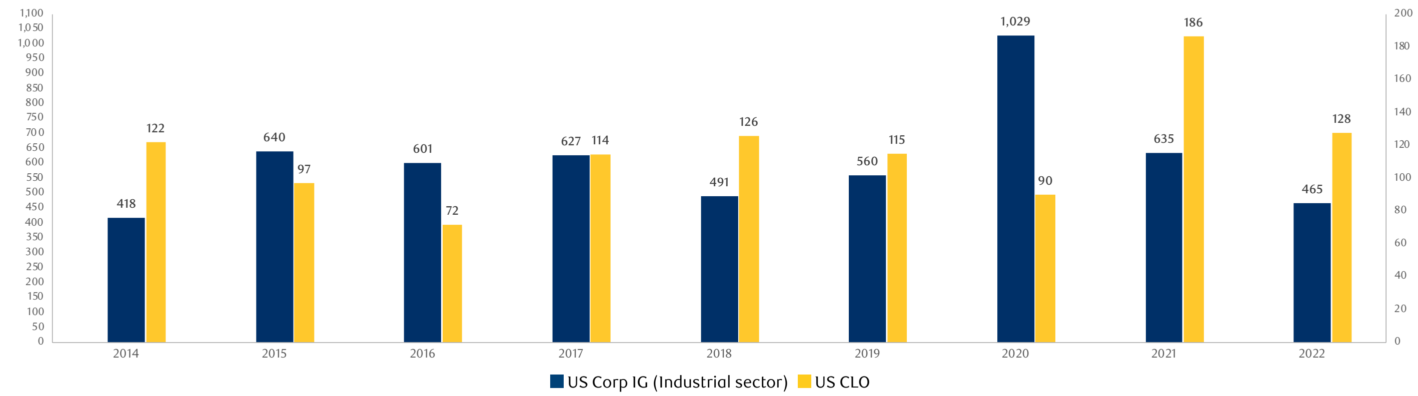
Source: Bloomberg, BofA US Corporate Index, Barclays CLO Research.

Why does this opportunity exist?

As stated previously, the attractive opportunity in Primary CLO AAA exists largely due to a mismatch in supply vs. demand. On the supply side, 2022 was the second-highest US CLO issuance year on record owing to a plethora of existing CLO warehouses with short-dated financing that banks and managers were trying eagerly to bring to market. On the demand side, some of the largest buyers of CLO Primary AAA bonds have stepped aside: whether it be Japanese banks (for regulatory / headline reasons) or US banks (lack of budget or balance sheet availability). This combination has created historically wide Primary CLO AAA spreads—and a historically attractive opportunity set for investors.

On the flip side, 2022 Corp IG supply in the Industrials sector (net of Non-corporates, Financial, and Utility) was the lowest since 2014. Supply in 2022 was muted given the amount of issuance that was front-loaded to 2020 and 2021 (rising rates and lack of maturity wall allowed many issuers to stay put in 2022). Meanwhile, demand remained healthy for the issuance that did come to the market owing to yield-focused buyers such as pensions and life insurers who continued to have interest in long-dated Industrial paper.

Figure 8: New Issue Supply ($bn): US Corp IG (Industrial Sector) vs. US CLO



Source: Bloomberg, Barclays Research.

Summary

In summary, US Primary CLO AAA are historically attractive vs. US IG Corp (and even vs. US BBB Corp) both on a spread and yield basis—and provide lower spread duration at a higher rating point. We believe getting ~6.5% all-in yields (with additional upside from early call) makes US Primary CLO AAA one of the most attractive parts of the CLO capital structure, on a risk-adjusted basis, in the US or Europe.

The returns on US Primary CLO AAA, while still available, match those of other lower-rated instruments including even direct lending—but with more liquidity and the ability to source in size in a fairly quick manner. Due to the technical pressure of a glut of CLO warehouses coupled with numerous traditional US Primary CLO AAA buyers sitting out of the market, we believe this opportunity may continue to persist in Q1 2023. But these opportunities typically don't last for long.

Author

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Mark is a Senior Analyst on the Securitized Credit team at BlueBay. Before joining the firm in December 2021, he was Vice President at Oxford Funds, responsible for evaluating CLO tranches and executing all parts of the investment process including sourcing, underwriting, and trading. Prior to that, he was a Manager at EY, providing quantitative and advisory services for structured finance transactions. Mark began his career in the investment industry in 2008.

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