TCW

Manager of the TCW, MetWest, and TCW Alternative Fund Families

INSIGHT

MONTHLY COMMENTARY

February Credit Update

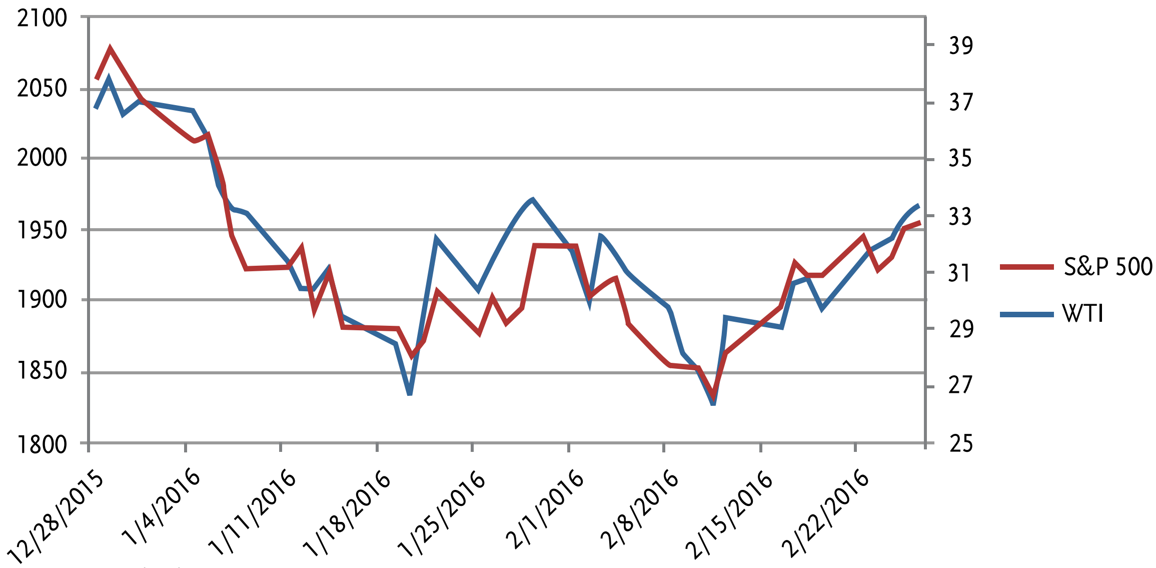
TAMMY KARP | MARCH 1, 2016

February was another volatile month in the credit markets as commodity price gyrations caused some pretty violent moves in risk assets. Oil prices (West Texas Intermediate) fluctuated between $26 and $33 and the myriad of OPEC headlines in the end did little to convince the market of an imminent production cut. In addition to the litany of market concerns, we can add Brexit fears to the mix. The British referendum on staying in the European Union will be held on June 23. To state the obvious, a Britain/EU divorce would be messy and complex with likely significant economic consequences for Europe and the U.K. In the face of a fragile world economy, U.S. economic data has been mediocre at best with Q4 GDP coming in at 1% and Q4 earnings showing an 8.2% earnings per share (EPS) decline for the S&P 500. Lurking on the horizon is the European Central Bank (ECB) meeting (March 10) that could result in another cut in the deposit rate and possible increase in asset purchases – though the efficacy of central bank stimulus has certainly been questionable and past rallies have been short lived. The good news is, from a valuation standpoint, investment grade (IG) credit looks more attractive now than it has in several years, with spreads trading meaningfully wider versus the historical (15-year) average. Symptomatic of late stage cycle behavior, credit metrics have weakened as corporate leverage has increased due to M&A and other shareholder friendly actions. Not all leverage is created equal however, like adding leverage to fund growth via M&A, when paired with a clear plan to de-lever, can be advantageous. This is the segment of the market that has presented some of the better opportunities for bond investors as M&A related supply has resulted in significant spread widening for fundamentally sound sectors and credits – like pharma, healthcare, and telecom.

Tammy Karp
Managing Director
U.S. Fixed Income

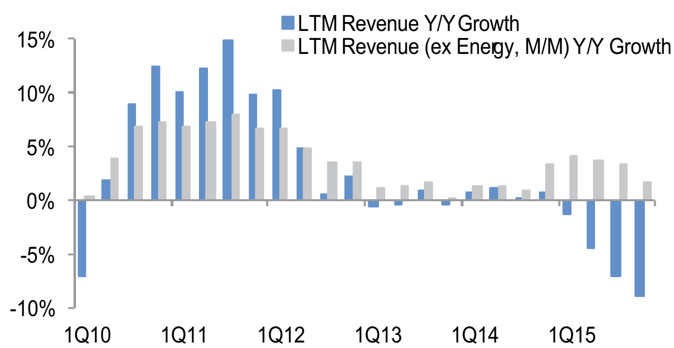
Ms. Karp is a Managing Director in the U.S. Fixed Income group where she trades investment grade and cross over securities. Ms. Karp joined TCW in 2009 during the acquisition of Metropolitan West Asset Management LLC (MetWest). Prior to joining MetWest in 1997, she was with the fixed income department at The Capital Group. Ms. Karp earned her BS in Business from University of Arizona.

WTI and S&P 500

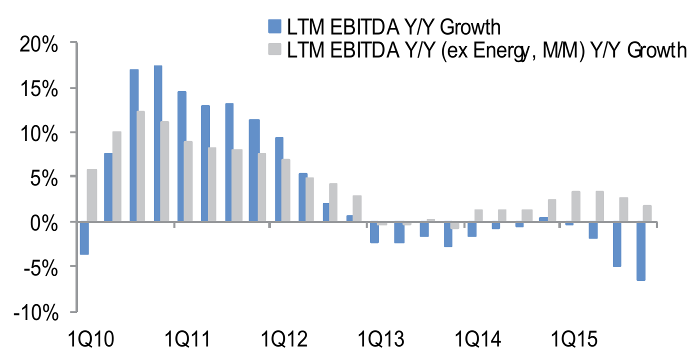


Source: Bloomberg

Earnings: 96% S&P 500 reporting. Another soft quarter with revenue and EBITDA declining 9% and 6.5%, respectively. When we exclude the metals & mining and energy sectors, revenue and EBITDA were a modest +1.6% and +1.8%, respectively.

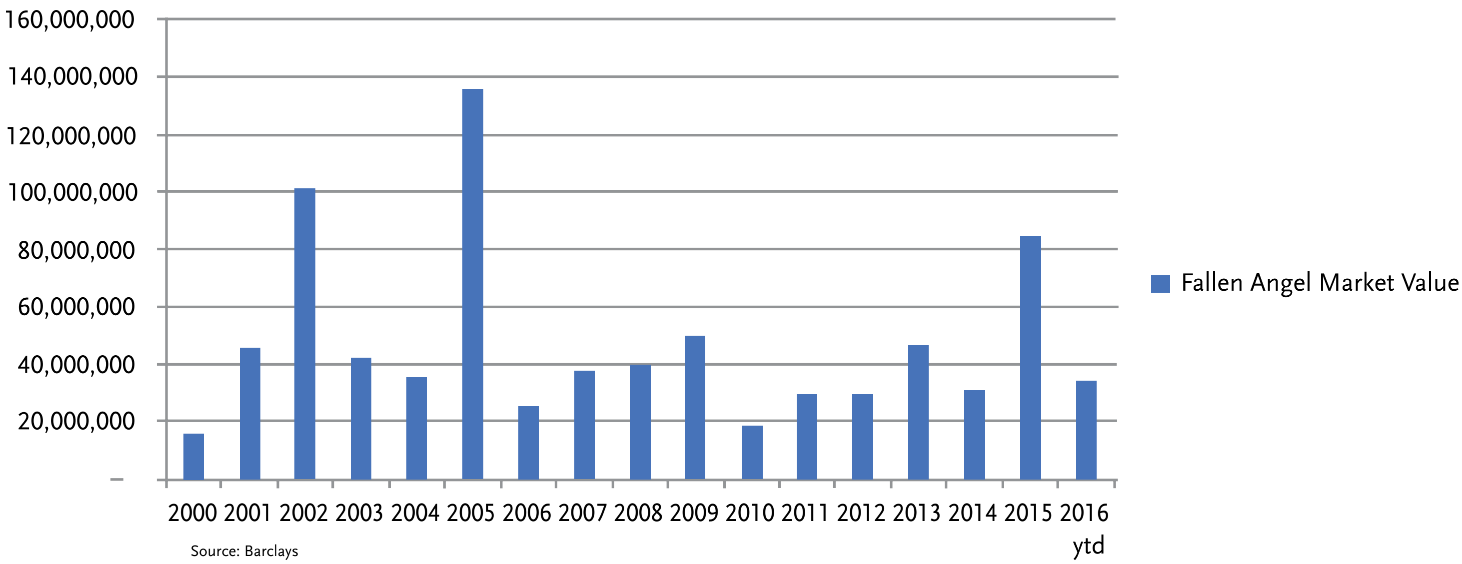


Source: JP Morgan



Fallen Angels: Negative ratings actions for the commodity related issuers continued in February with the Moody's wholesale downgrade of the E&P sector. Several names saw 3-4 notch downgrades as Moody's lowered its price deck for oil sighting a lower for longer scenario for prices. Ironically, most E&P credits rallied post the downgrade as oil prices showed some stabilization. Those downgrades resulted in $25 billion of IG debt falling out of the Barclays Credit Index this month, bringing the year-to-date total to $34.5 billion. Out of approximately $538 billion market value of energy and metals & mining debt in the index, the downgrades represented roughly 5% of both sectors combined debt.

Barclays Index Fallen Angels



Source: Barclays

Index performance: A volatile month for credit with spreads trading in a 19 basis point range in February. After starting the month and an oas of +181, spreads touched +200 mid-month then rallied back to end the month at a spread of +184 basis points (bps) over Treasuries. At a current option-adjusted spread (OAS) of +184, spreads are 29 bps wider YTD and 91 bps wider versus the cycle tights (June 2014). Spreads x commodities have moved as well: Current OAS of +161 bps over Treasuries is +27 bps YTD, +73 versus the cycle tights and wide of the long-term average.

In terms of sector performance, financials underperformed this month, led by Yankee banks, subordinate bank paper, life insurers, and healthcare REITS. In the banking sector, European banks led the widening due to several factors, including Brexit fears (pressured UK banks), concerns over energy exposure, and overall concerns about the impact of negative deposit rates on bank profitability. U.S. money center banks outperformed with 10-year senior spreads unchanged in February. Subordinate spreads widened for all banks with the average senior/sub relationship for the big six out to 100 bps versus the average of 60 bps over the past three years.

The best performing sector was metals & mining, led by the gold names, as commodity prices bounced off the lows. The two largest gold names have tendered for debt with asset sale and equity issuance proceeds – in an effort to improve credit metrics/de-lever the balance sheet. The worst performing sectors in February were oil field servicers (-3.45% excess return), refiners (-2.52% excess return), life insurers (-2.36% excess return), and healthcare REITS (-2.19% excess return).

U.S. Credit ex Energy ex Metals ex Sovs

Key	Axis	Name	Last	Minimum		Maximum		Mean
	right	U.S. Credit - OAS	183.678	93.271	06/23/2014	231.262	11/25/2011	141.041
	right	US Credit x Energy x Meta...	160.923	88.007	06/24/2014	229.709	11/25/2011	135.133

Source: Barclays

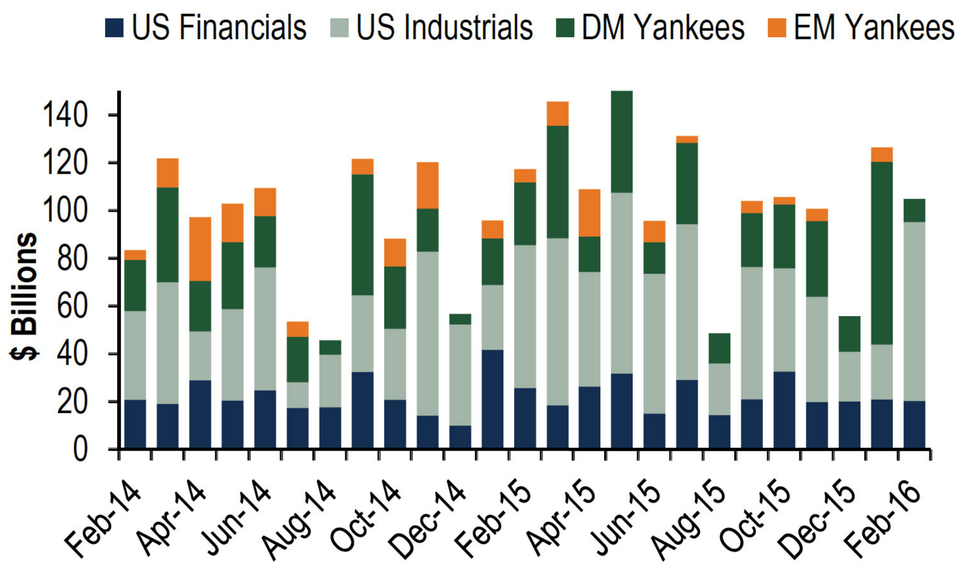
February Credit Index Returns:

	Month-to-Date Excess Return	Month-to-Date Total Return	Option-Adjusted Spread	Option-Adjusted Spread Month-to-Date Change
Credit Index	-0.26%	0.84%	184	+3
Industrials	0.03%	1.22%	210	-6
Financials	-1.03%	-0.16%	178	+21
Utilities	-0.17%	1.41%	163	+3
Municipals	-0.78%	1.21%	183	+7
Sovereigns	0.27%	1.64%	220	+1

Source: Barclays

Supply: Another heavy month for IG supply with $105 billion pricing. The bulk of new issues came from a handful of large bellwether industrial issuers including Apple (AAPL; $12 billion), Exxon Mobil Corporation (XOM; $12 billion), Johnson & Johnson (JNJ; $7.5 billion), and Cisco Systems, Inc. (CSCO; $7 billion). There wasn't a lot of M&A related issuance as the bulk of supply in February was intended for refinancing and share buybacks. However, the M&A pipeline remains robust and supply should pick up in the coming months. New issue concessions were a healthy 20 bps on average and deal performance was good for the first time in months.

Monthly IG Supply



Source: BofA Merrill Lynch Global Research