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MONTHLY COMMENTARY

Loan Review – December 2016

DREW SWEENEY | JANUARY 12, 2017

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Mr. Sweeney is a Senior Vice President in the U.S. 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.

December 2016 epitomized the year as a whole. The loan market produced very strong returns for the month, driven by inflows from both retail funds and CLOs. Demand overwhelmed supply not only in December but throughout most of 2016.

The year produced the best returns since 2010 as investors' concerns surrounding rising rates drove over $13.5 billion of inflows into retail funds in the fourth quarter. In addition to the largest retail inflow since 2013, the CLO market generated its largest inflow for the year with over $25 billion during the fourth quarter. The net effect of all this demand was to push loan prices higher and LIBOR spreads lower.

LIBOR garnered much attention this year as 3-month LIBOR finished 2016 at 1.0%, up from 0.62% at the beginning of the year. The LIBOR curve remains very steep with 1-month LIBOR finishing the year at 0.76%. The steep curve became a lender issue as many loan borrowers, who typically use 3-month LIBOR, toggled and began paying interest based on a 1-month LIBOR contract. This resulted in the true yield to lenders declining by roughly 25 basis points on many loans.

As loans produced their fifth largest return since 1992, one has to wonder what the impact of tighter spreads and higher prices will mean for 2017 returns. The year finished with roughly 72% of loans trading above par and 25% of loans trading above 101. Most loans have little call protection (6-12 months generally), meaning loans can generally be prepaid or "repriced" at any time. With 70% of the index trading above par, the overwhelming majority of loans could have a LIBOR spread reduction of ~0.25%- ~0.75%.

Obviously, permanent spread reductions would be detrimental to any lender; however, the impact is more troubling for CLOs than total-return accounts. The CLO market, which historically has represented 50%-60% of total institutional loan demand, has fixed liability spreads. This means LIBOR spread declines are not only detrimental to the equity returns but create instability in the overall vehicle if repricings are pervasive. Consequently, if the tsunami of loan repricings that occurred in the second half of 2016 continues in 2017, it could lead to a dislocation of CLO demand. Any dislocation in demand can create underlying loan volatility.

The rabid search for yield and floating rate investments in 2016 is reminiscent of demand in 2003 when bank loan current yields declined to as little as 4.31% and LIBOR spreads reached 305 basis points. In 2003, concerns of rising rates drove loan yields (assuming a three-year life) from 7.86% in January 2003 to 6.2% by year-end. In 2003, prices improved roughly 5.7 points and the three-year discount margin tightened by 169 basis points. The asset class also posted a double-digit return in 2003. 2016 was remarkably similar. The current yield of the Credit Suisse Leveraged Loan Index finished the year below 5.0%, like 2003. Bank loan yields (assuming a three-year life) declined from 7.5% to 6.0% and prices improved roughly 5.4 points. Finally, the three-year discount margin tightened by 108 basis points and several loan indices posted double-digit returns.

The natural question is – what happened in 2004? Loans produced returns in excess of the coupon and registered a 5.6% return. And while history does not often repeat itself, it sometimes rhymes.

Demand for loans at the beginning of 2017 is still overwhelming supply and the average price of the Index continues to climb.

Performance

In December 2016, the Credit Suisse Leveraged Loan Index ("CS LLI") was up 1.15% and the S&P Leveraged Loan Index ("S&P/LSTA") was up 1.16%.

- For the fourth quarter ending December 31, 2016, the CS LLI was up 2.25% and the S&P/LSTA was up 2.26%.
- For the twelve months ending December 31, 2016, the CS LLI was up 9.88% and the S&P/LSTA was up 10.16%.

Sector Performance

Higher-beta loans gapped upward in December as investors looked to put cash to work and wanted exposure to risk assets. Consequently, Energy, Metals/Minerals and Manufacturing led all categories and posted returns of 5.46%, 1.85% and 1.39%, respectively. Crude prices rose over 7% in December, continuing the rally that began in November. Natural gas prices also increased over 10% for the second straight month, further aiding a recovery in Energy loan prices. Manufacturing rallied in part as a result of investor sentiment. A number of investors are beginning to believe that a US recession may be pushed out several years and that the new administration will protect US manufacturing businesses. Consequently, manufacturing also outperformed.

Total Return by Sector

Sector	December	Sector	Q4	Sector	LTM
Aerospace	0.84%	Aerospace	1.82%	Aerospace	8.29%
Chemicals	0.79%	Chemicals	1.62%	Chemicals	8.68%
Consumer Durables	1.24%	Consumer Durables	1.84%	Consumer Durables	10.29%
Consumer Non-Durables	0.53%	Consumer Non-Durables	2.16%	Consumer Non-Durables	7.48%
Energy	5.46%	Energy	11.85%	Energy	37.22%
Financial	1.09%	Financial	2.43%	Financial	8.22%
Food and Drug	1.10%	Food and Drug	1.47%	Food and Drug	6.63%
Food/Tobacco	0.93%	Food/Tobacco	1.24%	Food/Tobacco	6.15%
Forest Prod/Containers	0.85%	Forest Prod/Containers	1.80%	Forest Prod/Containers	7.02%
Gaming/Leisure	0.86%	Gaming/Leisure	1.84%	Gaming/Leisure	11.14%
Healthcare	1.02%	Healthcare	1.17%	Healthcare	7.02%
Housing	0.90%	Housing	1.61%	Housing	7.91%
Information Technology	1.03%	Information Technology	2.67%	Information Technology	10.09%
Manufacturing	1.39%	Manufacturing	2.36%	Manufacturing	9.55%
Media/Telecommunications	1.17%	Media/Telecommunications	2.04%	Media/Telecommunications	9.09%
Metals/Mining	1.85%	Metals/Mining	7.59%	Metals/Mining	36.46%
Retail	-0.37%	Retail	-0.55%	Retail	6.30%
Service	1.16%	Service	2.16%	Service	9.39%
Transportation	1.18%	Transportation	1.91%	Transportation	8.70%
Utility	1.17%	Utility	2.13%	Utility	8.72%

Source: Credit Suisse Leveraged Loan Index

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Retail was the sole sector to produce a negative return in the month of December. Holiday sales for traditional bricks and mortar businesses' appear to be weak. The worst performing sectors in December were Retail, Consumer Non-Durables and Chemicals with returns of -0.37%, 0.53% and 0.79%, respectively. Actually, returns in Consumer Non-Durables and Chemicals were solid; however they lagged the overall index. Retail was notable as it was the only sector to post negative returns and returns were being driven by actual results.

The top sector returns in 2016 were Metals/Minerals, Energy and Gaming, with returns of 39.46%, 37.22% and 11.14%, respectively. Interestingly, only five sectors provided returns in excess of the index return for the year. This includes the three sectors listed above as well as Information Technology and Consumer Durables. Fifteen of the 20 sectors in the CS Index have underperformed the Index, which demonstrates the impact of Energy and Metals' returns on overall performance.

Triple Cs outperformed in December, gaining +4.0% this month and an impressive +25.6% gain on the year. Single-Bs outperformed BBs in December (+1.0% vs 0.8%). Single-Bs (+9.6%) also outperformed BBs (+6.9%) on the year.

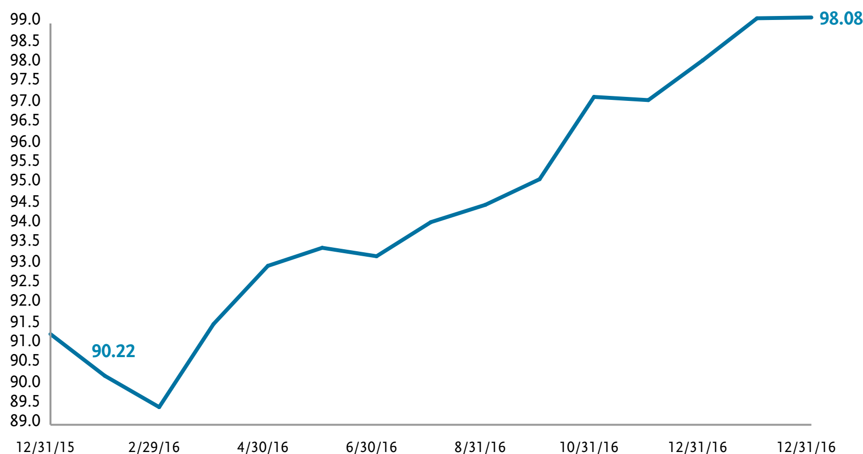
Total Return By Rating

	December	Q4	LTM
Split BBB	0.60%	1.17%	5.11%
BB	0.80%	1.27%	6.91%
Split BB	0.92%	1.68%	8.32%
B	1.03%	1.94%	9.56%
Split B	1.96%	6.03%	24.52%
CCC/Split CCC	4.04%	8.18%	25.63%
Distressed (CC, C and Default)	3.34%	7.60%	27.87%

The rally has increased the percentage of loans trading above par and allowed the refinancing wave to be extended through December. At month end, the percentage of The JP Morgan Loan Index trading above par was 72% with 25% trading above 101.

The average bid price for the S&P LSTA Leveraged Loan Index at month-end was 98.08 up from 90.2 earlier in the year. The broader index price has increased six consecutive months, or since Brexit concerns.

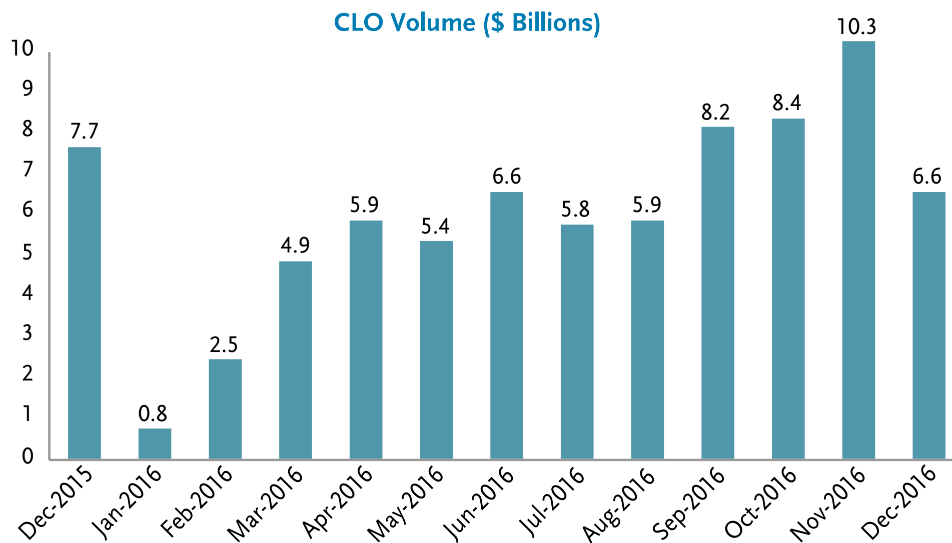
S&P/LSTA LLI Average Bid



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

Technical Conditions

The fourth quarter provided CLO issuance of over $25 billion for the largest quarterly tally of the year. December provided a $6.6 billion inflow, which was a 35% decline from November. The increase in demand for loans from CLOs has been driven by tightening liabilities. Foreign investment has continued to drive these liabilities. Foreign investment has continued to drive these liabilities tighter, which has allowed the underlying collateral borrowers to reduce spreads. This trend continues in 2017 and liability spreads look poised to tighten further.



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

Issuance in 2016 fell to $71 billion from $98.66 billion in 2015. Looking prospectively, the impact of risk retention on the CLO market will likely result in another decline in issuance. To date, a relatively small number of loan managers have actually set-up permanent risk-retention vehicles.

Leveraged loan funds reported an inflow of $924 million in the final week of 2016. December's total inflow of $7.2 billion was comparable to a record $7.8bn inflow in August 2013. The loan asset class has now attracted $15 billion of inflows the past two quarters after outflows of a cumulative $60 billion over the previous 10 quarters. AUM for retail loan funds has increased to $119.5 billion but remains below where it stood in 2013 ($154bn). Inflows for loan mutual funds in 2016 were +$8.4 billion (+$5.4bn ETF) compared to outflows in 2015 and 2014 totaling -$21.7bn and -$23.8bn.

As can be seen on the following page, these inflows pushed returns higher throughout 2016.

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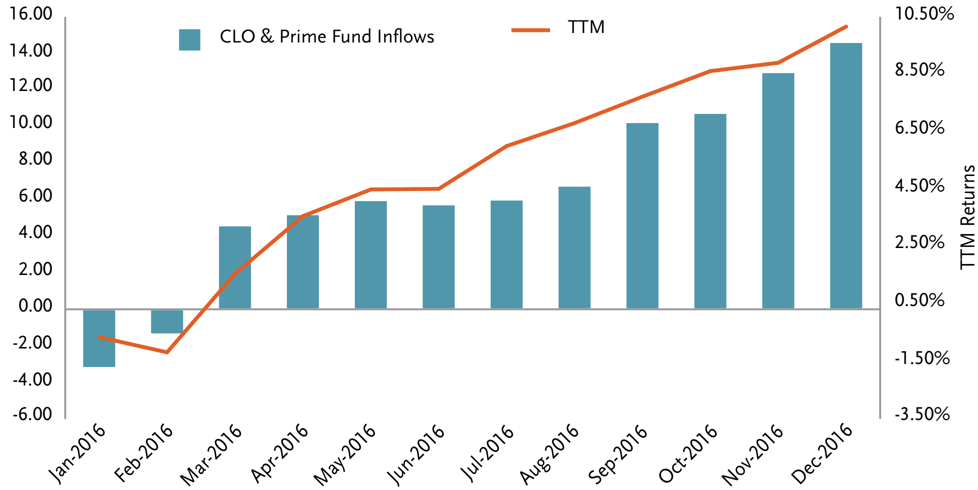
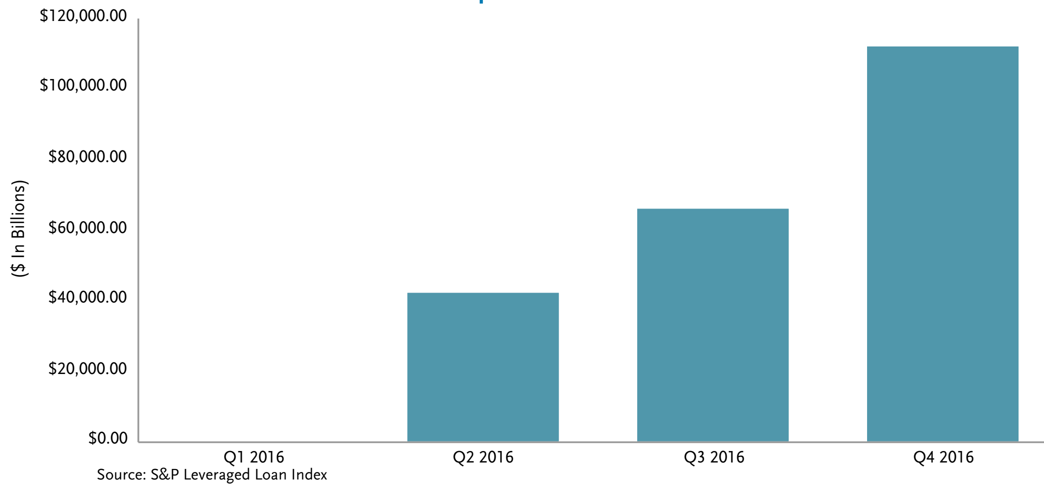


Source: S&P Leveraged Loan Index

At the same time that demand reached its highest levels of 2016, new-issue supply began to decline. There was less than $21.6 billion of institutional and pro rata issuance in December, representing a month-over-month decline in supply of over 48%. Approximately 78% of December's new-issue volume was re-pricing (50%) or refinancing (28%).



Source: S&P Leveraged Loan Index

In 2016, there was $336 billion of institutional new issuance and $141 billion of pro rata issuance. The combined $477 billion of total issuance was an increase of approximately 13.5%.

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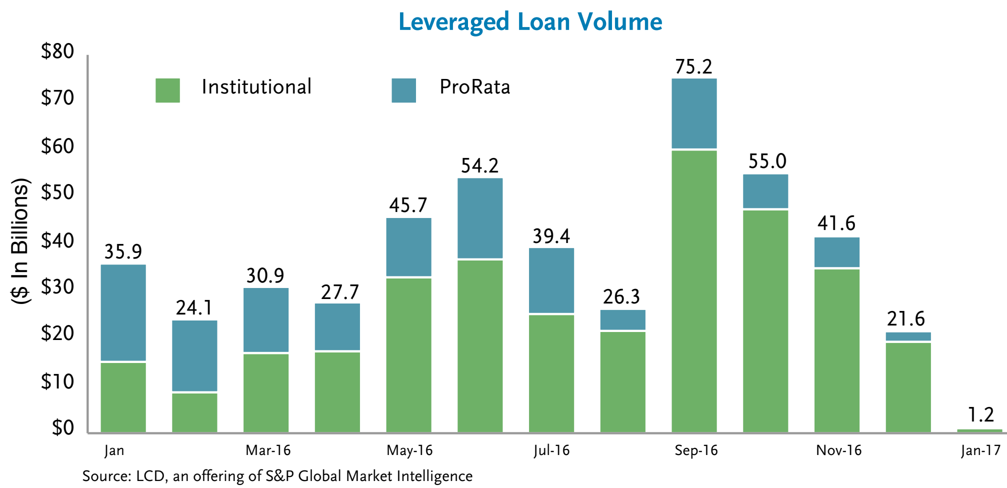
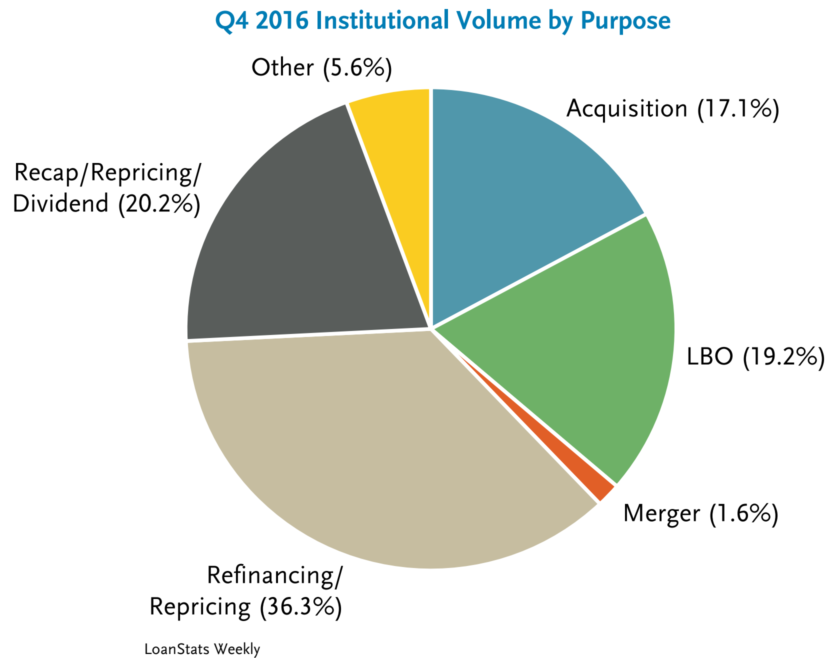


Source: LCD, an offering of S&P Global Market Intelligence

Despite the slightly larger calendar in 2016 as compared to 2015, Mergers and Acquisition activity dropped dramatically in the second, third and fourth quarters. In Q4 2016, 38% of new issue can be classified as LBO driven or acquisition related.



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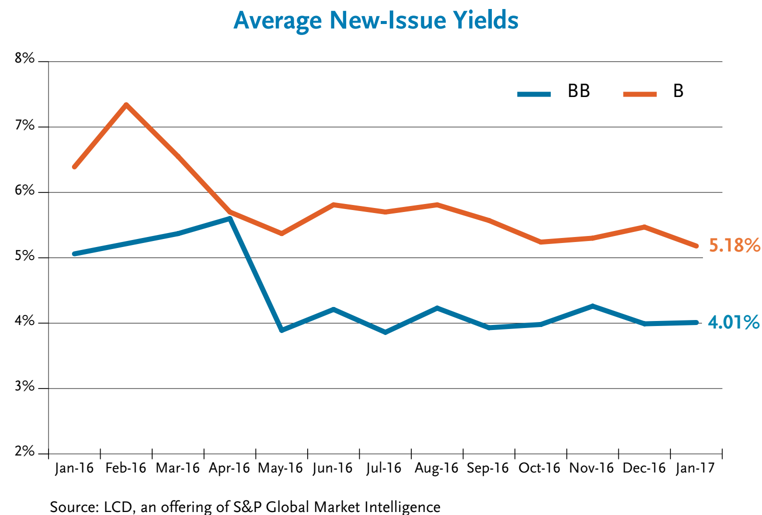
Fundamentals

Single-B new issue yield-to-maturity tightened 30 basis points from November while double-B new issue tightened 25 basis points in the month.

New-Issue First-Lien Yield to Maturity



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

However, the yields do not tell the story regarding the tightening credit market. There has been significant LIBOR spread contraction.

The overall LIBOR spread contraction of the Index is muted by the size of the Index. However, the quarterly new-issue spread contraction shows the rate at which LIBOR spreads are declining. In 2016, BB spreads were down 22% and single B spreads were down 19%.

New Issue S&P LSTA LLI LIBOR Spread Contraction

	BB Straight LIBOR Spread		B Straight LIBOR Spread
Split BBB	348		453
BB	370		489
Split BB	315		430
B	298		415
Split B	290		396
Y-o-Y Spread Contraction	-16.8%	Y-o-Y Spread Contraction	-12.7%
2016 Q1-to-Q4 Spread Contraction	-21.6%	2016 Q1-to-Q4 Spread Contraction	-19.1%

Source: S&P Leveraged Loan Index

Miller Heiman was the sole company to default in December. The LTM default rate continued to decrease, to 1.58%, based on a par amount outstanding from 1.98%. The default rate based on unique issuers also declined to 2.06%.

Lagging 12-Month Default Rates

Actual	Sep-16	Oct-16	Nov-16	Dec-16
By Number	2.25%	2.25%	2.25%	2.06%
By Principal Amount	1.98%	1.98%	1.98%	1.58%
Shadow Default Rate*				
By Number	0.42%	0.42%	0.42%	0.37%
By Principal Amount	0.21%	0.21%	0.21%	0.10%

Source: S&P Global Market Intelligence
* 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.

Fourteen of 26 defaults that have occurred in the last twelve months are Energy and Metals related borrowers. Overall default rates remain low and are concentrated in commodity sectors. Shadow default activity suggests the commodity sector will continue to drive the default rate during the next 12-18 months. However, the rally in crude may change the recovery profile for many of these borrowers.

Valuation

Since 1992, the average 3-year discount margin ("DM") for the CS LLI, is 463 basis points. If the global financial crisis (2008 & 2009) is excluded, the 3-year discount margin for the CS LLI is 416 basis points. At month end, the 3-year DM was wide of the historical average, at 461 basis points but 27 basis points tighter than the prior month.

The DM spread differential between double Bs and single Bs has tightened from January 2016 to December 2016 by 145 basis points. It is also 8.7 basis points tight of the historical spread differential.

3-Year Discount Margin Differential Between BBs and Single Bs

1/1992-10/2016 Average	192.5
Jan-16	328.7
Dec-16	183.8

Source: Credit Suisse Leveraged Loan Index

CS LLI Snapshot

YTD Total Return*	2.25%
Average Price	97.18
Average Price (excluding defaults)	97.68
Coupon	4.90%
Current Yield	5.06%
Yield (3-year life)	6.30%
Discount Margin (3-year life)	461 bps

* S&P LL Total Return 10.16%.

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	Spread	DM (3-year life)
Split BBB	250 bps	228 bps
BB	311 bps	296 bps
Split BB	372 bps	394 bps
B	416 bps	480 bps
Split B	612 bps	904 bps
CCC/Split CCC	670 bps	1,251 bps
Distressed (CC, C and Default)	522 bps	2,915 bps

Source: Credit Suisse Leveraged Loan Index

Summary

As of December 30, the S&P/LSTA Index imputed default rate was 2.83%, down from the prior month. It remained considerably below the multi-year high in February of 7.3%. While the imputed rate implies that the market will see an increase in defaults, it is not implying a very high overall default rate. The majority of 2016 certainly had a very bullish tone. Default activity over the past year has been concentrated within sectors tied to commodities and many of those underlying commodities have been in a multi-month rally. Therefore, the market is ascribing a lower probability of a material default rate.

The same persistent themes that have dominated most of 2016 remained intact in December. Technical characteristics have driven returns. Increasing LIBOR and the fear of the Federal Reserve increasing interest rates is pushing investors into the loan asset class. While demand has increased, supply is anemic. Merger and acquisition-driven supply has declined. Declining EBITDA levels, increased leverage and competitive bidding have made the generation of new deals tough, especially given leveraged lending guidelines. With 72% of the index trading above par, repricing activity has been very active. Lower spreads are offsetting any benefit from increasing LIBOR and without some disruption of capital markets, technical conditions will remain very supportive of loan prices. ■

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