

## MONTHLY COMMENTARY

## Loan Review – March 2018

DREW SWEENEY | APRIL 13, 2018

How prophetic...the Ides of March, the day when ancient Romans would settle their debts, served as the demarcation point for when loans began to weaken. Similar to the Roman Practice, in late March, loan investors felt like it was time to pay the piper. Loan prices dropped 12 basis points after March 15th and the Credit Suisse Leveraged Loan Index (“CS LLI”) ending the month at 98.19, its lowest price since Valentine’s Day. While loans represented a bastion of stability relative to most of the capital markets, prices did weaken for the second consecutive month.

As CLO liability spreads began to widen, loans experienced pressure. Most of the pressure was reflected in the primary market, particularly within single Bs. In the beginning of March, investment banks hurried out a host of deals, looking to reprice or lower their LIBOR spreads. There seemed to be little justification for the levels discussed, meaning each deal pushed the envelope in terms of spread tightening. Needless to say, these types of deals were getting done in January, February and the beginning of March. While double B new issue still priced at the tight end of “talk,” single B deals began to fail at price talk. Deals priced at the wide end of talk or even wide of talk. Meanwhile, the secondary market largely remained stable as the percentage of loans trading above par stood at 73.3%, not far below the year-to-date high (80.0%).

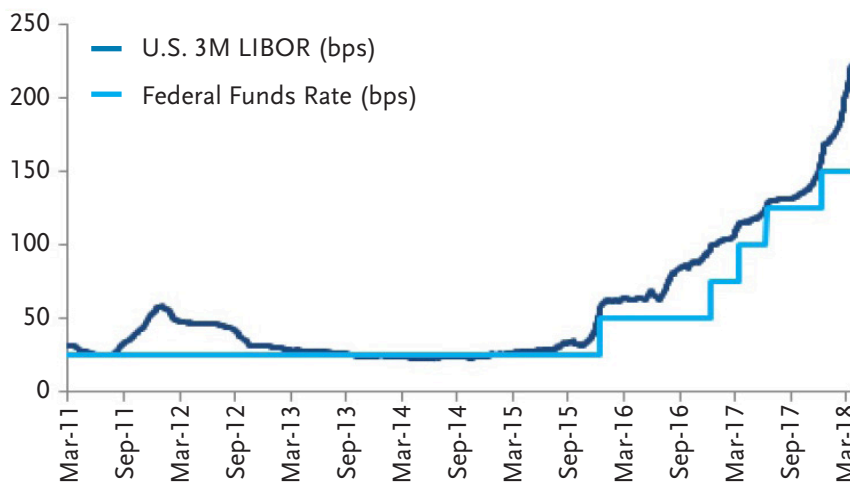
Demand for loans remained intact as inflows from retail funds continued to be positive, primarily as a result of the climbing LIBOR rate.



**Drew Sweeney**  
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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.

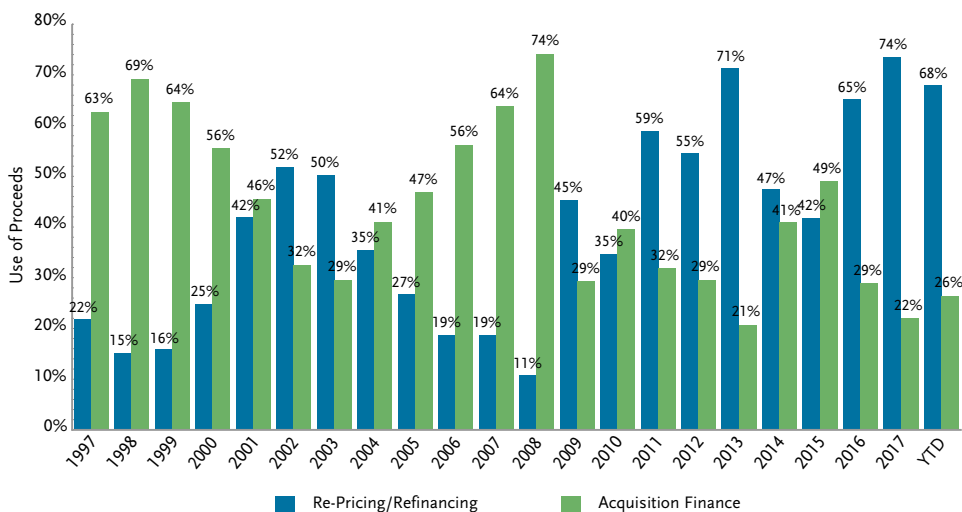
## Surge in LIBOR in 1Q18



Source: Credit Suisse, Bloomberg

## Loan Review – March 2018

The primary calendar continued to be dominated by repricing activity as spread compression has been a major theme of 2018 despite secondary price weakness in February and March.



Source: TCW

As mentioned in our last commentary, the repeal of risk-retention requirements for CLOs was announced in February. However, the opportunity for the government to file an appeal to the United States Circuit Court for the DC Circuit expired at midnight on March 26th with the agencies choosing not to pursue further action. On April 5th, the DC Court ordered a summary judgement granted in favor of the The Loan Syndications and Trading Association (LSTA), vacating the prior ruling. For practical purposes, CLO managers are no longer subject to the U.S. risk retention rule.

### Performance

In March, the CS LLI and the S&P Leveraged Loan Index ("S&P/LSTA") were both up, 0.32% and 0.28%, respectively.

- For the quarter the CS LLI was up 1.58% and the S&P/LSTA was up 1.45%.
- For the 12 months ending March 31, the CS LLI was up 4.64% and the S&P/LSTA was up 4.43%.

Lower quality loans (Split B, CCC and distressed) still provided the strongest returns in March despite market weakness in the back half of the month. During the last 12 months, higher quality lagged lower quality. Single Bs provided a return of 5.6% while Double B loans returned 4.04%.

| Total Return By Rating         |       |       |       |
|--------------------------------|-------|-------|-------|
|                                | March | YTD   | LTM   |
| Split BBB                      | 0.28% | 1.11% | 3.23% |
| BB                             | 0.34% | 1.18% | 4.04% |
| Split BB                       | 0.25% | 1.23% | 3.57% |
| B                              | 0.29% | 1.56% | 5.06% |
| Split B                        | 0.48% | 3.26% | 8.83% |
| CCC/Split CCC                  | 0.39% | 3.64% | 6.61% |
| Distressed (CC, C and Default) | 1.70% | 5.99% | 3.87% |

Source: Credit Suisse Leveraged Loan Index

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### Sector Performance

Nineteen of 20 sectors in the Credit Suisse LLI provided a positive return during the month led by Transportation (+0.63%), Metals (+0.57%) and Retail (+0.57%).

The worst performing sectors for the month were Consumer Durables (-1.66%), Consumer Non-Durables (0.03%) and Food / Tobacco (0.22%).

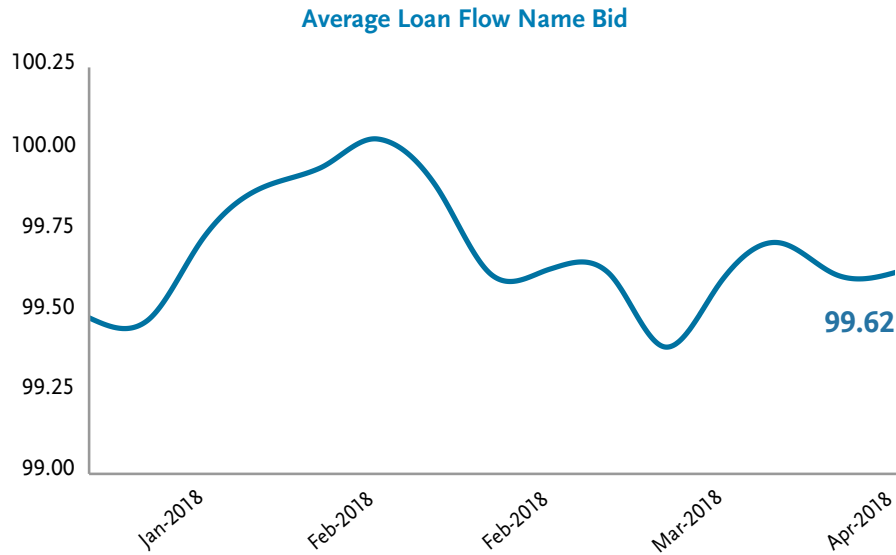
In the last 12 months, Metals, Manufacturing, and Financials led all sectors with total returns of 5.55%, 5.54% and 5.38%, respectively. In contrast, Consumer Durables, Retail and Consumer Non-Durables were the worst performing sectors with returns of -2.52%, 2.42% and 2.57%, respectively. Fear of the Amazon effect and the changing landscape of consumer shopping habits have pushed these sectors lower during the last year.

| Total Return by Sector   |        |                          |        |                          |        |
|--------------------------|--------|--------------------------|--------|--------------------------|--------|
| Sector                   | March  | Sector                   | QTD    | Sector                   | LTM    |
| Consumer Durables        | -1.66% | Consumer Durables        | -0.61% | Consumer Durables        | -2.52% |
| Retail                   | 0.57%  | Retail                   | 3.30%  | Retail                   | 2.42%  |
| Consumer Non-Durables    | 0.03%  | Consumer Non-Durables    | 1.81%  | Consumer Non-Durables    | 2.57%  |
| Food and Drug            | 0.53%  | Food And Drug            | 2.04%  | Food And Drug            | 3.60%  |
| Transportation           | 0.63%  | Transportation           | 1.89%  | Transportation           | 3.67%  |
| Energy                   | 0.43%  | Energy                   | 2.72%  | Energy                   | 3.93%  |
| Media/Telecommunications | 0.25%  | Media/Telecommunications | 1.49%  | Media/Telecommunications | 4.33%  |
| Food/Tobacco             | 0.22%  | Food/Tobacco             | 1.36%  | Food/Tobacco             | 4.42%  |
| Forest Prod/Containers   | 0.27%  | Forest Prod/Containers   | 1.02%  | Forest Prod/Containers   | 4.64%  |
| Housing                  | 0.31%  | Housing                  | 1.33%  | Housing                  | 4.80%  |
| Gaming/Leisure           | 0.30%  | Gaming/Leisure           | 1.15%  | Gaming/Leisure           | 4.81%  |
| Chemicals                | 0.40%  | Chemicals                | 1.29%  | Chemicals                | 4.86%  |
| Service                  | 0.24%  | Service                  | 1.38%  | Service                  | 5.08%  |
| Aerospace                | 0.27%  | Aerospace                | 1.42%  | Aerospace                | 5.20%  |
| Information Technology   | 0.45%  | Information Technology   | 1.56%  | Information Technology   | 5.25%  |
| Healthcare               | 0.29%  | Healthcare               | 1.53%  | Healthcare               | 5.28%  |
| Utility                  | 0.32%  | Utility                  | 1.67%  | Utility                  | 5.32%  |
| Financial                | 0.41%  | Financial                | 1.45%  | Financial                | 5.38%  |
| Manufacturing            | 0.32%  | Manufacturing            | 1.52%  | Manufacturing            | 5.54%  |
| Metals/Minerals          | 0.57%  | Metals/Minerals          | 2.61%  | Metals/Minerals          | 5.55%  |

Source: Credit Suisse Leveraged Loan Index

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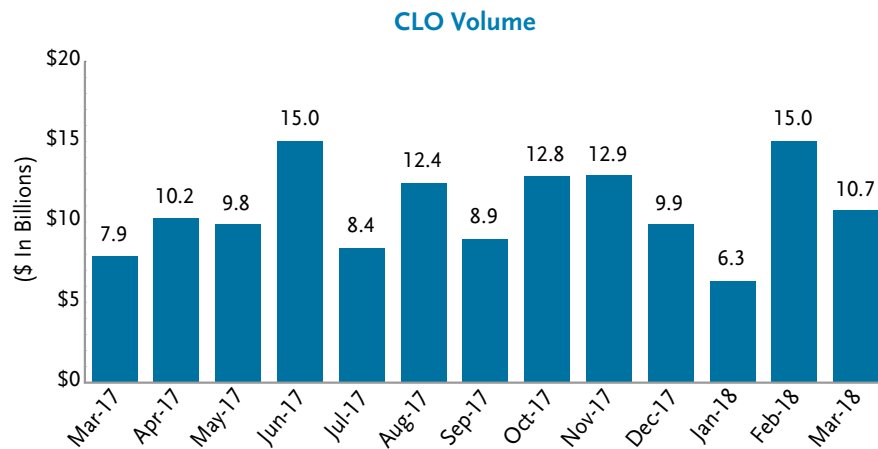
The average bid of the S&P LCD’s flow-name loan composite came in flat from the prior month at 99.62%.



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

### Technical Conditions

In March, CLO markets printed \$10.7 billion of new deals as demand for liabilities began to waiver. Liability spreads pushed wider in the back half of the month after an overwhelming number of deals were reset following the changes to risk retention requirements. However, issuance remained robust and the pipeline remains very large.



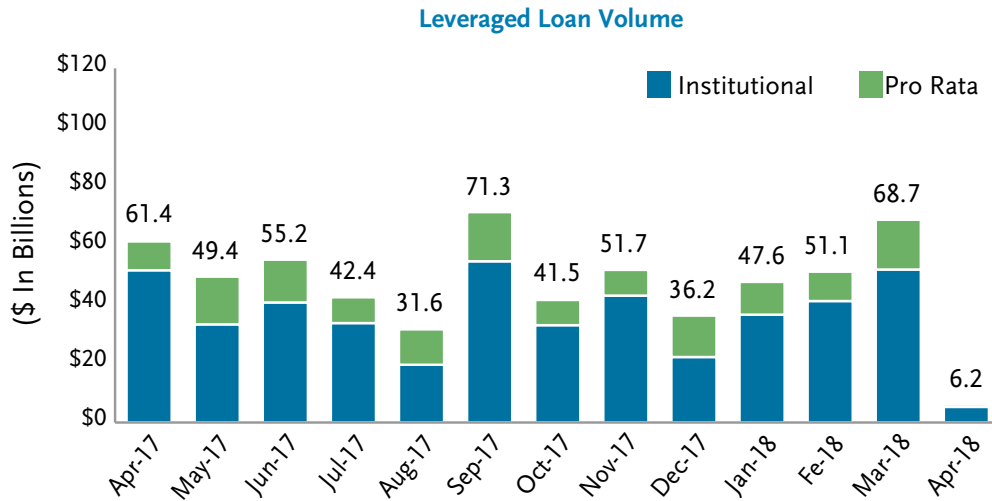
Source: LCD, an offering of S&P Global Market Intelligence

## Loan Review – March 2018

Leveraged loan funds reported an inflow in March of \$2.9 billion. Following two weak months of retail inflows, March inflows surged higher as 3-month LIBOR topped 2.3%.

For the first quarter overall, net inflows into retail funds totaled \$3 billion, starkly different from the \$3.7 billion of redemptions in Q4 2017.

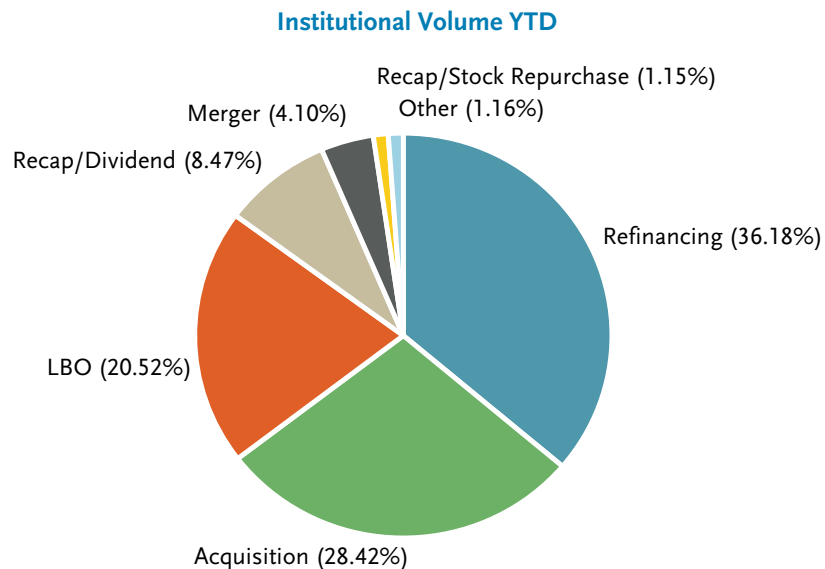
March institutional issuance picked up from the prior month.



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

In terms of the year-to-date new issuance, roughly 36.2% of the primary market was related to refinancing existing deals while acquisitions and LBOs accounted for 48.9%.

Month-to-date, \$85.1 billion of institutional loans have priced, 72% of which has been re-pricing (\$43.8 billion) or refinancing (\$17.3 billion). While total institutional loan volume equates to \$218 billion year to date and is down 32% y/y, the \$70 billion of net issuance (ex-re-pricing/refinancing) is 11% ahead of last year's pace.

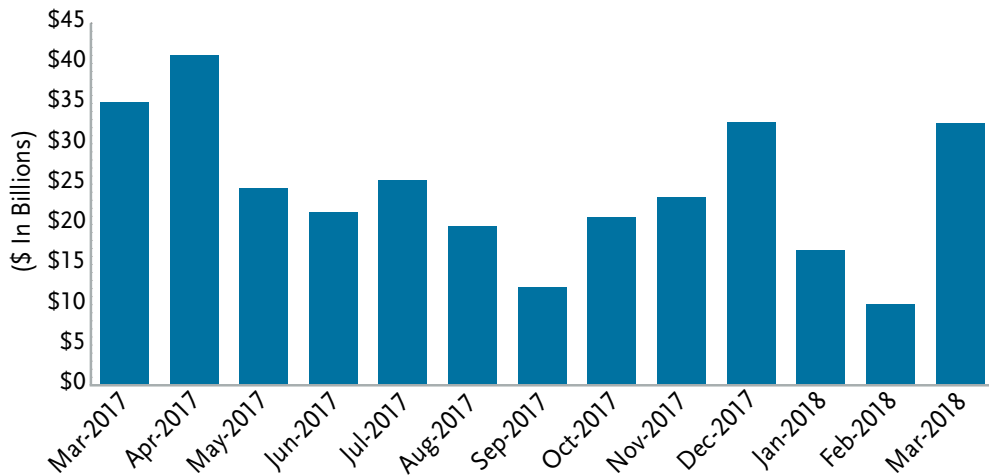


Source: LCD, an offering of S&P Global Market Intelligence

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Monthly repayments accelerated to nearly \$35 billion at quarter end, which created a technical pressure for investors to find more assets.

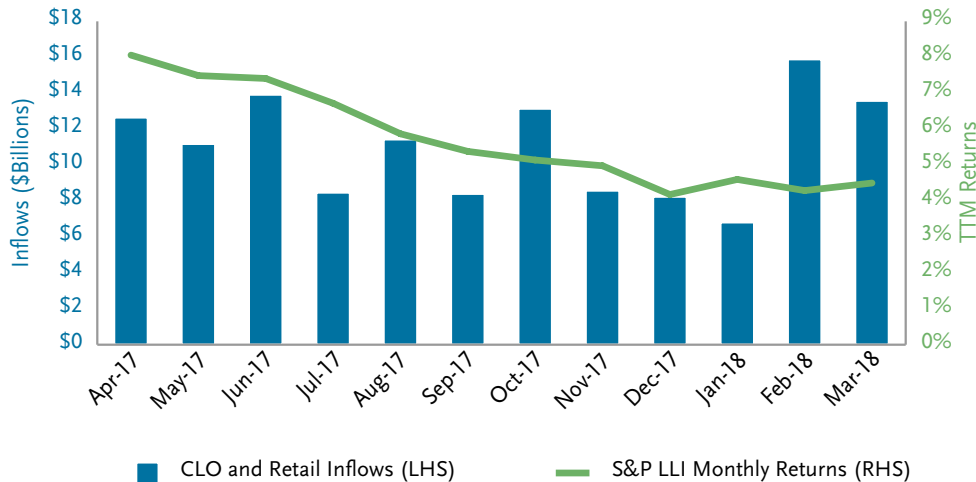
Monthly Repayments in the S&P/LSTA LL Index



Sources: LCD, an offering of S&P Global Market Intelligence; S&P/LSTA Leveraged Loan Index

Amid strong inflows, the trailing 12-month returns continued to pace close to 4.5%. The combination of lower LIBOR spreads and price declines resulting from repricing activity have weighed on returns.

Inflows and Rolling LTM Returns



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

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On a year-to-date basis, new issue spreads in March are -3.8% tighter for double Bs and -9.2% tighter for single Bs. The Index spread for the CS LLI ended March at roughly L+352 basis points. This is the tightest spreads have been for the CS LLI index since March 2011.

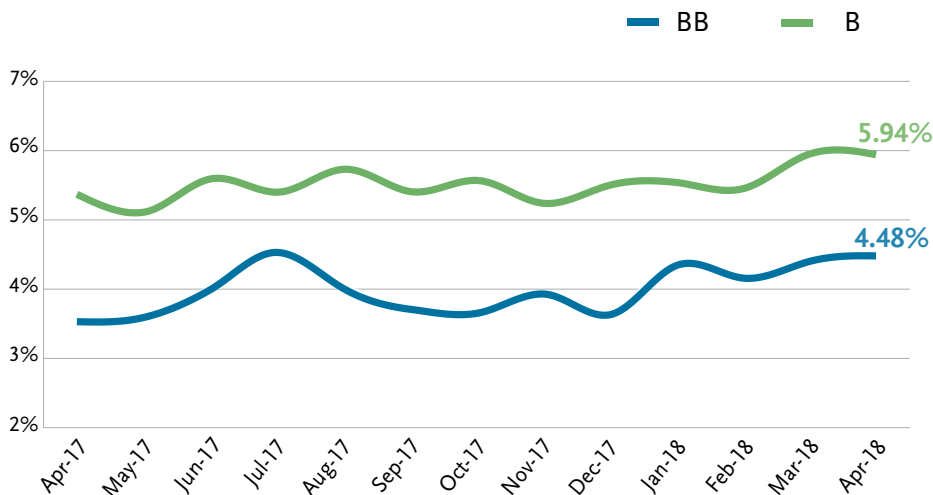
### New Issue Spread Changes

|                         | <b>BB/BB-</b> | <b>B+/B</b> |
|-------------------------|---------------|-------------|
| Mar-17                  | 243           | 382         |
| Jun-17                  | 240           | 370         |
| Sep-17                  | 243           | 373         |
| Dec-17                  | 233           | 375         |
| Mar-18                  | 224           | 341         |
| Month-Over-Month Change | -0.6%         | 0.4%        |
| YTD Change              | -3.8%         | -9.2%       |
| LTM Change              | -10.2%        | -13.4%      |

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

Average new issue yields widened month over month for Double Bs (0.08%) and contracted for single Bs (-0.01%). Rising LIBOR has offset much of the tighter LIBOR spreads during the last 12 months. In March, 3-month LIBOR moved higher by another 29 basis points.

### Average New-Issue Yields



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

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The default rate of the S&P/LSTA Leveraged Loan Index remained flat at 2.00% by principal amount in March. There were three defaults (Claire's Stores, Clear Channel Communications and Harvey Gulf). This level is still down from an 18-month high of 2.05% at the end of December.

The last-12-month default tally is 27. Retail defaults lead all categories with eight while Oil & Gas is close behind with six.

### Lagging 12-Month Default Rates

| Actual                     | Jan-18 | Feb-18 | Mar-18 |
|----------------------------|--------|--------|--------|
| By Number                  | 1.83%  | 1.94%  | 1.94%  |
| By Principal Amount        | 1.95%  | 2.00%  | 2.00%  |
| <b>Shadow Default Rate</b> |        |        |        |
| By Number                  | 0.32%  | 0.43%  | 0.43%  |
| By Principal Amount        | 1.08%  | 0.98%  | 0.98%  |

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 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 (396 basis points) and excluding January, this was the tightest 3-year discount margin since October 2007.

The DM spread differential between double Bs and single Bs tightened by 11 basis points from April 2017 to March 2018 and is still 38 basis points tighter of the historical spread differential.

### 3-Year Discount Margin Differential Between BBs and Single Bs

|                       |       |
|-----------------------|-------|
| 1/1992-1/2018 Average | 84.1  |
| Apr-17                | 111.3 |
| Mar-18                | 122.7 |

Source: Credit Suisse Leveraged Loan Index



## Loan Review – March 2018

## CS LLI Snapshot

|                               |        |
|-------------------------------|--------|
| YTD Total Return*             | 1.58%  |
| Average Price                 | 98.19  |
| Spread                        | 351.77 |
| Coupon                        | 5.43%  |
| Current Yield                 | 5.54%  |
| Yield (3-year life)           | 6.62%  |
| Discount Margin (3-year life) | 396 bp |

\*S&P LLI Total Return 1.16%  
Source: LCD Loan Stats

|                                | Spread  | DM<br>(3-Year Life) |
|--------------------------------|---------|---------------------|
| Split BBB                      | 207 bps | 203 bps             |
| BB                             | 263 bps | 259 bps             |
| Split BB                       | 312 bps | 312 bps             |
| B                              | 386 bps | 409 bps             |
| Split B                        | 539 bps | 798 bps             |
| CCC/Split CCC                  | 669 bps | 1,075 bps           |
| Distressed (CC, C and Default) | 519 bps | 2,867 bps           |

Source: Credit Suisse Leveraged Loan Index

## Summary

As of March 31, the S&P/LSTA Index imputed default rate was 1.17%, its second lowest level since October 2007.

Loans represented a stable asset class relative to the broader capital markets. Loans outperformed high yield bonds for a sixth consecutive month. LIBOR's rise brought retail fund flows in and a long line of CLOs pricing brought significant demand. However, the market felt generally weak as the month ended despite positive flows and a moderate new issue calendar.

As CLO liabilities widen, conventional wisdom would suggest that the collateral will widen as well. However, as we look ahead to April, numerous CLOs are trying to source paper and loans appear to be rebounding again. This demand, combined with a high level of repayments in March left many managers with significant cash to put to work in April. ■

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