TCW

# INSIGHT

MONTHLY COMMENTARY

## Loan Review – December 2018

**DREW SWEENEY** | 10 JANUARY 2019

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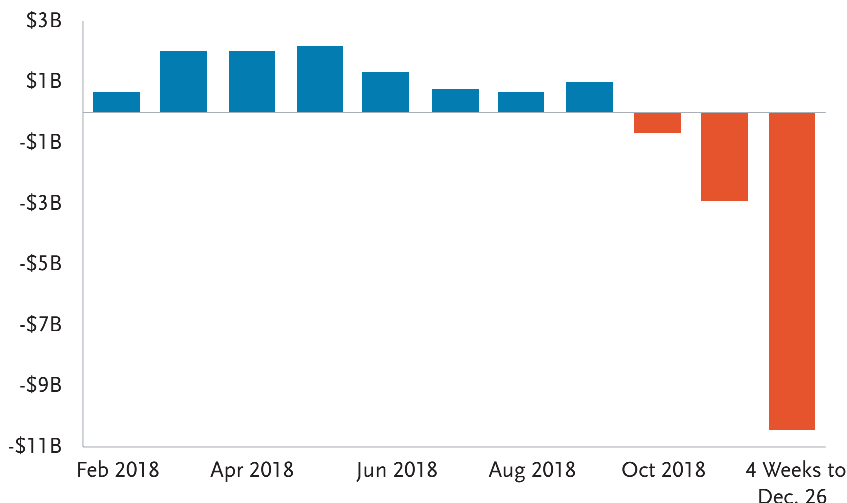
Mr. Sweeney is a Senior Vice President in the Fixed Income group where he trades leveraged loans. Mr. Sweeney joined TCW in 2015 from Bradford & Marzec, LLC where he managed loan strategies for both total return and CLO accounts as well as serving on the investment committee where he helped direct the firm's 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.


Where to begin? Should we start with a spoiler alert and then provide a flashback? Some months there is a dearth of information to provide in the commentary, however this December, there seems to be too much information. Loan returns were bad in the fourth quarter (the fifth worst quarter since 1998). Why measure returns back to 1998? The index only provided quarterly data starting in January 1999. We can't dive into what drove December performance until we provide the spoiler alert - the first five trading days of 2019 clawed back most of December's decline. So now that you have some context to the magnitude of the market's decline, we can fade to the flashback.

The weakness that began in November accelerated in December. Retail fund outflows drove the market down and the CLO market began to sputter after the first week of the month.

**Prime-Fund Flows (Weekly Reporters Only)**




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

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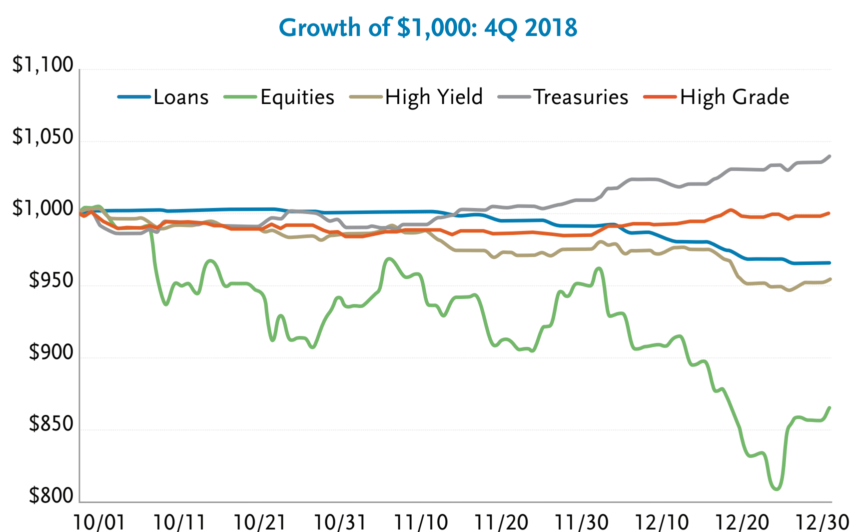
As risk sold off globally, retail funds recorded record outflows. At the same time, CLO liabilities widened. As CLOs ceased to be manufactured due to liability costs, demand for loans became negative as retail funds were forced to sell positions to raise cash and meet redemptions. There is a unique component of this weakness: Investment bank trading desks have much smaller balance sheets than they had prior to 2009. Therefore, as CLOs stopped buying and retail funds began selling – there were few investors left to take the other side of the trade. Consequently, these forced sales quickly pushed prices much lower. Much of the selling hit the largest and most liquid names first and price discovery would have been necessary to find levels for more off-the-run names. The Christmas – New Year's seasonal quiet could not come quickly enough. Loans, which had withstood so much of the year's volatility, almost had to throw in the towel in December. Pummeled, staggered and bewildered, the loan market ended the year with only a 44 basis point gain.




Source: LCD, an offering of S&P Global Market Intelligence, Bank of America, Merrill Lynch

In 2018, the CLO market produced its largest annual level of issuance in its history. This seemed to be a less emphasized headline after the first week of December. Furthermore, we know from discussions with investment banks that there were upwards of 150 warehouses open around the time of Opal, just after Thanksgiving. The fate of these warehouses became more questionable as the losses during the month piled up. Now, as indicated, the prices on the warehouse loans have improved dramatically in early January. However, until we see where liabilities price it is hard to know if there is an arbitrage that works yet for investors for these warehoused deals.

### Performance

In December 2018, the Credit Suisse Leveraged Loan Index (CS LLI) and the S&P Leveraged Loan Index (S&P/LSTA) were down -2.29% and down -2.54%, respectively.

- Quarter-to-date, ending December 31, the CS LLI was down -3.08% and the S&P/LSTA was up -3.45%.
- For the twelve months ending December 31, the CS LLI was up 1.14% and the S&P/LSTA was up 0.44%.

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In December, Single Bs were the top performing category followed by Triple Bs and then Double Bs. While distressed loans show only a -0.86% return, it is more likely a reflection that the loans were not traded in the back half of the month and the loan prices were consequently not forced lower as the more liquid single B loans and above. All the asset classes performed somewhat similarly, without a preference for high quality loans. That is most likely a result of mutual funds seeking liquidity wherever they could find it, regardless of rating. It was evident that liquid names and often higher quality names were getting hit first.

### Total Return by Rating

| | December | Q4 2018 | LTM |
|---|---|---|---|
| Split BBB | -2.21% | -2.65% | 0.56% |
| BB | -2.32% | -3.18% | 0.17% |
| Split BB | -2.54% | -3.53% | -0.04% |
| B | -2.19% | -2.85% | 1.41% |
| Split B | -2.92% | -4.66% | 3.44% |
| CCC/Split CCC | -2.60% | -4.01% | 4.40% |
| Distressed (CC, C and Default) | -0.86% | -9.14% | -1.22% |

Source: Credit Suisse Leveraged Loan Index

## Sector Performance

No sector was spared as all 20 sectors in the CS LLI provided a negative return during the month. The top performing sectors in December were Utility (-1.53%), Transportation (-1.64) and Service (-2.03%).

The worst performing sectors for the month were Manufacturing (-2.64%), Media/Telecommunications (-2.64%) and Food & Drug (-3.95%).

On a quarter-to-date basis, Utility (-1.97%), Transportation (-2.14%) and Service (-2.03%) outperformed while Food & Drug (-4.43%), Metals/Mining (-4.51%) and Retail (-4.56%) underperformed.

In the last 12 months, Retail, Transportation and Energy have led all sectors with total returns of 3.99%, 3.11% and 2.62%, respectively. In contrast, Media/Telecommunications, Forest Products/Containers and Consumer Durables were the worst performing sectors with returns of -0.02%, -0.07% and -1.24%, respectively.

### Industry Returns

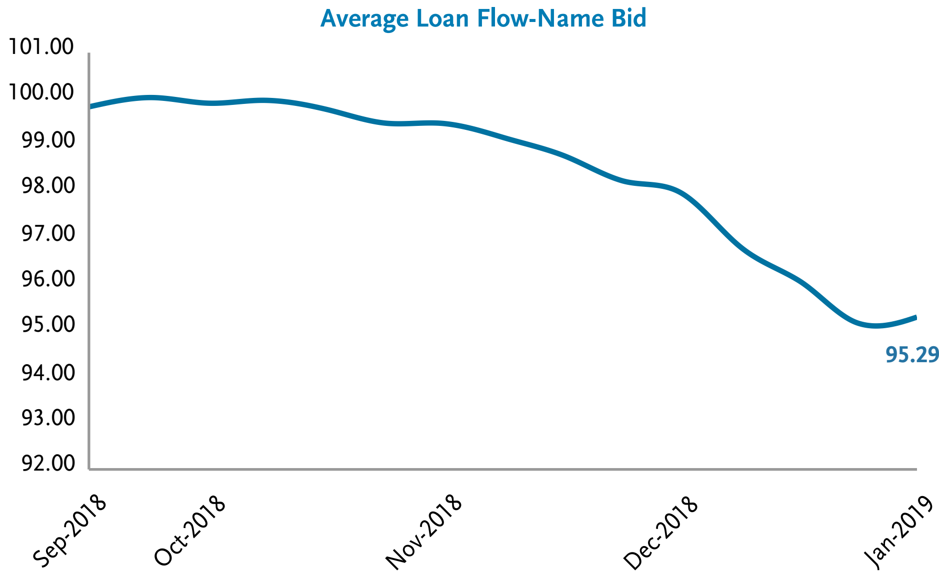
| | December | Q4 2018 | LTM |
|---|---|---|---|
| AEROSPACE | -2.09% | -2.81% | 0.50% |
| CHEMICALS | -2.28% | -2.76% | 1.14% |
| CONSUMER DURABLES | -2.09% | -2.69% | -1.24% |
| CONSUMER NON-DURABLES | -2.07% | -3.10% | 1.13% |
| ENERGY | -2.62% | -4.30% | 2.62% |
| FINANCIAL | -2.07% | -2.47% | 1.49% |
| FOOD AND DRUG | -3.95% | -4.43% | 0.98% |
| FOOD/TOBACCO | -2.08% | -2.65% | 0.72% |
| FOREST PROD/CONTAINERS | -2.39% | -3.23% | -0.07% |
| GAMING/LEISURE | -2.14% | -2.77% | 0.57% |
| HEALTHCARE | -2.38% | -3.06% | 1.21% |
| HOUSING | -2.50% | -3.70% | 0.26% |
| INFORMATION TECHNOLOGY | -2.40% | -3.10% | 1.15% |
| MANUFACTURING | -2.64% | -3.37% | 0.67% |
| MEDIA/TELECOMMUNICATIONS | -2.64% | -3.61% | -0.02% |
| METALS/MINERALS | -2.21% | -4.51% | 1.78% |
| RETAIL | -2.19% | -4.56% | 3.99% |
| SERVICE | -2.03% | -2.38% | 1.31% |
| TRANSPORTATION | -1.64% | -1.97% | 3.11% |
| UTILITY | -1.53% | -2.14% | 2.33% |

Source: Credit Suisse Leveraged Loan Index

# Loan Review – December 2018



CS LLI prices decreased -273 basis points in December while the average bid of the S&P LCD flow-name loan composite drifted -295 basis points from 98.24 to 95.29.

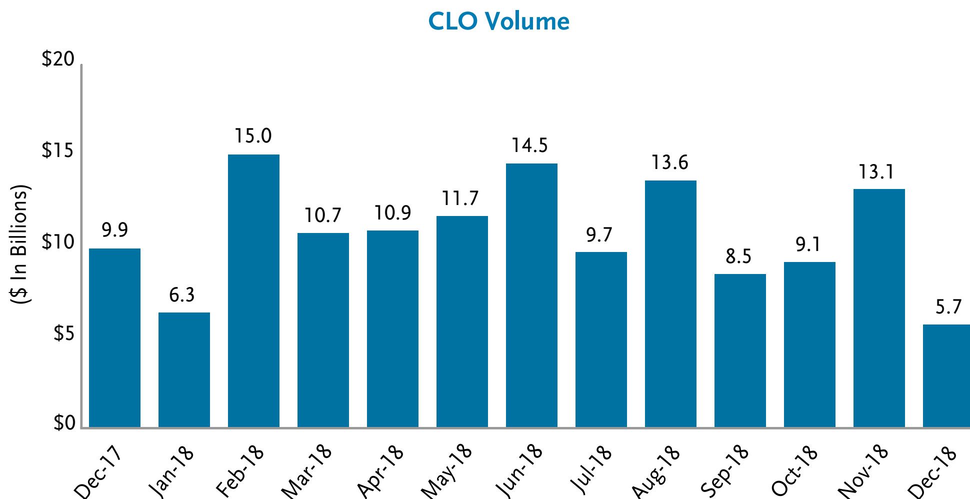



Source: LCD, an offering of S&P Global Market Intelligence

## Technical Conditions

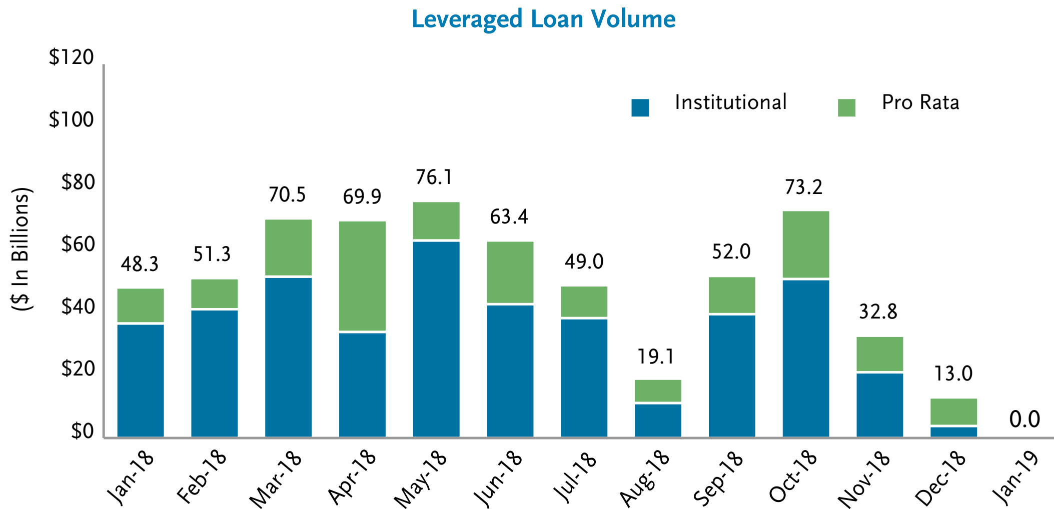
Leveraged loan funds reported an outflow totaling -$2.3 billion for the short week ending January 2 with December's outflow reaching -$12.6 billion. The last three weeks of December registered the three largest weekly outflows on record for the asset class. For context, loan mutual funds have had seven consecutive $1+ billion weekly outflows, totaling $15.8 billion, during the last seven weeks. This amounts to roughly 15.9% of assets under management. December was also the largest monthly outflow for the asset class ($12.6 billion vs $7.4 billion December 2014 and $7.2 billion August 2011). AUM for the loan mutual fund base is down to $130 billion from as high as $154 billion earlier in the year.

There were $5.7 billion of CLOs issued in December, which brought year-to-date issuance to $129 billion. This represents the all-time highest annual issuance for the market since inception. Most of that issuance occurred in the first week of the month before risk assets began selling off and by month end, the CLO new-issue market was effectively closed.



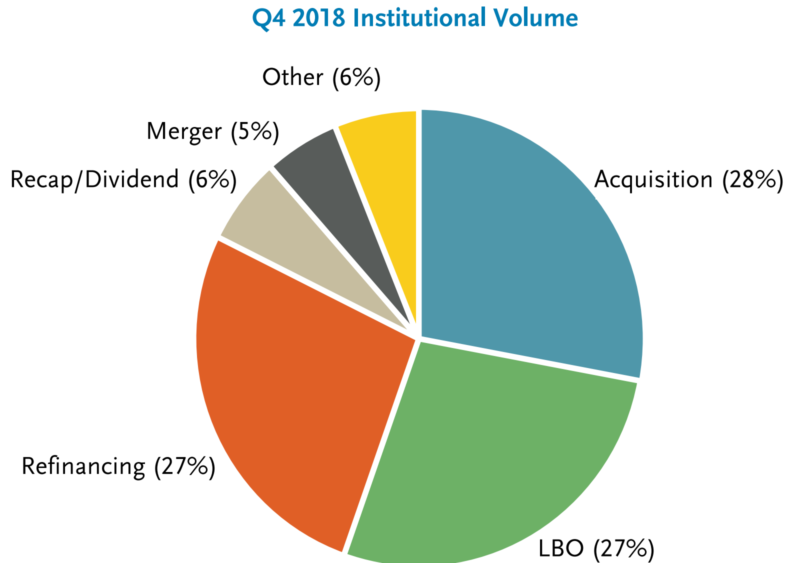

Source: LCD, an offering of S&P Global Market Intelligence

Institutional new issuance declined in December to $3.9 billion, which was the lowest Institutional issuance in 2018. For the year institutional new issue is down -13.3% from 2017.



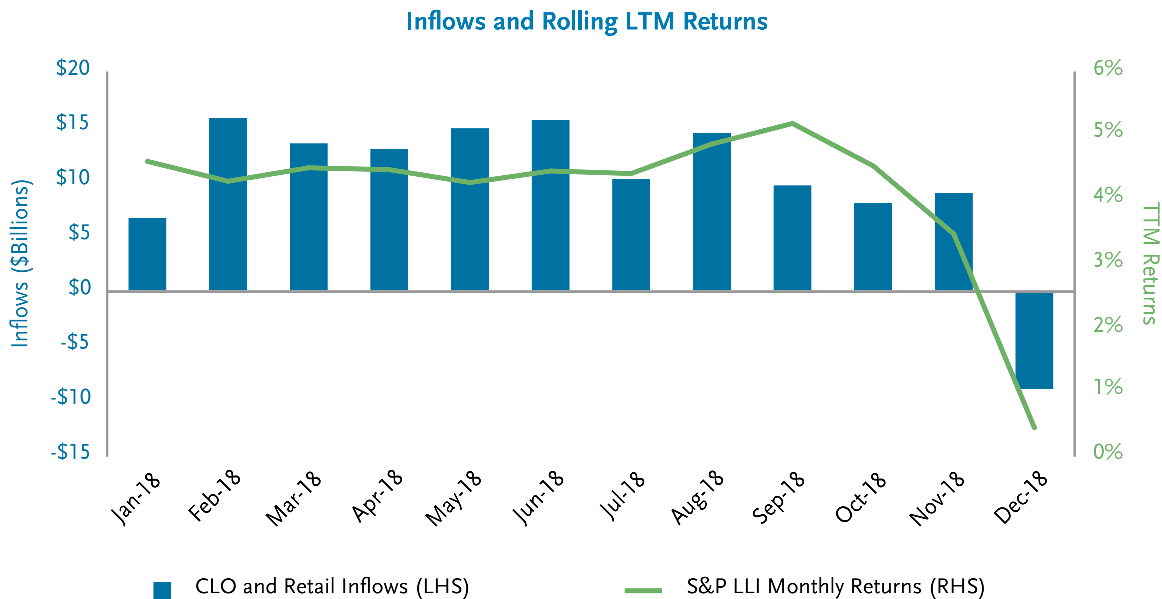

Source: LCD, an offering of S&P Global Market Intelligence

Repricings have declined in significance since the end of May. In fact, refinancings represented approximately 27% of total new issuance while acquisitions, mergers and LBOs represented 60% for the year.




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

Amid December retail outflows, we saw gross CLO and retail issuance decline to their lowest levels in 2018. The negative overall outflows pushed returns from trailing 12-month returns of roughly 3.5% in November 2017 to 0.44% in December 2018.




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

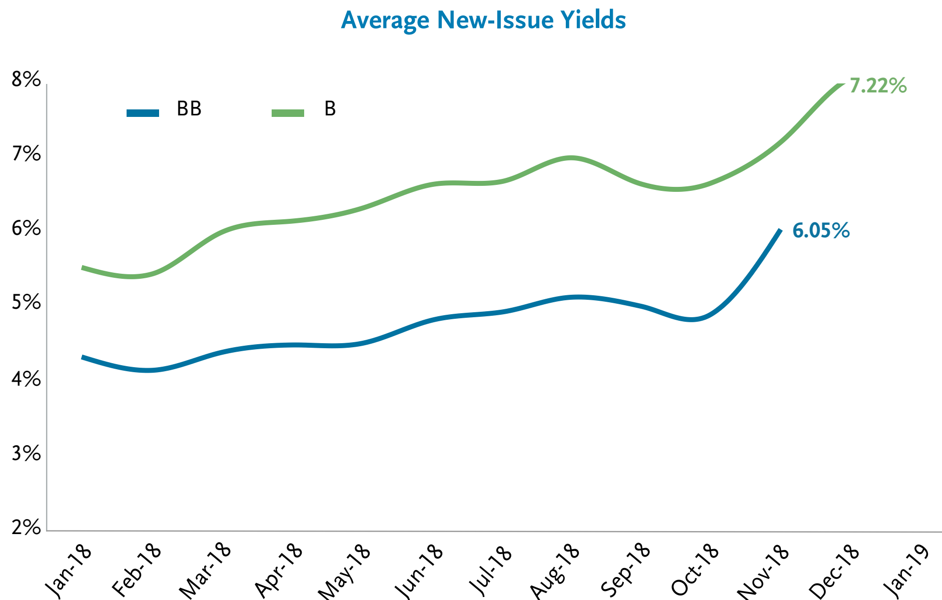
December saw new issue spread widen month over month by 12.8% while year-to-date spreads were wider by nearly 30.6%. It is important to note that there was little issuance during the month and several deals were pulled in favor of waiting until 2019. Clearing levels for loans that did get syndicated not only included much higher spreads but typically deep discounts well below typical Original Issue Discount (OID).

### New Issue Spread Changes

| | All Loans |
|---|---|
| Mar-18 | 317 |
| Jun-18 | 362 |
| Sep-18 | 378 |
| Nov-18 | 401 |
| Dec-18 | 452 |
| Month-Over-Month Change | 12.80% |
| 2018 | 30.57% |
| LTM Change | 15.8% |

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

In terms of new issue yields, single Bs widened 87 basis points while no double B new issues were syndicated. On a year-to-date basis, single Bs are 254 basis points wider.




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

The default rate changed from 1.61% in November to 1.63% in December. There was one default, a Catalina Marketing first lien loan that traded in the teens at month end.

The last 12-month default tally for the S&P/LSTA is 18. Retail leads all categories with six, while Oil & Gas is close behind with four.

**Lagging 12-Month Default Rates**

| **Actual** | **Oct-18** | **Nov-18** | **Dec-18** |
|---|---|---|---|
| By Number | 1.79% | 1.56% | 1.56% |
| By Principal Amount | 1.92% | 1.61% | 1.63% |
| **Shadow Default Rate** | | | |
| By Number | 0.75% | 0.73% | 0.73% |
| By Principal Amount | 0.50% | 0.46% | 0.39% |

Source: LCD Loan Stats

* 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

## Valuation

Since 1992, the average 3-year discount margin ("DM") for the CS LLI is 460 basis points. If the global financial crisis (2008 & 2009) is excluded, the 3-year discount margin for the CS LLI is 416 basis points. The 3-year DM finished the month at 550 basis points, which is the highest it has been since June 2016.

The DM spread differential between double Bs and single Bs widened from January 2018 to December 2018 by 4 basis points and was still 43 basis points wider than the historical spread differential at year end.

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

| | |
|---|---|
| 1/1992-12/2018 Average | 85.2 |
| Jan-18 | 124.8 |
| Dec-18 | 128.4 |

**CS LLI Snapshot**

| | |
|---|---|
| YTD Total Return* | -3.08% |
| Average Price | 94.09 |
| Spread | 348.27 |
| Coupon | 6.12% |
| Current Yield | 6.50% |
| Yield (3-year life) | 8.09% |
| Discount Margin (3-year life) | 550 bp |

*S&P LLI YTD Total Return 3.06%

Source: Credit Suisse Leveraged Loan Index

| | Spread | DM (3-Year Life) |
|---|---|---|
| Split BBB | 194 bps | 328 bps |
| BB | 254 bps | 414 bps |
| Split BB | 299 bps | 491 bps |
| B | 382 bps | 568 bps |
| Split B | 508 bps | 978 bps |
| CCC/Split CCC | 675 bps | 1,164 bps |
| Distressed (CC, C and Default) | 446 bps | 3,104 bps |

Source: Credit Suisse Leveraged Loan Index

## Summary & Looking Forward

As of December 31, the S&P/LSTA Index imputed default rate was 3.34%, up from 1.95% in the prior month. This is the highest level since September 2016. The loan market, which has often been sleepy, has begun to move faster and react quickly to changes in sentiment. The 3-year discount margin widened from L+443 to L+550 during the month. This is nearly 20% wider than the historical discount margin.

Volatility has increased in the loan market and as quickly as we saw prices drop to end the year, we have seen prices rise in the early days of 2019. The increased volatility reflects a confluence of factors. First, the production of CLOs is broken. Second, the broader loan market has experienced record outflows from mutual funds. Finally, investment banks historically served as a buffer to outflows and muted volatility. In the past, trading desks have held much higher levels of loan inventory than they do today. Their reduced involvement certainly contributes to a portion of the volatility. This was evidenced in December by the fact that large, liquid loans (often higher quality) were used as a currency to meet fund redemptions. These names led the decline in prices. In addition to this trading dynamic is the fact that there was clearly a change in sentiment. The complexion of conversations on TV and in newspapers has changed. People are discussing the end cycle with increased frequency and the introduction of those conversations clearly influenced behavior at the end of 2018. ■

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