TCW

INSIGHT

MONTHLY COMMENTARY

Loan & CLO Review – May 2019

DREW SWEENEY & PALAK S. PATHAK | 10 JUNE 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.

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Ms. Pathak is an Analyst in the Fixed Income group, specializing in asset-backed securities. Prior to joining TCW in 2007, Ms. Pathak was an Investment Specialist at Merrill Lynch in their Private Banking and Investments group where she helped manage $4 billion in High Net Worth assets and Co-Managed a proprietary equity derivatives portfolio. Ms. Pathak was previously an Assistant Vice President at the Bank of New York in their Strategic Consulting group. Ms. Pathak graduated cum laude from Barnard College/Columbia University with a BA in Economics and she also holds an MBA in Finance from Columbia Business School. She is a CFA charterholder.

Up and down, like a boat at sea, the loan market bobs and bounces with every sentiment change in risk. Loans are up on a year-to-date basis nearly 5.5%, so they have had a good year. However, it is hard to forget that 2018 returns were quite strong in the first half before the market succumbed to a broader risk-off sentiment. Another pattern evident in 2019 that is reminiscent of the last several years is episodic volatility. Loans were down in March, up in April and down in May.

These patterns are in part an outcome of the technical environment surrounding loans. First, there has been continued bond issuance where the proceeds are used to pay down loans. This dynamic has certainly mitigated the persistent outflows in the loan retail market. Second, high yield investors have served as the marginal investor. When high yield funds receive inflows, the managers often put that money to work opportunistically in loans. Likewise, when the funds face outflows, then the loan market sees more sellers as fund managers liquidate to meet redemptions. The third theme is CLO warehousing. While loans have dropped in price a few times this year, there always seem to be ramping CLOs willing to step-in when the discounts become compelling. Therefore, support has never been far when broader loan sentiment turns negative.

Finally, fundamental concerns have impacted loan issuers. In May, many companies reported first quarter earnings reports that were mixed. A number of loans in the retail, chemicals, metals and energy sectors disappointed and this disappointment was reflected in lower trading levels. Trade wars and tariffs obviously dominated global markets, and loans were no exception. One interesting anecdote we heard was from a retailer issuer who said 15% of the firm's products are currently being impacted by the tariffs applied to Chinese goods. However, when the tariffs escalate to the next level, 85% of their goods will be impacted. The point is, we did see some business impacted by the trade wars but if some sort of agreement is not reached, the impacts will be far greater.

Performance – Loans

In May 2019, the Credit Suisse Leveraged Loan Index (CS LLI) and the S&P Leveraged Loan Index (S&P/LSTA) were down -0.23% and -0.22%, respectively.

- Year to date, ending May 31, the CS LLI was up 5.19% and the S&P/LSTA was up 5.49%.
- For the 12 months ending May 31, the CS LLI was up 3.99% and the S&P/LSTA was up 3.83%.

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During the month triple Bs modestly outperformed double Bs and double Bs outperformed single Bs. On a year-to-date basis, double Bs outperformed single Bs while the distressed segment led all returns.

On an LTM basis, split single Bs and single Bs led all categories while triple Bs were slightly behind the leaders but still in front of the remainder. The distressed category was up less than 1.0% on an LTM basis.

Total Return by Rating

	May	YTD	LTM
Split BBB	-0.17%	5.10%	3.87%
BB	-0.19%	5.48%	3.81%
Split BB	-0.37%	5.58%	3.66%
B	-0.27%	5.09%	4.16%
Split B	0.03%	7.42%	6.81%
CCC/Split CCC	-0.05%	3.05%	2.45%
Distressed (CC, C and Default)	-0.43%	8.88%	0.82%

Source: Credit Suisse Leveraged Loan Index

Sector Performance

In the CS LLI, 17 of the 20 sectors provided negative returns in May. The top performing sectors were Consumer Durables (0.13%), Service (0.06%) and Manufacturing (0.05%).

The worst performing sectors for the month were Retail (-1.26%), Metals/Minerals (-0.84%) and Chemicals (-0.46%).

On a year-to-date basis, Food & Drug (7.46%), Housing (6.00%) and Retail (5.95%) were the top performing sectors.

Industry Returns

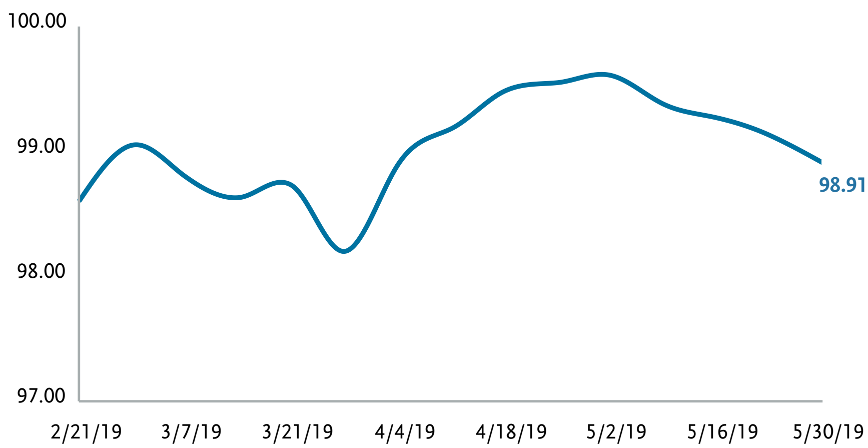
Sector	May	YTD	LTM
Aerospace	-0.28%	4.78%	3.41%
Chemicals	-0.46%	5.29%	4.28%
Consumer Durables	0.13%	1.03%	0.41%
Consumer Non-Durables	-0.13%	4.77%	4.08%
Energy	-0.22%	5.01%	3.74%
Financial	-0.27%	5.09%	4.37%
Food and Drug	-0.26%	7.46%	5.24%
Food/Tobacco	-0.07%	4.64%	3.35%
Forest Prod/Containers	-0.40%	5.30%	3.49%
Gaming/Leisure	-0.12%	5.68%	4.42%
Healthcare	-0.33%	5.16%	4.00%
Housing	-0.17%	6.00%	4.03%
Information Technology	-0.08%	5.04%	3.95%
Manufacturing	0.05%	4.96%	3.24%
Media/Telecommunications	-0.34%	5.91%	3.59%
Metals/Minerals	-0.84%	5.61%	2.45%
Retail	-1.26%	5.95%	6.19%
Service	0.06%	4.54%	3.77%
Transportation	-0.12%	4.35%	4.65%
Utility	-0.02%	5.48%	5.39%

Source: Credit Suisse Leveraged Loan Index

In the last 12 months, Retail, Utility and Food & Drug have led all sectors with total returns of 6.19%, 5.39% and 5.24%, respectively. Retail continues to lead all categories in defaults during the last 12 months as well as lead returns. In contrast, Consumer Durables, Metals/Minerals and Manufacturing were the worst performing sectors with returns of 0.41%, 2.45% and 3.24%, respectively.

CS LLI prices decreased -73 basis points (bps) in May while the average bid of the S&P LCD flow-name loan composite decreased 70 bps from 99.61 to 98.91. The average flow name bid is up 362 bps on a year-to-date basis.

Average Loan Flow-Name Bid



Source: Credit Suisse Leveraged Loan Index

Performance – CLOs

CLOs outperformed HY and Leveraged Loans in May. April's month end strength continued into May with CLO spreads tighter across the capital stack. As macro volatility hit later in the month, CLO spreads outperformed the widening in corporate credit with longer duration AAA spreads flat to 2-5 bps tighter for tier 1 issuers. Tier 1 AAAs tightened from 120 to 115 discount margin (DM) by mid-month and retraced a few bps of that tightening and ended May at 115-118 DM. Mezzanine tranches also performed well with BBs 20-30 bps tighter; however, tiering in longer maturity deals became more pronounced by month end with the basis between tier 1 and tier 2/3 BBs widening to over 50 bps.

CLO equity performance was mixed with NAVs down due to lower loan prices but distributions up from higher asset spreads.

Secondary CLO 2.0 Total Returns

	May	YTD	LTM
Total	0.57%	3.37%	3.45%
AAA	0.46%	2.54%	3.21%
AA	0.61%	3.51%	3.44%
A	0.75%	4.69%	3.36%
BBB	0.83%	6.51%	4.33%
BB	1.41%	8.32%	5.42%
B	0.67%	6.18%	4.53%

Source: JPM CLOIE

Secondary CLO 2.0 Spreads (DM)

	May	MoM Change (bps)
AAA	95-130	-5
AA	155-190	-10
A	195-265	-10
BBB	300-370	-15
BB	550-700	-25
B	850-975	-25

Source: TCW

Technical Conditions- Demand

May retail loan outflows were approximately -$2.4 billion. The week ending May 31st represented the 28th consecutive withdrawal for the asset class. Outflows for floating rate loan funds now total -$37 billion since the beginning of 4Q and AUM for the loan mutual fund base is down to $117 billion from a high of $154 billion. Year-to-date outflows for loan funds total -$16.1 billion which compare to +$9.7 billion of inflows YTD18.

CLO issuance also declined in May with $10 billion pricing vs. $15 billion in April. The arb continues to be challenged; however, YTD CLO issuance is still up 5.8% year-over-year (YoY). Limited supply helped spreads tighten over the month with tranches on many deals oversubscribed and pricing inside guidance. Tier 1 AAA spreads moved from 133-135 DM to 130-132 DM. In addition, the number of deals that priced with AAAs preplaced declined as more and more issuers were able to get their AAAs syndicated at tighter levels. Single As and BBBs were the most in demand with tranches oversubscribed multiple times over. Single As tightened 25 bps and BBs 20 bps over the month. AAs continue to lag as the tranche lacks a definitive buyer base, but still managed to tighten 10 bps month-over-month (MoM).

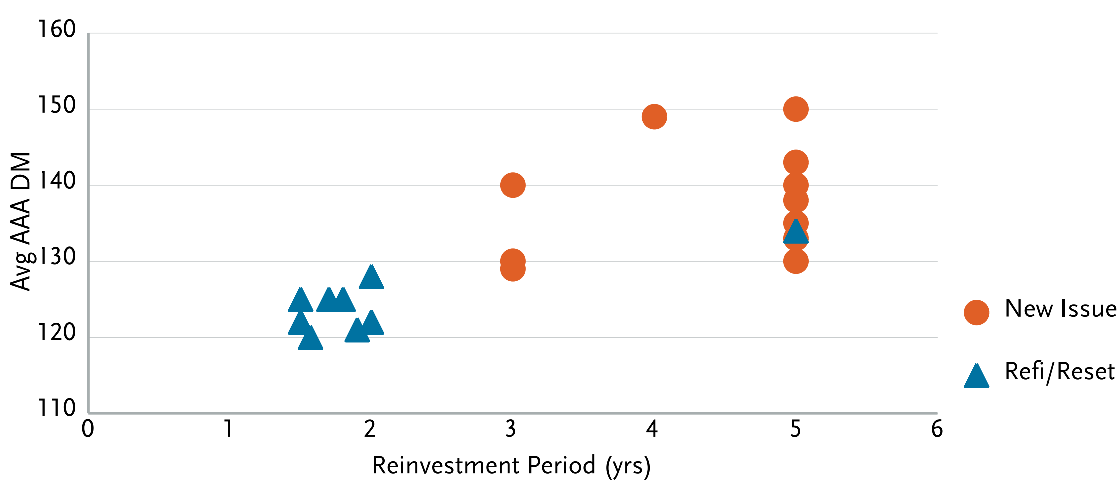
Refi / reset supply increased slightly in May with ten restructurings vs. eight in April. However, compared to 2018, refi supply is down significantly. By month-end the AAA term curve slightly steepened as demand for shorter duration AAAs was high but supply was limited.

CLO New Issuance

	May-19	YTD 2019	YTD 2018	YoY %Δ
New Issue ($bn)	$10bn	$54.60	$51.60	6%
Refi (#)	7	20	30	-33%
Reset (#)	3	16	98	-84%

Source: TCW

New Issue BSL AAA DM – May



Source: TCW

Tier 1 New Issue Spreads (bps) (5yr reinvestment)

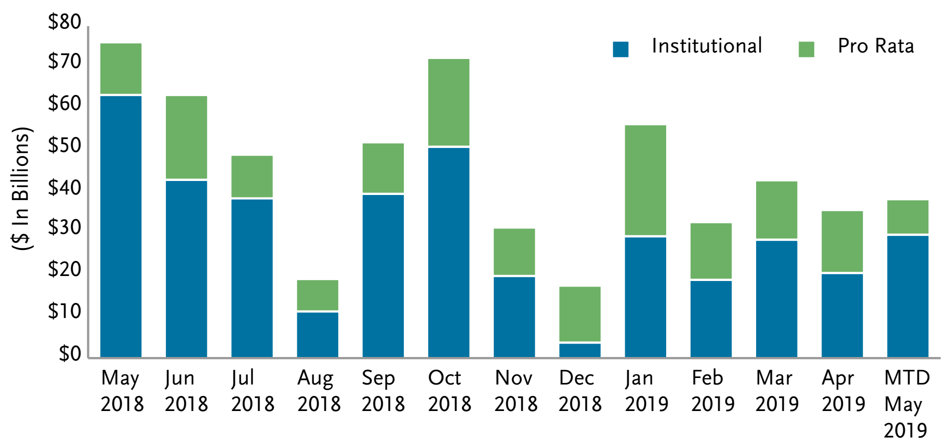
	May 2019	MoM Change
AAA	130	-5
AA	175	-15
A	235	-25
BBB	350	-20
BB	660	-30

Source: TCW

Technical Conditions – Supply

The institutional new issuance in May declined 43.6% from $29.7 billion to $8.6 billion. This was the lowest monthly total of the year.

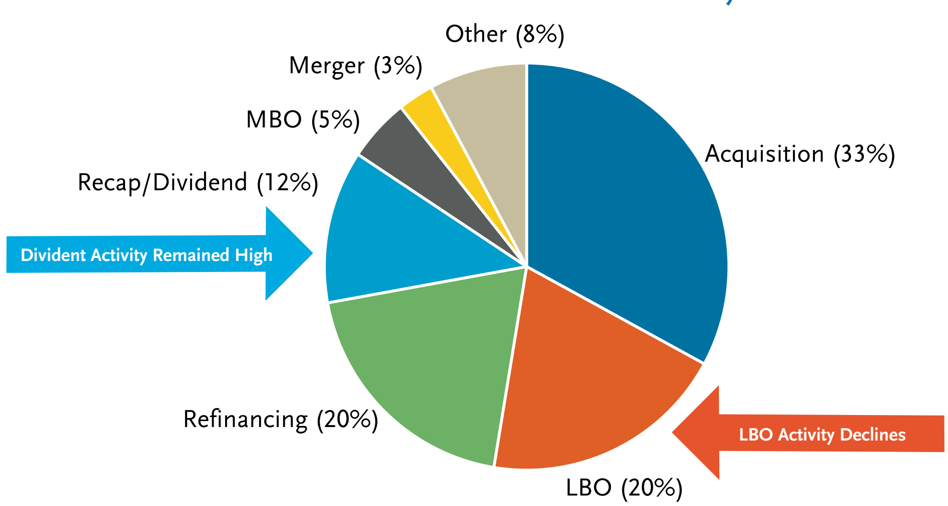
Leveraged Loan Volume



Source: LCD, an offering of S&P Global Market Intelligence
MTD updated as of Friday, May 31, 2019

May acquisitions, mergers and LBOs represented 60% of primary issuance, which was in line with the 60% mark set year-to-date. We have continued to see dividend activity represent a double-digit percentage of the market while we also saw a decrease in LBO activity.

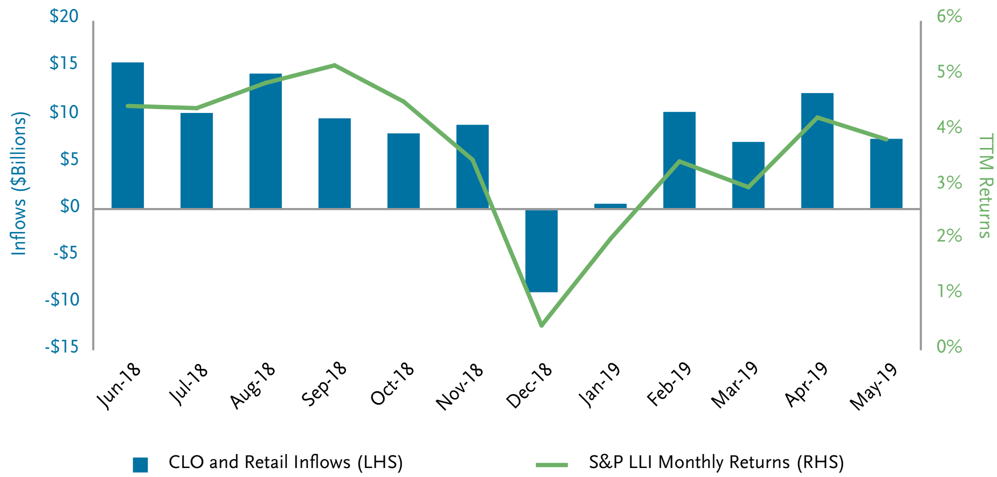
Institutional New Issue Volume in May



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

Loan fund outflows have been offset by strong CLO production. However, in May, high yield crossover investors also became better sellers and the lower overall demand contributed to a lower LTM return.

Inflows and Rolling LTM Returns



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

New issue spreads in May tightened and were -12.08% tighter on a year-to-date basis. New issuance spreads remain 9.8% wider than 12 months prior.

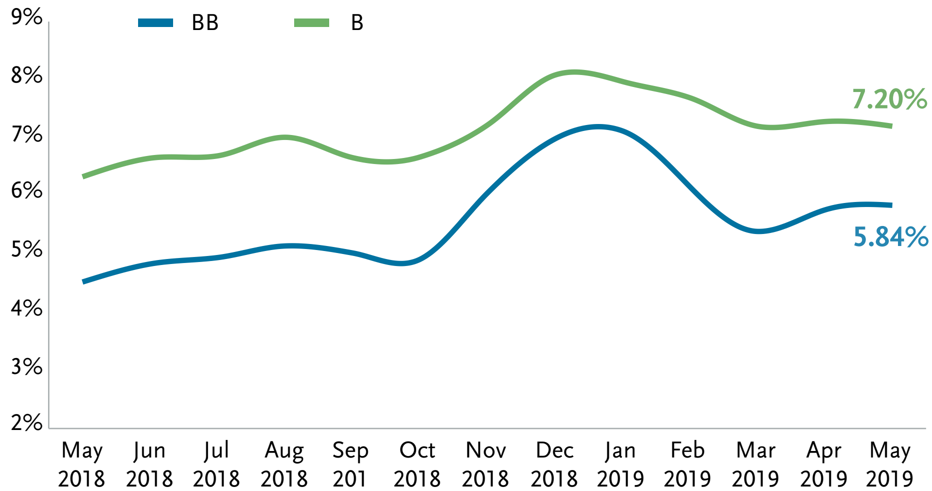
New Issue Spread Changes

	All Loans
Jun-18	362
Sep-18	378
Dec-18	452
Mar-19	403
Apr-19	400
May-19	397
Month-Over-Month Change	-0.55%
YTD Change	-12.08%
LTM Change	9.8%

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

In terms of new issue yields, yield remained essentially flat, MoM. Double B yields widened by 9 bps while single B yields were tighter by 9 bps.

Average New-Issue Yields



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

Fundamentals - Loans

There was one default in May, Empire Generating (Utility). The default rate changed from 1.01% in April to 1.00% in May.

The last 12-month default tally for the S&P/LSTA is 20. Retail leads all categories with five while Oil & Gas has declined to just one default.

Lagging 12-Month Default Rates

Actual	Feb-19	Mar-19	Apr-19	5/30/19
By Number	1.52%	1.40%	1.59%	1.56%
By Principal Amount	1.62%	0.93%	1.01%	1.00%
Shadow Default Rate*				
By Number	0.51%	0.30%	0.20%	0.49%
By Principal Amount	0.27%	0.17%	0.18%	0.48%

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

Fundamentals – CLOs

CLO fundamentals showed slight deterioration over the month with an increase in Caa assets by 10-20 bps. With loan prices down over the month there was a commensurate decrease in market value OC coverage as well as in equity NAV. WARF levels remained stable with WAS slightly up. B3 / B- exposure was stable during the month, while the share of CLO assets that have a negative Moody's outlook is now at 13.1%.

Valuation

Since 1992, the average 3-year DM for the CS LLI is 460 bps. If the global financial crisis (2008 & 2009) is excluded, the 3-year DM for the CS LLI is 417 bps. The 3-year DM finished the month at 452 bps, which widened 23 bps from the prior month.

The DM spread differential between Double Bs and Single Bs is 34 bps wider from June 2018 to May 2019; however, it is still 7 bps tighter than the historical spread differential.

3-Year Discount Margin Differential Between BBs and Single Bs

4/1992-3/2019 Average	189.5	189.5
Jun-18	148.1	144.7
May-19	183.0	178.7

CS LLI Snapshot

YTD Total Return*	5.19%
Average Price	96.72
Spread	351 bp
Coupon	6.09%
Current Yield	6.30%
Yield (3-year life)	6.43%
Discount Margin (3-year life)	452 bp

*S&P LLI YTD Total Return 5.49%

	Spread	DM (3-Year Life)
Split BBB	195 bps	222 bps
BB	253 bps	292 bps
Split BB	316 bps	375 bps
B	382 bps	475 bps
Split B	541 bps	883 bps
CCC/Split CCC	660 bps	1,177 bps
Distressed (CC, C and Default)	377 bps	362 bps

Source: Credit Suisse Leveraged Loan Index

Summary & Looking Forward

As of May 31st, the S&P/LSTA Index imputed default rate was 2.14%, up from 1.79% in the prior month.

Loan weakness in May was indicative of broader risk market concerns. Many of the fears that the market had reacted to in December, specifically, trade war concerns, were the same areas of focus for investors last month. While these concerns have hit the entire market, it has impacted cyclical businesses and businesses with the exposure to China the most. This combined with the change in interest rate outlooks and the decline in LIBOR has led to persistent outflows in the retail loan market.

While the supply outlook for loans remains moderate, the demand picture continues to be volatile. CLOs are certainly ramping and the main source of demand. Retail loan funds have been better sellers since the fall and these outflows have been offset periodically by crossover investors. When the marginal high yield investor began to sell loans in May, the market had nowhere to go but down.

Weakness has been orderly with a CLO bid at each lower level. However, we have seen an increase in dispersion and an increase in industries being influenced by the trade war. With loans providing returns close to the annual coupon just five months into the year, we would expect to see more volatility in the back half of 2019.

Although loans were weaker during the month, CLO spreads tightened which we feel was more of a catchup given how CLOs had underperformed credit in the first quarter. Going forward, CLO technicals remain strong with lower new issuance, refi / reset supply; however, demand is to be tested as corporate underperformance has reduced the relative value of CLOs. Additionally, the future direction of rates will be a headwind for CLO spreads as yield buyers may find fixed rate assets more attractive vs. floating. For June, we believe primary CLO spreads will remain rangebound with the potential for secondary levels to soften amid the volatility in loans.