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MONTHLY COMMENTARY

Loan Review – May 2017

DREW SWEENEY | JUNE 13, 2017

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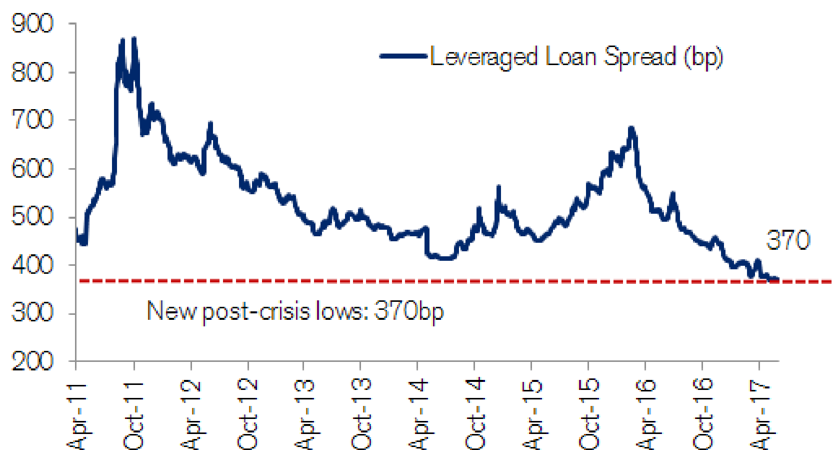
Mr. Sweeney is a Senior Vice President in the U.S. Fixed Income group where he trades leveraged loans. Mr. Sweeney joined TCW in 2015 from Bradford & Marzec, LLC where he managed loan strategies for both total return and CLO accounts as well as serving on the investment committee where he helped direct the firm's 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.

In many respects little changed in the loan universe between April and May. Index prices have remained flat for two consecutive months and returns mirrored coupon payments. New issuance volume continued to decline while inflows to retail funds produced their 11th consecutive positive month and CLO volumes registered roughly $10 billion of inflows for the second consecutive month.

What did change in May was the magnitude of the spread compression in the primary market, which was truly astonishing. In April, year-to-date double B spreads had already compressed -6.6% from year-end while single B spreads slightly widened 1.5%. However, in May, double B and single B spreads tightened -4.2% and -10.4% month-over-month. The stair-step function in coupon decline in the primary market generally begets more re-pricing volume and this is exactly what the market has witnessed in early June.

From an index spread perspective, the Credit Suisse LELI index tightened 7 basis points to 3.70% during the month, which is a new post-crisis tight.

Loan Spreads Hit New Tights in May



Source: Credit Suisse

It is hard to reconcile the spread compression with the general news flow. Uncertainty in Britain, North Korea and Qatar combined with political gridlock and slow growth in the United States would all suggest a greater risk premium for risk assets. However, loans continue to grind tighter. While several sectors seem to face structural headwinds, market participants gain some comfort by the low default rate.

Performance

In May 2017, the Credit Suisse Leveraged Loan Index ("CS LLI") was up 0.38% and the S&P Leveraged Loan Index ("S&P/LSTA") was up 0.37%.

- Year-to-date ending May 31, 2017, the CS LLI was up 2.03% and the S&P/LSTA was up 1.96%.
- For the 12 months ending May 31, 2017, the CS LLI was up 7.59% and the S&P/LSTA was up 7.49%.

Sector Performance

All but three sectors had positive returns with the worst performing sectors being: Utilities (-0.46%), Energy (-0.30%) and Metals (-0.03%). Utilities continued to be weak as a result of softness in the independent power sector while Energy declined in sympathy with crude prices falling -2.6% on the month. Metals eroded as well based on general commodity weakness.

Retail, Aerospace and Services were the top performing sectors for the month of May with returns of 0.84%, 0.62%, and 0.57% respectively. Surprisingly, Retail had its best month of the year bouncing back with a positive return for the second consecutive month. Despite positive performance, most retailers are still trying to learn to compete in a market with a rapidly changing landscape.

On a year-to-date basis, the commodity driven sectors of Energy and Metals are still outperforming by a substantial amount and Utilities and Retailers have provided the weakest returns.

Total Return by Sector

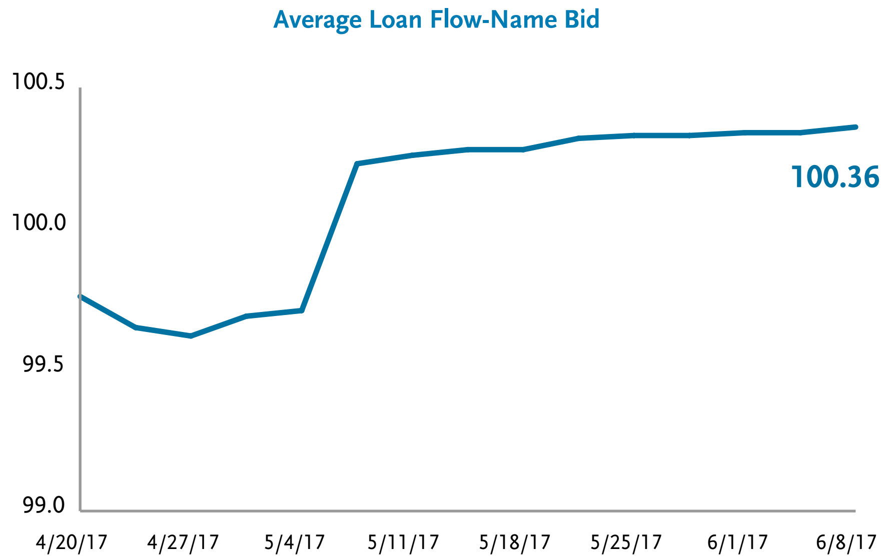
Sector	March
Aerospace	0.62%
Chemicals	0.46%
Consumer Durables	0.43%
Consumer Non-Durables	0.03%
Energy	-0.30%
Financial	0.42%
Food And Drug	0.52%
Food/Tobacco	0.36%
Forest Prod/Containers	0.44%
Gaming/Leisure	0.51%
Healthcare	0.50%
Housing	0.37%
Information Technology	0.43%
Manufacturing	0.36%
Media/Telecommunications	0.31%
Metals/Minerals	-0.03%
Retail	0.84%
Service	0.57%
Transportation	0.12%
Utility	-0.46%

Sector	YTD
Aerospace	1.95%
Chemicals	2.07%
Consumer Durables	2.32%
Consumer Non-Durables	1.55%
Energy	5.33%
Financial	1.84%
Food And Drug	1.50%
Food/Tobacco	1.54%
Forest Prod/Containers	1.57%
Gaming/Leisure	2.39%
Healthcare	2.41%
Housing	1.77%
Information Technology	2.14%
Manufacturing	2.43%
Media/Telecommunications	1.99%
Metals/Minerals	3.24%
Retail	-1.17%
Service	2.89%
Transportation	1.67%
Utility	-0.39%

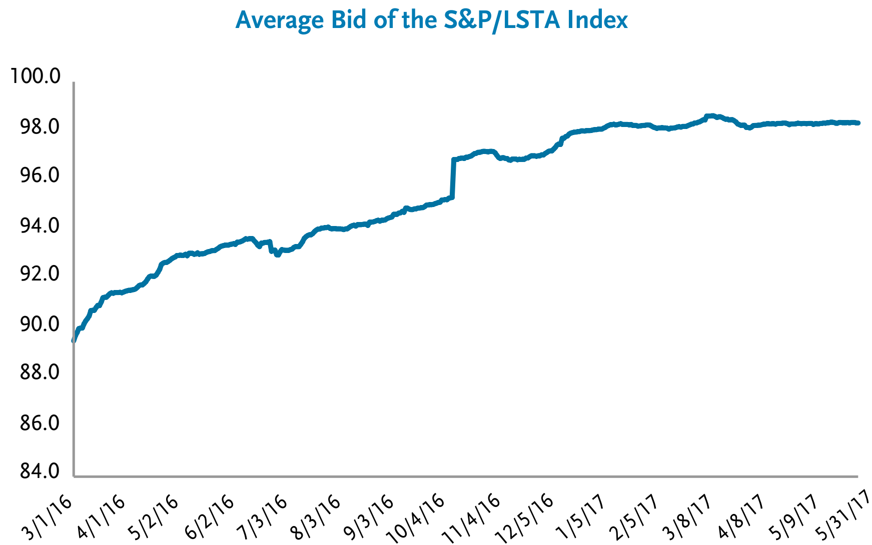
Sector	LTM
Aerospace	6.66%
Chemicals	6.04%
Consumer Durables	8.20%
Consumer Non-Durables	5.96%
Energy	31.33%
Financial	7.29%
Food And Drug	5.50%
Food/Tobacco	4.66%
Forest Prod/Containers	5.59%
Gaming/Leisure	7.79%
Healthcare	5.61%
Housing	5.56%
Information Technology	8.38%
Manufacturing	8.23%
Media/Telecommunications	6.84%
Metals/Minerals	27.87%
Retail	1.13%
Service	7.94%
Transportation	7.11%
Utility	4.26%

Source: Credit Suisse Leveraged Loan Index

The flow-name prices in the S&P Index below illustrate overall index performance during the month. Prices spiked in the beginning of the month before stabilizing at these higher levels. However, improving prices of large, liquid loans have made it easier for smaller issuers to launch re-pricings during the month.



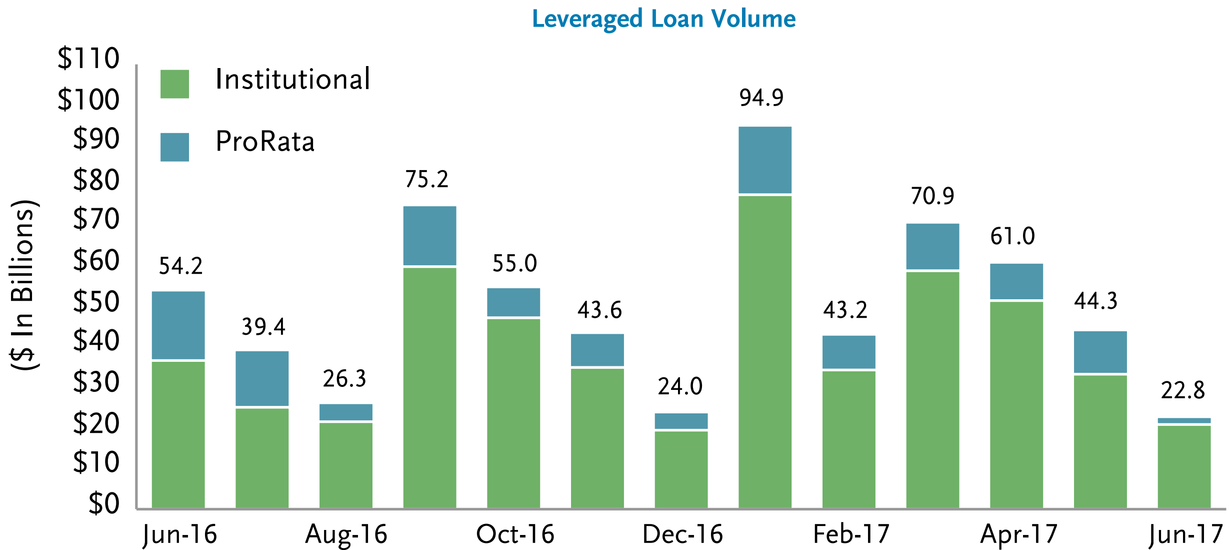
The average bid of the broader loan index remained relatively flat during the months of April and May after a torrid pace of price appreciation since the first quarter of 2016.



Technical Conditions

CLO new issue supply reached $9.8 billion in May for the second largest inflow of CLO monthly demand on the year, following April's CLO inflow of $10.2 billion. Retail inflows declined to their lowest total since August 2016. Slowing retail inflows ($1.3 billion) reflect a change in sentiment concerning the prospect of rising rates. As rising rate fears moderate, so too do the inflows to retail loan funds. However, it appears that high yield crossover demand as well as traditional banks are more than offsetting declining retail inflows.

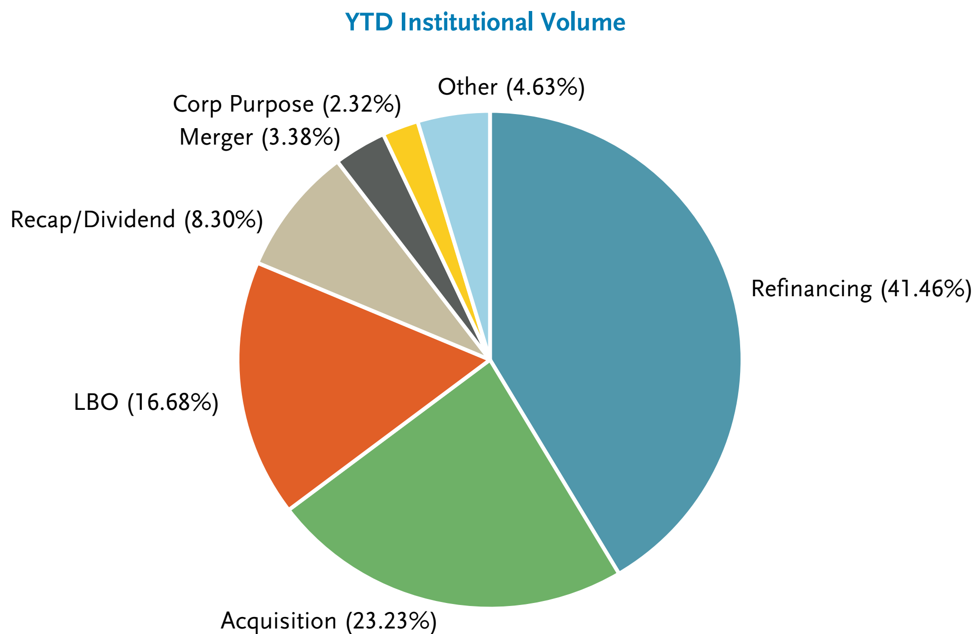
New issue volumes dropped to $22.8 billion from $44.3 billion in the previous month and provided the lowest monthly output in the last 12 months.



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

Scarce supply helped keep prices stable and allow for the magnitude of spread compression.

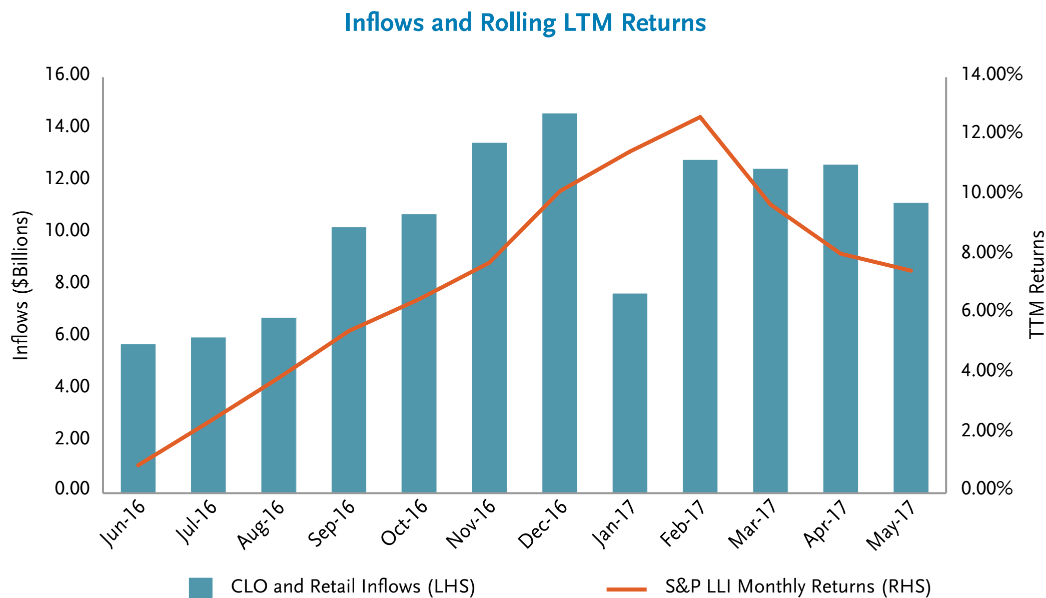
Acquisitions, mergers and leveraged buyouts contributed to less than half of the institutional new issue volume in May and YTD. The remaining portion was largely made up from opportunistic transactions, borrowers' extending maturities, repricing coupons and taking dividends.



Source: LevFin Quarterly

While the retail market has slowed, CLO flows continue to contribute to overall demand. With $10.0 billion of the total $11.2 billion of inflows in May, CLO demand provided a stable environment to produce positive returns. After inflows peaked in December 2016, trailing 12-month returns peaked in February 2017. As inflows have moderated in 2017 so have trailing 12-month returns in March, April and May. With little opportunity for price increases, returns now are driven by coupon.

Inflows and Rolling LTM Returns



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

Spreads continue to tighten at an astonishing rate. Year-to-date, single B loans have tightened -9.0%, primarily as a result of the -10.4% tightening in May. Double B's have tightened -10.5% year-to-date and -4.2% in May.

Spread Changes

	BB/BB-	B+/B
Jun-16	305 bps	429 bps
Dec-16	268 bps	388 bps
Apr-17	250 bps	393 bps
May-17	239 bps	352 bps
Month-over-Month Change	-4.2%	-10.4%
Year-over-Year Change	-21.5%	-17.9%
YTD Change	-10.5%	-9.0%

Source: LCD Loanstats TrendLines

Average new issue yields continue to grind tighter and Double B and Single B yields are roughly 66 and 77 basis points tighter than June 2016, respectively.

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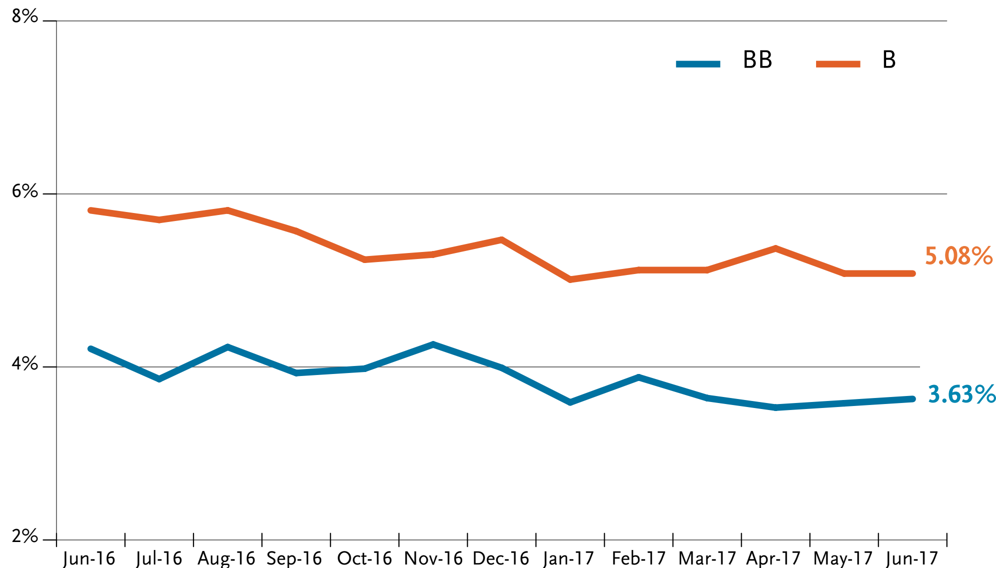

Source: LCD, an offering of S&P Global Market Intelligence

There have been 19 defaults in the last 12 months with three in May: Mood Media, Rue 21 and AF Global. The LTM default rate decreased slightly from 1.37% to 1.17%, based on a number of defaults, while the default rate decreased from 1.43% to 1.29% based on par amount outstanding. Regardless of measurement, default rates remain very low on a historical basis.

Lagging 12-Month Default Rates

Actual	**Mar-17**	**Apr-17**	**May-17**
By Number	1.36%	1.37%	1.17%
By Principal Amount	1.49%	1.43%	1.29%
Shadow Default Rate			
By Number	0.77%	0.88%	1.58%
By Principal Amount	0.42%	0.53%	0.34%

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

Commodity sectors continue to be the largest contributor to the default rate, however, just five of 19 defaults that have occurred in the last 12 months are Energy and Metals related borrowers. This is the lowest reading in the last several years. Retail/Restaurants is the second largest contributor with four defaults.

Shadow default activity remains very low, suggesting that there will not be any broad-based increase in the next 12 months.

Valuation

Since 1992, the average 3-year discount margin ("DM") for the CS LLI, is 463 basis points. If the global financial crisis (2008 & 2009) is excluded, the 3-year discount margin for the CS LLI is 416 basis points. At month end, the 3-year DM was tight to the historical average, at 434 basis points and 6 basis points tighter than the prior month.

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The DM spread differential between double Bs and single Bs widened by 11 basis points from June 2016 to May 2017. However, it is still 30 basis points tight of the historical spread differential.

3-Year Discount Margin Differential Between BBs and Single Bs

1/1992-4/2017 Average	83.0
Jun-16	103.0
May-17	113.1

Source: Credit Suisse Leveraged Loan Index

CS LLI Snapshot

YTD Total Return*	2.03%
Average Price (excluding defaults)	97.93
Spread	374.37
Coupon	4.91%
Current Yield	5.04%
Yield (3-year life)	6.00%
Discount Margin (3-year life)	434 bp

*S&P LLI Total Return 1.15%
Source: LCD Loan Stats

	Spread	DM (3-Year Life)
Split BBB	221 bps	206 bps
BB	293 bps	290 bps
Split BB	349 bps	344 bps
B	406 bps	445 bps
Split B	591 bps	850 bps
CCC/Split CCC	633 bps	1,198 bps
Distressed (CC, C and Default)	519 bps	2,515 bps

Source: Credit Suisse Leveraged Loan Index

Summary

As of May 31, the imputed default rate for the S&P/LSTA Index was 1.77%, the lowest level since December 2007. It remained considerably below the multi-year high of 7.3%, set in February 2016. One would think that the spread tightening that has taken place in the last 12 months, and accelerated in May, would suggest that loan earnings are improving. There has not been a concurrent level of earnings improvement and other than a low trailing 12 month default rate, it is difficult to point to a fundamental reason for the spread compression. In fact, sector concerns in Energy, Metals, Utilities, Retail and a handful of pharmaceutical borrowers have witnessed increased stresses. Despite so much unease in so many sectors, year-to-date re-pricing

activity has been aggressive and underwriting standards have declined. While the number of re-pricings moderated in May from prior months, the magnitude of the spread decline in deals that were repriced was the largest of the year. This would suggest we should see an uptick in re-pricing activity in June and July. ■

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