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INSIGHT

MONTHLY COMMENTARY

June Credit Update

TAMMY KARP | 3 JULY 2019

June was a strong month for risk assets as accommodative central bank policy was the main driver of spread performance. The whipsaw in both credit spreads and market sentiment came on heels of more dovish Fed and ECB speak, with the implications being that the "CB put" continues to be the panacea to slowing global growth and an aging credit cycle. The market's expectation that the ECB will restart its asset purchase program and the Fed will cut rates and possibly end balance sheet normalization (i.e. more QE) sent global yields lower and the stock of negative yielding assets to a record $13 trillion (globally). These forces were powerful as the QE-led yield grab resulted in strong demand for spread product. The credit market finds itself, yet again, in an environment where the technicals are the main drivers of spread performance, while the fundamentals take a back seat. At an index spread of +109 basis points over Treasuries, valuations look stretched as spreads are trading well through long term averages. As we approach the YTD tights, some risk reduction is warranted. We are mindful of the fact that the underlying issues – deteriorating credit fundamentals, massive growth in the credit markets, worsening liquidity conditions and rising idiosyncratic risks – have not abated. Corporate leverage continues to rise as cheap money drives debt-funded M&A and other shareholder expansion efforts. North American M&A volumes were $368 bln in June and are on track to surpass last year's $2.4 trillion record. The latest deal comes from Abbvie, which announced the acquisition of Allergan for $63 bln in equity plus $24 bln in assumed debt. The largest share of M&A activity over the past five years has come from the healthcare sector as issuers look for new avenues of growth and ways to achieve better scale and vertical integration. In Abbvie's case, the pending loss of exclusivity for its best-selling drug Humira, was the key driver for the deal. The financing mix of 64% cash and 36% will require $30-$35 bln of new debt and will add 2 turns of leverage (from 2x to 4x). Similar to Bristol Myers' purchase of Celgene, announced earlier this year, Abbvie has committed to reducing leverage to 3x within 18 months of closing.

Tammy Karp
Managing Director
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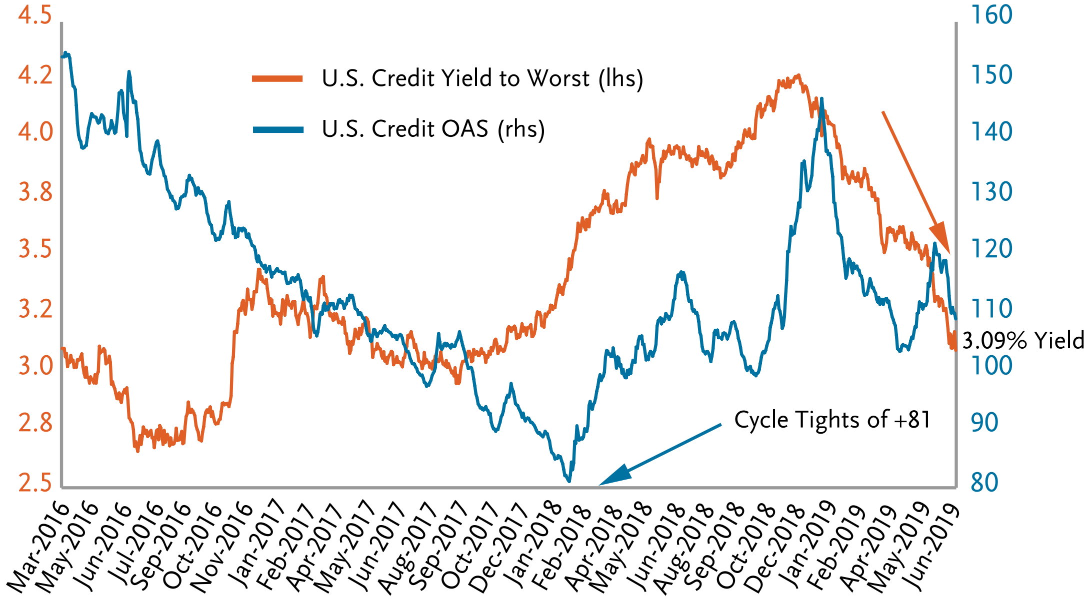
Ms. Karp is a Managing Director in the Fixed Income group where she trades investment grade and cross over securities. Ms. Karp joined TCW in 2009 during the acquisition of Metropolitan West Asset Management LLC (MetWest). Prior to joining MetWest in 1997, she was with the fixed income department at The Capital Group. Ms. Karp earned her BS in Business from University of Arizona.

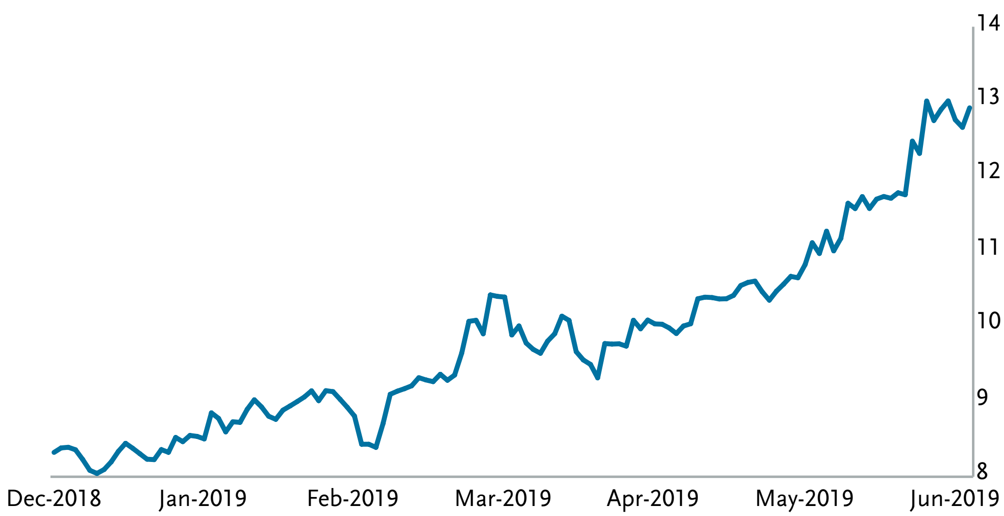
Spreads Tighten

Credit Index OAS of +109 was 11 bps tighter while the index yield of 3.09% was 26 bps lower



Source: Bloomberg Barclays

Market Value of Negative Yielding Bonds ($ Trillion)



Source: Bloomberg

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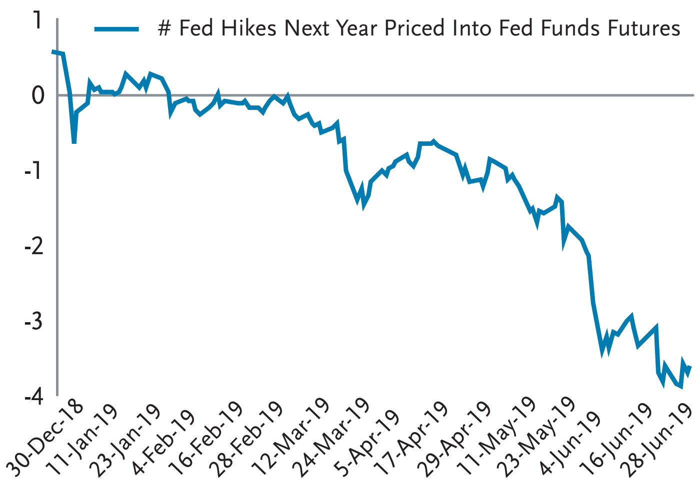
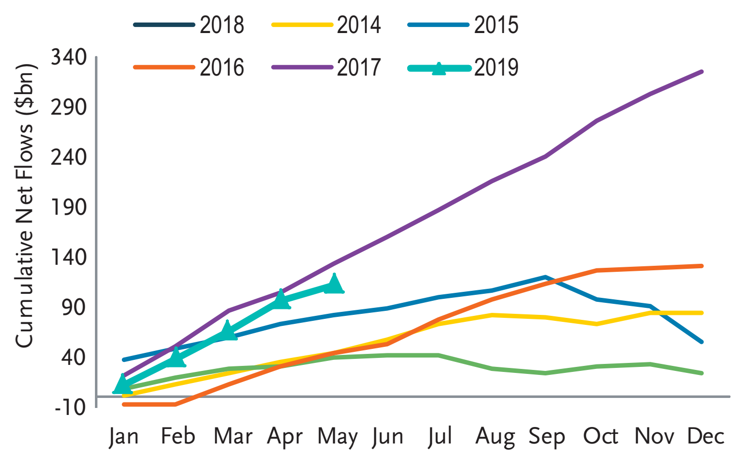
Market Expects 3 Rate Cuts Over Next 12 Months



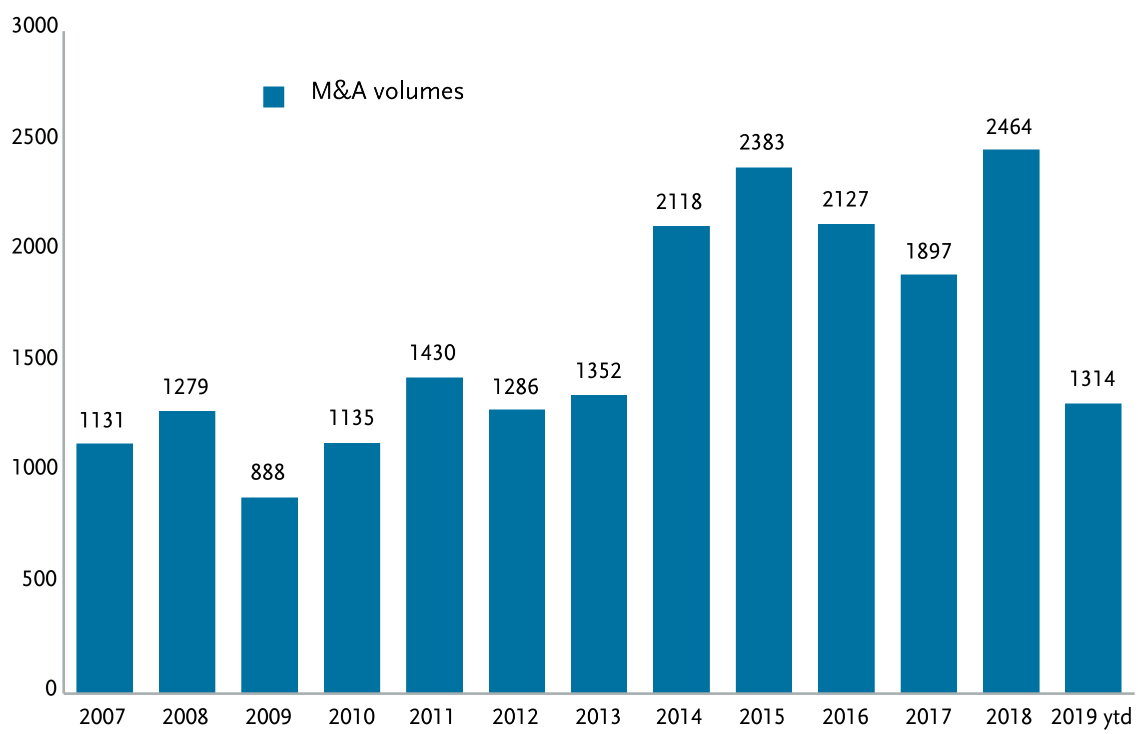
Source: Bloomberg , BofA Merrill Lynch Global Research

Strong YTD Inflows Into HG Funds



Note: Flows prior to 2012 are from AMG, flows for year 2012 are from EPFR.
Source: BofA Merrill Lynch Global Research, Lipper / AMG, EPFR

NA M&A Volumes are Robust



Source: BofA Merrill, Bloomberg

Index Performance

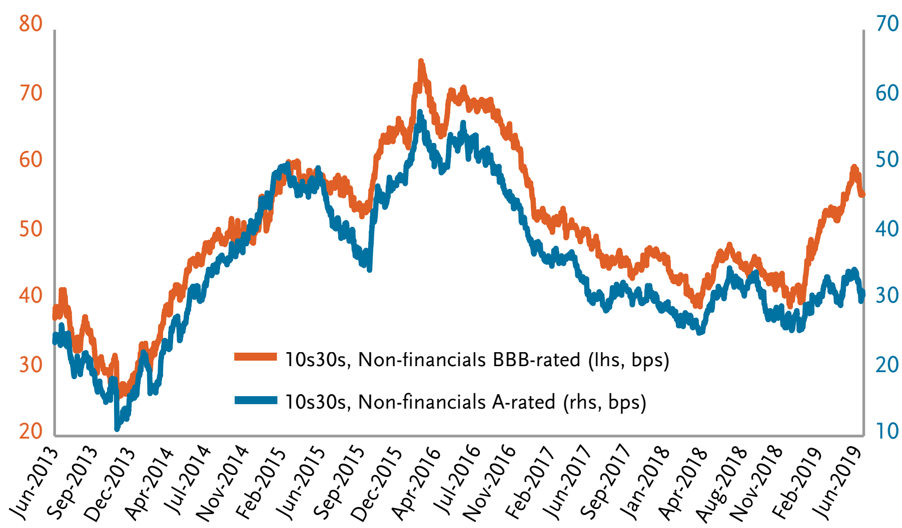
The credit index OAS tightened 11 bps in June, an almost complete reversal of the spread widening experienced in May. The index OAS of +109 bps over Treasuries is now 34 bps tighter since December 31, 2018 and is a stone's throw away from the YTD tights of +103 touched in April. Lower Treasury yields and tighter spreads resulted in strong total and excess returns of +2.26% and +1.27% respectively. The reach for yield theme resumed as the widest sectors and issuers outperformed. BBBs tightened 15 bps, causing the BBB/B basis to tighten 4 bps to 64 bps, which is near the cycle mean. Credit curves flattened as the bid for spread duration improved. The non-financial BBB 10-30's curve compressed by 4 bps to 55 bps, though remains steep vs. the 10-year mean of 40 bps. Best performing sectors in June were metals (-28 bps), cable (-22 bps), wirelines (-21 bps), food and beverage (-20 bps) and sovereigns (-20 bps) as the wider, more cyclical and/or M&A-dominated BBB names outperformed. YTD, independent energy remains the best performing sector (-59 bps), driven by oil price appreciation (WTI +28% YTD) and sector consolidation. Autos are a close second (-54 bps), followed by midstream energy (-51 bps) and wirelines (-50 bps). De-leveraging continues to be a main theme for the cohort of M&A driven sectors. Recent earnings pressure in the food and beverage space caused several issuers to miss their de-leveraging goals. Those delays triggered dividend cuts and asset sales as companies look to mitigate possible ratings actions. ABIBB (Inbev) for example, is in the process of selling a 15% stake (via IPO) in its Asia business for an estimated $8-$10 bln. The company has indicated that proceeds from the IPO will go towards debt reduction, which would go a long way ($10 bln is almost ½ turn of leverage) towards meeting de-leveraging goals post the 2016 SabMiller acquisition.

June Index Returns

	June Excess Return	June Total Return	YTD Excess Return	YTD Total Return	6/30/19 OAS	Monthly OAS Change
Credit Index	1.27%	2.26%	3.56%	9.35%	109	-11
Industrials	1.68%	2.72%	4.25%	10.51%	120	-16
Financials	1.08%	2.00%	3.68%	8.71%	103	-13
Utilities	0.93%	2.06%	2.10%	9.45%	115	-7
Municipals	0.13%	4.24%	3.07%	9.68%	119	3
Sovereigns	2.08%	3.19%	4.52%	11.33%	122	-20
AA	0.66%	1.59%	1.87%	7.27%	62	-6
A	1.17%	2.17%	3.10%	8.99%	87	-11
BBB	1.65%	2.68%	4.82%	10.90%	151	-15

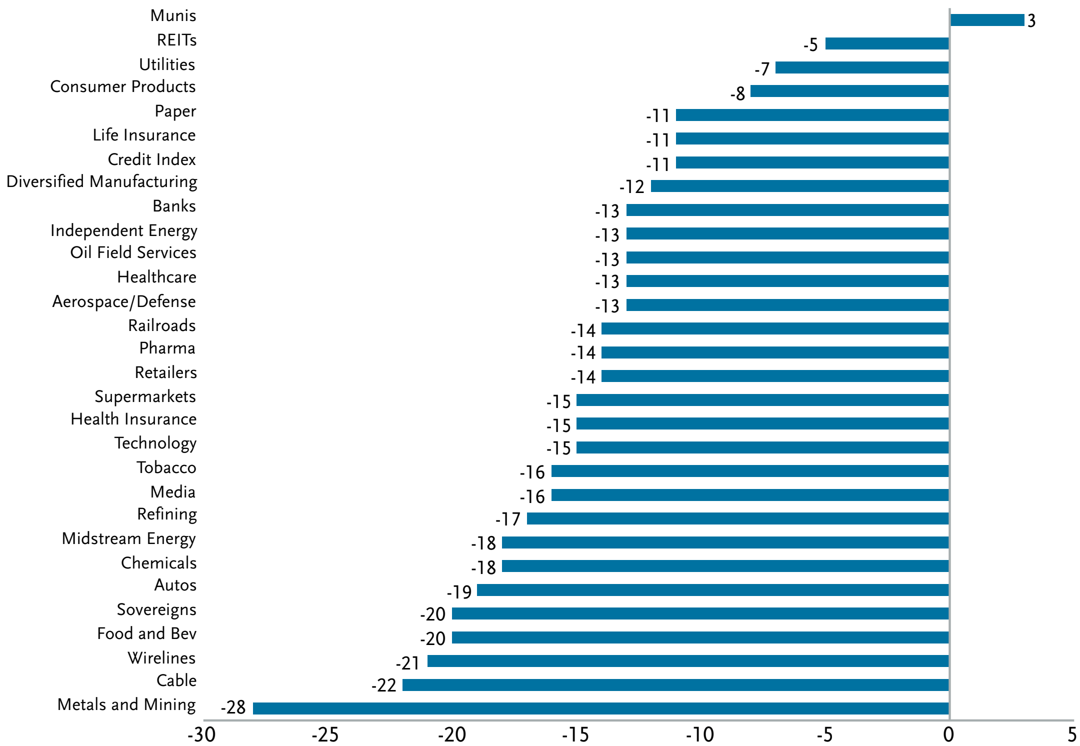
Source: Bloomberg Barclays

Credit Curves Flattened in June But are Still Steep vs Long Term Averages



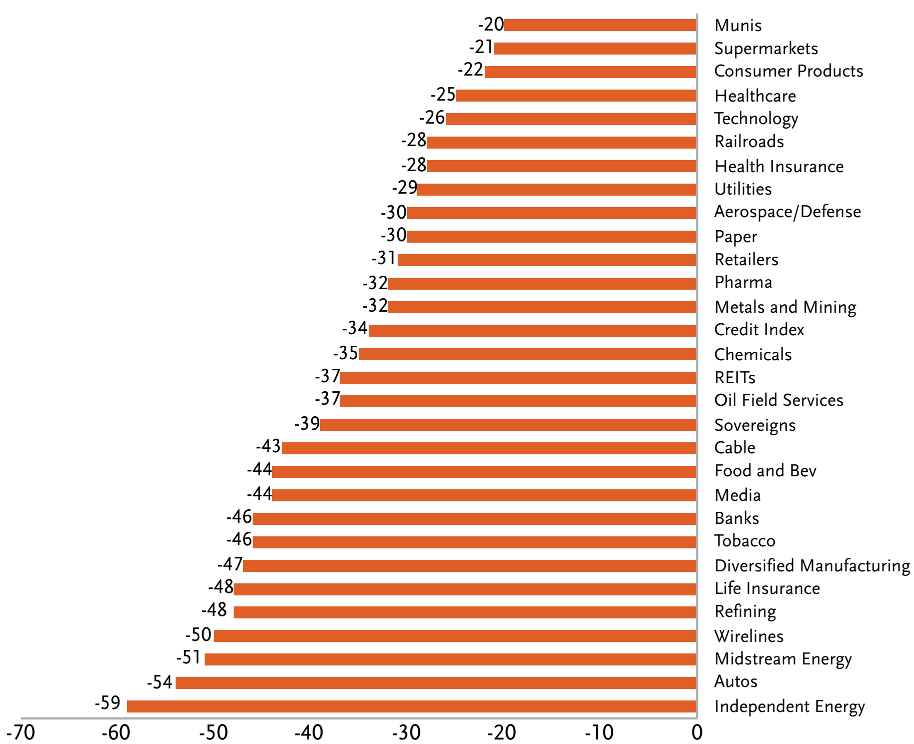
Source: BofA Merrill Lynch Global Research

June Sector OAS Changes

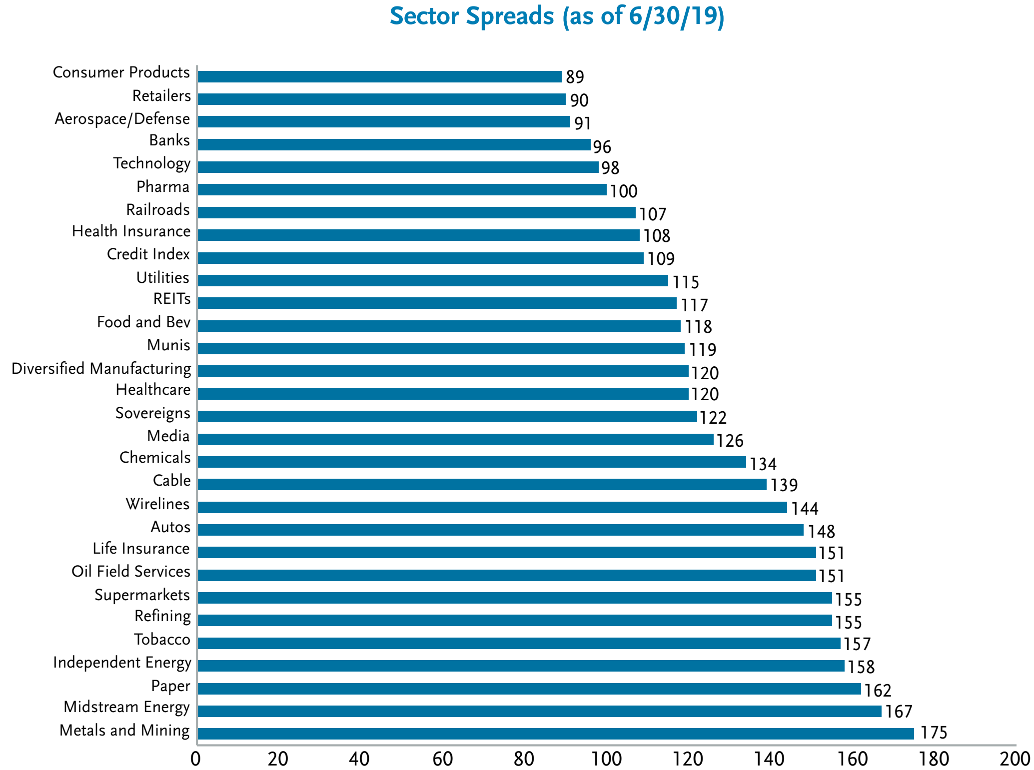


Source: Barclays Capital

YTD Sector OAS Change



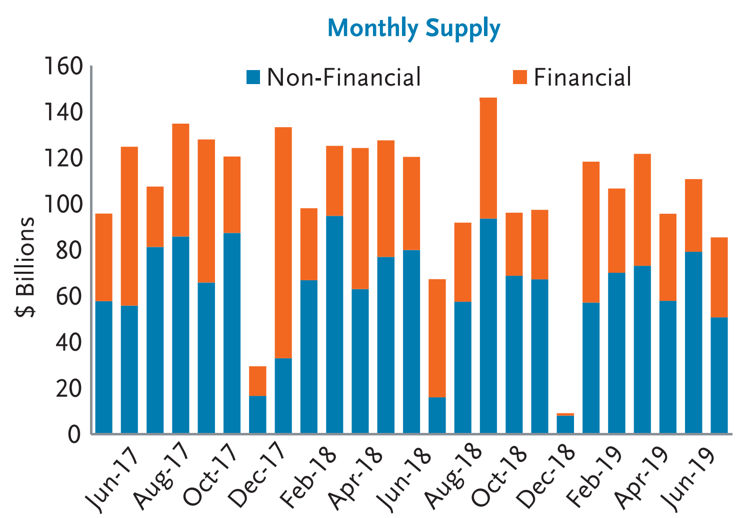
Source: Barclays Capital



Source: Barclays Capital

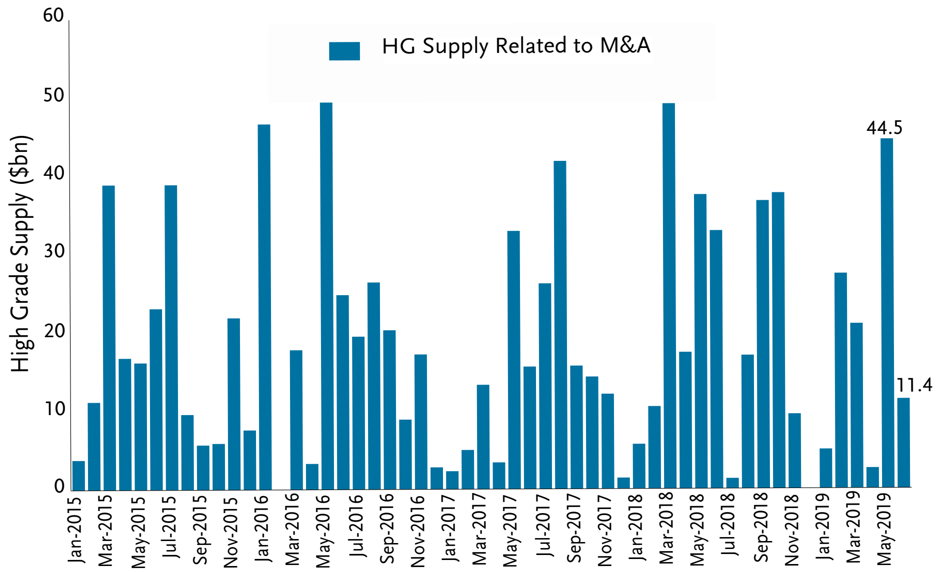
June Investment Grade Supply

Supply volumes were $85.5 bln for the month, bringing the YTD gross total to $639 bln, down 12% vs. the same period last year. M&A related supply was modest at $11 bln, comprised of only two acquisition related deals – Fiserv ($9 bln across four maturities, 10yrs priced at +138, 30yrs at +182) and Parker-Hannifin ($2.375 bln across three maturities, 10yrs priced at +117, 30yrs at +145). YTD, acquisition related issuance of $112 bln is down 26% vs. the first six months of 2018 but should accelerate given the recent uptick in deal announcements. In line with the risk sentiment for the broader market, new issue demand improved after the FOMC meeting on June 19. As such, new issue concessions were more attractive during the first half of the month. One of the largest concessions came from Vodafone, which priced $2.25 bln 30-year bonds with a 20-basis point new issue concession (30yrs priced at +237.5/olb).



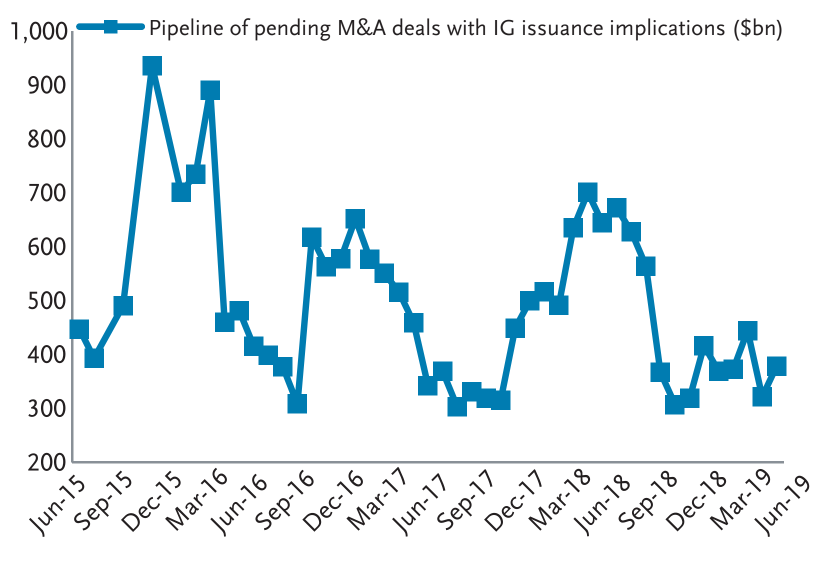
Source: BofA Merrill Lynch Global Research

M&A Related Supply



Source: BofA Merrill Lynch Global Research

Pipeline of M&A Deals (Enterprise Value)



Source: BofA Merrill Lynch Global Research

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