A CLO Hat Trick on the Horizon?

The CLO markets have been marred by many different headwinds over the past two years, which has unsettled some CLO equity investors. Strong demand for newly minted CLOs has contributed to the equilibrium between the loan and CLO markets becoming increasingly off-balance. CLO equities felt the brunt of this dynamic as CLO equity cash yields narrowed quarter-over-quarter over the past year. We believe these markets may be reaching an inflection point that should bring comfort to CLO equity investors.

We outline three key dynamics that have contributed to the technical imbalance in the marketplace and offer some positive catalysts that may benefit CLO equity investors.

1. Organic loan supply will need to increase as PE firms face more pressure to generate liquidity for LPs by harvesting existing portfolios and winding down seasoned PE funds.
2. The prominent role of CLO manager captive funds in newly created CLO equity has side-stepped an important, natural balance in the economic arbitrage of CLO structures. So far this year, new issue CLO creation has been slower than prior years. This is driven by the tight spread environment and virtually no capital support from third-party CLO equity investors in the primary CLO markets. Lower CLO issuance helps to correct the supply-demand balance for loans.
3. Prevailing credit spreads across the market are historically tight, which has kept overall yields tight in the credit markets. We believe a repricing of credit risk (a reversion back to historical levels) is a matter of "when," not "if." Market uncertainty and significant bouts of volatility could accelerate the widening of risk premia across the credit and broader markets.

The Calls for M&A Get Louder

New issue loan supply has not kept pace with growth in the CLO market, which has led to loan spread compression. With lower interest rates in 2021, large M&A activity contributed to growth in loan supply that we believe more than met the loan demand from the CLO market. As a reminder, CLOs are by far the largest buyer of large LBO loans. However, as interest rates rose in 2022 and onward, higher financing costs have proven to be a challenging backdrop for M&A activity. Yet, after a long slowdown in exits, Private Equity sponsors are now facing more pressure to harvest their portfolios as older funds begin to approach their maturities. According to Pitchbook, today, 40% of PE fund portfolios are made up of companies that have been held for 7 years or more. By comparison, prior to 2021, only a quarter of a typical PE fund portfolio was made up of longer-held companies. This demonstrates that sponsors may be waiting for a more opportune time to exit, which has limited new deals coming to market.[1] However, these private equity funds cannot hold their portfolios indefinitely and will become increasingly pressured by their funds' stated maturities. Tim Ingrassia, Co-Chairman of Global Mergers & Acquisitions at Goldman Sachs, believes that because PE buyout fund distributions are near a 16-year low historically, there

[1] Pitchbook LCD, as of May 22, 2026. Q1 2026 Global Private Market Fundraising Report.

will be a "need to sell" to generate liquidity for LPs.[2] Should M&A return as previously discussed, both existing CLOs in their reinvestment period and newly created CLOs should benefit from wider spreads and therefore higher income from those loan assets.

2026 CLO Issuance on Pace to Fall Short of Last Year's Record

CLO captive equity funds fueled CLO creation that drove demand for loans—a large contributor to the loan market supply and demand imbalance in 2025. As we've discussed in our *Clarion Credit Snaps Q2 2026 Recap* video, captive CLO equity funds are so called 'captive' because they are controlled by the CLO manager who has an overwhelming asset management revenue incentive to continue to make new CLOs. The strong expansion in the CLO market and increased demand for loans contributed to the deterioration in new issue CLO equity net interest margins and projected returns of new issue CLO equity. Historically, CLO equity investors provided a natural 'check' to the economics in creating new CLOs. If loan prices were too high, loan spreads too tight, or the cost of CLO liabilities were too expensive, CLO creation would have slowed significantly and naturally limited the growth in the CLO market. CLO equity buyers would just not buy new deals, slowing their creation. This helped to preserve the supply and demand equilibrium between the loan and CLO markets. With CLO issuance slower this year (CLO new issuance is down 20% through May year over year)[3], the supply-demand picture of the loan market may be marginally improving. Less CLO creation (and thus less demand) will help limit the competition for loans and keep average loan prices below par, which should help to prevent future loan repricing activity. This would be a positive indicator for existing CLO equity investors that have dealt with the negative effects of loan repricings and consequent spread compression. While it may not improve CLO equity net interest margins (and thus cash yields) immediately, it could help solidify a trough in the market and help improve CLO equity investor confidence.

Credit Spreads

While the Fed interest rate path this year looks to be more uncertain, overall credit spreads remain historically tight. The ICE BofA US High Yield Index Option-Adjusted Spread was 2.6% on June 17th, 2026, which is only 22 basis points from the historical lows in 2007 (the lowest spread was 2.4% in June of 2007).[4] Single B loan spreads ended May at S + 2.87%, which is just inside of post-Great Financial Crisis ("GFC") tights set in January of this year (S + 2.82%).[5] According to a survey of investors by J.P. Morgan, 50% of cross asset investors saw the most relative value in CLO debt. This was compared to only 6% of respondents who thought Leveraged Loans provided the best relative value and 2% who saw relative value in High Yield Bonds. This survey indicates that the financing of CLOs is much more expensive on a relative basis compared to what that debt is financing (the purchase of leveraged

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[2] Goldman Sachs Global Banking & Markets as of April 24, 2026. M&A Volume Expected to Surge This Year Despite Economic Uncertainty.

[3] BofA CLO Research as of June 12, 2026. CLO Factbook.

[4] United States - ICE BofA US High Yield Index Option-Adjusted Spread and Trading Economics as of June 22, 2026. An **Option-Adjusted Spread (OAS)** is the specific yield spread added to a risk-free benchmark curve (like U.S. Treasuries) to discount a bond's payments to match its market price, dynamically adjusting for embedded options such as calls, puts, or prepayments.

[5] Pitchbook LCD as of June 26, 2026.

loans).[6] This should act as a disincentive to deal creation, as evidenced by the 20% decline in new issuances year to date through May year over year.[7] Moreover, volatility can quickly re-calibrate investor sentiments and push spreads significantly wider. The HY Index OAS reached a record peak of 21.8% in December of 2008 amidst the GFC. This demonstrates how credit spreads can react quickly to significant volatility in broader markets. A CLO's reinvestment period allows CLO managers to capture the benefits of volatility through lower loan prices and higher loan spreads, which can greatly benefit existing CLO equity investors. We believe a reversion to historical levels of loan spreads will occur and may be accelerated by increased market uncertainty and volatility.

A Hat Trick for CLOs?

We may begin to see opportunities for these headwinds to reverse (potentially all at once) under the right market conditions that could provide tailwinds for existing CLO equity investors. If credit spreads widen, CLOs will be able to reinvest paydowns into higher yielding assets in the secondary market. If M&A returns, CLOs will be able to buy higher yielding assets in the new issue market and likely build par through the OID typically offered in these issuances. If CLO captive fund deployments slow, the demand for loans should soften, which could lower loan prices and increase loan yields. Additionally, widening loan spreads from increased loan supply or through lower asset prices may improve CLO equity cash yields (all else being equal).

Having experienced unprecedented tightening in credit markets, existing CLO equity investors may benefit from this point forward if market trends begin to reverse. Some current market signals help to support this narrative going into the second half of this year. CLO equity strategies that are patient and focused on long-term performance can be poised to benefit greatly if these previously outlined tailwinds materialize. While headlines, cash yields, and mark to market performance may make it feel like the worst of times, could it really be the best of times to invest in CLO equity?

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[6] J.P. Morgan Research as of June 26, 2026. J.P Morgan CLO Investor Survey: Inflation riles respondents.

[7] BofA CLO Research as of June 12, 2026. CLO Factbook.

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