

Back in the ABS seat

I respectfully disagree with several ABS investors who reached out following my recent post on structured products. While we can all acknowledge the current state of the market and the potential for further spread widening if the macroeconomic backdrop fails to improve, I take issue with some of the drivers mentioned as having brought us to this point.

Artificial intelligence and broader software-driven disruption are undoubtedly significant factors, but they are not the primary ones.

Interest rate expectations—only fully repriced this year—are playing a substantial role in driving movements in CMBS and SRTs, while CLOs face distinct challenges stemming from both technical factors and underlying fundamentals that have been intensifying over time.

In CMBS and SRTs, I think, we are just at the beginning of a trend of wider spreads.

CLO asset pools have been deteriorating since mid-2025—and likely even earlier, given that manager tiering is not a recent phenomenon—and many so-called idiosyncratic cases have not been effectively managed within portfolios. Critical credit positions have been maintained in the asset pools due to limited liquidity, while in other instances, delayed exits at depressed prices have resulted in significant par value erosion. Bond market volatility and exposure to non-performing unsecured notes have further compounded the deteriorated situation. Meanwhile, the European high-yield distress ratio has risen steadily for seven consecutive months.

This was the market context in January 2026.

The broader leveraged loan market has underperformed, partly driven by asset repricing pressures that many CLOs have been unable to mitigate in the face of demands from private equity sponsors and shareholders. The ELLI index has been declining since June 2025, while CLO MVOCs have also shown a gradual and normal-contraction. The liabilities capital structure entered the current year with an excessively flat and tight yield curve relative to the historical shapes and marks of CLO 2.0.

To illustrate the flattening, consider the tranche spreads between BBBs–AAAs, BBs–AAAs, and Bs–AAAs in January 2026 compared with June 2025. While the overall WACC (weighted average cost of capital) tightened YoY by 25 basis points, the spread curve flattened over the six-month period by 40-45 bps in BBB tranches and by more than 90-100 bps in sub-investment-grade tranches (in the same timeframe AAAs compressed only by 10 bps over Euribor). I view this flattening as excessive, particularly against a backdrop of increasing dispersion and fat tails—a theme that has been building over time and widely discussed for more than a year.

The dislocation triggered by developments in artificial intelligence, alongside already-present, but strengthening, negative signals from credit market—such as the troubles observed in the chemical sector—has led to a repricing of liability capital structure and the embedded risks, although early warning indicators were already discernible to more attentive tranche investors.

Although in 2026 the pricing of certain BB and B tranches in the primary market remains opaque—these securities barely trade in secondary especially when the MVOC is below 100-, the recent curve steepening has brought yields back in line with 2022 levels (not in the BBBs, nor higher in the capital stack).

Do I believe value has emerged? In select cases, yes. Heterogeneity in portfolio management styles and vintages, coupled with marked differences in no-call periods and reinvestment horizons, creates opportunities to access convexity and attractive discount margins on a relative value basis.

However, a disciplined and highly selective approach remains essential across certain CLO platforms, particularly where idiosyncratic exposures have become pronounced. In such instances, portfolio performance may be disproportionately reliant on exogenous improvements or the passage of time, thereby postponing the realization of optimal entry points.

Describing the approach as a preference for “clean portfolios” understates, in my opinion, the complexity. In practice, it requires a nuanced understanding of technical vehicle dynamics and credit fundamentals, perspectives that are not always central among typical liability investors.

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