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INSIGHT

MONTHLY COMMENTARY

Loan Review – February 2019

DREW SWEENEY | 12 MARCH 2019

Loan volatility has increased in the last four months. November and December 2018 witnessed loan price declines of 3.95 points, however, the first two months of 2019 have seen prices rebound 2.80 points. In part, volatility has increased because investment banks carry less inventory, therefore, they are less likely to act as a buffer when markets are going down and sometimes exacerbate problems by chasing short positions when the market is going up.

Retail funds saw a moderation of outflows in February relative to the heavy outflows witnessed last year. Regardless of the moderation, the market was left with fewer real participants contributing to demand, which had the effect of furthering liquidity issues. CLO demand remained robust as several funds tried to ramp new deals to take advantage of January's trading levels. Unfortunately, several managers ran to the same proverbial 'open door' at the same time and many got 'stuck in the door' as loan levels surged in the back half of the month. Given the fact that CLO Triple A liabilities have not tightened (and really widened), month-end loan levels were seemingly overdone. Alongside CLOs ramping, the market also saw crossover high-yield investors continue to add issuers that typically have high yield bonds in their capital structure. While trading volumes were not overwhelming, there were a sufficient number of loan buyers combined with little new supply. That demand was enough to see prices jump higher for the second consecutive month.

It should be highlighted that volatility has also been augmented by earnings season. Anecdotally, results seem mixed. However, borrowers that report earnings below expectations tend to get penalized severely. Therefore, while aggregate loan prices were up 108 basis points in the Credit Suisse Leveraged Loan Index (CS LLI), this included many loans that were down multiple points post earnings results.

We have seen higher quality loans outperform lower quality loans on a year-to-date basis. This presented a reversal in performance from December as retail funds sought liquidity anywhere they could. They often sold large Double B issuers rather than Single B issuers, simply because there was an available bid.

Performance

In February, the CS LLI and the S&P Leveraged Loan Index (S&P/LSTA) were up 1.57% and down 1.59%, respectively.

- Year-to-date, ending February 28, the CS LLI was up 3.90% and the S&P/LSTA was up 4.18%.
- For the 12 months ending February 28, the CS LLI was up 3.76% and the S&P/LSTA was up 3.44%.

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Mr. Sweeney is a Managing Director 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 firms 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.

Loan Review – February 2019

In February, Single Bs and distressed loans outperformed all categories. On a year-to-date basis, Split Double Bs and Double Bs were the top performing categories. In December, when the market sold off, there was not much disparity in the performance between higher quality loans or lower quality loans. In fact, while there was only -13 basis points difference in performance between Double Bs and Single Bs, Double Bs (-2.32%) actually performed worse. As noted previously, retail loan funds were experiencing outflows and needed to get liquidity wherever they could find it. Therefore, the natural relationship between higher quality loans and lower quality loans broke down. The rally we have seen year-to-date has largely restored this relationship.

Total Return by Rating

	February	YTD	LTM
Split BBB	1.35%	3.92%	3.62%
BB	1.39%	4.37%	3.66%
Split BB	1.61%	4.51%	3.44%
B	1.71%	3.83%	3.97%
Split B	1.56%	4.25%	4.87%
CCC/Split CCC	1.31%	1.91%	3.04%
Distressed (CC, C and Default)	2.98%	3.50%	-1.87%

Source: Credit Suisse Leveraged Loan Index

Sector Performance

All 20 sectors provided positive returns for CS LLI both in February and on a year-to-date basis. The top performing sectors in February were Food & Drug (2.21%), Metals/Minerals (2.19%) and Media/Telecommunications (1.92%).

The worst performing sectors for the month were Food/Tobacco (1.21%), Transportation (1.17%) and Consumer Durables (0.51%).

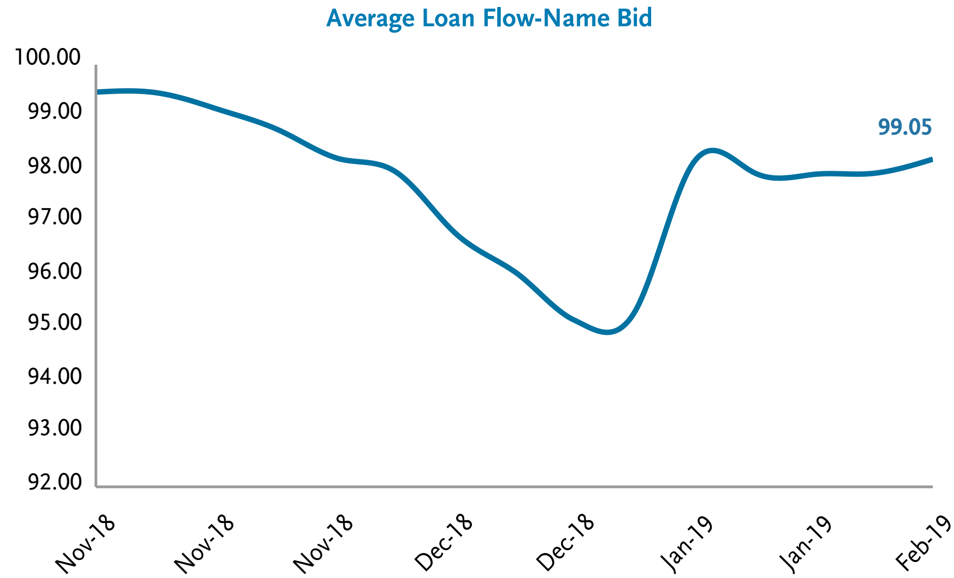
In the last 12 months, Retail, Food & Drug and Metals/Minerals have led all sectors with total returns of 5.57%, 5.33% and 4.93%, respectively. Interestingly, Retail leads all categories in defaults during the last 12 months as well. In contrast, Consumer Non-durables, Manufacturing and Consumer Durables were the worst performing sectors with returns of 3.07%, 2.80% and 0.04%, respectively. The dispersion between the top performing sector and bottom performing sector has contracted in the last 12 months from 8.07% to 5.53%.

Industry Returns

Sector	February	YTD	LTM
RETAIL	1.55%	4.30%	5.57%
FOOD AND DRUG	2.21%	5.95%	5.33%
METALS/MINERALS	2.19%	5.27%	4.93%
TRANSPORTATION	1.17%	3.00%	4.87%
UTILITY	1.50%	3.54%	4.51%
FINANCIAL	1.89%	4.00%	4.45%
ENERGY	1.57%	4.01%	4.34%
CHEMICALS	1.47%	4.05%	4.28%
GAMING/LEISURE	1.49%	4.36%	4.06%
INFORMATION TECHNOLOGY	1.64%	3.87%	3.89%
HEALTHCARE	1.37%	3.93%	3.87%
HOUSING	1.70%	4.43%	3.62%
AEROSPACE	1.59%	4.29%	3.61%
FOREST PROD/CONTAINERS	1.49%	4.15%	3.28%
SERVICE	1.37%	3.09%	3.26%
MEDIA/TELECOMMUNICATIONS	1.92%	4.48%	3.16%
FOOD/TOBACCO	1.21%	3.52%	3.08%
CONSUMER NON-DURABLES	1.72%	3.73%	3.07%
MANUFACTURING	1.45%	3.36%	2.80%
CONSUMER DURABLES	0.51%	2.37%	0.04%

Source: Credit Suisse Leveraged Loan Index

CS LLI prices increased 108 basis points in February while the average bid of the S&P LCD flow-name loan composite jumped 84 basis points from 98.21 to 99.05. The average flow name bid is up 376 basis points on a year-to-date basis.

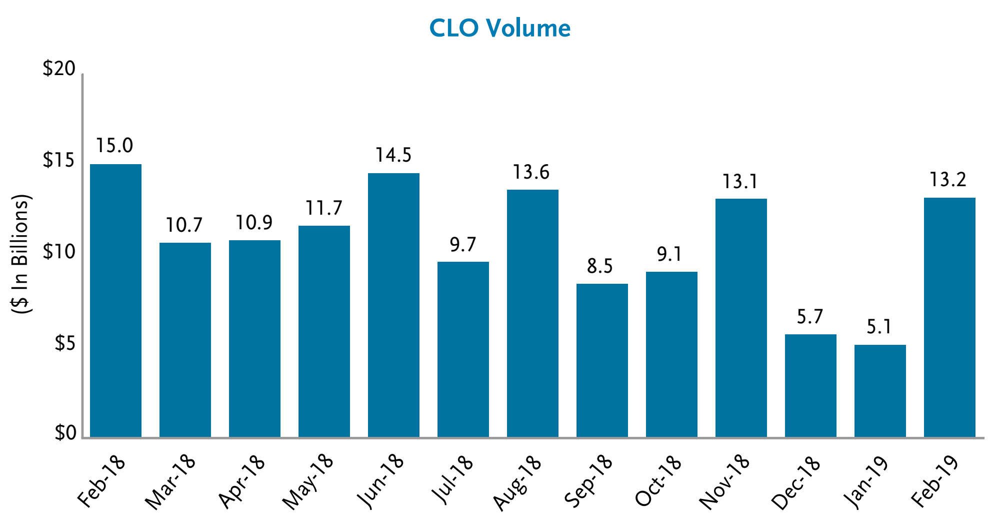


Source: LCD, an offering of S&P Global Market Intelligence

Technical Conditions

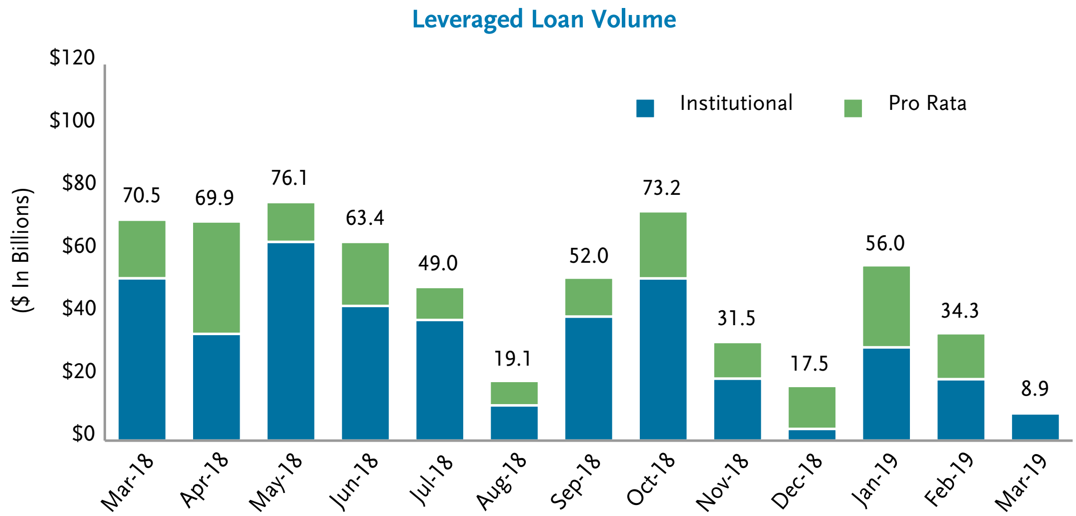
Leveraged loan funds reported an outflow -$1.9 billion in February, however, the flows became less negative as the month wore on and turned positive in the beginning of March. AUM for the loan mutual fund base is down to $125 billion from as a high of $154 billion in October. YTD outflows for loan funds totaled -$6.5 billion in February.

There were $13.2 billion of CLOs issued in February, which is up from $5.1 billion in January 2019 and down year-over-year from $15.0 billion in February 2018. The rally in risk markets created an environment where many hung deals from 2018 were able to get priced. Despite shedding much of that overhang, we have not seen a rally in CLO Triple A pricing, which would be necessary to justify the rally in February loan prices.



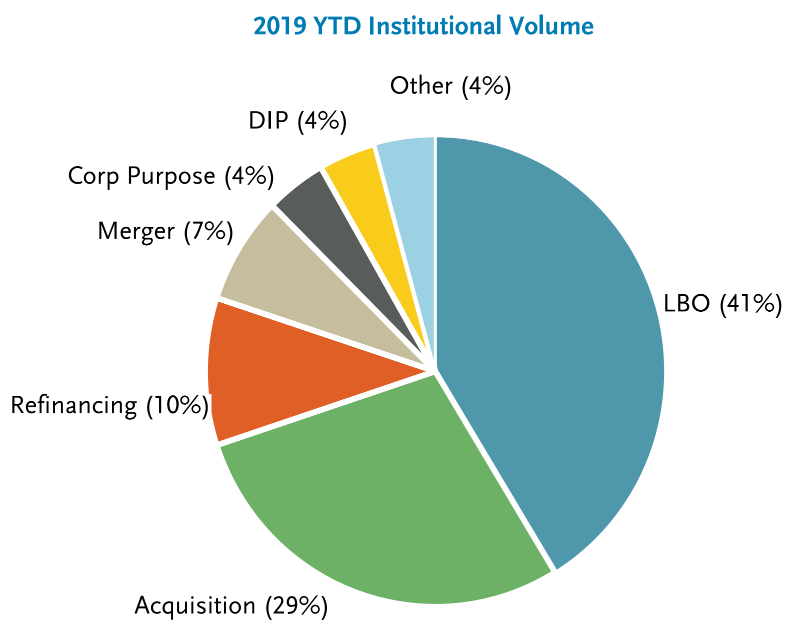
Source: LCD, an offering of S&P Global Market Intelligence

Institutional new issuance in February was $19.6 billion, making it the third lightest issuance month in the last 12 months. Despite the secondary market rallying, new issue spreads and OID continued to price considerably wider than the secondary market.



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

Acquisitions, mergers and LBOs represented 77% of the year-to-date transactions, while DIPs, Capital Expenditure Financings and Refinancing represented the remainder.



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

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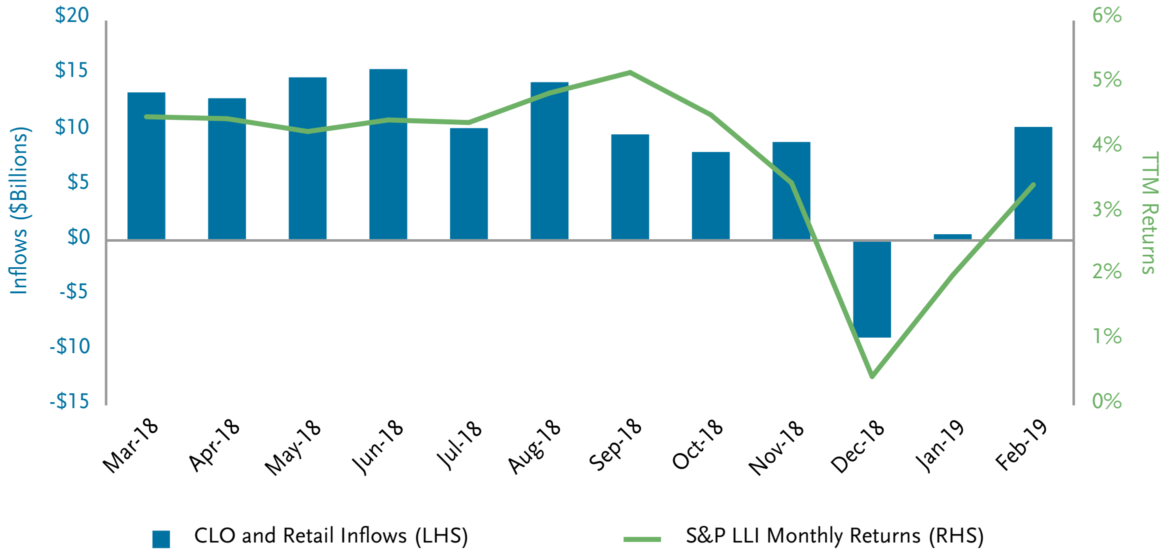
In February we saw positive CLO issuance and negative loan fund outflows net a positive number. The technical conditions in the market remained positive for loans to trade higher during the month. Consistent with January, light new issuance, crossover buyers, inflows and, in particular, a ramping CLO market all pushed prices higher.

Inflows and Rolling LTM Returns



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

New issue spreads continued to widen in February and were 40% wider than new issuance spreads 12 months prior. While spreads tightened slightly from December, it is important to remember that December was a month where the new issue market actually broke down and issuers postponed issuance until 2019.

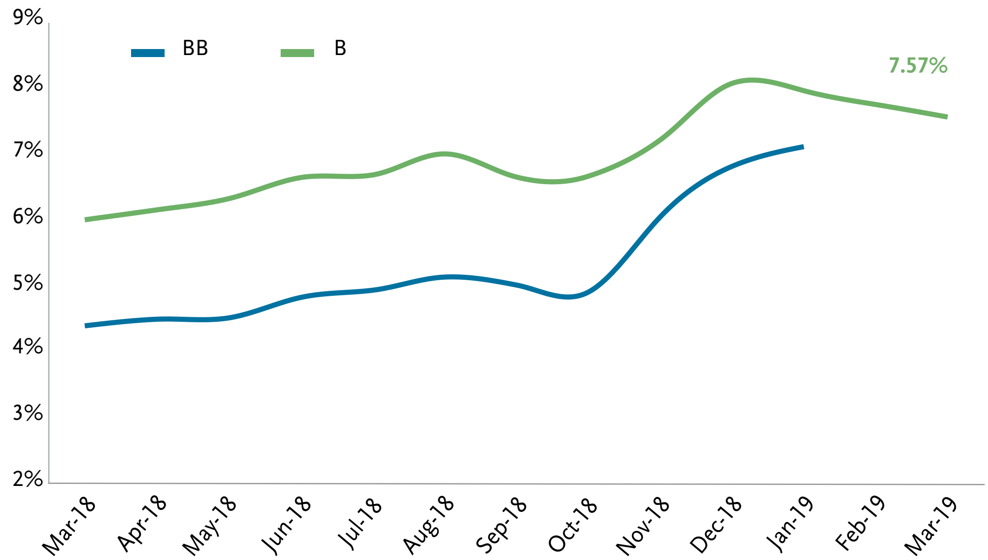
New Issue Spread Changes

	All Loans
Dec-17	346
Mar-18	317
Jun-18	362
Sep-18	378
Nov-18	401
Dec-18	452
Jan-19	434
Feb-19	445
Month-Over-Month Change	2.48%
YTD Change	-1.61%
LTM Change	40.5%

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

In terms of new issue yields, Single B yields tightened compared to January 2019. The change was primarily driven by LIBOR contracting from 2.74% to 2.62% in February.

Average New-Issue Yields



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

There were two defaults in February, including Windstream (Telecom) and Ditech (Real Estate) and the default rate changed from 1.42% in January to 1.62% in February.

The last 12-month default tally for the S&P/LSTA is 17. Retail leads all categories with five while Oil & Gas has declined to just two defaults.

Lagging 12-Month Default Rates

Actual	**Nov-18**	**Dec-18**	**Jan-19**	**Feb-19**
By Number	1.56%	1.56%	1.44%	1.52%
By Principal Amount	1.61%	1.63%	1.42%	1.62%
Shadow Default Rate*				
By Number	0.73%	0.73%	0.62%	0.51%
By Principal Amount	0.46%	0.39%	0.39%	0.27%

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 417 basis points. The 3-year DM finished the month at 443 basis points, which tightened 106 basis point from December 2018.

The DM spread differential between Double Bs and Single Bs is flat from March 2018 to February 2019, however, it is still 37 basis points wider than the historical spread differential.

3-Year Discount Margin Differential Between BBs and Single Bs

3/1992-2/2019 Average	85.5
Mar-18	122.7
Feb-19	122.3

CS LLI Snapshot

YTD Total Return*	3.90%
Average Price	96.89
Spread	348 bp
Coupon	6.23%
Current Yield	6.44%
Yield (3-year life)	7.00%
Discount Margin (3-year life)	443 bp

*S&P LLI YTD Total Return 4.18%
Source: Credit Suisse Leveraged Loan Index

	Spread	DM (3-Year Life)
Split BBB	196 bps	221 bps
BB	257 bps	291 bps
Split BB	299 bps	357 bps
B	379 bps	464 bps
Split B	491 bps	841 bps
CCC/Split CCC	675 bps	1,154 bps
Distressed (CC, C and Default)	478 bps	6,981 bps

Source: Credit Suisse Leveraged Loan Index

Summary & Looking Forward

As of February 28, the S&P/LSTA Index imputed default rate was 1.97%, down from 2.43% in the prior month. This level is more in line with 2017 trading levels.

The boomerang effect was in full force in February. The Leveraged Loan index continued to rally and by month end recouped 64.5% of a $4.60 peak-to-trough decline since October.

Given the fact that CLOs are the primary buyer in the loan market right now, the market feels as if it has gotten ahead of itself. Liability costs for CLOs remain sticky and unwilling to tighten. The natural arbitrage, which seemed attractive for CLO buyers in January, seems to have been eclipsed in the early days of March. New issue loans underscore this point as pricing in the new issue market continues to offer a large concession to secondary levels. Investment banks understand that pricing for new issue needs to be attractive to CLOs and that other sources of demand (retail funds and crossover high yield investors) will not get a deal fully subscribed. Finally, the fact that CLO loan managers are requiring new issue spreads to be so much wider relative to ratings offered in the secondary market suggests that secondary prices are too high in the near term. ■