June: Signals from a Changing Landscape

Looking Beyond the Noise

New Fed Chairman Kevin Warsh has signaled after the latest Central Bank meeting a meaningful shift in the Federal Reserve's communication strategy by placing less emphasis on forward guidance and avoiding explicit indications regarding the future path of interest rates—a communication approach that the ECB has already largely adopted. Although he reaffirmed the Fed's commitment to restoring price stability (despite the inflation remained above target for several years), he stressed that future policy decisions will remain data dependent. While changes in the Fed's communication strategy and the pace of balance sheet reduction are likely over the coming year, I do not expect for the remaining part of 2026 the overall direction of interest-rate policy to differ materially from current market expectations. However, the absence of explicit forward guidance is likely to increase volatility at the short and intermediate segments of the yield curve, as investors place greater weight on incoming economic data and market signals. The long end of the curve should remain comparatively stable, although this will also depend on Treasury issuance decisions. Warsh appears to favour a market-driven approach in which investors price risk with less reliance on Federal Reserve intervention. While the Fed will undoubtedly continue to act to preserve financial stability when necessary, it seems less inclined to respond to day-to-day market fluctuations. This philosophy is consistent with Warsh's preference for reducing the importance of forward guidance. Although markets now have greater confidence that the Fed remains firmly committed to its 2% inflation objective, uncertainty persists regarding the degree of restrictiveness of current policy and the possibility of future changes to the Fed's monetary policy framework. Be aware of the Fed’s new communication strategy.

The ECB meeting was comparatively less eventful. The Governing Council argued that raising interest rates was appropriate under all the scenarios it considered, including one in which oil prices quickly returned to normal. According to the ECB, the objective was not to reduce energy prices directly but to prevent higher energy costs from feeding into wages and broader inflation dynamics through second-round effects. Such effects could keep inflation above the ECB's 2% target for longer than desired. By tightening monetary policy, the ECB aimed to moderate demand, anchor inflation expectations, and prevent temporary energy-price shocks from becoming embedded in underlying inflation. The ECB also reiterated that maintaining price stability remains its primary mandate and that allowing inflation to remain above target for a prolonged period would impose significant economic costs. The ECB stated that the rate hike was not intended as an insurance measure, but the decision was criticized by many as misguided. Because of iason's role and relationship with the Central Bank, it would be inappropriate for me to comment on this point.

Turning to HY credit markets, Golub Capital has continued to expand its private credit platform through the pricing of a European middle-market CLO. The transaction highlights the continued (but slow) maturation of the European private credit market, where alternative asset managers are increasingly using CLOs as an efficient funding tool to diversify financing sources and invest capital into new lending opportunities. The investor's demand for floating-rate assets offering attractive risk-adjusted returns remains robust despite the uncertain macroeconomic backdrop and ongoing criticism of the private credit. In my view, the new MM transaction priced fairly, with spreads appropriately reflecting the premium over large syndicated loan (BSL) CLOs. Interestingly, the AAA tranche priced broadly in line with previous European middle-market CLO transactions when we observe the premium above the BSL CLO AAAs, while the BBB notes offered particularly attractive value, likely reflecting the underlying portfolio characteristics of the Golub deal. A comment from my side: the notable trend is the increasing convergence between the broadly syndicated loan and bond markets and private debt. The links between these two segments are becoming progressively stronger, with large investment platforms leveraging economies of scale and their ability to assess credit from a 360-degree perspective.

Meanwhile, the major rating agencies have provided a supportive (and necessary) backdrop for the European CLO market through proposed revisions to their rating methodologies. Following its updated global CLO criteria, Fitch has placed more than 400 European CLO tranches under review, with expectations that between 5% and 15% could receive upgrades, most likely by one or two notches. The review process is expected to conclude within six months. At the same time, Moody's has launched a consultation on proposed revisions to its global CLO methodology, incorporating updated default assumptions based on more recent credit performance and historical experience. If implemented, Moody's estimates that a certain number of European CLO tranches could be upgraded, although the timing remains uncertain pending completion of the consultation. Overall, these methodological revisions should provide a modest but positive tailwind for European CLO ratings. It remains unclear, however, whether the revised methodologies will benefit tranches that have been downgraded in recent months, particularly those within the single-B category. My advice here is to watch the mezz-notes prices of old vintage portfolios and play convexity trades. The new criteria will be incorporated into future CLO transactions and portfolio managers will gradually adapt the asset pools through adjustments to structural tests and other rating-sensitive provisions. It is easy to understand why similar changes are unfolding at this moment. Investors exposed to CLO liabilities and equity should closely monitor these developments, assess their implications carefully, and maintain a critical perspective when evaluating the potential impact on PM investment decisions. Aside from the structure, where is the credit risk heading?

The European CLO market is approaching the end of the first half of the year with issuance broadly matching last year's record pace, supported by exceptionally strong demand for ABS liabilities. Beneath these impressive headline figures, however, the operating environment for managers has become increasingly challenging. Asset spreads continue to compress amid another wave of loan repricings, while roughly half of the CLO-eligible loan universe now trades above par. Although the revised rating methodologies should support issuance activity, they may also encourage managers to assume incrementally greater portfolio risk. I return in these lines to the central challenge facing CLOs: constructing portfolios capable of navigating an environment characterised by persistent uncertainty and tight yield. Investors must balance two interconnected risks: ongoing spread compression driven largely by technical market factors and the underlying evolution of credit risk. While this balancing act has become considerably more difficult than in previous years, disciplined portfolio construction and active management remain the most effective tools available. In today's market, CLO managers should work closely with equity investors to define the appropriate risk profile for each CLO transaction. Broadly speaking, two portfolio construction approaches are available. The first is a more defensive strategy. This involves building a relatively concentrated portfolio of high-conviction, fundamentally resilient credits, even at the cost of accepting lower spreads at inception. The objective is to preserve trading and reinvestment flexibility. Such an approach should allow managers to rotate the portfolio when needed (even taking a small par loss), to deploy capital selectively during periods of market dislocation, wider credit spreads or issuer-specific weakness, thereby improving over the quarters the portfolio carry and long-term returns for the equity. The second is a more aggressive strategy. Here, managers should seek to maximize portfolio earnings from inception by constructing a larger and more diversified asset pool across industries, issuers, ratings and types of assets. Rather than concentrating exposures, diversification in alpha credits (not only software and AI sector) allows managers to capture today incremental carry while maintaining compliance with collateral quality tests (now you can see better the rationale behind the rating agencies changes described before). It also provides greater resilience against idiosyncratic defaults and creates more opportunities to change the holdings as relative value in credit names evolves during the reinvestment period (from here the importance to keep the vehicle performing and up and running; an advice I always give to CLO credit platforms). Neither strategy is inherently superior. The optimal approach depends on prevailing market valuations, the shape of the credit curve, the availability of opportunities in both the primary and secondary markets, and, above all, the return objectives and risk tolerance of the equity investors. Ultimately, this is where the dialogue between CLO managers and investors begins. Fascinating.