TCW

INSIGHT

MONTHLY COMMENTARY

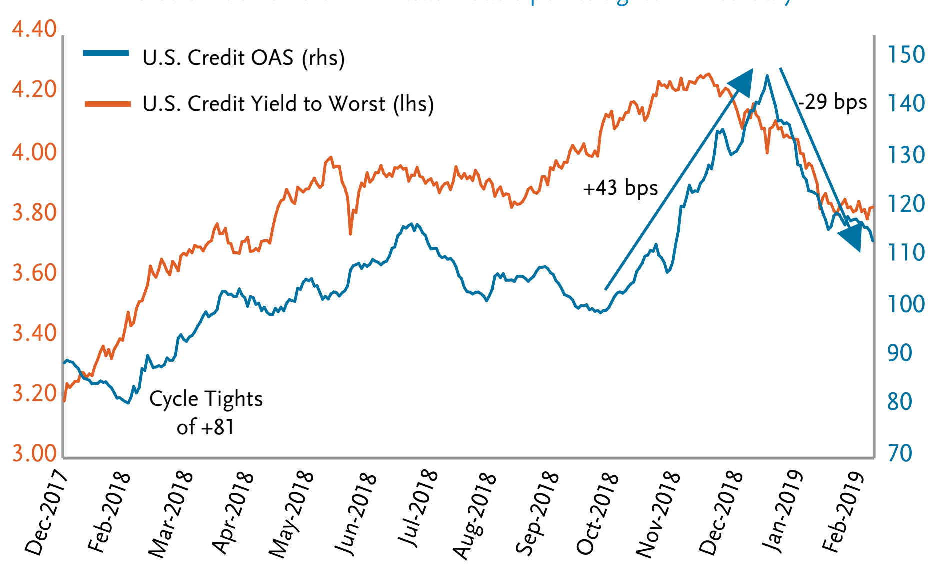
February Credit Update

TAMMY KARP | 12 MARCH 2019

The rally in IG credit continued in February on the heels of a "patient" Fed and U.S. – China trade optimism. Stable Treasury yields, strong overseas demand for spread product, inflows into high grade funds and light dealer inventories provided a strong technical backdrop for credit. The move has been notable, with credit spreads tightening 29 basis points (bps) in the first two months of this year, recovering about two-thirds the widening experienced in Q4. Given the recent snapback in spreads, the current index OAS of +114 bps over Treasuries is now closer to the tights than the mean. As such, some risk reduction is warranted, as our late cycle view remains intact. Weaker credit metrics, tighter liquidity conditions and rising idiosyncratic risks are fundamental issues that have accumulated over a decade of easy monetary policy. Consecutive years of low volatility and a perceived central bank put have conditioned investors to buy the dips. But cracks have begun to emerge – like the acceleration of ratings downgrades after years of rating agency forbearance, resulting in a record $233 bln of fallen A downgrades in 2018. BBBs now represent 47% of the investment grade credit universe, up from 32% pre-crisis (12/07) while the $6 trillion dollar credit index has grown at a CAGR of 9.5% during the same time period. These are vulnerabilities that will exacerbate market corrections. Those that are positioned and prepared for the cycle's turn will reap the benefits.

IG Credit Index Yields and Spreads

Credit Index OAS of +114 was 7 basis points tighter in February



Source: Bloomberg Barclays

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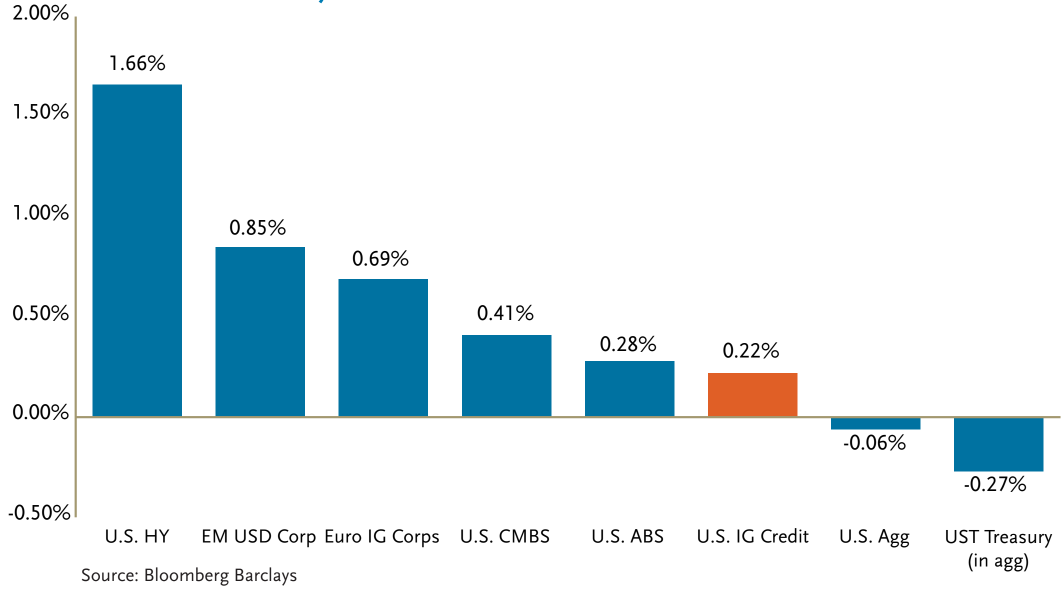
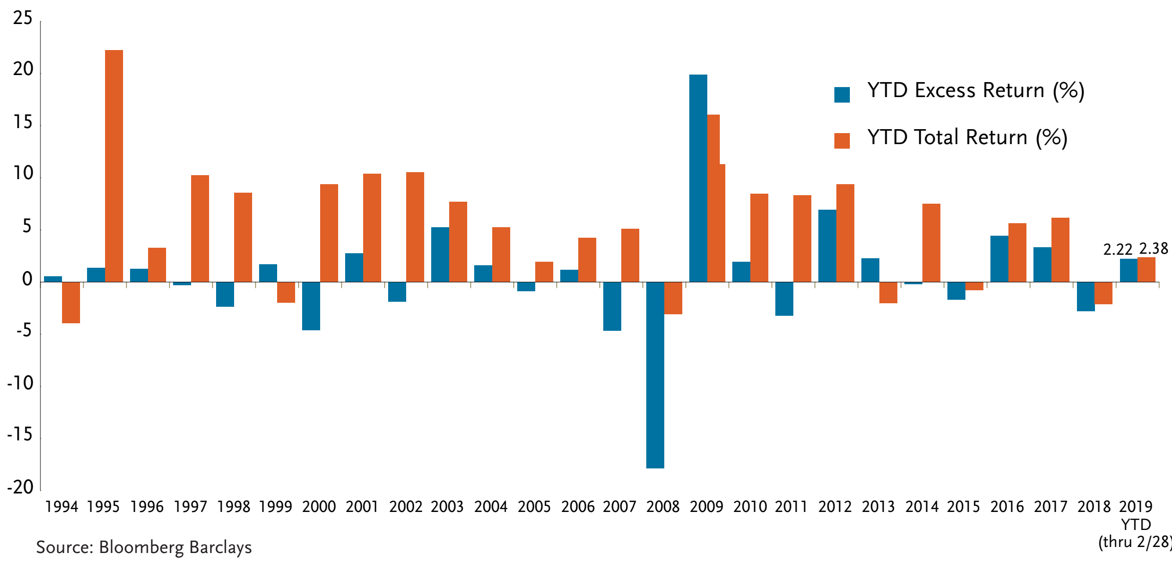
Ms. Karp is a Managing Director in the Fixed Income group where she trades investment grade and cross over securities. Ms. Karp joined TCW in 2009 during the acquisition of Metropolitan West Asset Management LLC (MetWest). Prior to joining MetWest in 1997, she was with the fixed income department at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

February Total Returns for Various Fixed Income Classes



Source: Bloomberg Barclays

Annual Excess and Total Returns



Source: Bloomberg Barclays

Index Performance

The credit index OAS of +114 bps over Treasuries tightened 7 bps in February, bringing the YTD spread move to -29 bps. Higher beta outperformance continued, led by the cyclical sectors (autos, energy). Diversified manufacturing also outperformed, led by GE (-36) after the company announced the sale of its biopharma business to Danaher for $21 bln. The sale multiple of ~17x will go a long way in de-levering the company's balance sheet. Additionally, this asset sale (as opposed to a full spin) allows the company to retain about two-thirds of its healthcare business, which has strong earnings power.

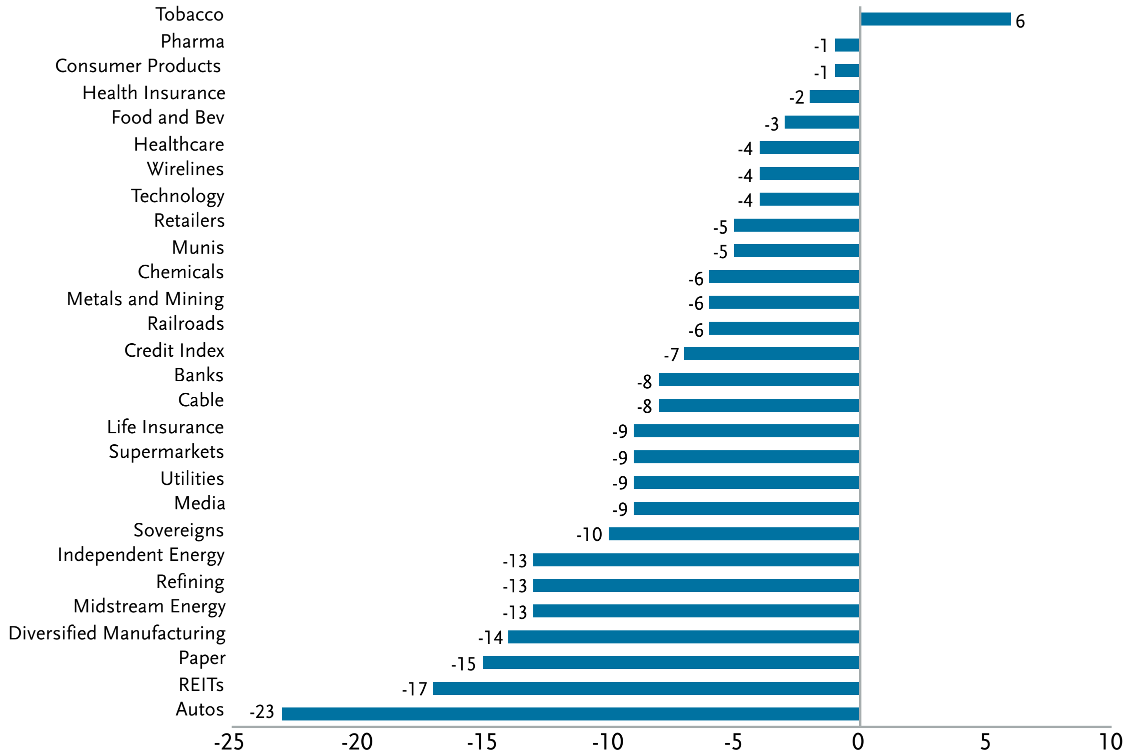
Underperforming sectors were concentrated in non-cyclical industrials that have been active on the M&A front: tobacco (+6), pharma (-1), consumer products (-1), health insurers (-2) and food and bev (-2). Thematically, earnings pressure in sectors that have levered up for M&A has provoked a sense of urgency on the part of management teams (and investors) to prioritize balance sheet improvement and ratings preservation. If/when projected EBITDA growth has missed the mark, companies have resorted to dividend cuts and asset sales – as in the case of Kraft Heinz for example. The ability and willingness to pull levers and prioritize bondholders over equity holders is paramount. In the case of Kraft Heinz, management announced asset divestitures and a 36% dividend cut for the purpose of debt reduction.

February Index Returns

	February Excess Return	February Total Return	2/28/19 OAS	Monthly OAS Change
Credit Index	0.57%	0.22%	114	-7
Industrials	0.58%	0.16%	127	-6
Financials	0.55%	0.30%	110	-9
Utilities	0.88%	0.29%	118	-9
Municipals	0.68%	0.02%	131	-5
Sovereigns	0.97%	0.47%	129	-10
AA	0.32%	0.01%	62	-4
A	0.50%	0.13%	90	-6
BBB	0.77%	0.38%	161	-9

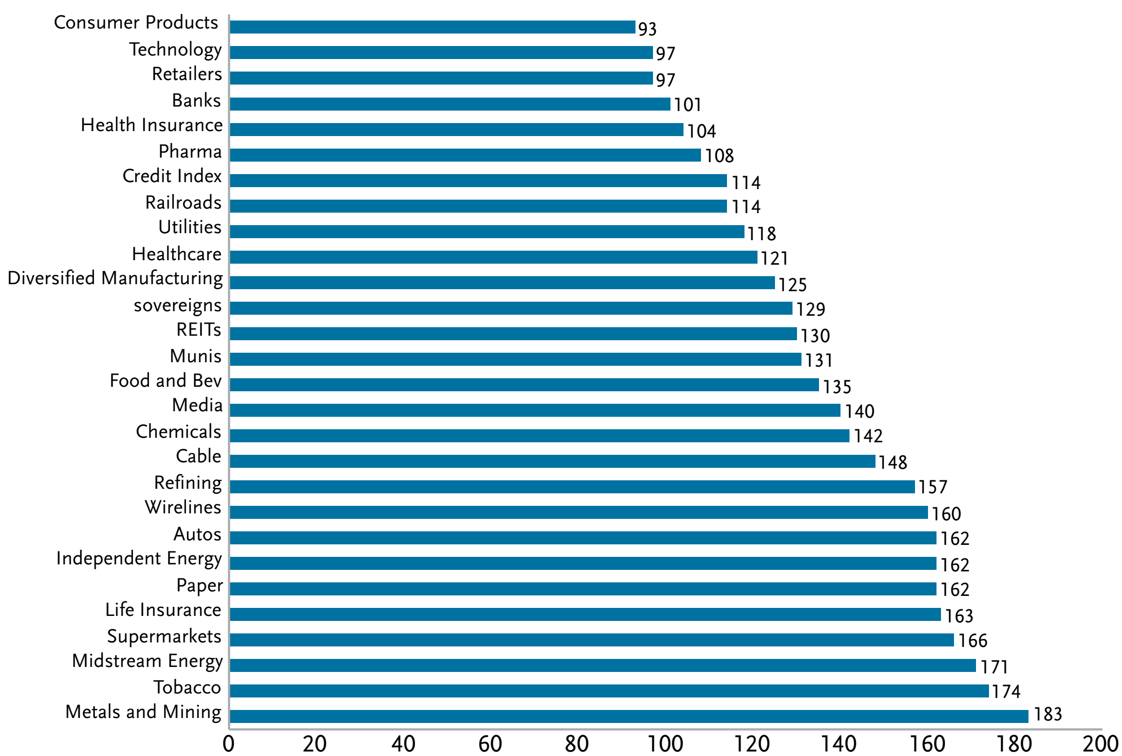
Source: Bloomberg Barclays

February OAS Changes



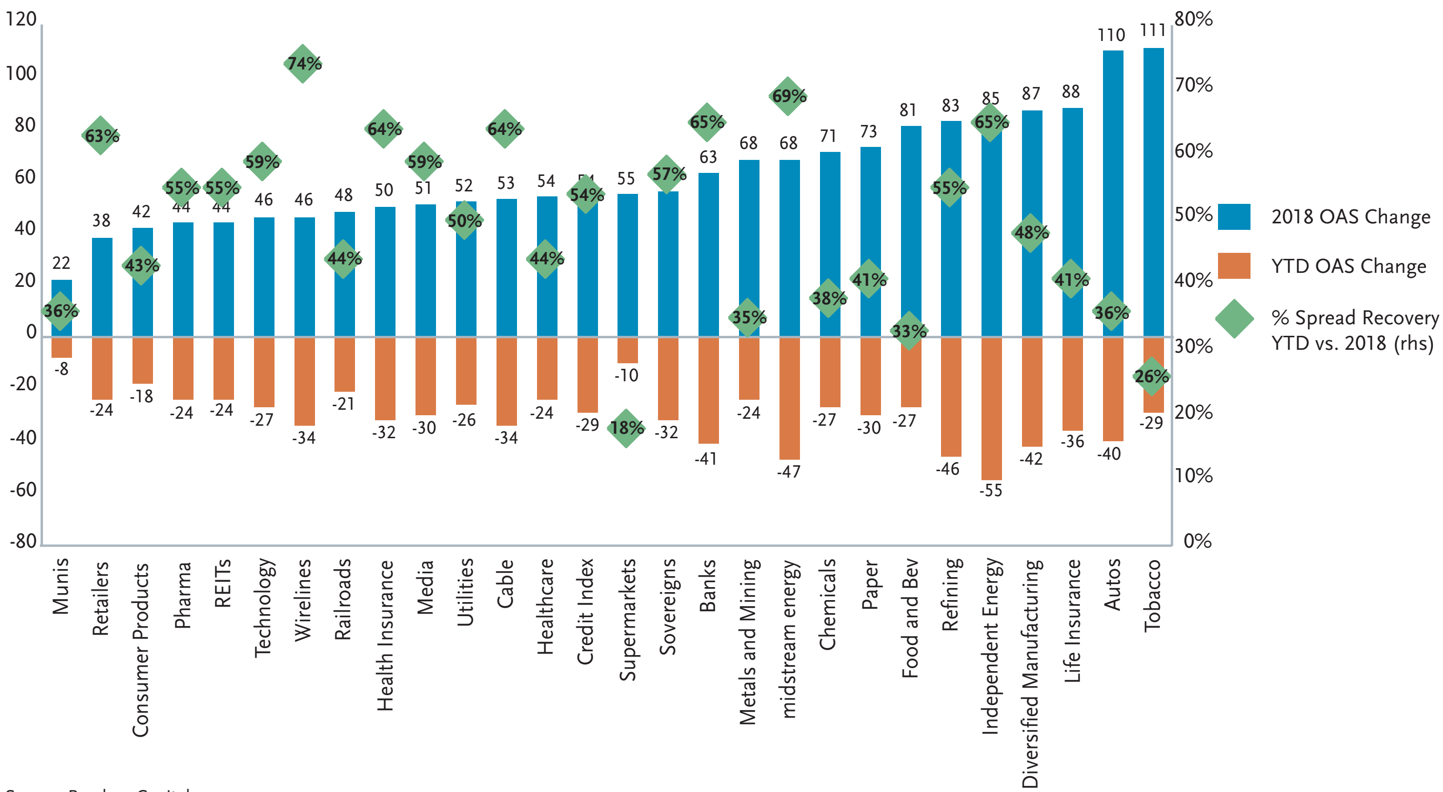
Source: Barclays Capital

February 28, 2019 Sector Spreads



Source: Barclays Capital

2018 Sector OAS Changes vs. YTD OAS Changes

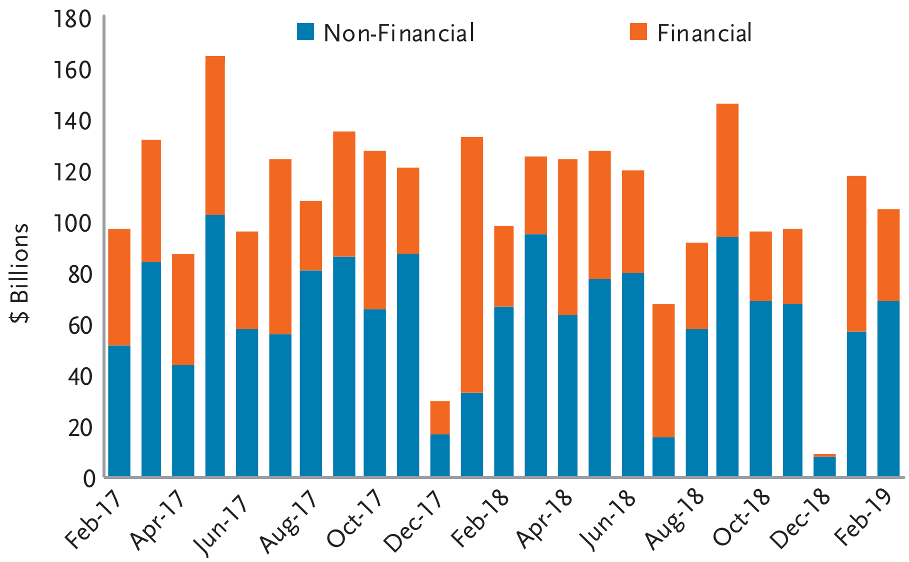


Source: Barclays Capital

Investment Grade Supply

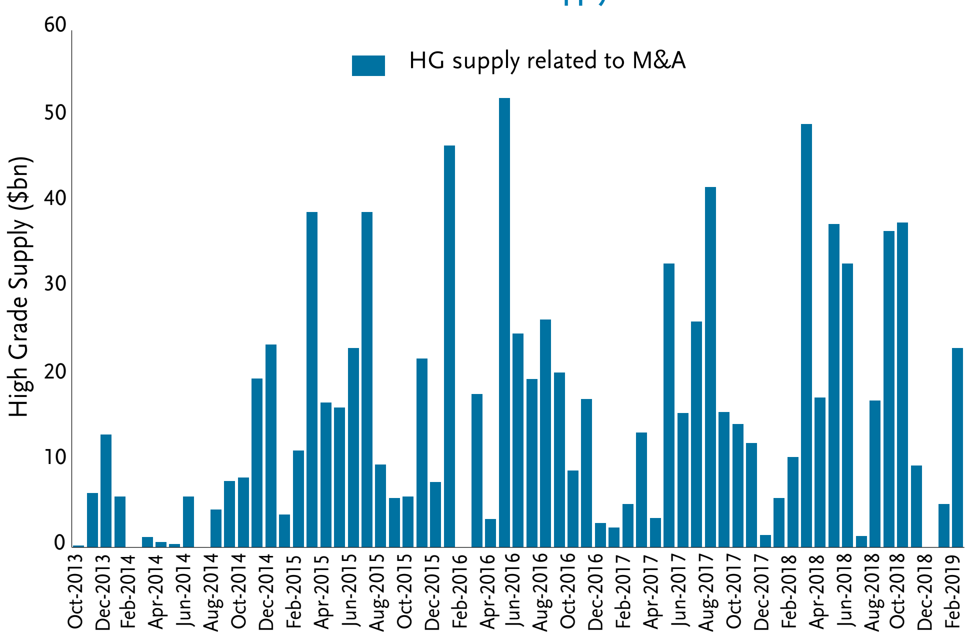
February supply volumes were $106 bln, dominated by industrial issuance of $64 bln. M&A related supply increased to $23 bln comprised of four acquisition-related deals, including Altria ($11.5 bln across six tranches to fund the Juul investment; 5yrs priced at +135, 10yrs at +215, 30yrs at +295). Boston Scientific ($4.3 bln across five tranches to fund BTG acquisition; 5yrs priced at +95, 10yrs at +135 and 30yrs at +170). And Eli Lily ($4.5 bln across four tranches to fund Loxo Oncology acquisition; 10yrs priced at +75, 30yrs at +100). Overall, new issue concessions were negligible and deal performance was mixed. The backlog of M&A-related issuance continues to grow, the largest of which is the pending Bristol Myers acquisition of Celgene. The deal is expected to be ~60% debt financed, or $34 bln, though there is deal risk with equity pricing in a 50% probability of success.

Monthly IG Supply



Source: BofA Merrill Lynch Global Research

M&A-Related Supply



Source: BofA Merrill Lynch Global Research, Bloomberg