

Chart of the Moment: Nothing to See in CLOs

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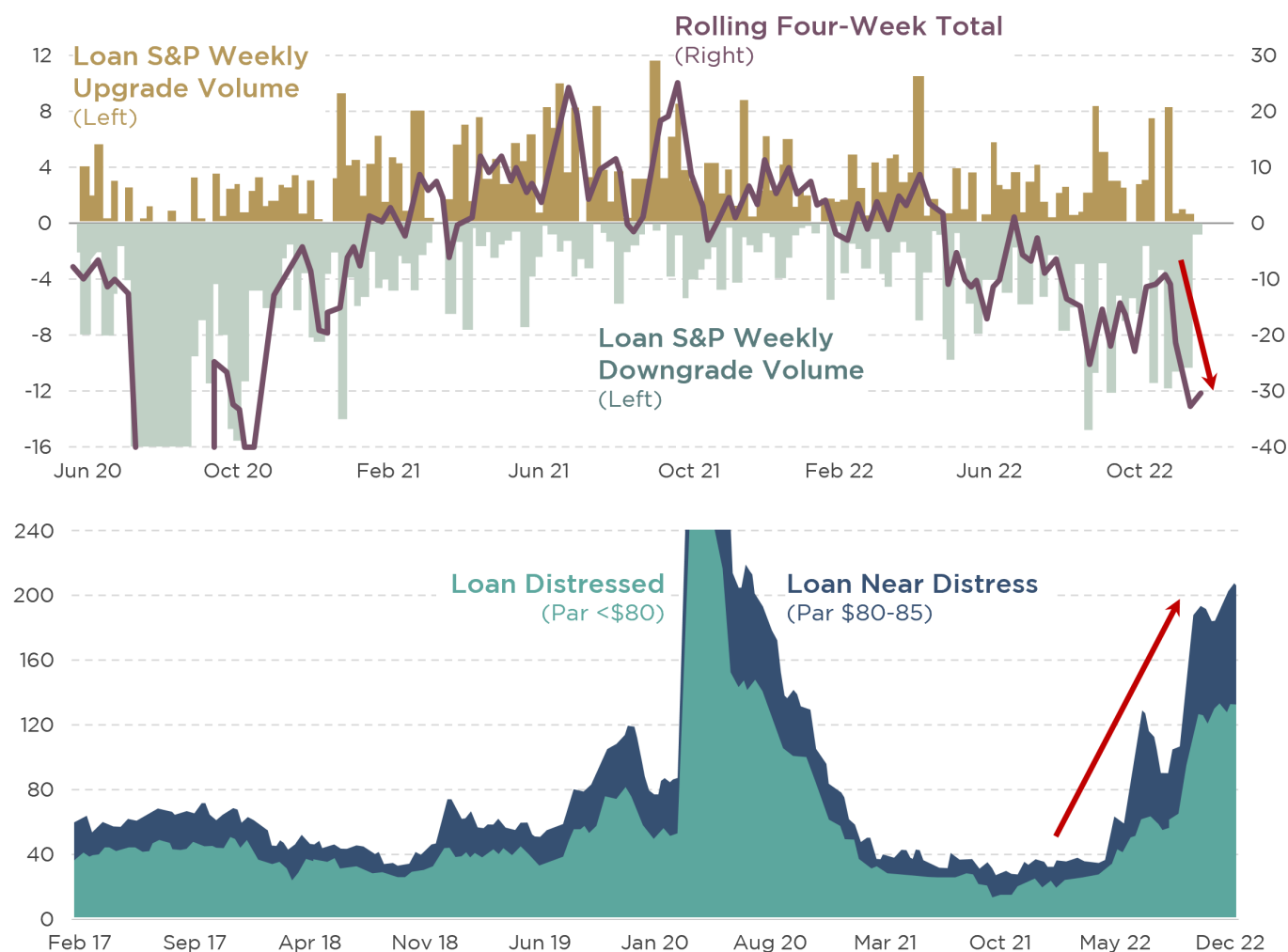
After last year's tremendous interest rate volatility and rapidly changing housing market and consumer fundamentals, a look across the structured credit landscape reveals that not all opportunities are created equal heading into 2023. In our recent blog, we reviewed the attractive valuations and supportive fundamentals within [agency mortgage-backed securities](#). In contrast, the view for collateralized loan obligations (CLOs) looks dim.

In the second half of 2022, we began to see deteriorating loan fundamentals evidenced by higher downgrades and distress ratios. Additionally, the CLO warehouse overhang is another factor that may cause loan spreads to widen. A warehouse provider must hold the leveraged loans until the CLO can be packaged and sold. If CLO new issuance slows down because of a lack of investor appetite or weak economics, warehouses will be forced to liquidate those loans, likely triggering a widening of loan spreads.

We believe the mark-to-market volatility will remain high for CLO BBBs and CLO BBs due to a higher credit risk premium. Liquidity will be hard to obtain when the market is forming a bottom, despite the relatively higher yield CLOs offer. CLO AAAs also offer cheap valuations. However, the risk resides in the fact that their main investor group is Japanese investors. As the Bank of Japan contemplates a gradual removal of its yield curve control, there is a risk that CLO AAAs could lose their sponsorship as Japanese investors repatriate their overseas investments back to the domestic market. With that being said, we are closely monitoring the CLO market and think at some point, it will offer attractive value to compensate for the liquidity, credit, and sponsorship risks.

Loan Downgrades Accelerating, Number of Distressed Loans Rising

\$Billion, As of 12/31/2022



Source: Credit Suisse

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