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INSIGHT

MONTHLY COMMENTARY

April Credit Update

TAMMY KARP | MAY 4, 2017

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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.

Risk assets remained resilient in April as geopolitical risks and policy uncertainty had a negligible impact on the credit markets. Demand for spread product continued to be supported by healthy inflows into high grade funds, totaling $94 bln year-to-date through April 26. A rebound in earnings (Q1 EPS growth tracking @ 12%) has also been supportive of risk assets, though we did see a pickup in M&A activity – primary debt funded – which could negatively impact credit metrics. Three M&A deals in the healthcare space were announced, with the largest transaction being BDX's acquisition of BCR for $24 bln (a hefty 20x EBITDA multiple). BDX intends to pay for the acquisition using approximately 50/50 debt/equity, resulting in a 2x increase in leverage to just under 5x. Consequently, Moody's put BDX ratings on watch with the expectation of a two notch downgrade to Ba1 once the deal closes. Currently, BDX is only rated by S&P and Moody's, which means that its bonds will fall out of the IG index unless the company can secure an investment grade Fitch rating. The company's willingness to forgo full IG ratings in a sector that generally considers IG ratings sacrosanct (due to the amount of R&D spending and product liability issues) is disconcerting.

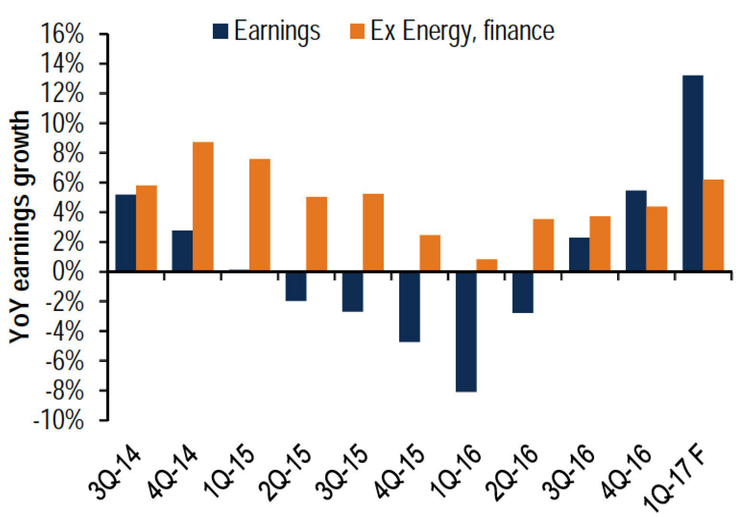
The results of the first round of the French elections were well received by the markets given expectations that centrist candidate Macron will win in the final round on May 7. The latest polls have Macron ahead by roughly 20 points at 60% support to Le Pen's 40% - but to state the obvious, the polls weren't exactly accurate predictors of the Brexit vote or the U.S. elections. On the policy front, Treasury Secretary Steven Mnuchin outlined the Trump administration's tax reform blueprint – likely a starting point for congressional negotiations. The outline included cutting the corporate tax rate to 15%, reducing the number of personal tax brackets to three, and repealing most itemized tax deductions. There were no specifics on repatriation, no mention of a BAT or VAT tax or of the elimination of debt interest deductibility for corporations. Given the political climate in Washington, a bipartisan agreement on tax reform seems difficult to achieve. Tax cuts via the budget reconciliation process, which requires only a simple majority to pass, also has its challenges given the revenue-neutral standard. A revenue-neutral plan is not an easy task if you're cutting taxes across the board. Cutting deductions like interest on debt and/or adding a BAT or VAT tax will be met with a lot of resistance.

Tax Plan Outline

	Trump Administration
Personal Tax Rates	Three brackets: 10%, 25, and 35%
Standard Deduction	Doubles standard deduction
Capital Gains & Investment Income	No specific mention, beyond lower capital gains
Business Tax Rates	15% top cororate rate 15% top pass thru rate
International Taxation & Border Adjustments	Territorial system No border adjustability provisions
Accumulated Foreign Profits & Repatriation	Mandatory tax on accumulated foreign profits
Net Interest Deductibility for Business	No mention
Depreciation Cost Recovery	No mention

Source: Morgan Stanley Research

Q1'17 IG Universe Earnings Snapshot: 70% Reported. 13% Earnings Growth Driven by Financials, Technology and Energy.



Note: 1Q17 based on the actual results when available and consensus estimates otherwise
Source: BofA Merrill Lynch Global Research, FactSet.

Q1 Earnings by Sector

Sector	Earnings growth (YoY)	Sales growth (YoY)
Aerospace/Defense	7.3%	-1.4%
Automobiles	-7.6%	5.6%
Banks/Brokers	21.1%	7.3%
Basic Materials	12.8%	9.8%
Consumer Products	4.0%	5.5%
Energy	626.5%	30.6%
Finance	53.6%	14.5%
Food, Bev, & Bottling	0.0%	-0.8%
Health Care	5.2%	4.8%
Industrial Products	10.9%	5.4%
Insurance	12.8%	5.5%
Media & Entertainment	4.9%	4.8%
REITs	-1.6%	0.8%
Retail	2.2%	3.2%
Technology	14.3%	5.9%
Telecom	-3.4%	-4.1%
Transportation	-8.2%	7.6%
Utilities	6.2%	5.6%
Other	4.0%	7.9%
Total US HG public co's	**13.2%**	**6.6%**
Total ex. Financials	11.7%	6.6%
Total ex. Energy	9.0%	4.5%
Total ex. Fin. & Energy	6.2%	4.2%

Source: BofA Merrill Lynch Global Research

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Index Performance: At an OAS of +110, credit spreads are 2 basis points tighter on the month and 8 basis points tighter on the year. At a current spread of +110, the index OAS is just 17 basis points off the post crisis tights of +93 touched in June 2014. The yield on the index dropped 9 basis points in April to 3.14% as spreads and Treasury rates rallied. Of the five broad sectors, sovereigns outperformed (-6 bps) while munis underperformed (+4). The muni underperformance was driven by weakness in Chicago and Illinois spreads which widened 28 and 33 bps respectively in April. Budget deficits and underfunded pension liabilities have resulted in multi-notch downgrades over the past two years and ratings agencies have warned that if no budget deal is reached by May 31, more downgrades could ensue. The worst performing issuer was BDX, widening 41 basis points post the leveraging acquisition (and expectation of high yield ratings at Moody's).

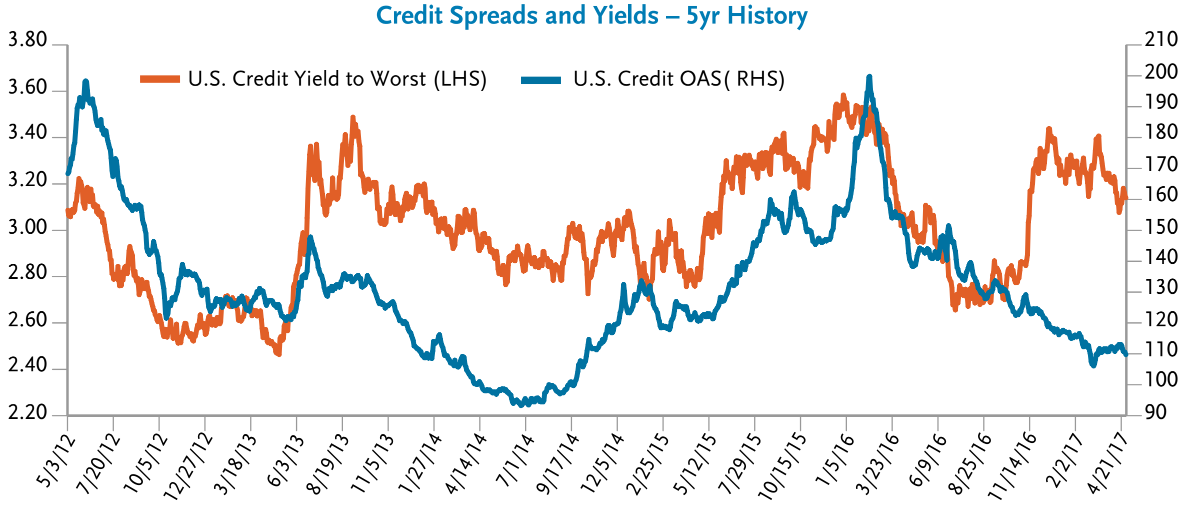
The best performing sectors were refiners (-8 bps), midstream (-7 bps), life insurers (-6) and paper (-6). Midstream has been one of the best performing sectors YTD as the space has continued to de-risk. WPZ recently announced its sale of the Geismar petrochemical plant for $2.1 bln. The sale reduces commodity exposure for WPZ as well as de-levers the balance sheet. Another name that recently took measures to de-lever the balance sheet is EEP (Enbridge Energy Partners), announcing a 40% equity distribution cut and asset sale, resulting in ~ .8x reduction in leverage. The midstream sector OAS has rallied to +171 basis points over Treasuries which is 55 bps wide of the corporate index (the corp index OAS is +116), in line with historical averages.

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	.19%	1.00%	110	-2
Industrials	.25%	1.14%	119	-2
Financials	.21%	.92%	111	-2
Utilities	.10%	1.11%	115	-1
Municipals	-.39%	.83%	158	+4
Sovereigns	.08%	1.06%	132	-6

Source: Bloomberg Barclays

Credit Spreads and Yields – 5yr History



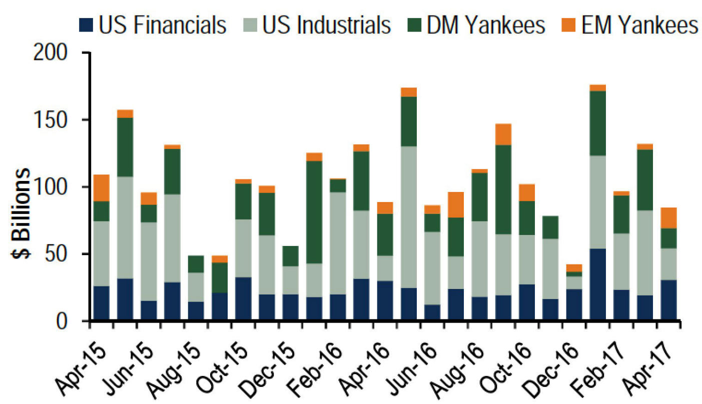
Key	Axis	Name	Last	Minimum		Maximum	
(blue)	Right	U.S. Credit – OAS	110.012	93.271	06/23/2014	199.808	02/12/2016
(orange)	Left	U.S. Credit – Yield to Worst	3.157	2.464	05/02/2013	3.584	12/29/2015

Source: Barclays Live

April IG Supply: Supply volumes totaled $85 billion in April. While this figure was down significantly vs. March's $129 billion number, it was in line with the April average over the past few years. M&A related supply was a mere $3.4bln comprised of two deals: Cenovus Energy issued $2.9 bln in bonds across three maturities to fund a $13 bln asset purchase from COP. 10yrs priced at +190, 30yrs at +240. DRI issued $500 mln in 10yr notes at +150 to partially fund the Cheddar's restaurant acquisition. M&A related supply should pick up as several large deals are pending, including ATT/TWX, MON/Bayer, QCOM/NXP.

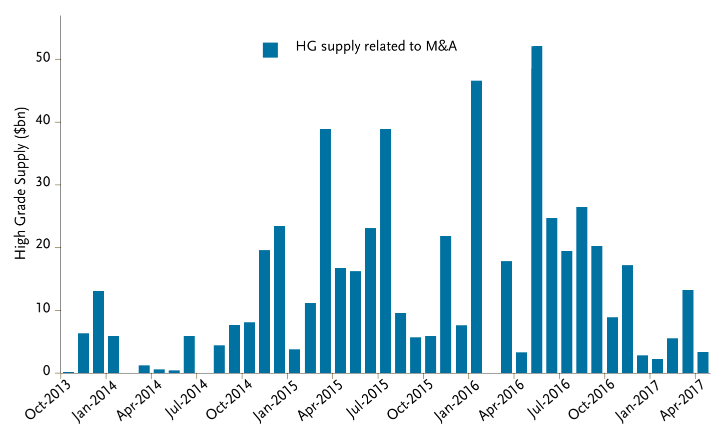
U.S. financial issuance was $30.5 bln (36% of total supply) with three of the four large money centers issuing debt post earnings. BAC, JPM and C printed large benchmark deals with the new TLAC friendly callable structures (6NC5, 11NC10m 31NC30). BAC issued $6.75 bln in bonds across three maturities. The 11NC10 year priced at a spread of +150/10yr, a 40 basis point pickup vs. where the 5 year bullets were trading. The 5-10's credit curve for banks has steepened about 20 basis points YTD, making 10 year bank paper cheap relative to 5 years. ■

Monthly IG Issuance



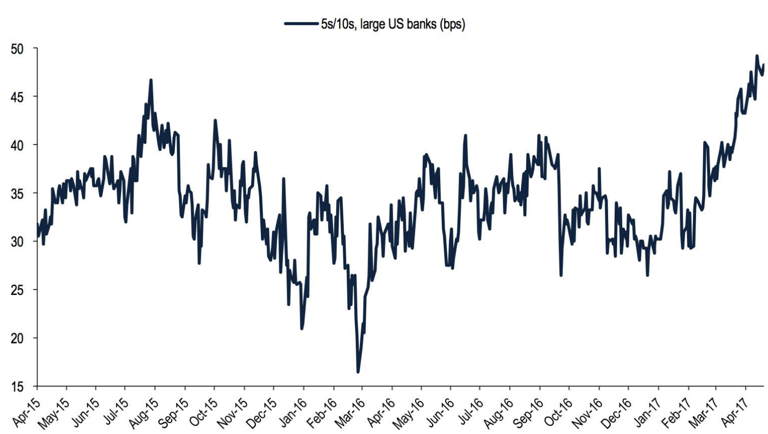
Source: BofA Merrill Lynch Global Research

M&A Related Issuance



Source: BofA Merrill Lynch Global Research

Bank 5-10's Credit Curves



Source: BofA Merrill Lynch