

MONTHLY COMMENTARY

May Credit Update

TAMMY KARP | 6 JUNE 2019

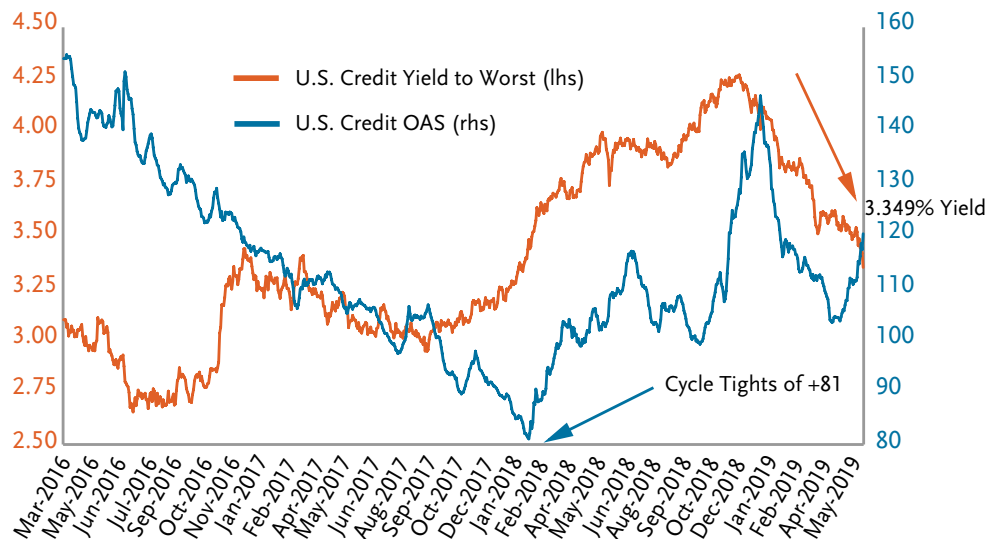
Risk assets experienced significant weakness in May as escalating trade tariff actions and rhetoric took center stage. The result was a broad-based risk sell off as the market digested the implications of a prolonged trade war, including the impact on economic growth, corporate profits and geopolitical relations. In addition to the China tariffs, the Trump administration proposed a new 5% tariff on imports from Mexico effective June 10 and increasing to 25% by October 1 if an agreement is not reached. Mexico sovereign debt widened 29 bps in May (vs. 16 bps for the overall credit index) as the country exports about \$300 billion annually (30% of Mexico GDP) to the U.S. Other sectors that were disproportionately impacted were autos (+33 bps wider on the month) and tech (+20 bps). While the escalating trade war was the main catalyst for market volatility, other headwinds emanating from the UK (Brexit) and Italy added pressure to an already tenuous market. Global weakness and increased recession risk led to the largest 3month/10yr Treasury yield curve inversion this cycle (-22 bps). Moreover, the Fed Fund futures market is currently pricing in two Fed rate decreases by the end of this year and a third by mid 2020. The credit index OAS of +120 basis points over Treasuries was 16 bps wider in May, posting the weakest monthly excess return (-1.26%) in over three years while the big drop in Treasury yields generated positive returns of 1.47%. The credit index yield of 3.349% was lower by 18 basis points on the month and is 74 bps lower since the start of the year.



Tammy Karp
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Ms. Karp is a Managing Director in the 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.

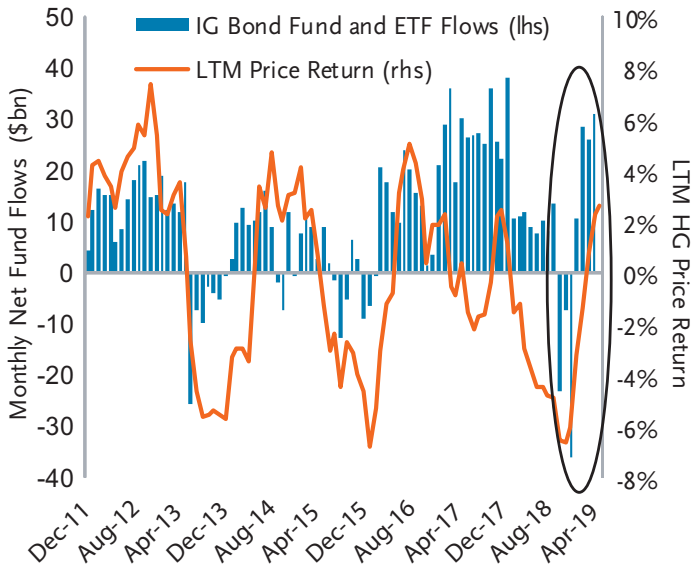
Credit Index Yields Fell 18 bps While Spreads Widened 16 bps



Source: Bloomberg Barclays

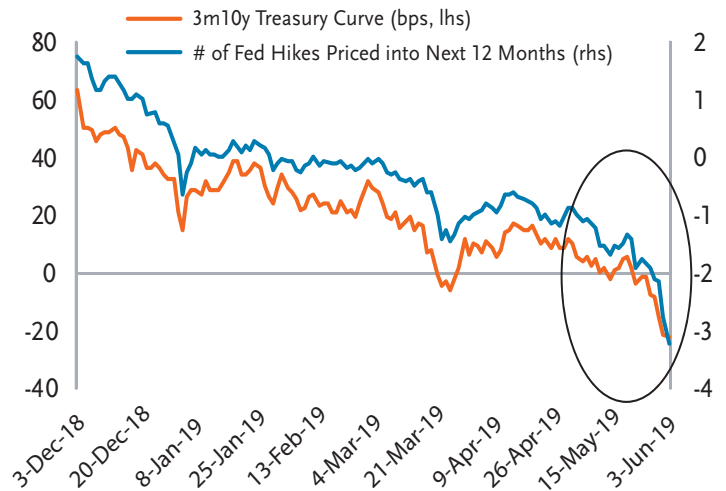
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Returns Have Been Strong = Inflows



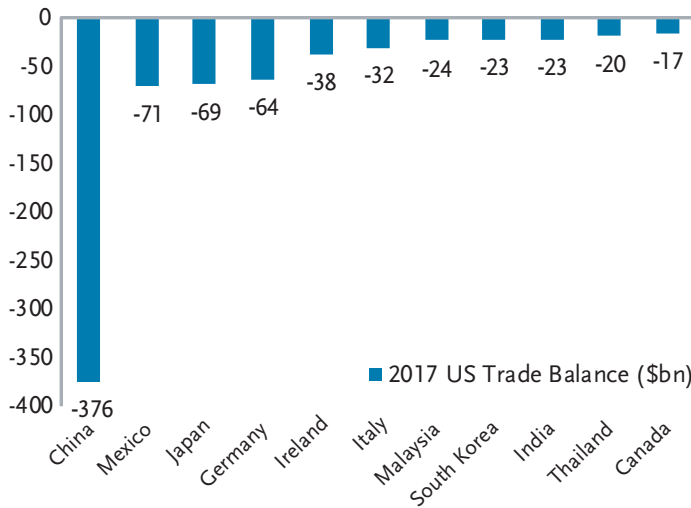
Note: Returns tend to drive flows as retail investors chase performance
 Source: Epfr Global, ICe Data Indices, LLC< BofA Merrill Lynch Global Research

3month/10yr Treasury Yield Inversion Reached -22 bps



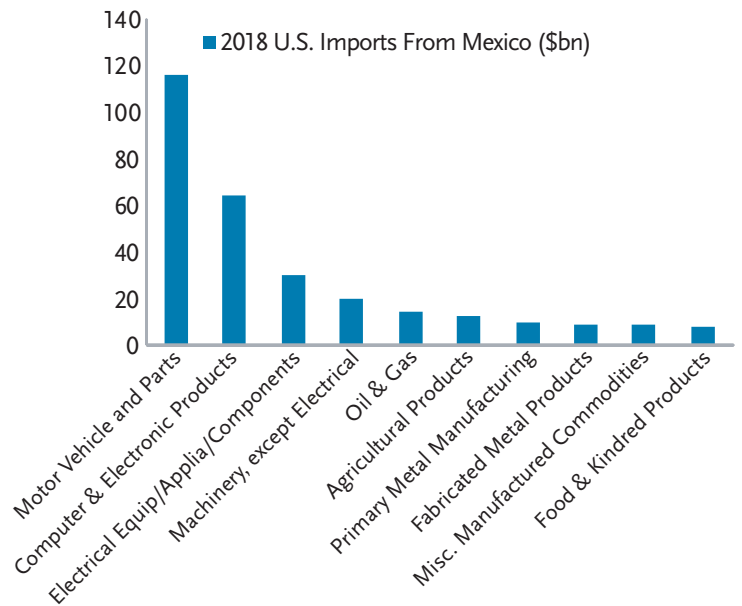
Source: BofA Merrill Lynch Global Research, Bloomberg

U.S. Top 10 Trade Deficits



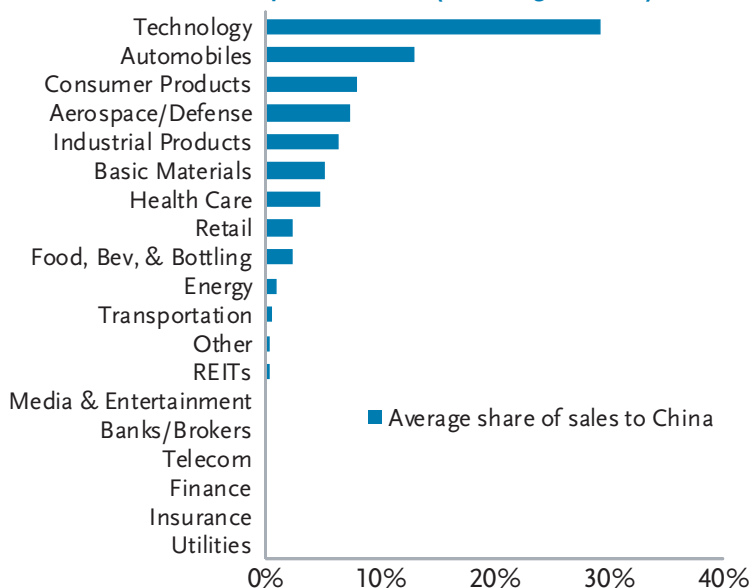
Source: U.S. Department of Commerce

Sectors Most Impacted by Tariffs on Imports from Mexico



Source: U.S. Census Bureau

Sectors most exposed to China (Percentage of Sales)



Source: BofA Merrill Lynch Global Research

Index Performance

Escalating trade wars against the backdrop of lingering late cycle fears, bloated corporate balance sheets and relatively stretched valuations led to a big reversal in risk sentiment. The 16 bp move wider in spreads was the worst since January 2016, though lower Treasury yields produced positive total returns of 1.47% on the month and 6.94% YTD. From a valuation standpoint, the current OAS of +120 bps over Treasuries is near the middle of the YTD range (+104 to +143) but still significantly through historical pre and post crisis averages. May spread performance was generally weak across the board with BBBs, cyclicals and higher beta underperforming, a reversal from the recent compression theme. The one exception to the beta decompression move was tech (+21 bps), which underperformed relative to its quality and ratings. For example, INTC (A1/A+) and ORCL (A1/AA-) were 20 bps wider, AAPL (rated Aa1/AA+) was 18 bps wider on the month, and MSFT (Aaa/AAA) was 12 bps wider. The sector has significant exposure to trade tariffs, deriving a considerable portion of sales as well as production from China. Mitigating some of these risks, (from a bondholder perspective), the sector is generally high quality, i.e. low leverage and strong free cash flow, but trades relatively tight (+113 OAS) as a result.

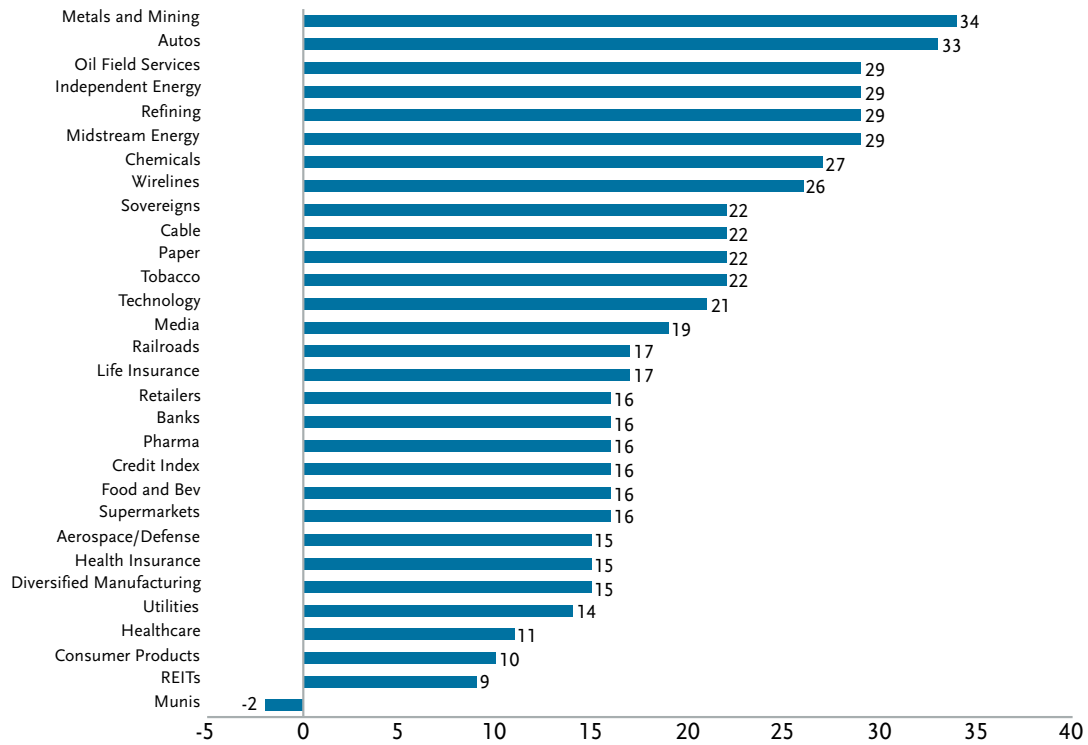
The best performing sector in May (and only sector tighter on the month) was muni's (-2). Worst performing sectors were metals (+34) autos (+33) and energy (+29), driven by commodity weakness as well as tariff concerns (in the case of autos). YTD, independent energy remains the best performing sector (-46 bps), driven by oil price appreciation (+18% YTD), balance sheet remediation and sector consolidation.

May Index Returns

	May Excess Return	May Total Return	YTD Excess Return	YTD Total Return	5/31/19 OAS	Monthly OAS Change
Credit Index	-1.26%	1.47%	2.19%	6.94%	120	16
Industrials	-1.65%	1.39%	2.42%	7.58%	136	20
Financials	-0.87%	1.32%	2.50%	6.58%	116	15
Utilities	-1.50%	2.31%	1.10%	7.25%	122	14
Municipals	0.13%	4.24%	3.07%	9.68%	116	-2
Sovereigns	-2.05%	1.33%	2.25%	7.89%	142	22
AA	-0.65%	1.88%	1.17%	5.60%	68	9
A	-1.09%	1.70%	1.84%	6.68%	98	14
BBB	-1.70%	1.19%	3.01%	8.01%	166	21

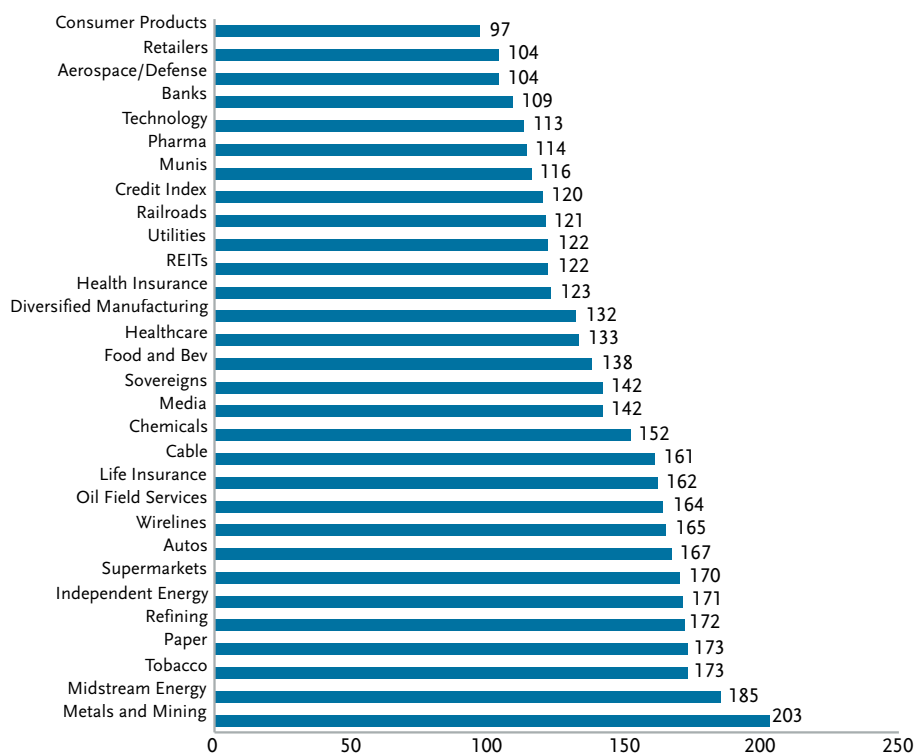
Source: Bloomberg Barclays

MTD OAS Changes by Sector



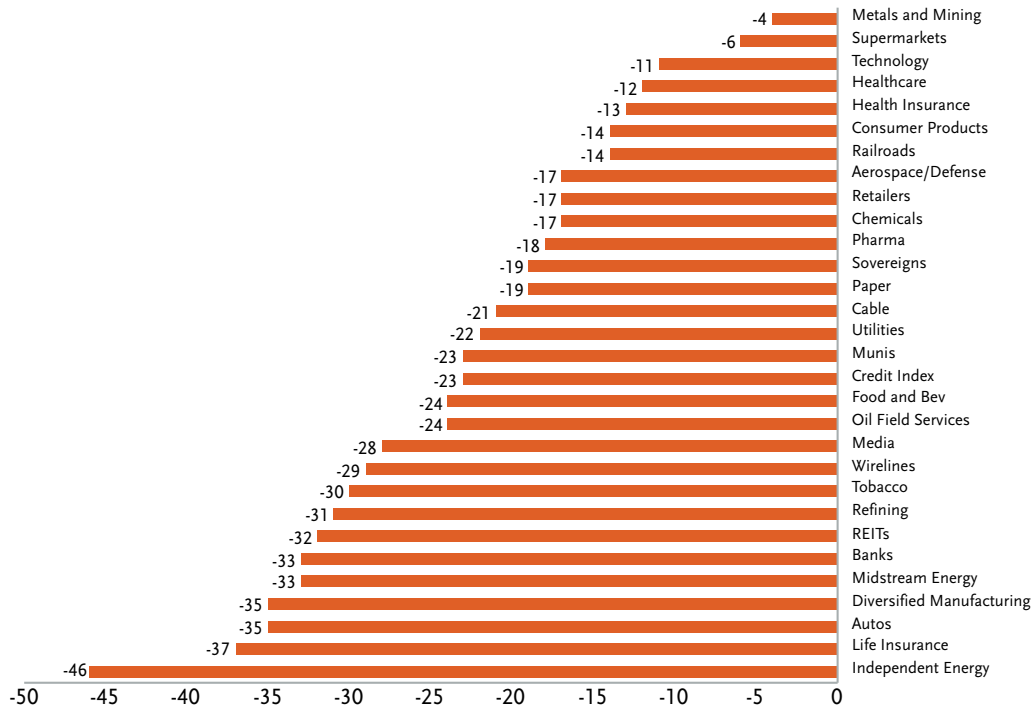
Source: Barclays Capital

Sector Spreads (as of 5/31/19)



Source: Barclays Capital

YTD OAS Changes by Sector



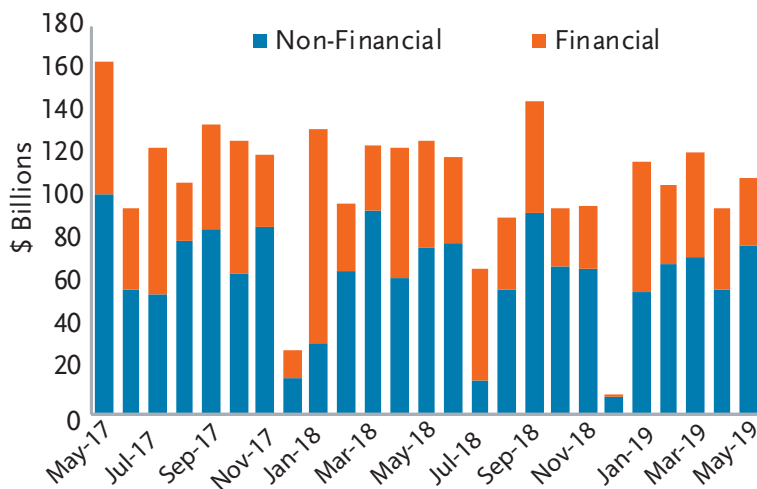
Source: Barclays Capital

May Investment Grade Supply

May supply volumes were \$110 bln, including \$44 bln in M&A-related supply. The largest deals came from IBM (\$20 bln across seven maturities to fund Red Hat acquisition. 10yrs priced @ +105, 30yrs @ +145) and Bristol Myers (\$19 bln across eight maturities to fund Celgene acquisition. 10yrs priced at +105, 30yrs @ +145).

New issue concessions improved to 7 bps due to increased market volatility, though deal performance was mixed as spreads continued to widen as the month progressed.

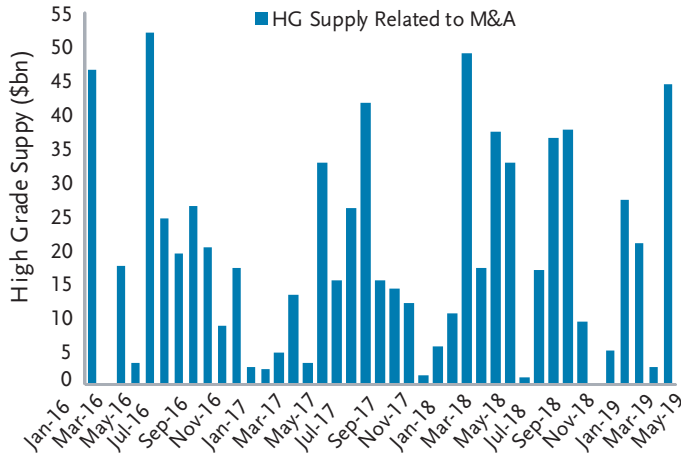
Monthly IG Supply (Gross)



Source: BofA Merrill Lynch Global Research

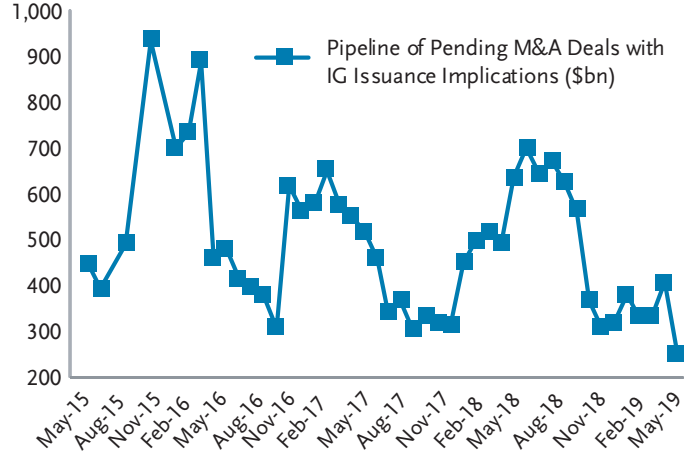
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Supply Related to M&A



Source: BofA Merrill Lynch Global Research

Current Pipeline of M&A Deals (Total Enterprise Value)



Source: BofA Merrill Lynch Global Research

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