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INSIGHT

MONTHLY COMMENTARY

June Credit Update

TAMMY KARP | JULY 6, 2017

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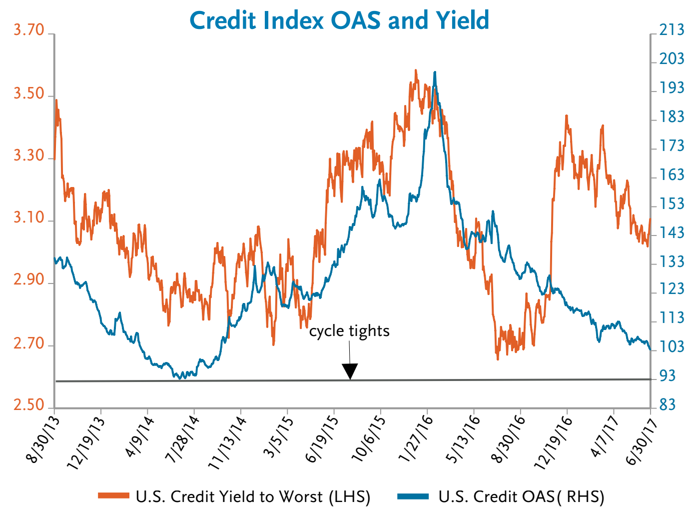
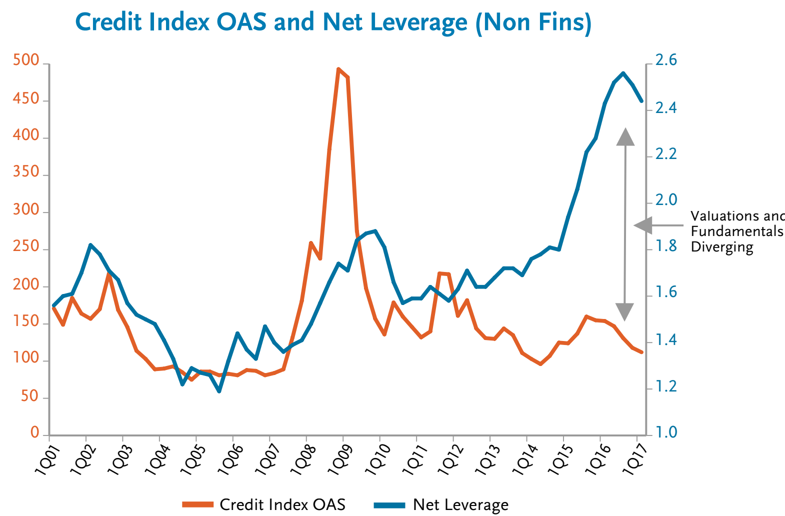
Ms. Karp is a Managing Director in the U.S. Fixed Income group where she trades investment grade and cross over securities. Ms. Karp joined TCW in 2009 during the acquisition of Metropolitan West Asset Management LLC (MetWest). Prior to joining MetWest in 1997, she was with the fixed income department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

The credit rally persisted in June as spreads for the investment grade index tightened another 4 basis points, ending the month at an OAS of +103 basis points over Treasuries. Despite a delay in the healthcare bill vote by the Senate and its implications for tax reform (or the lack thereof), the demand for credit was strong, underpinned by a sharp decrease in supply due to a seasonally slower summer month, light dealer inventories and continued inflows into high grade funds. These strong technicals are driving valuations tighter, with spreads approaching the post crisis tights of +93 basis points over Treasuries touched in June 2014. On the fundamental side, corporate leverage remains near all-time peaks, having steadily increased since the trough of 2011 with cheap money fueling debt funded M&A, dividends and share buybacks. Given tight valuations and the already peak levels of leverage at this point in the credit cycle, now in its ninth year, there is not a lot of margin for error. Beta compression, tight subordination premiums and flatter credit curves call for more defensive positioning. Thus, we continue to favor a strategy of yield capture rather than one of spread compression.

Bank stress tests and CCAR: The Dodd Frank Act Stress Test (DFAST), which applies to banks with greater than $50 bln in assets, is an annual test designed to simulate the stresses on bank balance sheets under severe hypothetical scenarios (recession, 10% unemployment, etc). This year, all 34 banks passed the test's most severe adverse case scenario — an outcome that should be expected given the improvement in bank capitalization levels post crisis. The Comprehensive Capital Analysis and Review (CCAR), released about a week after DFAST, incorporates the capital plans of the respective banking institutions into the stress tests. All but two banks' plans were approved as submitted. AXP reduced payouts and resubmitted prior to the release of CCAR while COF received approval conditional on addressing some material weaknesses in its capital planning. For the first time since stress tests were instituted in 2011, payout ratios were close to 100% - meaning almost 100% of earnings will go to shareholders. This could be viewed as a marginal negative for bondholders as capital growth/cushion is diverted to shareholders. However, overall capital levels are strong and regulatory oversight imposes discipline.



Source: Bloomberg Barclays



Source: Bloomberg Barclays, BofA Merrill Lynch Global Research

Index Performance: The investment grade credit index OAS of +103 basis points over Treasuries is 4 bps tighter on the month and 15 bps tighter year-to-date. The credit index yield of 3.11% rose 5 basis points in June resulting in a marginal return of .26% as higher yields offset some of the spread compression and carry. Demand for credit was strong across all maturity buckets though longer-dated corporates outperformed as credit curves continued to flatten. The 10-30s non-fin credit curves are flatter by about 8 bps year-to-date with BBBs (x fin, x commodities) at 48 bps and As at 30 bps. Credit curves, though now in line with historical averages, are the flattest they've been since mid-2014. They reached their steepest levels in March 2016 when BBB 10-30s got as wide as 75 basis points apart.

In terms of sector performance, the best performers were autos (-9 bps tighter), media (-9 bps), pharma (-8 bps) and Sovs (-8 bps). After lagging for most of the year, pharma is now one of the best performing sectors YTD (-22 bps). This is a result of 1) M&A-related supply being down significantly (-30% vs 2016) and 2) on the regulatory front, talks of pricing controls taking a back seat at least for now. The space has been generally free of negative headlines and rhetoric over the past couple of months.

The worst performing sector in June was energy (+4 bps wider), which is not surprising given the oil price volatility, though performance was bifurcated within the various energy subsectors. Servicers were 14 bps wider on the month, independents +10 with higher beta/higher cost names underperforming. MLP/midstream spreads were only 1 bp wider while refiners were actually tighter on the month (-4 bps).

The second worst performing sector was supermarkets (+3), which was entirely driven by the spread widening in Kroger (+ 17 bps). The company lowered 2017 EPS guidance, citing intense price competition. Additionally, Amazon's announced acquisition of Whole Foods is seen as a threat to the industry. While grocery delivery sales currently account for a small (about 2%) percentage of the U.S. grocery sales pie, the fear is that Amazon could upend the grocery business in much of the same way it did the apparel business.

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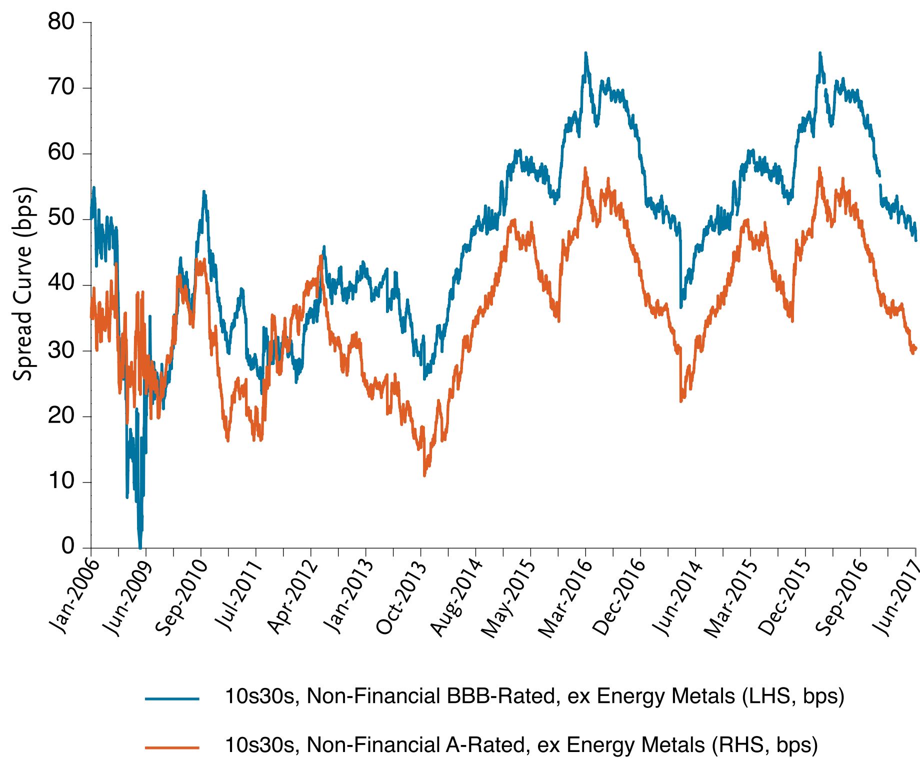
June Credit Index Returns

	Month-to-Date Excess Return	Month-to-Date Total Return	Option-Adjusted Spread	Option-Adjusted Spread Month-to-Date Change
Credit Index	.46%	.26%	103	-4
Industrials	.52%	.33%	112	-4
Financials	.46%	.22%	103	-5
Utilities	.58%	.46%	110	-3
Municipals	1.07%	.93%	146	-8
Sovereigns	.65%	.45%	125	-8

Credit Curves have normalized. 10-30's BBB curve is flatter by 27 bps from the steepest levels in 3/16.



Source: BofA Merrill Lynch Global Research

June Investment Grade Supply: New issue volumes were $94 bln, in line with the June average over the past three years. Supply related to M&A dropped to $16 bln vs. $33 bln in May. The two largest M&A-related bond deals were CAH (issued $ 5.2 bln across six tranches to fund medical supply business from MDT, 10yr priced at +120, 30yr @ +150) and RBLN/Reckitt Benckiser ($7.75 bln issued in four tranches to fund MJN acquisition, 10yrs priced at +87). Demand remained strong and new issue concessions were negligible as a result. CAH and RBLN priced with negative new issue concessions despite undertaking transactions that are leveraging – in RBLN's case about 2x additional leverage. The market does not seem to be demanding any additional spread for the added leverage.

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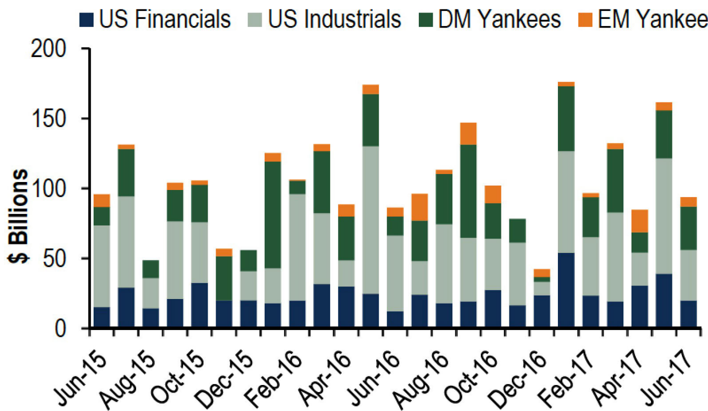
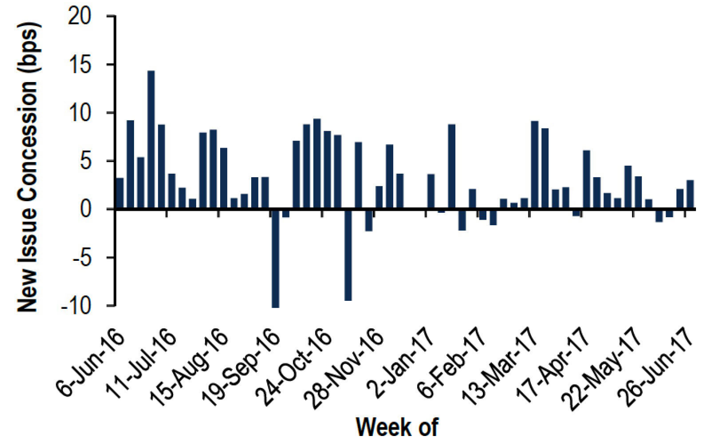
Monthly IG Issuance



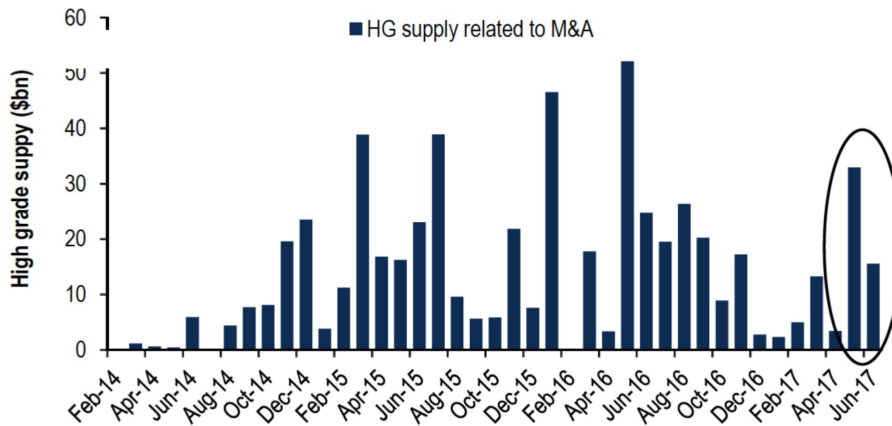
Source: BofA Merrill Lynch Global Research

New Issue Concessions



Source: BofA Merrill Lynch Global Research

M&A- Related Issuance



Source: BofA Merrill Lynch Global Research

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