Place Your Bets

THE LEAD | May 12, 2014

A few days before last month's running of the 140th Kentucky Derby, the WSJ published a piece detailing six reasons why *California Chrome* wouldn't win. Of course, the California-bred colt, a 5-2 favorite, dominated the field and took home the $1.2 million first-prize. No word on whether the sports editor has been reassigned.

Against all odds, the CLO market has been on a tear. According to S&P almost $35 billion of new vehicles have crossed the finish line so far in 2014. That's ahead of last year's pace of about $30 billion. JPM noted that April was the second highest month on record for CLO issuance at $13.5 billion (26 deals). November 2006 ranks #1 with $14 billion (also 26 deals).

That's despite all the regulatory headwinds, both real and imagined, as we discuss in this week's interview with the LSTA's head of research, Meredith Coffey. What's more, the forward calendar for new CLOs is strong and building. Almost $16 billion is in the pipe, which caused JPM to revise upwards its estimate for the full year to as much as $100 billion, from $70 billion.

Why should loan players care? The supply/demand imbalance, which has been favoring issuers for months, could be resetting. On the demand side, cash continues to leak out of retail loan funds, another $40 million or so (per Lipper FMI) last week. On the supply side, the market has seen an uptick in M&A activity as well as a pretty well-stocked forward calendar of loan business – $63.4 billion – the most in almost four years.

Which means that more CLO capacity could tip the scales in favor of issuers. Behind this race to the finish line is, as always, a chase for yield. As rising Treasury prices continue to defy the smartest handicappers' expectations, CLO managers have an eye on firming loan spreads and are betting those will spur investor appetite.

This is particularly ironic given the scrutiny loan securitization is now getting. Regulators and major media are jockeying for position – who will be the most alarmist and misinformed about CLO structures?

A respected business publication last week noted the growing demand for loan vehicles, and the perils of banks holding CLOs and supplying investors with (risky!) leverage to buy them. It also informed readers the last time the market headed down this path with sub-prime mortgages and CDOs, well… bad stuff happened.

This despite the fact, as Ms. Coffey reminds us, that banks don't own CLOs; they may own CLO*notes*. Plus no investor has ever lost a dime on the highly rated CLO tranches.

We may be beating a dead horse, but if regulators force banks to disgorge their ownership of CLO notes, won't that result in the very losses at those institutions Volcker and Dodd-Frank were ostensibly designed to prevent?