MARKET COMMENTARY

2018 CLO Update

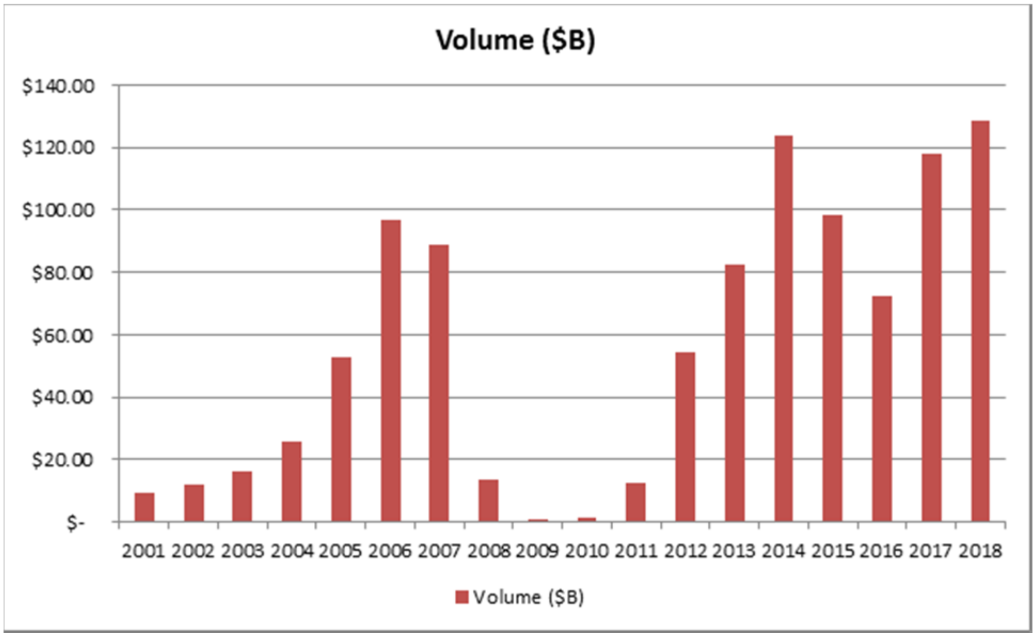
January 2019

SHENKMAN

2018 was an interesting year, to say the least, but we think many investors are happy to start 2019 fresh. In some respects, we continued many of the trends that began in 2017: record CLO issuance, the building trend of CLO resets, and continued focus on regulation. In many other respects, 2018 was the total opposite of 2017: spreads generally moved wider and the rise of volatility. Many investors expected a continuation of 2017 this past year, which is what we got for a while, but the year ended with a 180° turn and left us with memories of 2015/16. Outlined below are a few things that made 2018 such a memorable year.

Primary Market

CLOs had a big year of new issuance and a volatile year as well. New issue volume was $129bn, reset volume was $122bn and refinancing volume was $34bn vs. $118bn, $65bn and $102bn, respectively in 2017 according to S&P LCD. So while 2018 total volume ended almost exactly the same as 2017, the composition was different with an increase in new issue to a record level (surpassing 2014 volume by ~$5bn), a large increase in reset volume (almost doubling from 2017), and a drastic decrease in refinancing volume, the timeline outlined in the Crescent No Action Letter, spurred refinancing's to get done in 2017. Looking toward 2019, expectations are for robust primary market volumes, though not quite as high as 2018 - generally in the $100bn range for both new issue and refinancings/resets.



As of 12/31/18
Source: JP Morgan

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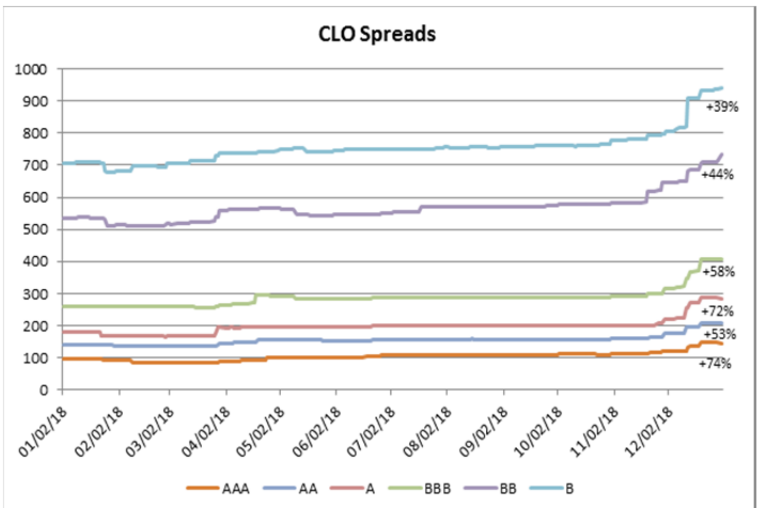
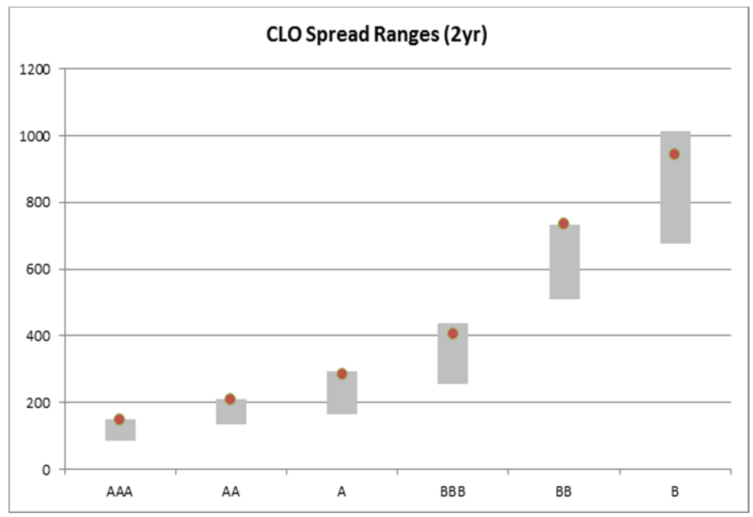
Secondary Market

Secondary market activity picked up during the last few months of the year, but overall, trading activity was down from where it was in 2015/16. This may largely be the result of the focus on the primary market as new issue and resets have taken center stage over the last two years. But as spread volatility picked up in Q4 2018, the secondary market activity increased, as there were more attractive profiles to trade relative to the opportunity set in the primary market.

2018 was marked by a constant widening of spreads, starting in February after reaching local tights, until year-end, when volatility picked up significantly. Spread movement across the capital structure was as follows:

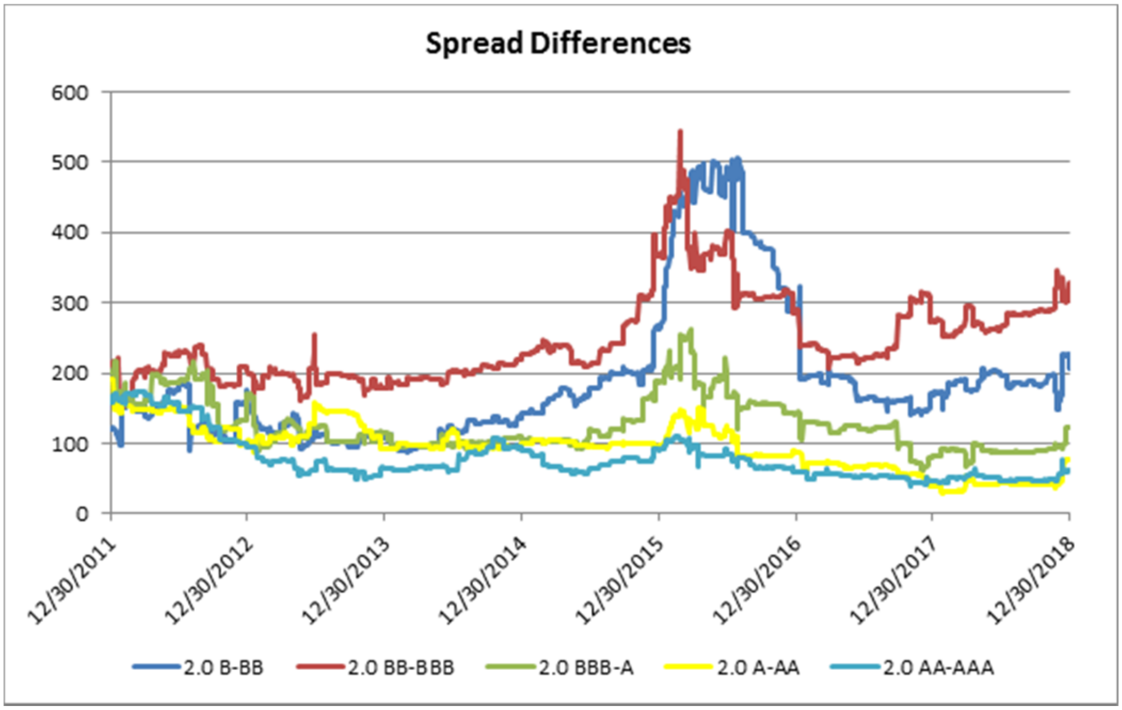




As of 12/31/18
Source: JP Morgan

The secondary market has also become a more appealing market as of late. In the primary market, new issue CLOs typically come with a two-year non-call period and five year reinvestment period. Resets are generally similar, but sometimes come with shorter timelines, and of course, their portfolios are seasoned. Refinancings have been a bit rarer in 2018, but generally provide a shorter duration option. In the secondary market, a large variety of profiles is available to investors – recently issued, clean, longer deals, seasoned shorter deals, high quality portfolios, lower quality portfolios, lower dollar price bonds with convexity, premium dollar price bonds with optionality (until recently – not much trading above par), etc. In volatile periods, the secondary market often leads the primary, so it became much easier in the fourth quarter to source paper at realistic market levels in the secondary market instead of waiting for levels to adjust in the primary market. Additionally, the relative value within the CLO space changed quite a bit throughout the year based on differing spread movements across the capital structure.

One metric we frequently examine is the spread basis between tranches within the CLO capital structure vs. the historical average. While AAAs are generally cheap vs comparable asset classes, the relative value of BBs vs BBB's have increased throughout the year, offering a spread basis of ~250bps early in the year to ~325bps currently according to JP Morgan. Single-As, though wider than earlier in the year, still trade on the tighter side given on-going support from insurance company buyers. Single-Bs still appear to offer value, but are a very small part of the universe and can swing wildly when volatility picks up. AAs and BBBs seem closer to fairly valued.



Source: JP Morgan

Outlook

As we begin 2019, we expect the primary market to get off to a slow start. While there are a number of deals that were pushed back at the end of 2018, as well as approximately 150 warehouses that are believed to be open at the moment, the market is still in price discovery mode. Without knowing exactly where the liability stack will price, it's hard to imagine January will be a strong month for issuance. Issuance should pick up as we move further into the year, but with all the recent volatility and many of the existing unknowns in the market, it feels like it will be a volatile year. The same logic applies to the secondary market, which can be a little more fluid, but at the same time, can be very volatile. We expect investors to put on their buying hats, as it's a fresh new year and everyone starts with a clean slate and there is always a "Fear Of Missing Out" whenever there's a quick market rally. We may even experience a sustained rally if markets begin to stabilize since there is no widely-held expectation for any near-term spike in defaults or recession.

The current geopolitical environment, along with fears about external shocks to our economy, should provide the necessary backdrop for a bit of a rollercoaster ride throughout the year. The conclusions here are that the market is constantly changing, relative value will shift between tranches, as well as between the primary and secondary market. As such, we believe that having a dedicated manager and an actively managed strategy is prudent to navigating the CLO market.

Have a good 2019!

Disclaimers and Notes

January 2019

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