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US Market Commentary: CLO Q&A with Bain's Jeff Garver—BSL Q1 AAAs to test S+110 area on strong technicals, spread compression challenging equity and European CLO tranches offer compelling pickup

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In an exclusive interview, *LFI* spoke with Jeff Garver, director at **Bain Capital,** who explains that BSL CLO AAA spreads are expected to test +110 in Q1, driven by a strong technical environment. The growth of CLO ETFs, running at $2bn-$3bn per month, and AAA amortization activity are key factors. The reduced likelihood of numerous rate cuts has increased demand for floaters, with CLOs being the most scalable option. New issue BBs are clearing at 425-450bps, considered rich compared to the underlying collateral. These tranches are 25% thinner than previous vintages, potentially leading to weaker performance in credit metrics. Manager tiering is not high, as about 75% of loans trading above par, leaving minimal differentiation across headline credit metrics.

Opportunities in the CLO market are seen in shorter tenor tranches benefiting from de-leveraging during amortization. European tranches lag behind US markets, offering a compelling spread pickup. Despite the weaker European economy, these tranches have strong credit enhancement and a solid track record. The term curve is inverted for the capital structure, except for CLO AAAs. This inversion presents value in certain tranches that remain spread neutral or pick up spread versus new issues.

Innovations in CLO structures may continue in 2025, with junior AAAs and BBBs becoming commonplace. Investors may seek creative solutions like split tranches to source yield. The longevity of these tranches will depend on their performance in market downturns. Junior BBBs from 2021 faced poor liquidity but showed strong credit performance, increasing demand in 2024. The market may see more split tranches like senior/junior AAs and As.

CLO equity investors face challenges from spread compression across loan portfolios. This can be offset by lower loss rates and refinancing liabilities in structures with shorter non-calls. The significant tightening of CLO liabilities over the past year reduces returns for these tranches. Investors focus on higher-quality, liquid opportunities to build value through active management in weaker markets. The imbalance between CLO and loan issuance continues to impact equity investors.

Technical factors like paydowns and potential rate cuts create a favorable backdrop for CLO spreads. ETF growth and CLO paydowns are expected to continue in 2025, though at a lesser extent due to decreased amortizations.

With ~90% of CLOs in the money to refinance, investor focus shifts to primary markets. Managers struggle to source assets for new issue CLOs, leading to scarcity value and tighter spreads. Bond buckets are a net positive, allowing managers to rotate out of distressed loans into performing bonds, reducing credit risk without burning significant par.

What do you expect for CLO AAA/BB new-issue spreads in Q1 and do you expect manager tiering to remain high?

We anticipate new-issue AAA spreads to test 110bps this quarter, as they continue to benefit from an incredibly strong technical environment. CLO ETF growth is running at a cadence of ~$2bn-$3bn/month, AAA amortization activity continues to drive redeployments into CLO primary (albeit with some de-acceleration vs 2024) and the diminished likelihood of numerous rate cuts has been a positive demand driver for floaters across fixed income, of which CLOs are the most scalable option. New issue BBs are clearing 425-450, which we view as rich compared to the underlying collateral (300-330), especially when accounting for the weaker structure they’re getting placed into: These tranches are 25% thinner than prior vintages of new-issue BBs, which could ultimately drive weaker performance in credit metrics or ratings migration. We don’t believe manager tiering is high in this market, as we are seeing little differentiation in levels across the manager spectrum. This makes intuitive sense when you consider that three-fourths

of loans are trading above par, leaving minimal differentiation across headline credit metrics for CLO investors that aren't as familiar with manager performance or the ability to look at the fundamental quality of the underlying credits in the portfolios.

Where are you seeing opportunities in the BSL CLO market?

The term curve is inverted for the capital structure apart from CLO AAAs. We find compelling value in shorter tenor CLO tranches that benefit from de-leveraging activity during the CLO's amortization period while remaining spread neutral or, in certain instances, picking up spread versus new issue. Globally, European tranches are significantly lagging the move tighter in US markets and offer a compelling pickup in spread. While the European economy is on weaker footing than that of the US, European CLO tranches are issued with greater levels of credit enhancement and have an excellent track record, having demonstrated strong credit performance through multiple periods of volatility in the past.

Are there any innovations in CLO structures expected in 2025?

Junior AAAs and junior BBBs have become commonplace over the past year—it's certainly possible we will continue to see additional split tranches, such as senior/junior AAs and As, as investors seek creative solutions to source yield. The longevity of these tranches will be dependent on their ultimate performance in the next market downturn. For example, while 2021 vintage junior BBBs experienced very poor liquidity and bid depth during 2022-2023, they did have strong credit performance, resulting in additional demand for these tranches in 2024.

What challenges do equity investors face in 2025 (e.g., tightening asset spreads)?

CLO equity investors will face headwinds in the near term from continued spread compression across loan portfolios as the imbalance between CLO and loan issuance continues. This can ultimately be offset by a combination of lower loss rates in a benign market, in addition to refinancing liabilities in structures with shorter non calls. While this is topical and a risk investors should absolutely incorporate in their runs, this risk is not unique to CLO equity; CLO liabilities have tightened 50-300bps over the past year, which definitionally reduces go-forward returns for these tranches as well. In these markets, we focus on adding exposure to higher-quality, liquid opportunities that ultimately allow us to build value via active management in weaker markets.

How are technical factors like paydowns and potential rate cuts impacting the CLO market?

It's a very favorable technical backdrop for CLO spreads. We anticipate continued growth in the ETF space during 2025, as well as CLO paydowns (albeit to a lesser extent, as the quantum of CLOs amortizing has significantly decreased via liquidations, amortizations and resets over the past year). With ~90% of CLOs in the money to refinance, investor focus has shifted toward primary, with significant call risk for the vast majority of bonds trading in secondary. While managers are struggling to source assets for new-issue CLOs with the dearth of true new-issue loans, this ultimately results in scarcity value for new-issue CLOs, again driving spreads tighter in that part of the market.

What's your view on the use of bond buckets?

Bond buckets are a net positive for CLOs. Many CLOs are issued with some amount of fixed-rate liabilities, generally ranging in size of 2%-5% of the capital structure. It makes sense for a CLO to have the ability to purchase up to that amount in fixed-rate assets. Bond buckets also offer managers the opportunity to rotate out of distressed loans into performing bonds that are trading at significant discount due to interest rate sensitivity, as opposed to default risk. This has allowed managers to reduce credit risk without burning significant par—a net positive for debt tranches. While loans have historically experienced better recovery rates than bonds, we have seen significant convergence between the two asset classes over the last several years, leading us to believe bond bucket flexibility is ultimately a credit positive for CLO investors.

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