2019 European CLO Outlook
Sunny journey but with clouds on the horizon

After a strong 2018 which has seen EUR 38.5bn issued year-to-date, issuance volumes will increase slightly in 2019 to about EUR 45bn, owing to a balanced mix of new transactions and refinancings/resets (EUR 25bn and EUR 20bn, respectively). Scope's European CLO credit outlook is stable.

Despite concerns rising from political uncertainties affecting the UK and Italy, the solid fundamentals of Western European economies are conducive to a benign environment for corporate defaults and this fosters strong demand for speculative-grade debt. The rapid pace of European M&A and leveraged buyout activity will continue in 2019 and provide supply of leveraged loans to fuel European new CLO issuance. The hunt for yield among investors will continue in 2019 because Eurozone monetary policy is set to remain accommodative. Demand for European CLOs will remain strong.

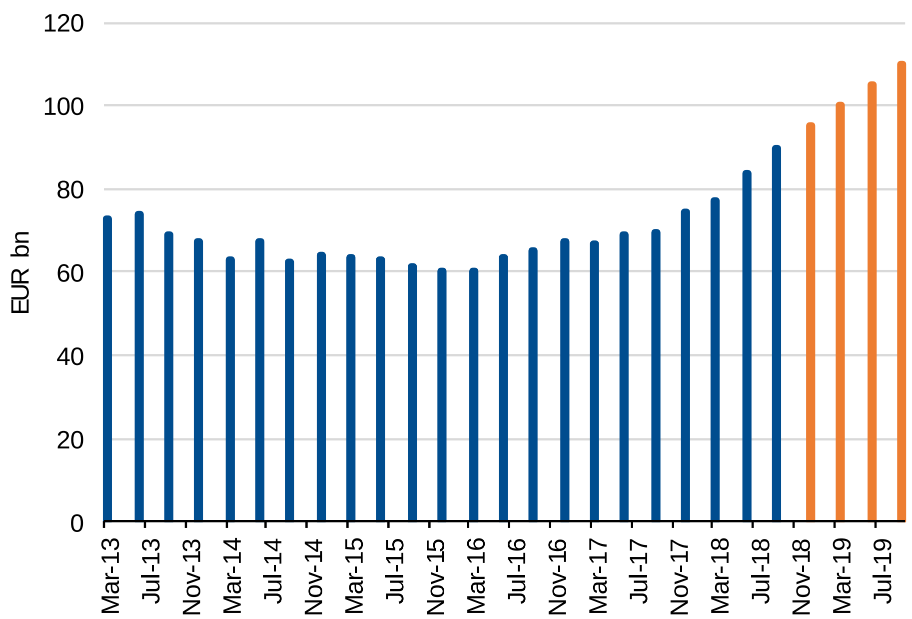
Several factors, however, could contribute to European CLO spreads remaining at or above their current levels. Technical factors include the large supply of transactions combined with a limited investor base and a high concentration of investment portfolios (in CLO manager and obligor terms).

The credit risk of European CLO tranches will also reflect the following fundamental factors:

- Potential for deteriorating underwriting standards in European loans, as currently seen in the US, leading to increasing investor caution and increasing loan recovery-rate downside risks
- Political uncertainties, particularly in the UK and in Italy
- Trade protectionism, possibly affecting European corporate revenues

Outstanding managed EUR CLO transactions are set to exceed EUR 100bn in 2019, as displayed by Figure 1.

Figure 1: Outstanding EUR CLOs in EUR bn



Source: Refinitiv

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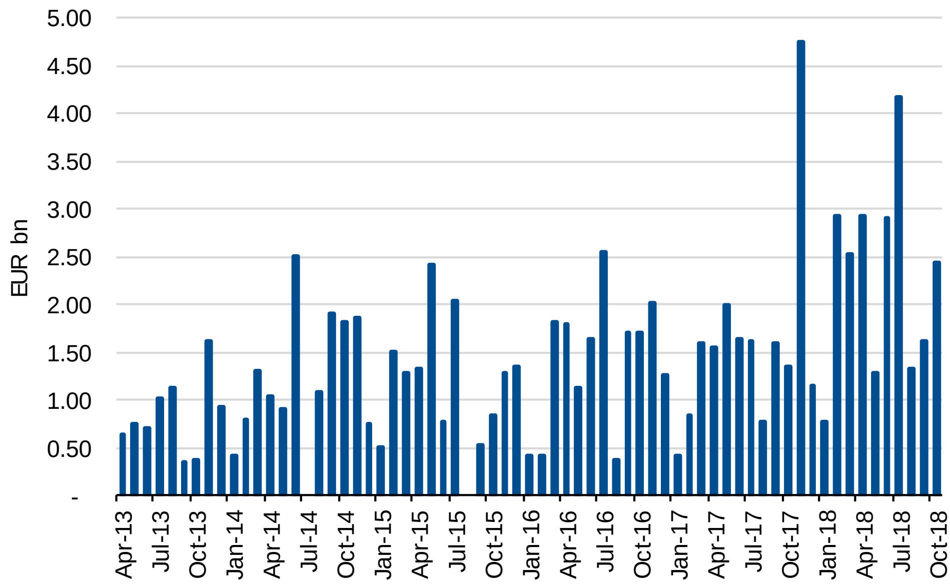
Continued robust issuance volumes for 2019

Favourable fundamentals will continue driving supply and demand for European CLOs

In 2019, we expect robust issuance volumes, owing to a balanced mix of new issuance and refinancings/resets of about EUR 25bn and EUR 20bn respectively. European CLO debt will continue offering attractive spreads, whereas yields of more traditional investment products will remain low, following the stance of the ECB's monetary policy which is expected to remain accommodative at least until fall 2019. Should inflation expectations move upwards and interest rates rise at a faster-than-expected pace, European CLO debt would remain an attractive asset class given the floating-rate nature of the collateral, which limits duration risk; so long as rate levels remain sustainable for issuers to manage refinancing and debt servicing.

New-issue volumes of European CLOs in 2018 slightly outpaced our expectations, with a total YTD of EUR 22.9bn in priced transactions (2017 new issue volume was EUR 19.2bn).

Figure 2: European CLO new issuance to date

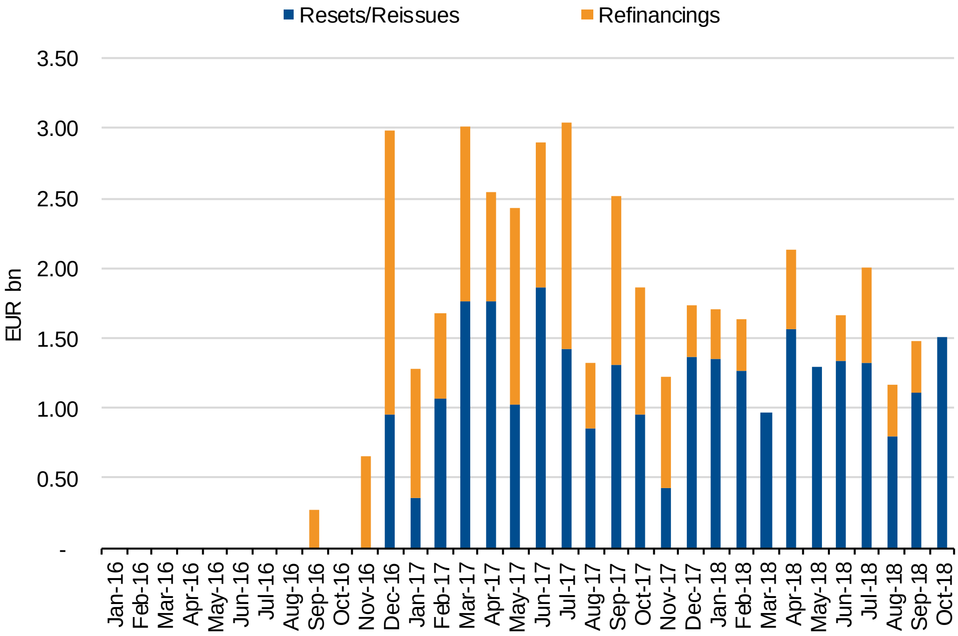


Source: Refinitiv

Volumes will grow from both new issue and refi/resets

The refinancings or resets of earlier 'CLO 2.0' vintages will continue in 2019, as they offer a convenient way for CLO managers to maintain assets under management, and will contribute to elevated issuance volumes. Figure 3 illustrates the substantial activity to-date. Issuance in 2018 of combined refinancings and resets volume has reached EUR 15.6bn.

Figure 3: European CLO refinancings and resets to date



Source: Refinitiv

Gathering headwinds to prevent spreads from further tightening

We expect the strong credit fundamentals seen in 2018, with benign headline default rates for European leveraged loans, to carry into the first half of 2019.

Trade protectionism and political uncertainty are catalysts for higher credit spreads

However, global risks, such as political uncertainty in the UK and Italy and the growing escalation of a trade war between the US and China, pose significant threats to global growth, financial markets conditions and confidence, and could reduce potential output and cause credit spread volatility in 2019.

Should a hard Brexit scenario (i.e. the UK exiting the single market and customs union) crystallise, the impact on the UK economy would be material, with 10% to 17% of GDP potentially affected, along with a strong impact on the UK's closest trading partners such as Ireland and Germany. These three countries account for 29.3% of the overall country concentration in European 'CLO 2.0' vintages (12.5%, 2.1% and 14.7%, respectively[1]).

The current budget discussions between the Italian anti-establishment government and the EU have raised market concerns and harbour potential systemic risks for the Italian and, more generally, European banking sectors, given the large amounts of Italian government debt on banks' balance sheets. However, we note that Italian government spread levels are well below the levels seen during the Eurozone sovereign crisis of 2011-2012. Despite recent flattening, the Italian government bond yield curve is currently much steeper, another sign that financial markets do not assess the short-term situation as critical as in 2011-2012[2]. Additionally, a possible liquidity shortage resulting from a sluggish domestic banking sector may be offset by other sources of financing: according to the Bank of International Settlements[3]. Non-bank borrowers in advanced economies have growing access to credit via bond markets while bank loan financing has been

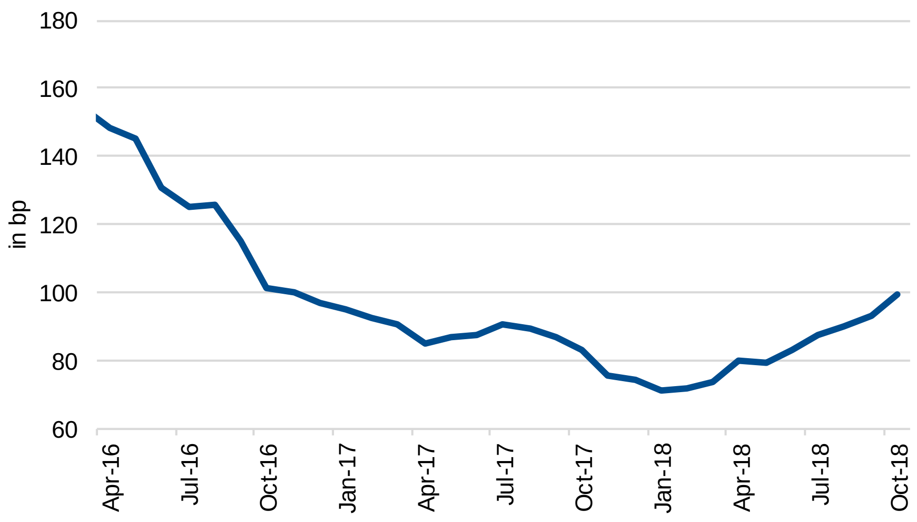
[1] Source: Morgan Stanley Research, Intex, Markit, as of Q3 2018
[2] One can define the steepness of a yield curve by the difference between 10Y and 2Y yields. As of 13 November 2018, the Italian government bonds yield curve steepness was 244bp. As of 25 November 2011, it was -34bp, highlighting the inverted nature of the yield curve then, characteristic of stressed market conditions (Source: Bloomberg)
[3] BIS Quarterly Review, September 2018

declining. For European CLOs specifically, potential contagion risk would have the larger impact as Italy only represents 3% of the overall country concentration in recent European CLO vintages[4].

Positive net supply and concentrated portfolios will drive investor demand for higher spreads

Various technical factors could support widening European CLO spreads. Despite recent growth, the European CLO investor base remains limited in comparison to the overall breadth of market participants. The expected volume of new transactions will outpace the level of redemptions – the positive net supply will be placed with investors already holding significant amounts of European CLO debt, who will require higher spreads to balance the perceived saturation. This effect will be magnified by the concentrated nature of European CLO market, where investors are likely to have portfolios with a small number of CLO managers (only a limited number of new managers are entering the market each year). Additionally, the collateral overlap between transactions is relatively high, reaching 42.3% for deals by different CLO managers and 81.8% for deals by the same manager[4].

Figure 4: European CLO AAA tranche spread



Source: Refinitiv

Looking at the US leveraged loan market for clues

Overall, the credit performance of European CLO in 2019 will resemble a sunny journey, during which investors will have to carefully prepare for clouds on the horizon and be increasingly selective.

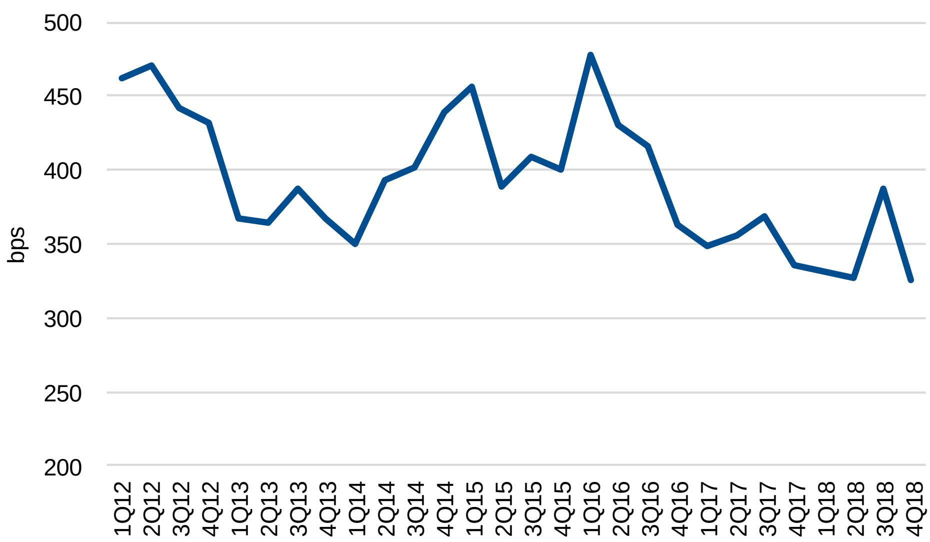
Considering the US market a leading indicator, we expect European CLO investors to closely follow developments in the US leveraged loan market. The continued economic recovery in Western Europe, coupled with the low rate environment, offers favourable conditions that borrowers will profit from. If signs in the US market indicate that we are nearing the peak or heading to a downturn of the credit cycle, volatility in credit markets will rise and European CLO investors will favour shorter-duration tranches higher up the capital structure and transactions from portfolio managers with a strong record in steering leverage loan investments in downturns through credit selection and recovery optimisation.

[4] Source: Intex, Markit, Morgan Stanley Research, as of Q1 2018

Current financing conditions in the US are loose

US high-yield borrowers are currently experiencing very favourable conditions, with strong investor demand pushing spreads tighter. The Chicago Fed's National Financial Conditions Index[5] shows that current financing conditions are loose, with US banks generally relaxing their underwriting standards on the back of less stringent regulation. Non-bank money has also been flowing into leveraged loans, as private equity companies (via direct lending funds or business development companies) and CLO managers have seen their assets under management grow rapidly. As displayed by Figure 5, the average spread of first-lien loans extended to large US corporate borrowers, currently at 325bp, is at a historically low level.

Figure 5: US first-lien loan average spread



Source: Refinitiv

The general strength of the US economy has resulted in a low default environment, leaving high-yield borrowers with strong corporate earnings growth and relatively high interest coverage, and has buoyed the market's confidence and risk appetite.

Market confidence is high despite early warning signs

However, there are gathering signs that the market's confidence and tolerance for risk may have become excessive:

- The proportion of borrowing by B or lower rated companies is trending higher
- Borrowers have negotiating power and are able to reduce the number of debt covenants imposed on them
- The money raised from new debt issuance is used to fund acquistions (arguably at currently high valuation multiples) or for share buybacks and dividend payments

These high amounts of debt will also become more burdensome in the context of expected further rises in interest rates by the Federal Reserve.

[5] https://www.chicagofed.org/publications/nfci/index

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