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What CLO investors should know in 2025

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Himani Trivedi, Head of Structured Credit at Nuveen, shares her thoughts on the current state of the CLO markets and a view of what the coming year holds for CLOs.

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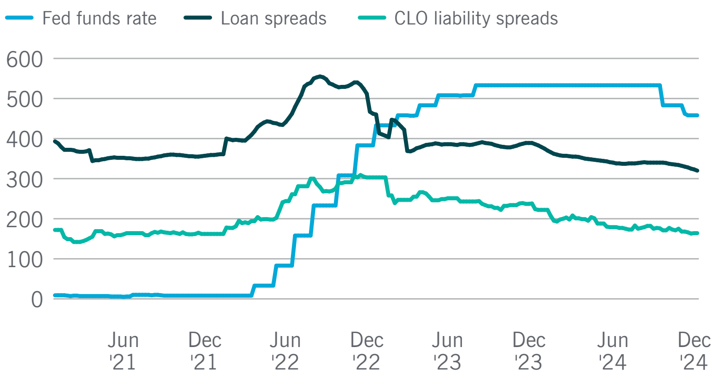
The last 18 months have seen the market backdrop shift dramatically. Coming out of the 2022 market drawdown, inflation was a top concern with central bank policy decidedly hawkish, whereas now rates are trending downward (albeit less so than the market might have expected previously) and risk appetites are robust.

Q: HOW HAVE THE BANK LOAN AND CLO MARKETS RESPONDING TO THE PARADIGM SHIFT?

A: The impact of high inflation and the hawkish tone from the Fed from 2022 to through 2023 certainly reverberated in the credit markets as spreads widened and borrowing costs increased. The result was a steep decline in new loan issuance as well as a drop in CLO new issue volume and a near-standstill in the CLO refinance and reset market. More recently, as central bank policy shifted dovish and rates began to decline, the probability of a soft landing for the economy increased. With inflation declining and the market's expectation of a favorable credit environment, spreads in loans and CLOs declined. (Figure 1)

Figure 1: With inflation declining and the market's expectation of a favorable credit environment, spreads in loans and CLOs declined.



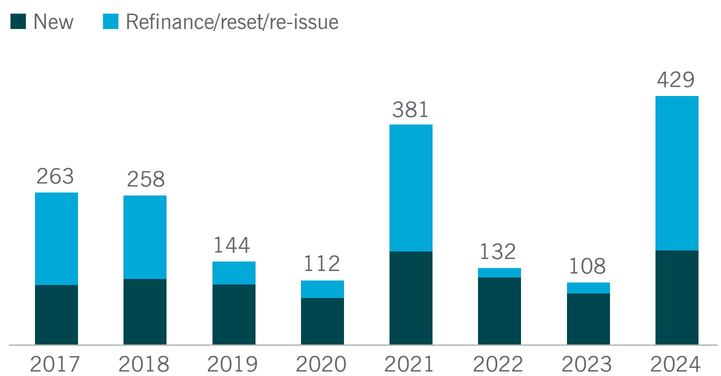
Sources: BofA Global Research, LCD

On the loan side, M&A activity, and with it, new loan issuance volume remained muted in 2024 as the decline in rates was relatively modest at 75 bps as compared to the 500+ bps of rate hiking from 2022 to mid-2023. Given the dearth of available new paper, spreads declined dramatically in 2024, providing ample opportunity for companies to lower their existing debt payments, which has contributed to a spike in repricings and refinancings. The relief provided by the combined benefit of a decline in base rates and spread compression has brightened the prospects for many issuers. Consequently, the market has seen lower quality credit such as B3s and CCCs rally meaningfully. This compression of risk premia has been tricky from a portfolio management perspective but a positive indicator for the expectation of a benign default backdrop going forward.

In contrast, CLO activity boomed in 2024 driven by robust reset and refinancing activity. The decline in CLO liability spreads allowed transactions issued during the last couple years, which were at relatively high levels, to reduce their financing costs, a benefit for the existing CLO equity investors in those transactions. CLO issuance volume in 2024 totaled over $400 billion surpassing the banner year of 2021. Much of this was driven by reset and refinance activity given the decline in financing costs, though new issue volumes also edged out 2021 to set a new all-time record in 2024. The CLO equity arbitrage, which measures the attractiveness of new issue equity, has been balanced given the declines in spreads on both the asset and liability sides. (Figure 2)

Figure 2: CLO issuance volume in 2024 totaled over $400 billion surpassing the banner year of 2021

($ Billions)



Sources: S&P, LCD, Moody's, Intex, Bloomberg Finance L.P., CreditFlux, JP Morgan

Q: MUCH HAS BEEN MADE ABOUT THE POTENTIAL FOR POLICY CHANGES STEMMING FROM THE RESULTS OF THE U.S. ELECTION. WHAT KIND OF IMPACT WILL THE NEW ADMINISTRATION HAVE ON THE CLOS AND INDUSTRIES IN WHICH THEY INVEST?

A: The prospect of a pro-business administration contributed to or perhaps amplified the risk-on atmosphere that we have seen post-election. More broadly, we expect the potential fiscal and regulatory changes that may be pursued by the Trump administration to continue to bolster risk appetites and, when combined with ample private equity dry powder, fuel M&A activity in 2025, which could drive new loan issuance. This mix of some new issuance alongside the continued opportunities in the secondary market should provide a balanced supply profile which may benefit CLOs through healthier (i.e., wider) asset spreads.

Diving into specific sectors and subsectors, we expect the impact to be more mixed with winners and losers varying depending on the situation. We remain constructive on defensive sectors such as subscription-based software, essential for running many businesses, and utilities, given the supply constraints from plant retirements and growing electricity demand. Immigration and tariff policy as telegraphed thus far are both inflationary which could contribute to price inflation and have downstream impacts to price-sensitive sectors such as retailers. While Department of Government Efficiency (DOGE) is introducing uncertainty for sectors such as healthcare and aerospace/defense, the actual recommendations made by the DOGE committee thus far are not new. Government agencies have highlighted trillions of dollars in potential reduction in spending for years, with hundreds of billions in fraud and payment integrity alone. We believe the changes will focus on efficiency rather than drastic cuts of agencies, which often require bi-partisan support.

Q: HOW DO YOU THINK ABOUT STRUCTURING CLOS IN THE CURRENT ENVIRONMENT OF TIGHT SPREADS IN BOTH LOANS AND CLO LIABILITIES?

A: The CLO creation thesis right now is interestingly the inverse of what we saw during 2022 and earlier in 2023. During that period, the new issue thesis was driven by the opportunity to acquire loans at discounted prices with a pull-to-par opportunity and reap the benefit of wider spreads which would offset the relatively high financing cost on the CLO liability side. Many deals were structured at the time with shorter non-call and reinvestment periods (i.e., 3-year reinvestment, 1-year non-call as compared to a more standard 5/2 structure). This allowed for those transactions to refinance their debt as soon as spreads declined, which we witnessed in size in 2024.

Today, the liability costs are tight which provides CLOs the opportunity to lock in cheap financing for the long-term. The attractive financing costs offset the impact of the decline in loan spreads, allowing CLO managers to patiently hunt for opportunities and wait for volatility to return to the loan market, at which point, they can rotate into discounted credits and widen their asset spreads. With the debt locked at low costs, the benefit of future spread widening and any trading gains accrue directly to the equity. In this context, longer non-call and reinvestment periods make more sense, and we are structuring our transactions to take advantage of that optionality accordingly. For our existing transactions, we have been actively optimizing our capital structures through resets and refinancings, pushing our cost of liabilities lower and extending cash flows for several deals issued over the past few years.

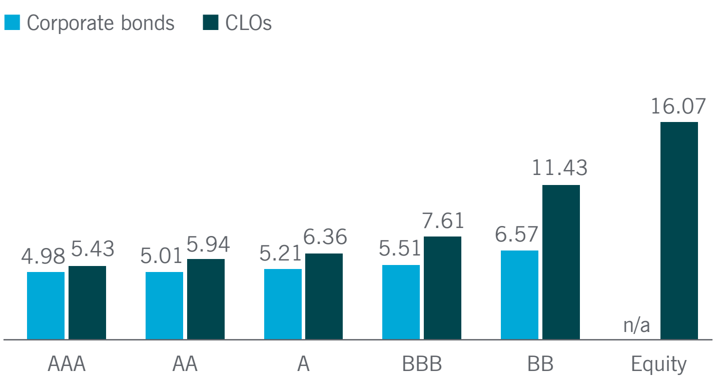
Q: WITH SPREADS TIGHTENING, WHAT SHOULD CLO DEBT INVESTORS HAVE TOP OF MIND AS THEY EVALUATE WHERE TO ALLOCATE THEIR CAPITAL UP AND DOWN THE CLO CAPITAL STRUCTURE?

A: While the spread tightening has been a positive for CLO equity, it, combined with the decline in base rates, has reduced all-in yields available to debt investors across the capital structure. While one might look at spread levels and question whether an allocation makes sense, we view CLOs as an all-weather investment that should be a persistent allocation.

Relative to similarly rated debt instruments which have also seen their spreads compress in the current market environment, CLO tranches continue to offer a yield premium and, given the still elevated base rates, their absolute yields continue to be attractive. The premium is driven in part by the complexity of CLOs, both investors' perception and the reality, as well as their accessibility to investors, which historically have been limited to sophisticated institutions who have been willing to do the work to understand the structures. In addition, while CLO liquidity has expanded dramatically in recent years, the asset class is not as liquid as Treasuries or corporate debts (especially for junior tranches in periods of market stress), which likely adds a layer of liquidity premium as well. With CLOs going mainstream in recent years and the investor base continuing to expand among both retail and institutional investors, some of this spread premium may erode over time, though we expect CLOs to maintain a healthy yield advantage for the foreseeable future (Figure 3).

Figure 3: CLO debt yields may offer premium vs. similarly rated corporate bonds

as of 31 Dec 2024 (%)

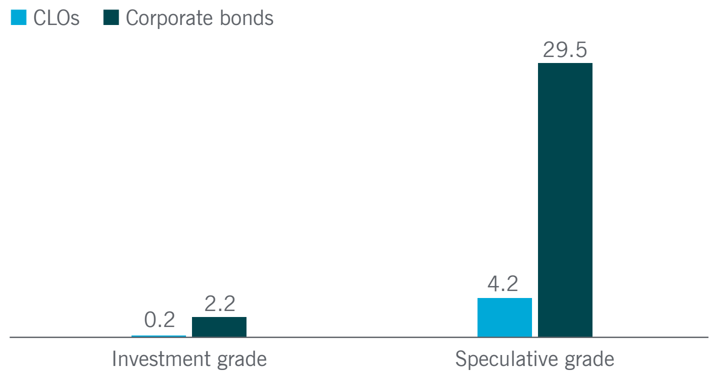


Sources: Nuveen, Bloomberg, JPMorgan and Bank of America as of 31 Dec 2024. Representative indexes: Investment grade corporates AAA-BBB: Bloomberg U.S. Corporate Investment Grade Index; High yield corporates BB-B: ICE BofA US High Yield Index; Investment grade and high yield CLOs AAA-BBB: J.P. Morgan Collateralized Loan Obligation Index (CLOIE); CLO equity: US BSL CLO Equity Distributions (IO) median. Different benchmarks, economic periods, methodologies and market conditions will produce different results. There is no assurance that any asset class or index will provide positive performance over time. **It is not possible to invest directly in an index.**

Yield: The yield quoted is yield-to-maturity except for CLO equity which is the median annualized U.S. broadly syndicated loan obligations equity distribution.

When combined with their historically low default rates versus other comparable debt, CLO debt continues to afford the opportunity to enhance income without taking on additional default risk, up and down the capital structure from AAA to BB (Figure 4). With issuance expected to remain near record levels in 2025, we expect continued robust demand for CLOs which could keep spreads near the current levels or potentially even tighter.

Figure 4: Cumulative default/impairment rates have been relatively low (%)

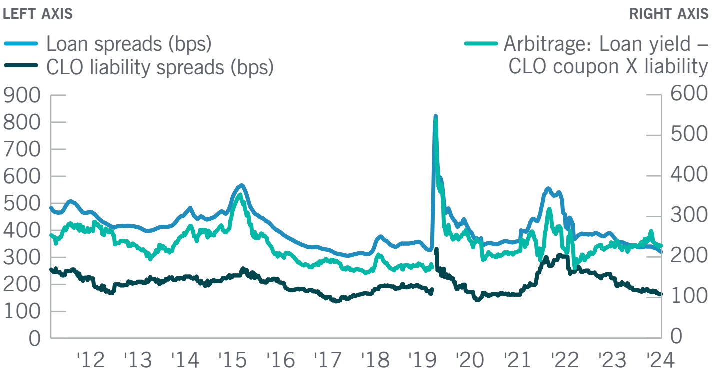


Source: Bloomberg Barclays Capital from 1/31/2006 - 6/30/2017. The following indexes are represented: Bloomberg Barclays U.S. Corporate Investment Grade Bond Index (corporate bonds); Bloomberg Barclays Capital Taxable Municipal Bond Index (taxable municipal bonds). It is not possible to invest in an index. Performance for indexes does not reflect investment fees or transaction costs.

Q: HOW DOES THE CLO EQUITY ARBITRAGE NOW COMPARE TO HISTORICAL LEVELS? WHAT KIND OF OPPORTUNITIES ARE YOU SEEING IN SECONDARY EQUITY?

A: CLO equity arbitrage is the difference in loan asset and CLO debt (liability) spreads which represents the residual income that CLO equity investors receive from the loan portfolio after all the debt tranches are serviced. As noted earlier, the arbitrage remained relatively balanced in 2024 as both asset and liability spreads declined. On average, 2024 was a more attractive year for the equity arbitrage than 2023, and while the arbitrage has declined a bit over the last few months, it still remains attractive relative to levels that we have seen over the past two years, as well as compared to 2021 and the years preceding COVID. While the arbitrage is a point in time measure, we feel that the optionality currently afforded by the tight CLO liability spreads continues to represent an attractive opportunity for entry (Figure 5).

Figure 5: CLO arbitrage remains attractive



Source: BofA Global Research

On the secondary side, we believe opportunities exist to purchase secondary equity positions that have optionality. These situations span both majority and minority equity with refinancings, resets and liquidations representing the potential capital structure events that could drive value creation. We see the potential for high cash-on-cash yields and cheaper entry points in these secondary opportunities, as shorter profile, callable equity can often be acquired at prices closer to NAV. While some situations may require capital infusions for portfolio clean-ups, a reset or refinancing could provide a bump in cash flows as well as price appreciation. These situations require a seasoned manager with credit expertise to review a deal's underlying portfolio, assess the probability of and navigate a capital structure event that could unlock value.

Q: WHAT ARE NUVEEN'S PREDICTIONS FOR WHERE CLO SPREADS AND VOLUME WILL TREND IN 2025?

A: The consensus view across market participants is that another strong year awaits in 2025 with respect to CLO issuance across new issue, resets and refinancings. We tentatively agree with that view given the already tight liability spreads and potential for new loan issuance spurred by M&A activity, we may see CLO issuance pick up. With respect to CLO liability spreads, further tightening is certainly possible. The compression we saw in 2024 was driven by a mix of (i) new entrants in the market, (ii) increased acceptance of CLOs by existing investors, (iii) attractive yield relative to other comparable / related asset classes and (iv) increased sensitivity to interest rate duration risk leading some investors to embrace CLOs as a rates hedge. These are all factors which we expect to persist (in varying degrees) going into 2025.

However, the environment could present some unexpected pitfalls – geopolitical risk, a resurgence of inflation or unexpected government policy could complicate the economic picture. We are positioning our portfolios accordingly, with a more cautious bias and patiently awaiting the eventual return of volatility to provide more attractive loan entry points and compelling relative value opportunities.

For more information, please visit nuveen.com.

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