TCW

INSIGHT

MONTHLY COMMENTARY

Loan Review – March 2019

DREW SWEENEY | 15 APRIL 2019

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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.

There is an expression that is considered a blessing and a curse: "May you live in interesting times." Well, the loan market has been interesting for some time now. Volatility in loans has picked up during the last 15 months. If we revisit some of the headlines since the beginning of 2018, we can see the magnitude events and the commensurate volatility associated with them:

- February 2018 – repeal of risk-retention requirements for CLOs.
- May 2018 – second highest level of institutional loan issuance in the history of the market.
  - Per S&P LCD, $66 billion of issuance led a 2% increase in the index size. According to JP Morgan, new issuance (including amended repricings), topped $100 billion.
- March, April and May 2018 – average leveraged loan issuance of greater than $70 billion per month.
- November 2018 – the biggest monthly drop in loan prices since December 2015.
- Q4 2018 – the fifth worst quarter for loan performance since 1998.
- Calendar year 2018 – CLO issuance reaches its largest annual level in history.
- Q4 2018 through 1Q19 – $31.8 billion in outflows from floating rate loan funds, 20% of total loan fund AUM.
  - AUM for the loan mutual fund base is down to $121 billion from a high of $154 billion in October 2018.
- January and February 2019 – the third best two-month return since 2009.
  - March 31, 2019 – trailing 12-month default rate declines to 0.9%, a new post-crisis low.

Loan Review – March 2019

After a historically strong start to the year, loan prices retreated in March. The January-February rally made it difficult for CLOs to continue ramping as CLO liabilities have not seen any commensurate spread tightening. Retail loan funds experienced very large outflows due to a change in the market's outlook for rising rates. Lower demand, combined with a moderately sized new issue calendar, meant loans gave up some of the gains seen earlier in the quarter. Loans did see support and a bounce in prices at the end of the month as crossover investors recognized the asset class's relative value.

Performance

In March 2019, the Credit Suisse Leveraged Loan Index (CS LLI) and the S&P Leveraged Loan Index (S&P/LSTA) were down -0.12% and -0.17%, respectively.

- In the first quarter the CS LLI was up 3.78% and the S&P/LSTA was up 4.00%.
- For the trailing 12 months, the CS LLI was up 3.33% and the S&P/LSTA was up 2.97%.

Despite loans being down in March, Triple Cs outperformed Double Bs and Split Double Bs. There was also very little performance difference between Single Bs and Double Bs.

Technical dynamics continued to influence returns in the first quarter. CLO generation in the first quarter was good by historic standards, however, a substantial portion of the issuance was derived from hung 2018 deals. Many of those deals had been largely ramped and did not create a significant amount of additional purchases. Meanwhile, retail loan funds had substantial outflows during the quarter. Consequently, there was not enough demand from loan-only accounts to meet supply in March. Loan returns are now being driven not just from ramping CLOs but also crossover bond buyers. At the end of 2018, Double Bs underperformed because bank loan investors were seeking liquidity anywhere they could find it. In the first quarter this trend reversed and Double Bs outperformed Single Bs by 62 basis points. For the last year, Single Bs have outperformed Double Bs and Triple Bs.

Total Return by Rating

	March	Q1 2019	LTM
Split BBB	0.03%	3.95%	3.37%
BB	-0.13%	4.23%	3.18%
Split BB	-0.44%	4.05%	2.73%
B	-0.22%	3.61%	3.44%
Split B	0.97%	5.26%	5.37%
CCC/Split CCC	0.26%	2.17%	2.90%
Distressed (CC, C and Default)	1.76%	5.32%	-1.81%

Source: Credit Suisse Leveraged Loan Index

Sector Performance

A full 16 sectors in the CS LLI provided negative March returns. The top performing sectors were also the only ones delivering positive returns: Energy (0.52%), Retail (0.39%) and Utility (0.24%).

The worst performing sectors for the month were Food & Drug (-0.40%), Consumer Non-durables (-0.43%) and Consumer Durables (-2.23%). Consumer Durables was an outlier as the remaining returns were all clustered within a 96-basis point band. Consumer Durables is a sector dominated by one large borrower that traded materially lower during the quarter.

In the last 12 months, Retail, Metals/Minerals and Utility have led all sectors with total returns of 5.39%, 4.58% and 4.44%, respectively. Interestingly, Retail leads all categories in defaults during the last 12 months as well. In contrast, Food/Tobacco, Manufacturing and Consumer Durables were the worst performing sectors with returns of 2.58%, 2.41% and -0.55%, respectively. The range between the top performing sector and bottom performing sector has contracted in the last 12 months from 9.31% to 5.39%.

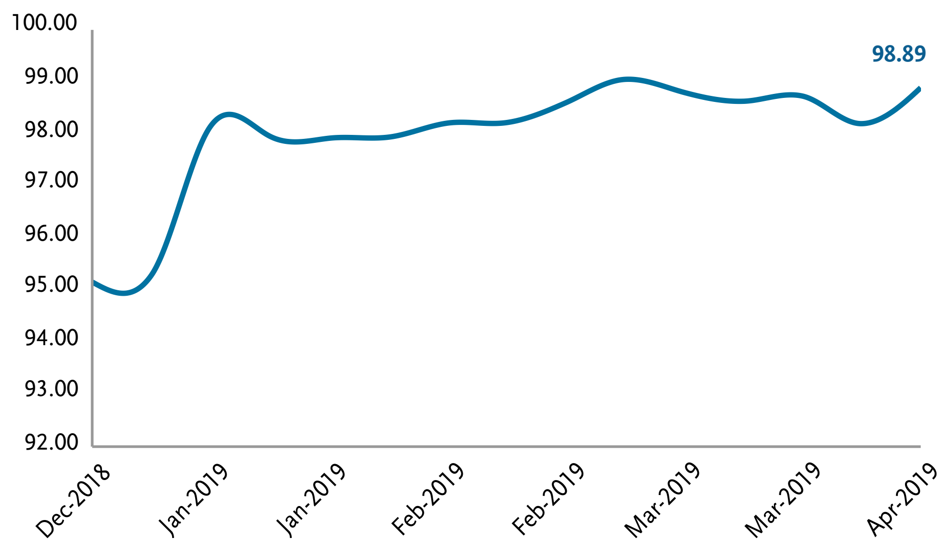
Industry Returns

Sector	March	Q1 2019	LTM
Aerospace	-0.22%	4.06%	3.11%
Chemicals	-0.01%	4.03%	3.85%
Consumer Durables	-2.23%	0.09%	-0.55%
Consumer Non-Durables	-0.43%	3.28%	2.59%
Energy	0.52%	4.56%	4.43%
Financial	-0.22%	3.76%	3.79%
Food And Drug	-0.40%	5.52%	4.38%
Food/Tobacco	-0.27%	3.24%	2.58%
Forest Prod/Containers	-0.29%	3.85%	2.71%
Gaming/Leisure	-0.27%	4.08%	3.47%
Healthcare	-0.26%	3.66%	3.31%
Housing	-0.29%	4.12%	3.00%
Information Technology	-0.09%	3.78%	3.34%
Manufacturing	-0.07%	3.29%	2.41%
Media/Telecommunications	-0.12%	4.35%	2.78%
Metals/Minerals	0.23%	5.51%	4.58%
Retail	0.39%	4.71%	5.39%
Service	-0.07%	3.02%	2.94%
Transportation	-0.04%	2.96%	4.19%
Utility	0.24%	3.79%	4.44%

Source: Credit Suisse Leveraged Loan Index

CS LLI prices decreased 59 basis points in March while the average bid of the S&P LCD flow-name loan composite dropped 16 basis points from 99.05 to 98.89. The average flow name bid is up 291 basis points on a year-to-date basis.

Average Loan Flow-Name Bid



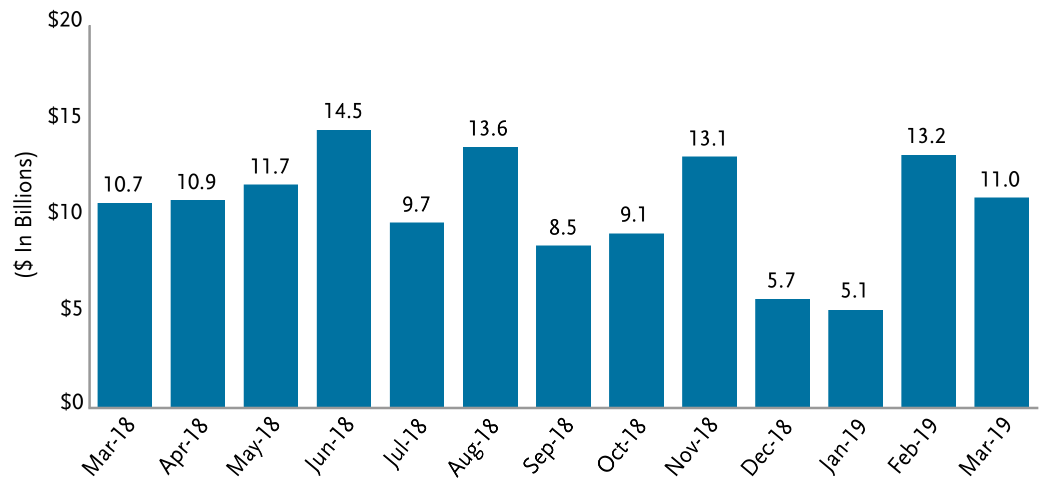
Source: LCD, an offering of S&P Global Market Intelligence

Technical Conditions

March retail loan outflows were approximately -$3.75 billion with loan funds having reported 19 consecutive weeks of outflows for the period ending March 27. Outflows for floating rate loan funds now total -$30.8 billion, or 20% of AUM, since the beginning of Q4 2018, a level comparable to inflows during the preceding two years. Meanwhile, AUM for the loan mutual fund base is down to $121 billion from the high of $154 billion in October. Rising rate concerns drove inflows and the abatement of those fears has led to outflows.

There were $11.0 billion of CLOs issued in March, down from $13.2 billion from February 2019 and flat year-over-year. In the first quarter, there were $29 billion of CLOs issued, down 8.6% from the prior year.

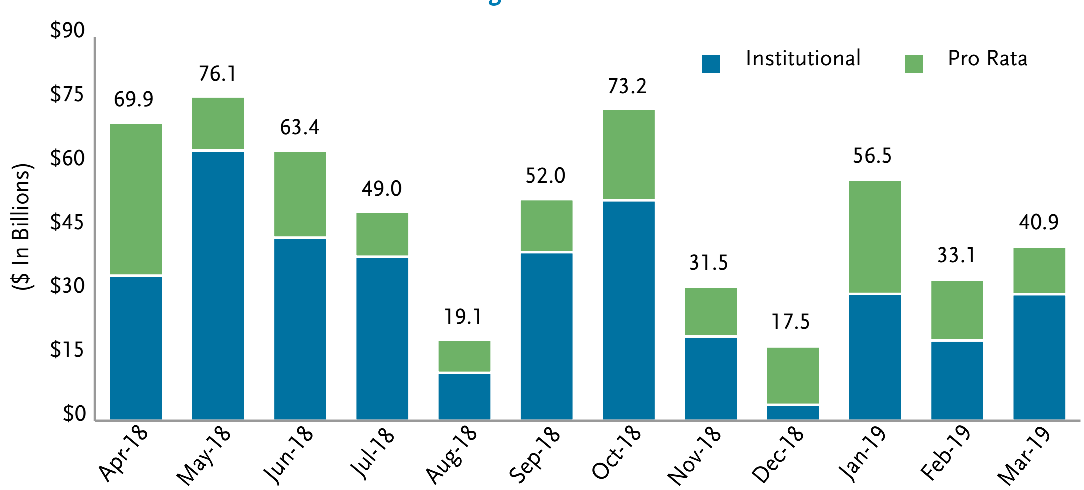
CLO Volume



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

Institutional new issuance in March was $29.7 billion, up 58% from the prior month and down 43% year-over-year.

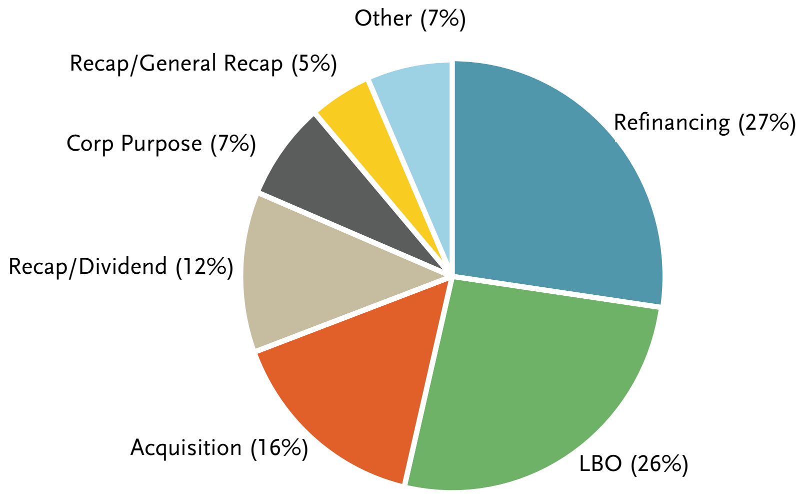
Leveraged Loan Volume



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

In March, acquisitions, mergers and LBOs represented 42% of primary issuance, well below the 67% mark set for the first quarter.

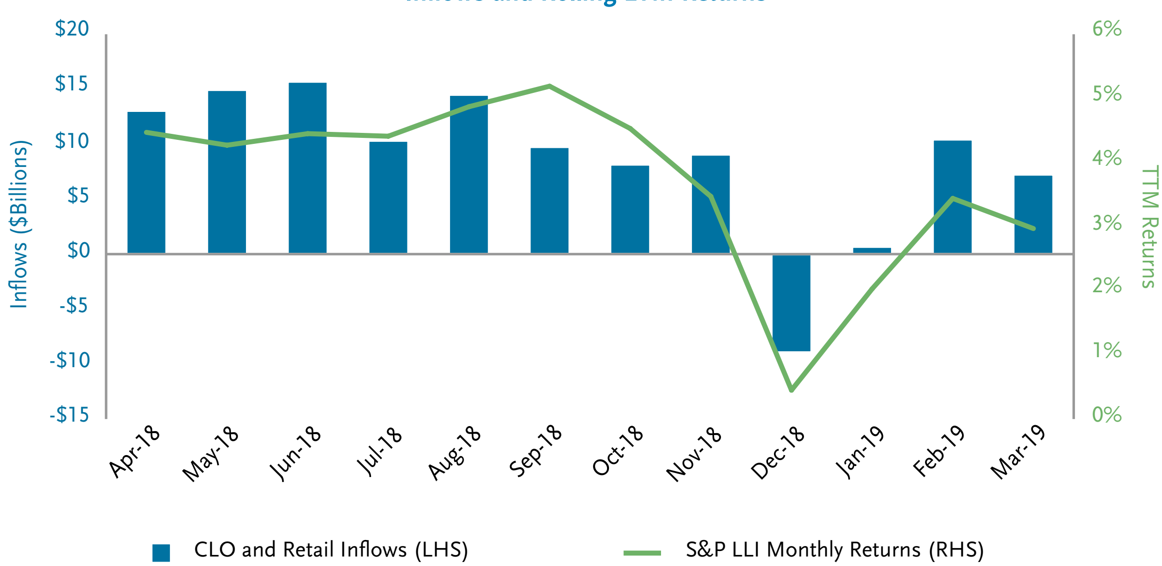
March 2019 Institutional Volume



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

Loan fund outflows and moderate CLO loan demand have created an environment where loans are generally more volatile month-to-month. Crossover high yield buyers have become the marginal investor in the market and that technical condition has made the loan market more susceptible to quick changes in risk appetite. When high yield investors see value in loans the asset class tends to rally. When high yield investors are less active, prices are more at risk to decline. In March, net loan-only demand declined as did the LTM return.

Inflows and Rolling LTM Returns



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

New issue spreads in March tightened but remained 27% wider than new issuance spreads 12 months prior.

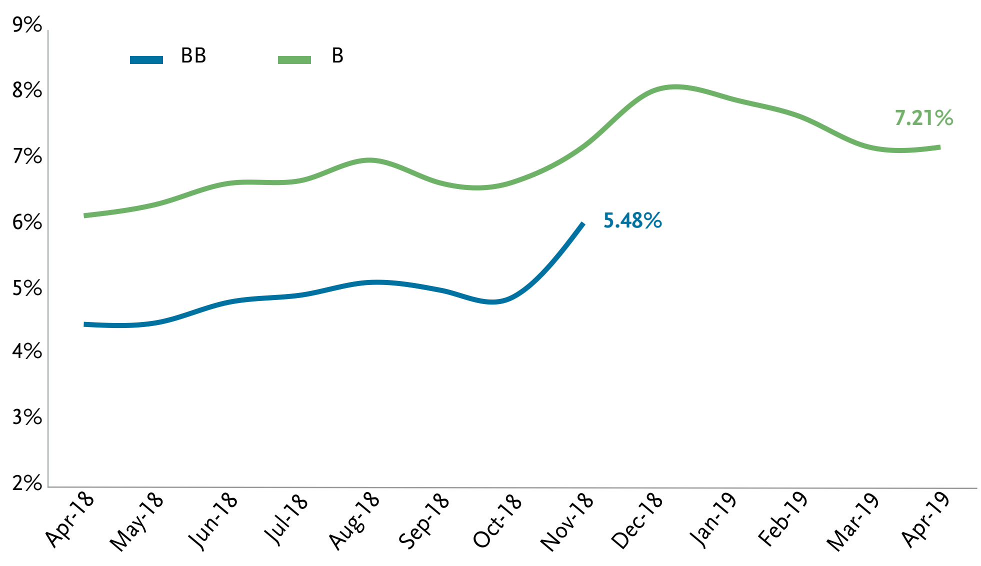
New Issue Spread Changes

	All Loans
Mar-18	317
Jun-18	362
Sep-18	378
Nov-18	401
Dec-18	452
Jan-19	434
Feb-19	445
Mar-19	403
Month-Over-Month Change	-9.43%
YTD Change	-10.89%
LTM Change	27.3%

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

In terms of new issue yields, Double B and Single B yields tightened compared to January 2019, 164 basis points and 76 basis points, respectively.

Average New-Issue Yields



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

There was one default in March, CTI Foods (Food & Beverage) and the default rate changed from 1.62% in February to 0.93% in March.

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

Lagging 12-Month Default Rates

Actual	Jan-19	Feb-19	Mar-19
By Number	1.44%	1.52%	1.40%
By Principal Amount	1.42%	1.62%	0.93%
Shadow Default Rate*			
By Number	0.62%	0.51%	0.30%
By Principal Amount	0.39%	0.27%	0.17%

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 and 2009) is excluded, the 3-year DM is 417 basis points. The 3-year DM finished the month at 467 basis points, 83 basis points tighter than December 2018.

The DM spread differential between Double Bs and Single Bs has widened 30 basis points since March 2019, however, it is still 8 basis points tighter than the historical spread differential.

3-Year Discount Margin Differential Between BBs and Single Bs

3/1992-2/2019 Average	189.6
Mar-18	151.7
Feb-19	122.3

CS LLI Snapshot

YTD Total Return*	3.78%
Average Price	96.30
Spread	350 bp
Coupon	6.18%
Current Yield	6.43%
Yield (3-year life)	6.97%
Discount Margin (3-year life)	467 bp

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

	Spread	DM (3-Year Life)
Split BBB	195 bps	234 bps
BB	258 bps	310 bps
Split BB	301 bps	391 bps
B	382 bps	492 bps
Split B	502 bps	878 bps
CCC/Split CCC	664 bps	1,149 bps
Distressed (CC, C and Default)	395 bps	1,620 bps

Source: Credit Suisse Leveraged Loan Index

Summary & Looking Forward

As of March 31, the imputed default rate for the S&P/LSTA was 2.34%, up from 1.97% in the prior month.

The ebb and flow of the loan market prices continued. The price gains seen in January and February pressured the arbitrage for CLOs and reduced the CLO bid for loans. Retail outflows left retail managers better sellers. By the end of the month, loans stabilized as crossover high yield investors boosted demand.

With little new issue on the horizon, many loan investors are bracing for a summer of loan prices grinding higher. This is typically combined with more opportunistic new issuance (dividend deals and tack-on first lien issuance to repay subordinate debt). The primary obstacle to loan prices going higher is simply the fact that 50-60% of the loan market is still held by CLOs and we have not seen any reduction in CLO liability costs. Without a commensurate reduction in liability costs, higher loan prices and lower spreads make the CLO arbitrage untenable. ■