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

INSIGHT

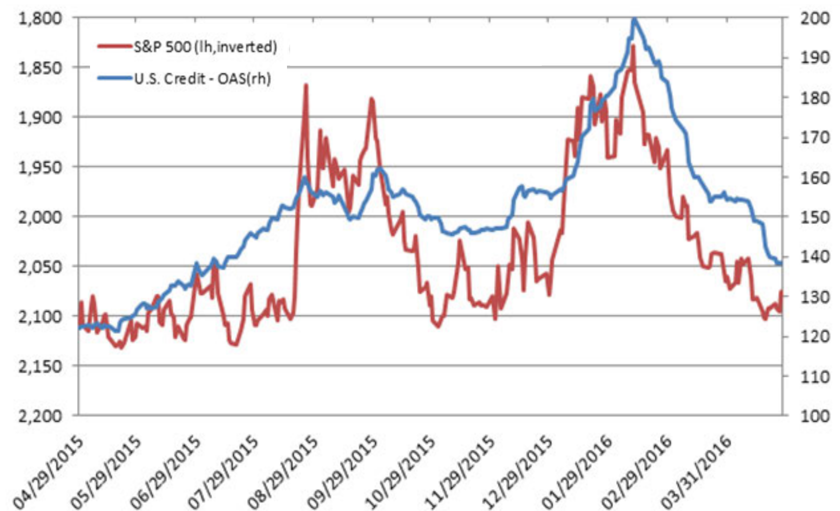
MONTHLY COMMENTARY

April Credit Update

TAMMY KARP | MAY 2, 2016

April saw another rally in credit spreads as the forces of QE have re-stoked investor appetite for "yielding" assets. Strong foreign and domestic inflows into U.S. high grade credit, coupled with a modest April new issue calendar and light dealer inventories have fueled the rally. While technicals have dominated since the ECB announced its CSPP (Corporate Sector Purchase Program) on March 9, the fundamental story for credit remains challenged. Corporate earnings have been anemic and the re-leveraging cycle will only get extended with the recent central bank actions. While NIRP (negative interest rate policy) and the CSPP have pushed up risk assets – and credit spreads have tightened 60 basis points from the 2/12 wides of +200- it is yet to be seen how the ECB's underwriting of credit risk translates into real economic growth. If companies use the "cheap" borrowed money to buy back stock and/or pay higher dividends vs. productively deploying money to fund growth, the re-leveraging cycle continues, corporate balance sheets further deteriorate, and the ultimate day of reckoning will be all the more painful.

Credit Spreads: Getting Close To The 12 Month Tights



Source: Barclays

Tammy Karp
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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.

Q1 Earnings: Not Pretty

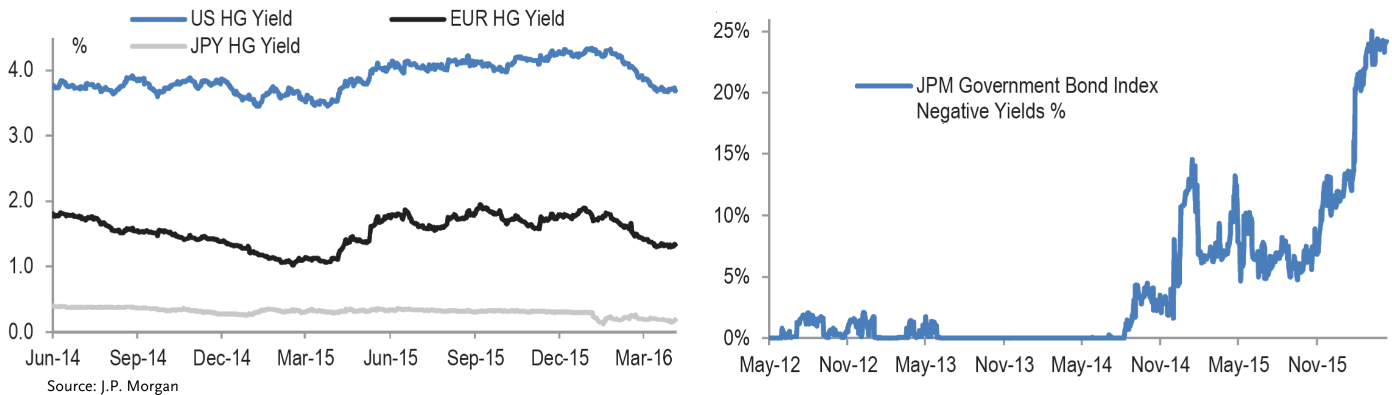
S&P 500 INDEX — Range: CQ1 Ending: Feb 16, 2016 - May 15, 2016

1) Surprise | 2) Growth

Sector (GICS)	Reported	Sales Growth	Earnings Growth
11) All Securities	315 / 500	-2.63%	-8.94%
12) > Energy	18 / 38	-31.48%	-96.51%
13) > Materials	18 / 27	-9.80%	-13.68%
14) > Industrials	53 / 65	-1.75%	-7.61%
15) > Consumer Discretionary	45 / 84	7.55%	29.35%
16) > Consumer Staples	20 / 37	-1.44%	0.89%
17) > Health Care	33 / 57	10.98%	6.53%
18) > Financials	71 / 90	-2.60%	-13.35%
19) > Information Technology	43 / 68	-3.85%	-8.62%
20) > Telecommunication Services	3 / 5	12.23%	17.01%
21) > Utilities	11 / 29	-12.44%	-5.29%

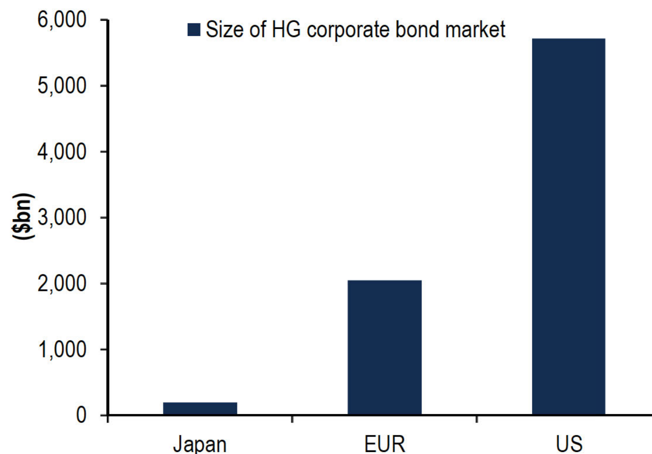
Source: Bloomberg

Global Relative Value: U.S. IG Yields higher versus Europe And Japan
24% Of Global Government Yields Are In Negative Territory



Source: J.P. Morgan

U.S. Corp Bond Market: Only Game In Town



Source: B0fA Merrill Lynch Global Research

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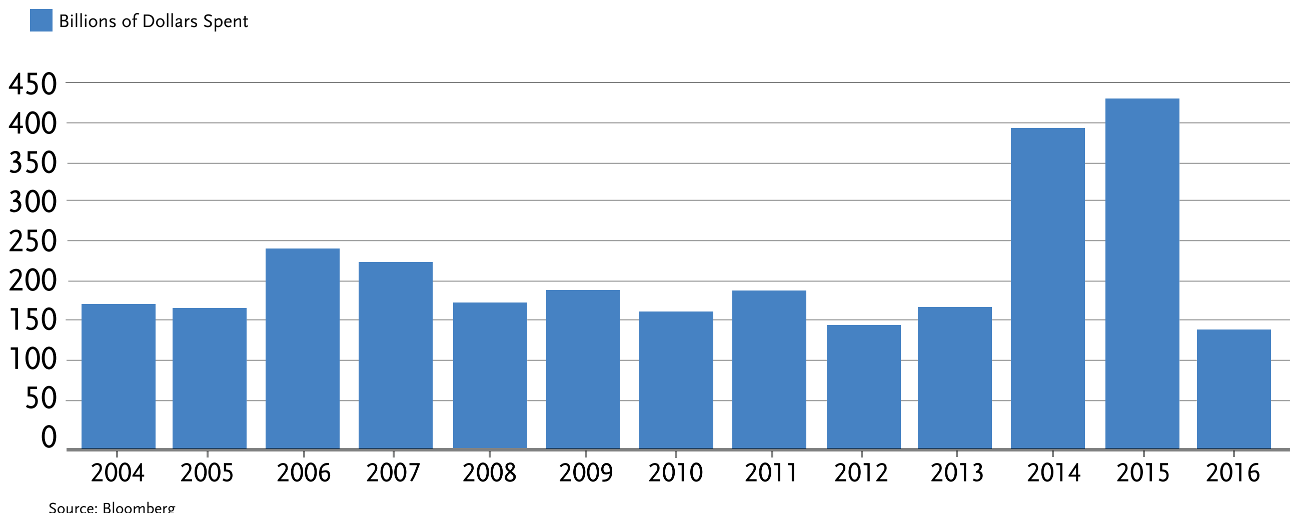
M&A: M&A announcements in the pharma/healthcare space continues despite the Treasury's anti-inversion rules. While tax inversion deals where a driving force for large M&A deals in the healthcare space, other motivating factors include buying growth and adding diversification to combat patent expirations and pricing pressures.ABT agreed to buy STJ for $25 bln (plus $5.7 bln in debt) comprised of $13.3 bln cash/debt and rest in stock. This is the second acquisition announcement by ABT this year (Alere acquisition announced in February) with both transactions expected to close in 4Q'16. If both acquisitions close as planned, leverage will go up more than 3x to ~ 4.6x. Consequently, both Moody's and S&P put ABT on watch downgrade, noting expected ratings of low BBB which would amount to a 4 and 5 notch downgrade respectively. Failed M/A: The Hal/BHI merger was terminated, citing challenges in obtaining regulatory approvals. Deal has a breakup fee of $3.5 bln.

Healthcare Deals Still Growing: Spending In 2016 So Far Is 27% Higher Than This Time Last Year



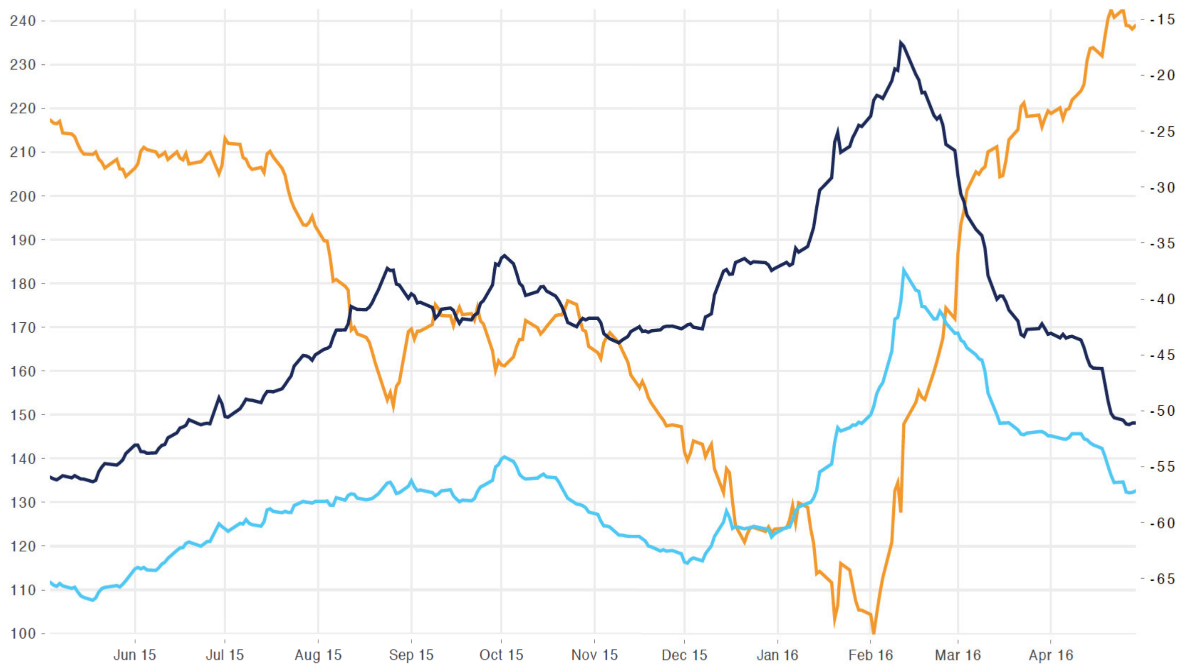
Source: Bloomberg

Index performance: A lot of volatility in credit spreads the first four months of the year as spreads have round tripped. The credit index oas has traded in a 61 basis point range year to date. That compares to a range of 44 basis point for all of 2015. Spreads started the year at an oas of +155, got as wide as +200 on 2/12, and are now at +139. The sharp reversal in spreads (and investor sentiment) since the wides of 2/12 can be attributed to: recessionary fears somewhat abated after decent payroll/jobs report, a commodity price recovery – WTI went from $26 on 2/11 to $45 currently, the ECB CSPP announcement, and a dovish Fed resistant to hike rates in the face of a weak global backdrop. From a sector performance standpoint, the worst performing sectors last year are the best performing sectors so far this year, namely, energy and metals. Energy spreads are 51 bps tighter on the month and 78 bps tighter on the year. Metals are 65 bps tighter on the month and 223 bps tighter on the year. Metals is the best performing sector so far in 2016 with a ytd excess return of 14%. The two worst performing sectors ytd are oil servicers (-2.12% excess return) and life insurers (-1.58% excess return). For oil servicers, several names dropped out of the index – at the wides in February- due to downgrades. For life insurers, the space has underperformed for several reasons: First, lower interest rates hurts investment income and is generally a negative for the sector. Other factors that have negatively affected spreads in the sector include shareholder activism as well as noise surrounding attempts by insurers to lose the SIFI designation (and regulatory burdens that come with it). The underperformance in financials is not limited to life insurers. Bank spreads have also underperformed industrials and the basis (bank-industrial basis) has gone from -64 bps at the beginning of the year to -15 bps now. NIMs (net interest margins) have been pressured by "perpetually" low interest rates and volatile capital markets activity has hurt profitability. Still, capital ratios and leverage ratios have improved dramatically given strict regulatory oversight – which is a good thing from a bondholder perspective. Additionally, energy exposure is quite manageable for the U.S. money centers at ~ 6% of total loans.

April 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	1.34%	1.22%	139	-15
Industrials	1.81%	1.67%	148	-20
Financials	.93%	.86%	142	-13
Utilities	1.18%	.98%	142	-9
Municipals	1.14%	.87%	170	-8
Sovereigns	.92%	.76%	183	-8

Bank-Industrial Basis: Banks Have Underperformed YTD



Key	Axis	Name	Last	Minimum		Maximum	
	Left	Invest. Grade: Industrial - OAS	148.168	134.715	05/18/2015	234.948	02/11/2016
	Left	Invest. Grade: Banking - OAS	132.579	107.636	05/18/2015	183.009	02/12/2016
	Right	banks - industrials	-15.589	-69.945	02/02/2016	-14.124	04/25/2016

Source: Barclays

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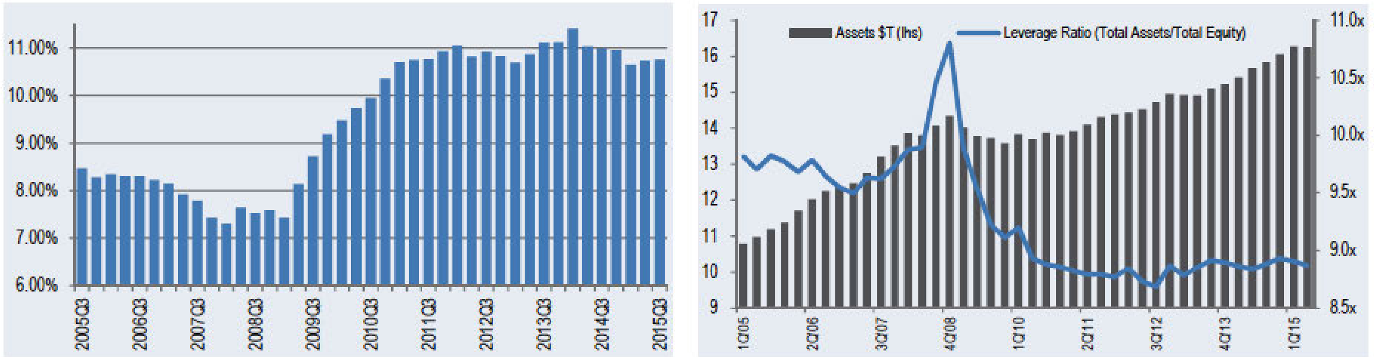
T1 Common Capital Ratios And Leverage Ratios For The Top 30 U.S. Banks



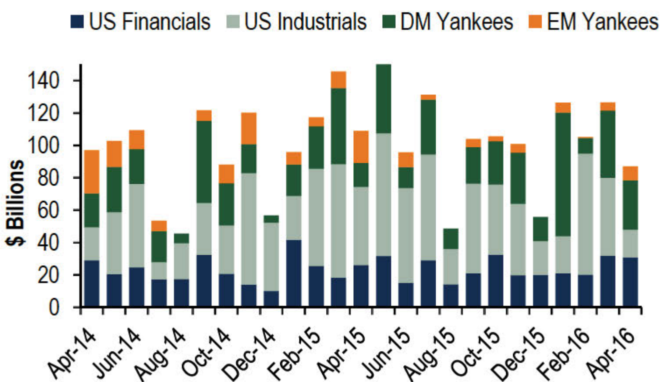
Source: SNL, FDIC, JP Morgan

April Supply: Supply was light, demand strong. IG supply totaled $87 bln in April, the lightest month ytd. Supply is expected to pick in May with estimates in the $120 - $140 bln range as issuers exit blackout periods. Several large M&A financings are expected including TEVA (~ $20 bln debt issuance), Mylan ($ 8 bln), Shire ($13 bln) and Tap ($8 bln). The two large managed care mergers (antm/ci, aet/hum) have not received regulatory approval yet.

April supply was heavily weighted toward financials, comprising 61% of total supply. Several Yankee banks tapped the market, including CS ($4.5 bln holdco debt, 10yrs at +280), MUFG ($2 bln sr holdco, 10yr priced at +155) and Mizuho ($4 bln, 10yr priced at +175). A couple energy names came to market given the remediation: EPD $1.25 mln multi tranched deal (11 year priced at +220/10yr) and BP issued $2 bln in 3 and 10yr paper at +75 and +130 over respectively.

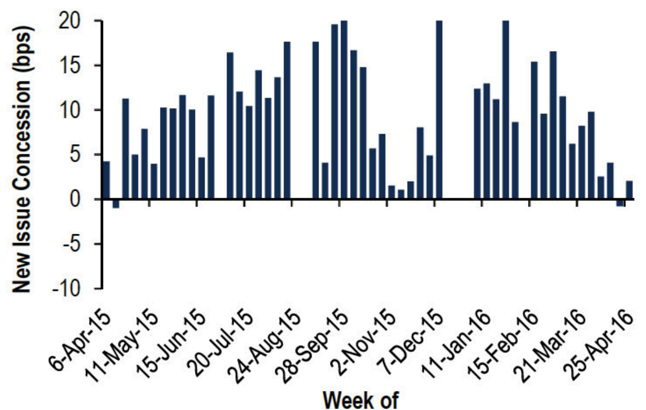
New issue concessions were negligible at 0-10 bps, even for the more volatile sectors like energy.

IG Monthly Supply



Source: BofA Merrill Lynch Global Research

New Issue Concessions



Source: BofA Merrill Lynch Global Research

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