TCW

# INSIGHT

LOAN & CLO REVIEW

## Risk Remains on as 2019 Exits in Force

**DREW SWEENEY & PALAK S. PATHAK** | 9 JANUARY 2020


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Mr. Sweeney is a Managing Director in the Fixed Income group where he trades leveraged loans. Mr. Sweeney joined TCW in 2015 from Bradford & Marzec, LLC where he managed loan strategies for both total return and CLO accounts as well as serving on the investment committee where he helped direct the firms overall investment strategy. Prior to Bradford & Marzec, Mr. Sweeney worked for Macquarie Group (fka Four Corners Capital Management) in Los Angeles, where he managed both bank loan and high yield bond investments. Prior to Four Corners, he evaluated leverage loan and bond opportunities for Columbia Management (Ameriprise Financial, Inc.). He also worked as an Analyst with ING Capital Advisors and as a member of the investment banking team at First Union Securities where he gained additional experience in underwriting, structuring and syndicating leveraged transactions. Drew holds an MBA from the University of North Carolina Kenan-Flagler Business School and a BS from Rutgers University.

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2019 ended as it began – with a bang. December provided the second best monthly return of the year, followed by January. Dissimilar to the first quarter, we saw risk outperform higher quality. With well over 50% of loans trading above par including most of the higher-quality segment, returns for the double B segment were essentially capped by yearend. Investors, in particular CLO investors, searched for OID and began reaching further and further down the quality spectrum to find discount. This led to a rally among triple C loans, which surpassed returns in all other ratings categories.

Earnings for the third quarter, which are announced in the fourth quarter, generally surpassed investor expectations. More importantly, there were few outliers of the type where a large loan might drop 40 points following results – outcomes that occurred in the second and third quarter with far too much frequency. By the end of November, it was clear that a number of CLOs were looking to print prior to the end of the year and that the new issue loan calendar could not satiate this demand. Then the market received additional positive news on ”surprise billing” for health care, a U.S.-China trade agreement and an oil price rally. This all contributed to a market rally and a more substantial rally in stressed energy, retail, metals and healthcare loans.

It seemed that few managers who had planned to issue in December pressed pause despite the strong rally in collateral prices. Lower priced loans trading in the low 90s popped in price, often in excess of 5 points. This was really driven by CLOs looking to create an average price for their portfolio.

As we think about 2019, returns were quite good and the year produced the fourth best returns of the decade. The average loan spread for the Credit Suisse Leveraged Loan Index (CS LLI) was 359 basis points (bps), up 11 bps year over year. However, given the percentage of loans trading above par (over 50%), it is hard to imagine a scenario where we do not see a repricing wave in the beginning of 2020, which will reverse some of the widening.

# Risk Remains on as 2019 Exits in Force

Despite increased volatility, loan default rates remained benign and lower than historical averages throughout the year. Low default rates and widening spreads provided a good backdrop for CLO issuance. In fact, 2019 CLO new issue volume passed 2017 volume and provided the third largest issuance in history. High CLO demand combined with lower institutional new issuance provided a good backdrop to squeeze prices higher.

| Year | Institutional Loan Volume Excluding Refinancing | % Change |
|---|---|---|
| 2019 | 214.63 | -30.7% |
| 2018 | 309.92 | 4.3% |
| 2017 | 297.12 | 38.9% |
| 2016 | 213.86 | 19.4% |
| 2015 | 179.06 | -31.9% |
| 2014 | 263.10 | 12.8% |
| 2013 | 233.27 | 40.8% |
| 2012 | 165.65 | 47.8% |
| 2011 | 112.08 | -0.4% |
| 2010 | 112.51 | 408.5% |

Source: S&P LCD, Barclays Research

### Performance – Loans

In December 2019, the CS LLI and the S&P Leveraged Loan Index (S&P/LSTA) were up 1.61% and 1.60%, respectively.

- Quarter-to-date, ending December 31, the CS LLI was up 1.68% and the S&P/LSTA was up 1.73%.
- For the 12 months ending December 31, the CS LLI was up 8.17% and the S&P/LSTA was up 8.64%.

During the month, triple Cs outperformed all other categories followed by single Bs. Triple Bs and double Bs lagged as these loans have lower coupons and the price appreciation is essentially capped at 101. High-risk loans outperforming marked a complete change in sentiment from most of 2019.

On an LTM basis, higher quality outperformed lower quality as triple Bs and double Bs produced returns of 8.79% and 9.09%, respectively. Single Bs returned 8.39% while triple Cs and the distressed categories posted returns of 2.70% and -18.04%.

**Total Return by Rating**

| | December | QTD | LTM |
|---|---|---|---|
| Split BBB | 0.51% | 1.23% | 8.79% |
| BB | 0.83% | 1.36% | 9.09% |
| Split BB | 1.27% | 1.44% | 8.84% |
| B | 1.95% | 2.11% | 8.39% |
| Split B | 2.87% | 0.98% | 5.19% |
| CCC/Split CCC | 3.38% | 1.20% | 2.70% |
| Distressed (CC, C and Default) | -6.02% | -20.36% | -18.04% |

Source: Credit Suisse Leveraged Loan Index

## Sector Performance

All 20 sectors in the CS LLI provided positive returns for December. The top performing sectors were Energy (4.11%), Retail (2.73%) and Consumer Durables (2.41%). These sectors have been arguably the most troubled sectors during the last several years – and the fact that they all outperformed certainly represent a change in outlook for many investors. The U.S.-China trade agreement along with higher WTI provided some support to these more trouble industries.

The worst performing sectors for the month were Housing (1.00%), Aerospace (0.99%) and Gaming (0.89%). There was a 323-basis-point difference between the top and bottom sectors in December.

In the last 12 months, Food & Drug, Housing and Aerospace have led all sectors with total returns of 12.44%, 10.48% and 9.62%, respectively. Consumer Durables, Energy and Metals/Minerals provided the worst performing sectors with returns of 2.67%, -0.29% and -3.77%, respectively.

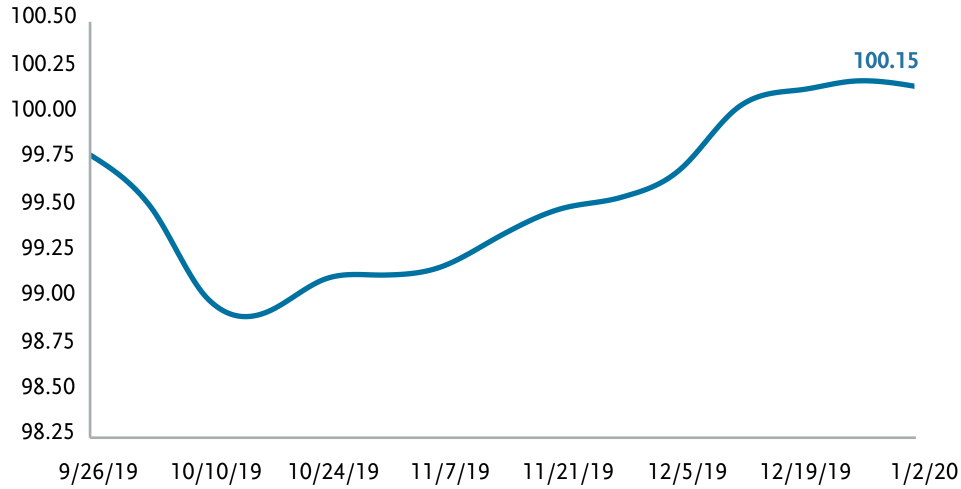
### Industry Returns

| Sector | December | QTD | LTM |
|---|---|---|---|
| AEROSPACE | 0.99% | 1.87% | 9.62% |
| CHEMICALS | 1.24% | 1.88% | 8.98% |
| CONSUMER DURABLES | 2.41% | 1.58% | 2.67% |
| CONSUMER NON-DURABLES | 1.41% | 0.89% | 6.85% |
| ENERGY | 4.11% | -0.73% | -0.29% |
| FINANCIAL | 1.11% | 1.87% | 9.59% |
| FOOD AND DRUG | 1.78% | 2.50% | 12.44% |
| FOOD/TOBACCO | 1.21% | 1.66% | 8.28% |
| FOREST PROD/CONTAINERS | 1.73% | 1.76% | 8.94% |
| GAMING/LEISURE | 0.89% | 1.37% | 9.39% |
| HEALTHCARE | 2.14% | 2.51% | 8.63% |
| HOUSING | 1.00% | 1.88% | 10.48% |
| INFORMATION TECHNOLOGY | 1.78% | 2.45% | 9.16% |
| MANUFACTURING | 2.38% | 1.88% | 7.56% |
| MEDIA/TELECOMMUNICATIONS | 1.29% | 1.25% | 9.16% |
| METALS/MINERALS | 2.20% | -3.28% | -3.77% |
| RETAIL | 2.73% | 4.21% | 9.39% |
| SERVICE | 1.16% | 1.07% | 7.12% |
| TRANSPORTATION | 1.33% | 1.87% | 7.37% |
| UTILITY | 1.47% | 0.65% | 7.59% |

Source: Credit Suisse Leveraged Loan Index

CS LLI prices (excluding defaults) increased 109  bps in December while the average bid of the S&P LCD flow-name loan composite increased 66 bps from 99.49 to 100.15. The average flow name bid is up 492 bps on a year-to-date basis.

**Average Loan Flow-Name Bid**




Source: LCD, an offering of S&P Global Market Intelligence

### Performance – CLOs

CLOs returned 0.75% in December, the year's highest monthly return except for January (+1.45%). Lower mezzanine tranches (BBB to B) led the rally with BBBs returning 2.1% and BBs returning 4.38%, the highest monthly BB return since January 2017. CLOs outperformed IG (+0.32%) during the month and underperformed HY (+2%) and LL (+1.6%). On an annual basis, CLOs returned a total of 5.5% in 2019, underperforming Loans (+8.64%), HY (+14.32%) and IG (+14.54%) credit.

The rally in CLOs during the month of December was caused by the underlying rally in leveraged loans, especially in lower tier loans (single B / CCC rated, loans trading <$90 etc.). These loans were holding down MVOC ratios and their price recovery in December led to higher MVOC coverage which caused spreads to tighten, especially for BB tranches. BB MVOC improved 50 to 100 bps over the past two months; however, the dispersion in BB MVOC remains large with over 2.5% difference between higher and lower covered bonds.

AAA spreads tightened by 5 bps over the month with longer duration bonds in the 115-125dm range and short, amortizing bonds covering in the 80-90dm range. AAs and As tightened 15-20 bps over the month with many bonds now trading at premiums. BBBs and BBs tightened 25-50 bps as MVOC ratios recovered. Tier 1 BBBs are now inside 350 dm and Tier 1 full duration BBs in the mid 600s dm. Spread tiering at the mezz level remains high with BBB spreads ranging by 50 -75 bps and BBs by as much as 200 bps.

Equity returns were low in 2019 (average total return ranged between -5% and 10%) as the 13-14 pts in collected distributions during the year could not beat the drop in NAV.

Secondary activity was robust especially given the holidays and the CLO OPAL conference which took many participants off the desk. Total BWIC activity was over $2 billion with the majority AAA followed by BB tranches. Dealers got lighter into year-end as demand for bonds overtook supply.

**Secondary CLO 2.0 Total Returns**

| | Dec-19 | YTD | LTM |
|---|---|---|---|
| **Total** | **0.75%** | **5.50%** | **5.50%** |
| AAA | 0.34% | 4.61% | 4.61% |
| AA | 0.54% | 5.95% | 5.95% |
| A | 0.78% | 6.72% | 6.72% |
| BBB | 2.10% | 8.93% | 8.93% |
| BB | 4.38% | 10.86% | 10.86% |
| B | 7.10% | 4.17% | 4.17% |

Source: JPM CLOIE Index

**Secondary CLO 2.0 Spreads (DM)**

| | Dec-19 | MoM Change (bps) |
|---|---|---|
| AAA | 90-135 | -5 |
| AA | 160-210 | -15 |
| A | 220-260 | -20 |
| BBB | 325-400 | -25 |
| BB | 600-800 | -50 |
| B | 950-1200 | -20 |

Source: TCW

## Technical Conditions – Demand

Leveraged loan funds reported an outflow totaling -$1.59 billion for the month of December, which was the smallest outflow of 2019. Outflows since the beginning of 4Q18 now total $58.4 billion or 38% of beginning period AUM. AUM for the loan mutual fund base is down to $97 billion from as high as $154 billion in October 2018 and is at a low since September 2016. Outflows for loan funds totaled -$37.8 billion which compares to -$4.7 billion of outflows in FY 2018.

CLO new issuance totaled $8.5 billion across 19 deals in December, down 11% from November. 2019 issuance totaled $118 billion across 247 deals, a 7% decrease from 2018 in terms of dollar amount but 3% higher than 2018 in number of deals.

Tier 1 AAA spreads tightened by 1 bp to 133dm. AAs and single As tightened 5-10 bps with Tier 1 AAs pricing at 185 dm and single As at 250dm. Most BBBs priced inside 400 dm with only one deal issuing a split Sr. / Jr BBB structure (vs. four deals in Nov). BBs tightened 30 bps with most Tier 1 BBs pricing at 700dm, many with no OID.

Three of 19 deals that were issued over the month were middle market CLOs. Sr AAA spreads ranged from 175-185dm. Total middle market issuance in 2019 was $14.7 billion across 33 deals (vs. $16 billion across 28 deals in 2018).

There was also one Collateralized Bond Obligation (CBO) that priced in December and one "enhanced" CLO, structured to hold up to 20% in CCC rated assets. It is estimated that $3-$4 billion in CBO/High CCC CLOs priced during the year.

There were no refis that priced in December and only two resets that priced over the month. Refi and reset activity is estimated to remain slow as projected refi/reset volume for 2020 is low given where current AAA spreads are (130s dm) versus AAA coupon levels for deals exiting their non-call periods (100-120 bps).

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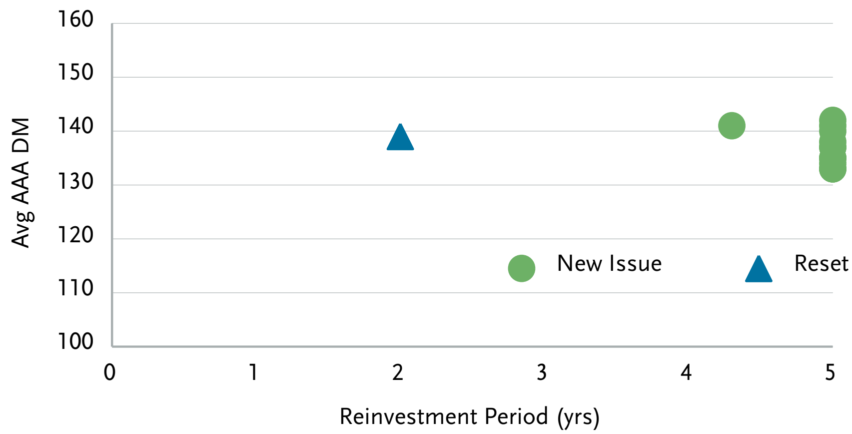
The CLO weighted average cost of debt declined by 4 bps to 191 dm due tighter spreads across the stack; however, with new issue loan spreads tighter over the month, gross arbitrage declined to under 140 bps.

**CLO New Issuance**

| | Dec-19 | YTD 2019 | YTD 2018 | YoY %∆ |
|---|---|---|---|---|
| New Issue ($bn) | $8.50 | $118.10 | $126.80 | -7% |
| Refi (#) | 0 | 61 | 79 | -23% |
| Reset (#) | 2 | 34 | 227 | -85% |

Source: TCW

**New Issue BSL AAA DM – December**




Source: TCW

**Tier 1 New Issue Spreads (5 yr reinv)**

| | Dec-19 | MoM Changes (bps) | YTD Changes (bps) |
|---|---|---|---|
| AAA | 133 | -1 | 5 |
| AA | 185 | -5 | -15 |
| A | 250 | -10 | -20 |
| BBB | 360 | -15 | -40 |
| BB | 700 | -30 | -20 |

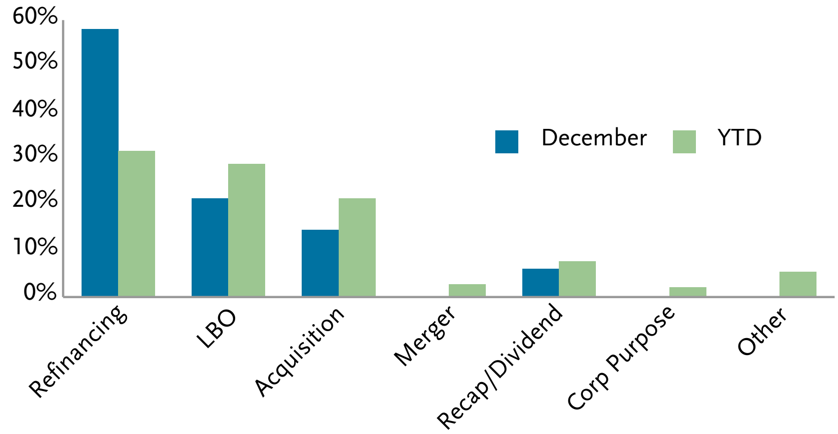
Source: TCW

# Risk Remains on as 2019 Exits in Force

## Technical Conditions – Supply

December continued to see an increase in refinancing activity marking a monthly high for 2019. Double B loans, which are in high demand, opportunistically hit the market, and generally reduced LIBOR spreads to L+175. On a year-to-date basis, M&A and LBO activity has accounted for roughly 53% of new issues while in December, M&A and LBO activity only accounted for 36% of new issuance.

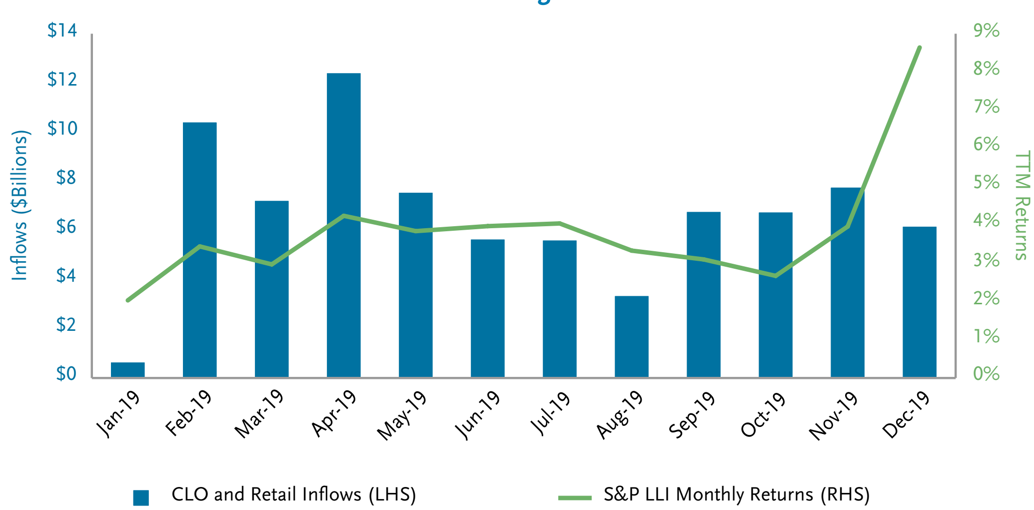
**Institutional New-Issue Volume by Purpose**




Source: LCD, an offering of S&P Global Market Intelligence

2019 U.S. CLO new issue supply of $118.1 is down -7.2% year over year but produced the third strongest year in CLO history. Solid CLO inflows and mild retail outflows allowed for strong returns during the month.

**Inflows and Rolling LTM Returns**




Source: LCD, an offering of S&P Global Market Intelligence

New issue spreads in December tightened -17.8% month-over-month and were -38.5% tighter on a year-to-date basis. While the change in quality mix always influences the monthly percentage change, repricings and new issue activity are clearly coming at tighter spreads than December 2018 and really tighter than almost any point in 2019.

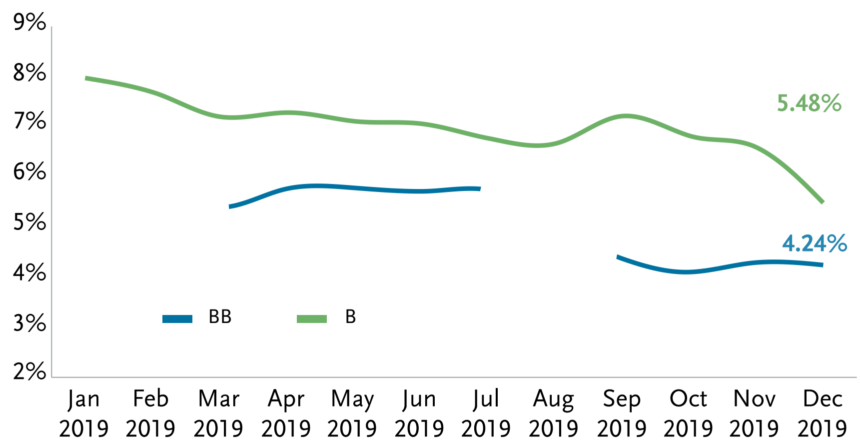
**New Issue Spread Changes**

| | All Loans |
|---|---|
| Dec-18 | 452 |
| Mar-19 | 404 |
| Jun-19 | 404 |
| Sep-19 | 394 |
| Dec-19 | 278 |
| Month-Over-Month Change | -17.81% |
| YTD Change | -38.5% |

Source: LCD, an offering of S&P Global Market Intelligence

In terms of new issue, yields continued to decline as a result of both tightening spreads and declining LIBOR rate, which is now below 1.88% (3-month LIBOR).

**Average New-Issue Yields**




Source: LCD, an offering of S&P Global Market Intelligence

## Fundamentals – Loans

There was one loan default in December. The default rate changed from 1.48% in November to 1.39% in December, based on par outstanding.

The last 12-month default tally for the S&P/LSTA is 23. Services and Leasing, Energy and Retail all have four defaults in the last 12 months.

As of December 31, the S&P/LSTA Index imputed default rate was 2.37 %, down from 2.91% in the prior month.

**Lagging 12-Month Default Rates**

| **Actual** | Oct-19 | Nov-19 | Dec-19 |
|---|---|---|---|
| By Number | 1.64% | 1.63% | 1.62% |
| By Principal Amount | 1.43% | 1.48% | 1.39% |
| **Shadow Default Rate** | | | |
| By Number | 1.09% | 1.00% | 1.90% |
| By Principal Amount | 1.35% | 1.17% | 1.10% |

*Shadow default rate includes potential defaults, including those companies that have engaged bankruptcy advisors, performing loans with SD or D corporate rating and those paying default interest.

Source: LCD, an offering of S&P Global Market Intelligence

### Fundamentals – CLOs

As lower priced loans rallied in December, the share of assets in CLOs trading below $80 and $90 improved to 3% and 10% respectively. However, some CLO fundamentals continue to deteriorate with WARF levels up another 10-15 pts as the amount of B3 and CCC rated assets increased over the month, mainly as a result of downgrades.

### Valuation

Since 1992, the average 3-year discount margin (DM) for the CS LLI is 460 bps. If the global financial crisis (2008 and 2009) is excluded, the 3-year discount margin for the CS LLI is 418 bps. The 3-year DM finished the month at 461 bps, which tightened 37 bps from the prior month.

The DM spread differential between Double Bs and Single Bs is 77 bps wider from January 2019 to December 2019 and 122 bps wider than the historical spread differential since inception.

**3-Year Discount Margin Differential Between BBs and Single Bs**

| | |
|---|---|
| 1/1992-12/2019 Average | 9.8 |
| Jan-19 | 54.9 |
| Dec-19 | 131.9 |

Source: Credit Suisse Leveraged Loan Index

**CS LLI Snapshot**

| | |
|---|---|
| YTD Total Return* | 8.17% |
| Average Price | 96.51 |
| Spread | 359 bp |
| Coupon | 5.51% |
| Current Yield | 5.74% |
| Yield (3-year life) | 6.27% |
| Discount Margin (3-year life) | 461 bp |

*S&P LLI Total Return 8.64%

| | Spread | DM (3-Year Life) |
|---|---|---|
| Split BBB | 206 bps | 194 bps |
| BB | 256 bps | 262 bps |
| Split BB | 305 bps | 328 bps |
| B | 388 bps | 470 bps |
| Split B | 512 bps | 1,106 bps |
| CCC/Split CCC | 648 bps | 1,365 bps |
| Distressed (CC, C and Default) | 749 bps | 4,961 bps |

Source: Credit Suisse Leveraged Loan Index

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## Summary and Looking Forward

November and December's loan price action (up 153 bps) almost completely reversed the risk-off sentiment from August, September and October, when loan prices traded lower by a cumulative 178 bps. As we enter January, investor sentiment is unchanged from the end of the year. CLO investors are flush with cash from year-end amortization payments and the forward calendar will not actually begin funding deals until we are into February. With nearly 55% of the market trading above par, we are seeing loans begin to reprice their LIBOR margins. As loan prices are higher and collateral spreads begin to reprice lower, the CLO market needs to see a commensurate amount of tightening in liabilities. Without this, the loan market gains will need to be reversed to make a CLO arbitrage compelling.

CLO issuance is estimated to be lower this year due to lighter anticipated loan issuance as well as a challenging arb. 2020 issuance predictions range from as low as $75 billion to $100 billion. For context, the last time we saw CLO issuance below $100 billion was in 2016. If issuance does slow down, CLO IG spreads will most likely tighten as demand is expected to be stable. Mezz spreads will remain highly dependent on loan fundamentals with loan downgrades likely to be a significant driver for mezz demand and spreads. ■