TCW

INSIGHT

MONTHLY COMMENTARY

Loan Review – January 2018

DREW SWEENEY | FEBRUARY 13, 2018

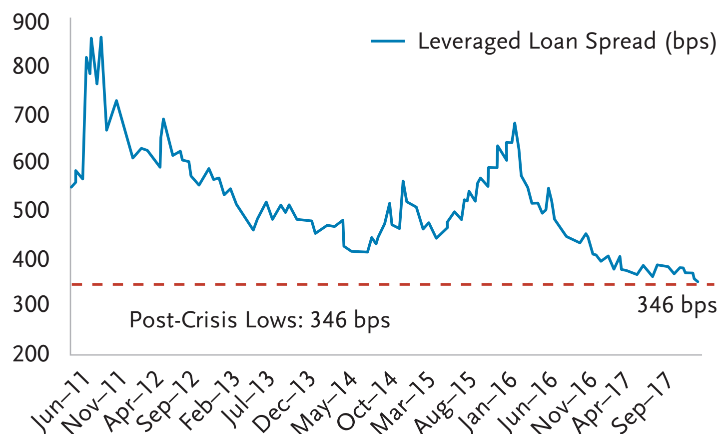
Up, up and away was the theme in January. Loan prices pushed higher and LIBOR spreads tightened materially. A dearth of merger and acquisition activity resulted in a sparse new issuance calendar to begin the year. With over 40 CLO warehouses actively ramping, demand quickly outstripped supply. The technical imbalance allowed new issue single B spreads to gap tighter by 37 basis points from December.

The average new issue spread for double Bs and Single Bs hit levels not seen since February 2009 and May 2010, respectively.

	January New Issue LIBOR Spread	CS LLI Average LIBOR Spread
BB	January-18 229 bps	February-09 228 bps
B	January-18 338 bps	May-10 335 bps

The broader CS LLI had spreads reaching a post crisis low of 346 basis points. The fear of rising rates drove investors into more floating rate products, helping to push 80.0% of loans in the JPMorgan Leveraged Loan index above par, a level not seen since January 2014.

Spreads Finish the Month at New Post-Crisis Low



Source: Credit Suisse

Drew Sweeney
Senior Vice President
Fixed Income

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.

The 3-year discount margin reached a pre-financial crisis level of 391 basis points. This is the tightest 3-year discount margin since October 2007.

Performance

In January, the Credit Suisse Leveraged Loan Index (CS LLI) and the S&P Leveraged Loan Index (S&P/LSTA) were both up, 1.08% and 0.96%, respectively. This was the sixth best monthly return for the CS LLI in the past five years.

- For the 12 months ending January 31, 2018, the CS LLI was up 4.81% and the S&P/LSTA was up 4.54%.

Split triple C and split single B loans provided the strongest returns both in January and during the last 12 months. In fact, split single B returns more than doubled the return of higher quality loans both in January and during the last 12 months.

Total Return By Rating

	Jan-18 (%)	LTM (%)
Split BBB	0.71	3.26
BB	0.81	4.22
Split BB	0.88	3.86
B	1.07	5.13
Split B	2.08	9.39
CCC/Split CCC	2.85	7.38
Distressed (CC, C & Default)	2.05	1.33

Source: Credit Suisse Leveraged Loan Index

Sector Performance

Every sector in the Credit Suisse LLI provided a positive return during the month while the top performing sectors in January were Consumer Durables (+3.30%), Retail (+2.73%) and Utility (+2.16%). Consumer Durables was driven by one large, levered mattress retailer that rallied back from a large decline in November. Retail and Utilities have lower average price borrowers that also rallied back closer to par with retail benefiting from many positive flash results and Utilities benefiting from a cold winter and high gas prices.

The worst performing sectors for the month were Forest Products/Containers (0.64%), Chemicals (0.72%) and Gaming/Leisure (+0.73%).

In the last 12 months, Metals, Manufacturing and Service led all sectors with total returns of 7.21%, 5.80% and 5.73%, respectively.

In contrast, Retail, Energy and Consumer Durables were the worst performing sectors with returns of 0.74%, 2.66% and 2.68%, respectively.

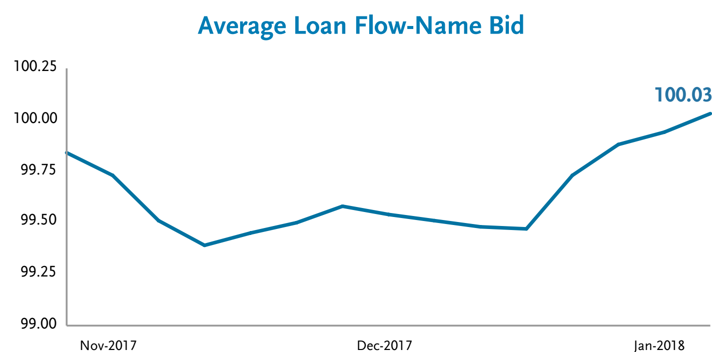
Total Return By Sector

Sector	Jan-18 (%)	LTM (%)
AEROSPACE	0.98	5.36
CHEMICALS	0.72	5.03
CONSUMER DURABLES	3.30	2.68
CONSUMER NON-DURABLES	1.54	3.16
ENERGY	1.75	2.66
FINANCIAL	0.86	5.24
FOOD AND DRUG	1.63	3.82
FOOD/TOBACCO	0.98	4.46
FOREST PROD/CONTAINERS	0.64	4.83
GAMING/LEISURE	0.73	5.24
HEALTHCARE	0.99	5.64
HOUSING	0.78	4.93
INFORMATION TECHNOLOGY	0.94	5.41
MANUFACTURING	1.01	5.80
MEDIA/TELECOMMUNICATIONS	1.04	4.83
METALS/MINERALS	2.16	7.21
RETAIL	2.73	0.74
SERVICE	0.82	5.73
TRANSPORTATION	1.08	3.27
UTILITY	1.16	4.94

Source: Credit Suisse Leveraged Loan Index
Green Returns= Best Performing Sector; Red Returns= Worst Performing Sector.

The average bid of the S&P LCD's flow-name loan composite came in at 100.03% of par, over 50 basis points higher than month-end December (99.47%).

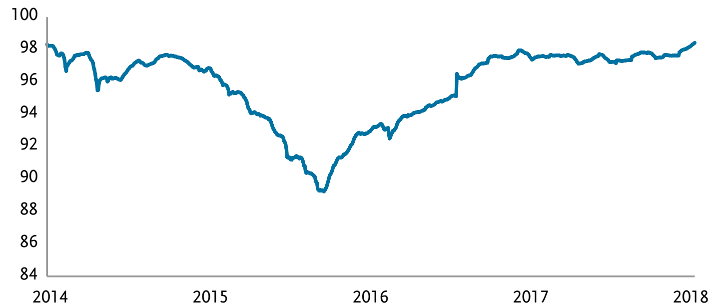
Average Loan Flow-Name Bid



Source: LCD, an offering of S&P Global Market Intelligence. As of January, 2018.

The CS LLI hit its highest price since September 2014, demonstrating just how strong demand for loans was in the month of January.

CS LLI Average Price (9/2014 –1/2018)

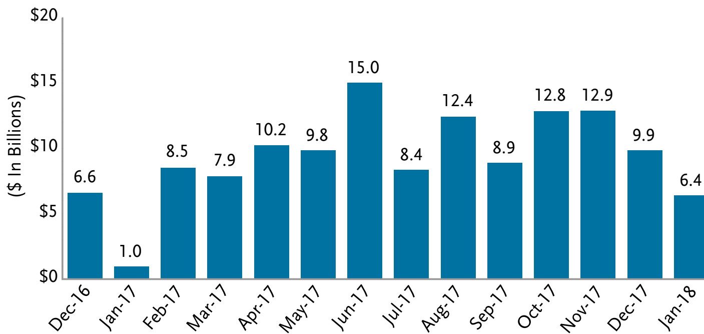


Source: CS LLI

Technical Conditions

CLO markets remained busy in January, in contrast to the beginnng of 2017. Over $6 billion of new deals priced during the month, which is typically a quiet period. Expectations for 2018 CLO issuance from Credit Suisse have been increased to $120 billion, surpassing 2017 issuance.

CLO Volume



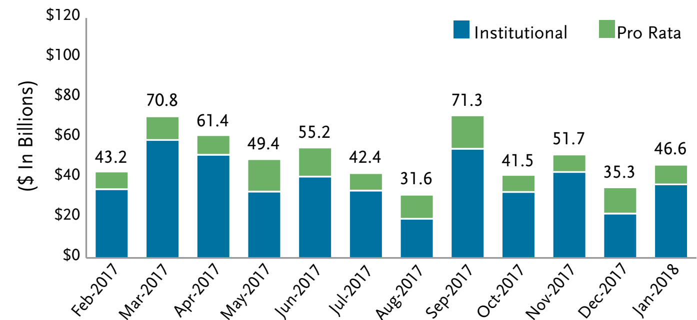
Source: LCD, an offering of S&P Global Market Intelligence

Leveraged loan funds reported an inflow in January of -$1.62 billion. In fact, 19 of the last 22 weeks have registered retail fund outflows.

Leveraged loan funds reported a second consecutive weekly inflow for the asset class in January following fourteen consecutive outflows. Inflows year-to-date for loan mutual funds have been $408 million. The asset class is experiencing steady inflows for the first time since July as the surge in 10 year U.S. Treasury yields has directed attention to rate risks across fixed income. AUM for the leveraged loan retail base is $141 billion, which is comparable to the peak in 2014 of $154 billion.

There was nearly $47 billion of new issue placed in January, almost 32% more than the prior month. However, higher issuance levels only increased the index size by $10 billion as repayments and quarterly amortization payments materially offset the new issue calendar.

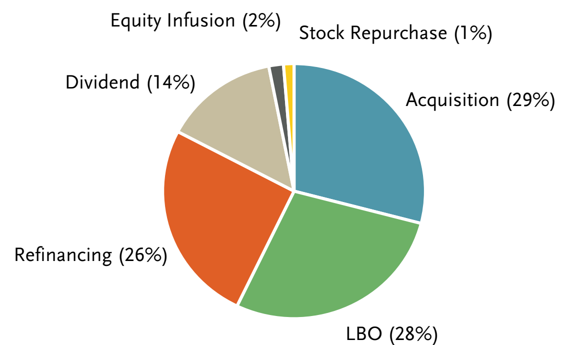
Leveraged Loan Volume



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

In terms of the new issuance, roughly 25.6% of the primary market was related to refinancing existing deals while acquisitions and LBOs accounted for 57.2% of new issuance. If amendment activity is included, then the mix of issuance so far this year has been 60% refi/repricing driven and 40% M&A and GCP related.

January 2018 Institutional Volume

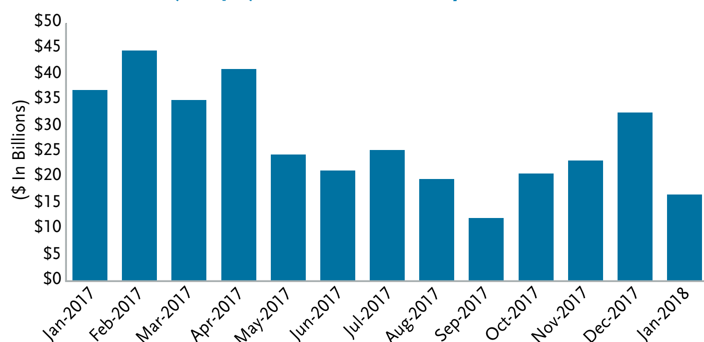


Source: LCD, an offering of S&P Global Market Intelligence. As of January, 2018.

The repricing volume is still dominated by amendments as compared to syndication withnearly 80% of all repricing activity completed via amendment. The first quarter and the fourth quarter tallied most of the activity as can be seen on the following page.

Monthly repayments fell to $16 billion following several months of high repayment activity. This decline eased the technical imbalance in the market.

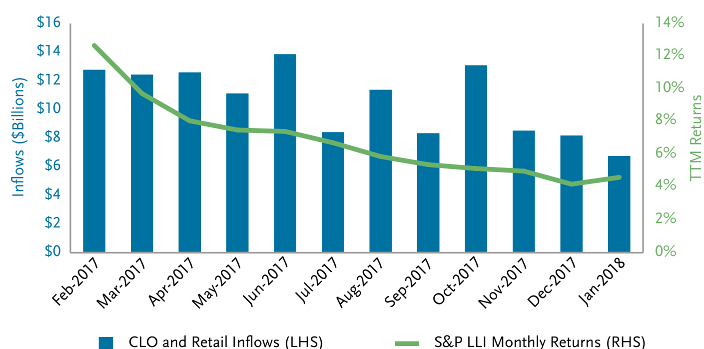
Monthly Repayments in the S&P/LSTA LL Index



Source: LCD, an offering of S&P Global Market Intelligence. As of January, 2018.

Despite strong inflows, the trailing 12-month returns continued to move lower throughout the year. The combination of lower LIBOR spreads and price declines resulting from repricing activity weighed on returns.

Inflows and Rolling LTM Returns



Source: LCD, an offering of S&P Global Market Intelligence. As of January, 2018.

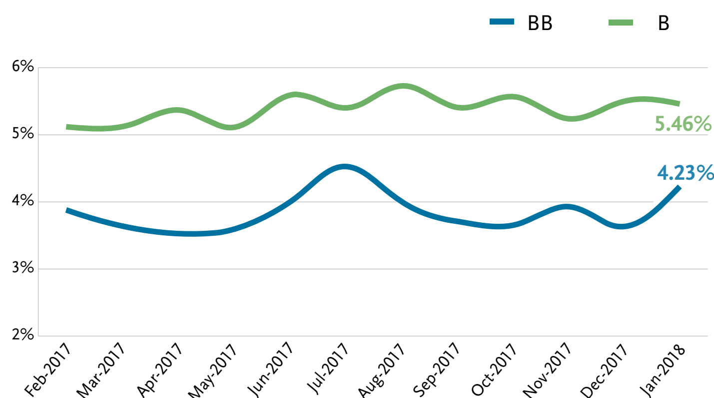
New issue spreads in January were -2.0% tighter for double Bs and -10.0% tighter for single Bs as compared to the prior month. The index spread for the CS LLI ended December at roughly L+355 basis points. This is the tightest spreads have been for the CS LLI index since March 2011.

New Issue Spread Changes	BB/BB-	B+/B
Dec-16	268	388
Mar-17	243	382
Jun-17	240	370
Sep-17	243	373
Dec-17	233	375
Jan-18	229	338
Month-Over-Month Change (%)	-2	-10
LTM Change (%)	-11	-15

Source: LCD, an offering of S&P Global Market Intelligence. As of January, 2018.

Average new issue yields widened month-over-month for Double Bs (0.60%) and were -0.04% tighter for single Bs. Rising LIBOR essentially offset tighter LIBOR spreads in 2017. In January, 3-month LIBOR moved higher by another 8 basis points.

Average New Issue Yields



Source: LCD, an offering of S&P Global Market Intelligence. As of January, 2018.

The default rate of the S&P/LSTA Leveraged Loan Index declined to 1.95% by principal amount in January, despite two new defaults. This level is dropping from a 17-month high of 2.05% at the end of December.

The two defaults brought the last 12-month default tally to 27 and both of the new contributors were Energy borrowers: Philadelphia Energy Solutions and Fieldwood Energy.

Lagging 12-Month Default Rates	Nov-17 (%)	Dec-17 (%)	Jan-18 (%)
Actual			
By Number	1.72	1.72	1.83
By Principal Amount	1.95	2.05	1.95
Shadow Default Rate*			
By Number	0.43	0.43	0.32
By Principal Amount	0.99	0.98	1.08

Source: LCD, an offering of S&P Global Market Intelligence. As of January, 2018.
* 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.

Oil & Gas and Retail dominated the defaulted loans, each with seven defaulted borrowers, contributing to over 50% of the default rate.

Valuation

Since 1992, the average 3-year discount margin ("DM") for the CS LLI, is 462 basis points. If the global financial crisis (2008 & 2009) is excluded, the 3-year discount margin for the CS LLI is 417 basis points. At month end, the 3-year DM (391 basis points) and was the tightest 3-year discount margin since October 2007.

The DM spread differential between double Bs and single Bs has widened from February 2017 to January 2018 by 18 basis points and is still 41 basis points wide of the historical spread differential.

3-Year Discount Margin Differential Between BBs and Single Bs	
1/1992-1/2018 Average	83.9
Feb-17	107.3
Jan-18	124.8

CS LLI Snapshot	
YTD Total Return	1.08%
Average Price (excluding defaults)	98.74
Spread	355.35
Coupon	5.13%
Current Yield	5.22%
Yield (3-year life)	6.39%
Discount Margin (3-year life)	391 bps

	Spread (bps)	DM (3 Yr Life) (bps)
Split BBB	210	198
BB	265	250
Split BB	324	309
B	390	403
Split B	584	807
CCC/Split CCC	635	1,118
Distressed (CC, C and Default)	370	1,220

Source: Credit Suisse

Summary

As of January 31, the S&P/LSTA Index imputed default rate was 1.25%, the lowest level since October 2007.

January performance was driven by the same characteristics that dominated 2017. CLO issuance and loan demand overwhelmed loan supply. Despite a very favorable capital market environment, we are not seeing a high level of merger and acquisition activity. Global demand for CLO investment remains very strong, pushing both CLO liabilities and CLO collateral tighter.

LIBOR continues to rise, bringing more investors into floating rate retail funds. All of this demand has resulted in a stair-step tightening of LIBOR spreads.

It is shocking to begin 2018 and see the 3-month discount margin and imputed default rate for the CS LLI and S&P LLI reach pre-crisis levels. It is also notable that many new issues in January priced at levels comparable to pre-crisis rates.

In order to change the technical environment, there would need a prolonged and sustained decline in the broader fixed income and equity markets to overwhelm current demand. Without such a disruption, loan demand will continue to drive prices higher. ■

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