TCW

INSIGHT

MONTHLY COMMENTARY

Loan & CLO Review – June 2019

DREW SWEENEY & PALAK S. PATHAK | 9 JULY 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.

With merely $21 billion of issuance, the new issue market was not particularly robust in June. However, that volume was enough to overwhelm loan demand, which was in the midst of a -$4.5 billion outflow from retail loan funds. Loan market demand is currently unbalanced with persistent retail outflows such that when the new issue market provides even moderate supply, the whole secondary market wobbles. CLOs and CLO warehouses still offer adequate demand and have repeatedly stepped in to add risk as prices decline. June was no exception and price weakness was orderly, meaning there was never a panicked feel to the market. Since the natural arbitrage for CLOs is stressed, CLO demand for secondary loans grows when loan prices decline.

There are two trends that have emerged in the last few months. First, dispersion of performance within the loan market by sector has increased. We saw certain sectors struggle: Consumer Durables, Healthcare, Metals, Oil & Gas, and Retail. For example, higher-beta energy names were quick to drop in price when oil (West Texas Intermediate crude "WTI") declined 10 points in May but offered little or no recovery in June when WTI bounced more than $5.0. Second, CLOs are seemingly full on lower-rated paper. In June, we saw that in order to get lower-rated deals syndicated, banks were forced to offer large price concessions. In the secondary, we saw higher-beta, lower-rated deals also come under pressure, particularly B3-rated deals that were refinanced to lower spreads in 2017 and the first half of 2018. Away from these sectors and categories, loan demand stayed relatively robust and higher quality loans did not show any signs of weakness.

On a year-to-date basis, loan returns are stellar and have provided their best results in 10 years. Despite this, we saw interest rate concerns weigh on the market in May and June. Consequently, loans prices were down the last two months even as most risk assets were higher. Interestingly, 3-month LIBOR is now down 47 basis points (bps) on the year, which certainly impacts the current coupon for loans and relative value as compared to high yield bonds.

Performance - Loans

In June 2019, the Credit Suisse Leverage Loan Index (CS LLI) and the S&P Leveraged Loan Index (S&P/LSTA) were up 0.22% and 0.24%, respectively.

- Quarter-to-date, ending June 30, the CS LLI was up 1.58% and the S&P/LSTA was up 1.68%.
- Year-to-date, ending June 30, the CS LLI was up 5.42% and the S&P/LSTA was up 5.74%.
- For the 12 months ending June 30, 2019, the CS LLI was up 4.11% and the S&P/LSTA was up 3.97%.

During the month, higher quality paper outperformed lower quality loans. Triple Bs and double Bs outperformed all other categories. Single Bs managed only a 14 basis point return while triple Cs and distressed loans were down on the month. During the quarter, performing loans provided a more clustered return as triple Bs, double Bs and single Bs all posted returns within 12 bps. On a year-to-date basis, returns were also more compressed but double Bs managed to outperform single Bs by nearly 73 bps. Distressed returns surpassed all categories with a return of over 7%.

On an LTM basis, triple Bs and double Bs outperformed single Bs. The distressed category was the sole category to post a negative return during this time period.

Total Return by Rating

	June	Q2 2019	YTD	LTM
Split BBB	0.42%	1.54%	5.55%	4.41%
BB	0.45%	1.66%	5.96%	4.31%
Split BB	0.31%	1.78%	5.90%	3.92%
B	0.14%	1.57%	5.23%	4.26%
Split B	0.23%	2.29%	7.67%	5.48%
CCC/Split CCC	-0.27%	0.58%	2.77%	2.08%
Distressed (CC, C and Default)	-1.70%	1.62%	7.03%	-1.27%

Source: Credit Suisse Leveraged Loan Index

Sector Performance

Fifteen of 20 sectors provided positive returns in the CS LLI for the month of June. The top performing sectors were Aerospace (0.68%), Food/Tobacco (0.56%) and Utility (0.49%).

The worst performing sectors for the month were Retail (-0.72%), Consumer Durables (-0.73%) and Metals/Minerals (-1.72%).

On a quarter-to-date basis, Utility (2.13%), Housing (2.08%) and Food & Drug (2.05%) were the top performing sectors.

On a year-to-date basis, Food & Drug (7.69%), Media/Telecom (6.37%) and Housing (6.29%) were the top performing sectors.

In the last 12 months, Utility, Transportation and Food & Drug have led all sectors with total returns of 5.48%, 5.15% and 5.05%, respectively. Retail dropped from a “top 3” return sector on an LTM basis in May to the sixth worst overall sector in June. Energy, Consumer Durables and Metals/Minerals provided the worst performing sectors with returns of 2.85%, 0.60% and 0.44%, respectively.

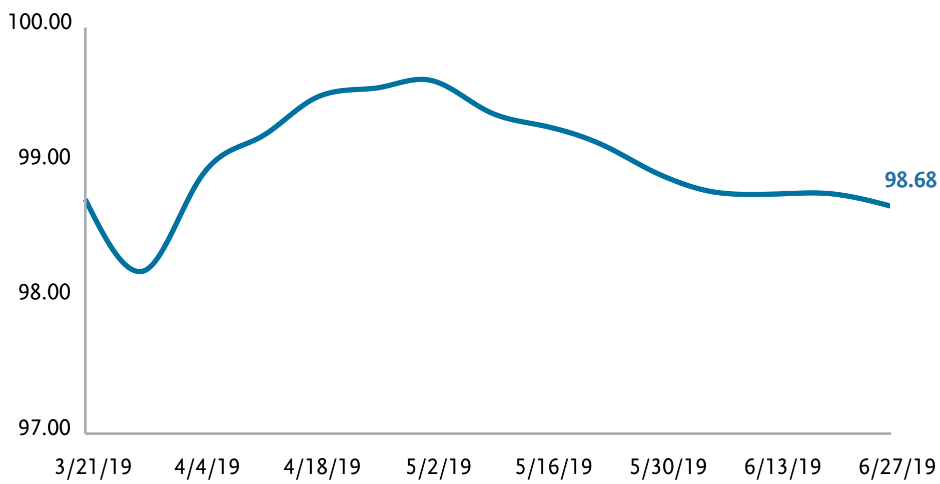
Industry Returns

Sector	June	2Q 2019	YTD	LTM
Aerospace	0.68%	1.37%	5.48%	4.09%
Chemicals	0.42%	1.64%	5.74%	4.79%
Consumer Durables	-0.73%	0.21%	0.29%	0.60%
Consumer Non-Durables	0.46%	1.91%	5.26%	4.17%
Energy	-0.43%	0.00%	4.56%	2.85%
Financial	0.39%	1.67%	5.49%	4.88%
Food and Drug	0.20%	2.05%	7.69%	5.05%
Food/Tobacco	0.56%	1.92%	5.22%	4.00%
Forest Prod/Containers	-0.04%	1.35%	5.25%	3.56%
Gaming/Leisure	0.25%	1.79%	5.95%	4.84%
Healthcare	0.13%	1.58%	5.30%	4.04%
Housing	0.28%	2.08%	6.29%	4.40%
Information Technology	0.24%	1.46%	5.29%	4.14%
Manufacturing	0.03%	1.65%	4.99%	3.33%
Media/Telecommunications	0.43%	1.93%	6.37%	4.13%
Metals/Minerals	-1.72%	-1.62%	3.80%	0.44%
Retail	-0.72%	0.45%	5.18%	3.84%
Service	0.44%	1.93%	5.00%	4.26%
Transportation	0.17%	1.52%	4.52%	5.15%
Utility	0.49%	2.13%	6.00%	5.48%

Source: Credit Suisse Leveraged Loan Index

CS LLI prices (excluding defaults) increased 5 bps in June while the average bid of the S&P LCD flow-name loan composite decreased -23 bps from 98.91 to 98.68. The average flow name bid is up 338 bps on a year-to-date basis.

Average Loan Flow-Name Bid



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

Performance - CLOs

CLO performance was muted in June against the backdrop of the Fed. Spreads remained flat at the top of the capital stack to wider in mezz. The first week of the month started with a record $2bn in BWIC supply, four times the weekly average. Most of the bonds out for bid were IG rated tranches from real money sellers. Much of the selling was rate driven and the supply was absorbed well with the dealer community net longer in IG by the end of the week. Spreads were a few bps wider for AAAs to 20-50 bps wider on BBs. Tier 1, short duration AAAs traded well and BBs with high MVOC coverage and lower coupon (higher discount) were better bid in mezz. The rest of the month, BBBs and BBs continued to lag while short AAAs tightened another 5 bps with amortizing deals covering inside 90dm and longer duration tier 1 AAAs at 120dm.

CLO equity NAVs were flat to down 2 pts with loan prices decreasing $0.23 over the month. July will be an important indicator for equity performance with many quarterly equity distributions scheduled to pay over the next month.

Secondary CLO 2.0 Total Returns

	June	YTD	LTM
Total	**0.22%**	**3.60%**	**3.47%**
AAA	0.26%	2.81%	3.33%
AA	0.21%	3.73%	3.39%
A	0.33%	5.03%	3.46%
BBB	0.13%	6.65%	4.20%
BB	-0.30%	7.99%	4.60%
B	0.11%	6.29%	3.79%

Source: JPM CLOIE

Secondary CLO 2.0 Spreads (DM)

	June	MoM Change (bps)
AAA	90-130	-5
AA	155-190	0
A	200-270	5
BBB	310-400	15
BB	600-725	50
B	900-1050	50

Source: TCW

Technical Conditions- Demand

June retail loan outflows were approximately -4.5 billion. Outflows for floating rate loan funds now surpass -$43 billion since the beginning of Q4 2018 and AUM for the loan mutual fund base is down to $114 billion from a high of $154 billion. Year-to-date outflows for loan funds total -$21 billion, which compare to +$12.1 billion of inflows during the same period in 2018.

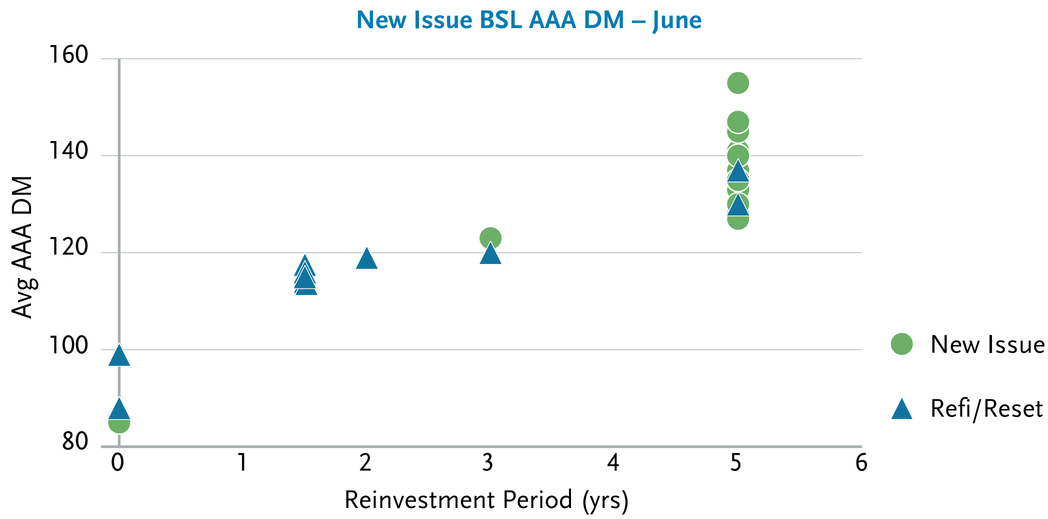
Despite ongoing retail outflows, CLO issuance continued at a similar pace to May with $10bn pricing in June, flat Month-Over-Month (M-O-M). AAA spreads tightened 2 bps with Tier 1 AAA spreads moving from 130dm to 128dm. The AAA term curve continued to steepen with static AAAs pricing mid to high 80s dm (10 bps tighter M-O-M) vs. longer duration AAAs which are only 2-3 bps tighter. As a result, we saw 10 refis price in June vs. 7 in May. Average AAA refi spread was 116 bps in June, 6 bps tighter M-O-M. AAAs continue to be well syndicated with domestic demand at tighter levels than demand from overseas. AA spreads were unchanged with single As, BBBs and BBs wider by 5 bps, 20 bps and 15 bps respectively.

CLO equity arb improved ~10 bps as CLO liability costs decreased with AAAs tightening. The weighted average CLO liability cost is currently 190 bps.

CLO New Issuance

	Jun-19	YTD 2019	YTD 2018	YoY %△
New Issue ($bn)	$10.10	$64.80	$66.16	-2.1%
Refi (#)	10	29	38	-24%
Reset (#)	3	19	124	-85%

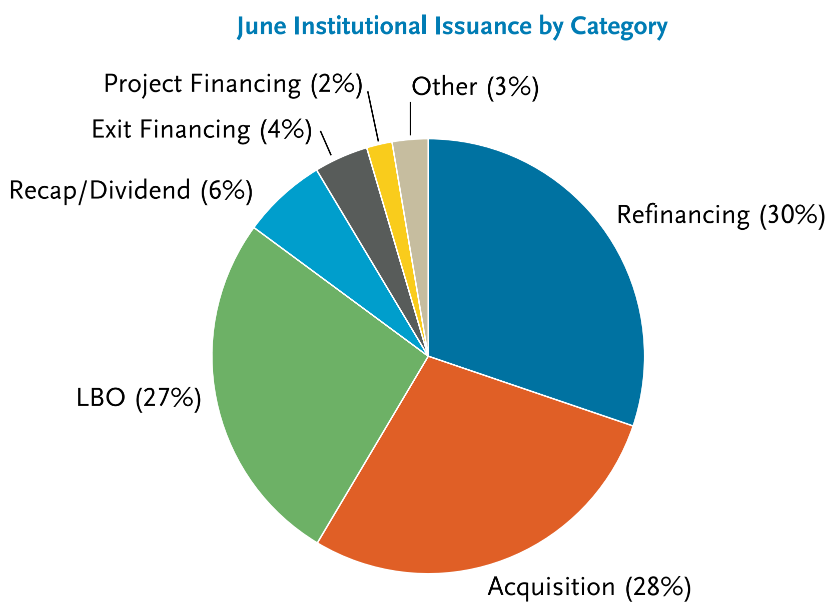
Source: TCW



Source: TCW

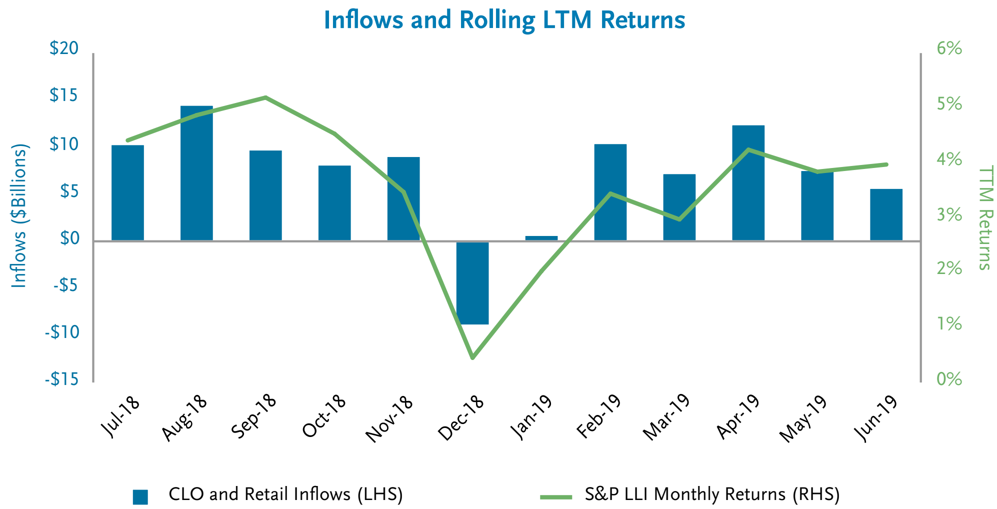
Technical Conditions- Supply

June acquisitions, mergers and LBOs represented 56% of primary issuance, which was slightly below the 60% mark set year-to-date. Dividend activity eased as loan prices pulled back.



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

Loan fund outflows have been offset by strong CLO production. This, combined with crossover high yield buyers, has created enough demand for loans to produce very strong YTD returns and modest 12-month returns.



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

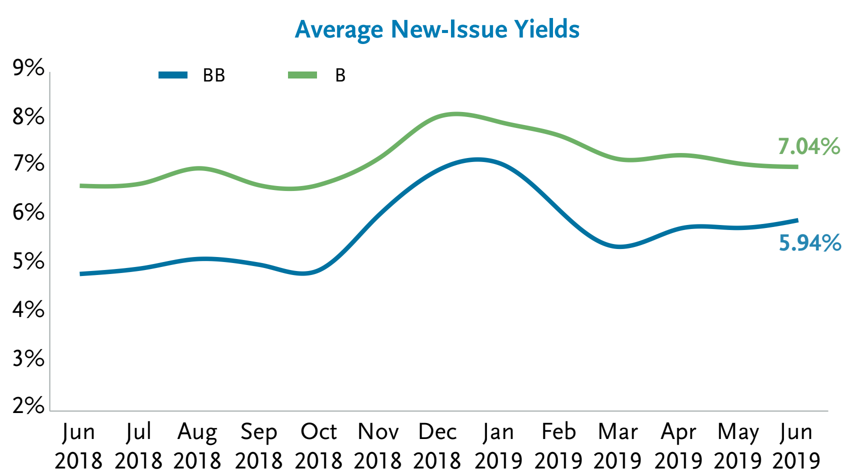
For new issues, yields remained essentially flat month-over-month. Double B yields widened by 16 bps while single B yields were tighter by 7 bps.

New Issue Spread Changes

	All Loans
Jun-18	375
Sep-18	377
Dec-18	452
Jan-19	433
Mar-19	404
May-19	390
Jun-19	404
Month-Over-Month Change	3.45%
YTD Change	-10.71%
LTM Change	1.34%

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

In terms of new issue yields, yields remained essentially flat month-over-month. Double B yields widened by 16 bps while single B yields were tighter by 7 bps.



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

Fundamentals – Loans

There were three loan defaults in June: Neiman Marcus (Retail), Monitronics (Services & Leasing) and Sheridan Production Partners (Oil & Gas). The default rate changed from 1.00% in May to 1.24% in June, based on par outstanding.

The last 12-month default tally for the S&P/LSTA is 21. Retail leads all categories with six defaults while Services & Leasing is just behind it with four. Oil & Gas is the third leading category with two.

Lagging 12-Month Default Rates

Actual	Apr-19	May-19	Jun-19
By Number	1.59%	1.56%	1.54%
By Principal Amount	1.01%	1.00%	1.24%
Shadow Default Rate*			
By Number	0.20%	0.49%	0.58%
By Principal Amount	0.18%	0.48%	0.52%

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

As loan downgrades pick up, WARF levels and the amount of B3/B- and Caa/CCC exposure within CLOs is also creeping higher. B3 assets increased by 20 bps to 25.7% and B- and lower rated issuers increased over 1% to 20%. WARF levels increased by 4 pts to 2843.

Valuation

Since 1992, the average 3-year discount margin (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 460 bps, which widened 8 bps from the prior month.

The DM spread differential between Double Bs and Single Bs is 50 bps wider from July 2018 to June 2019 and 10 bps wider than the historical spread differential since inception.

3-Year Discount Margin Differential Between BBs and Single Bs

1/1992-6/2019 Average	189.5
Jul-18	149.6
Jun-19	199.6

Source: Credit Suisse Leveraged Loan Index

CS LLI Snapshot

YTD Total Return*	5.42%
Average Price	96.78
Spread	351 bp
Coupon	6.02%
Current Yield	6.25%
Yield (3-year life)	6.32%
Discount Margin (3-year life)	460 bp

*S&P LLI YTD Total Return 5.74%

	Spread	DM (3-Year Life)
Split BBB	198 bps	222 bps
BB	255 bps	290 bps
Split BB	315 bps	377 bps
B	382 bps	489 bps
Split B	542 bps	893 bps
CCC/Split CCC	672 bps	1,204 bps
Distressed (CC, C and Default)	373 bps	1,600 bps

Source: Credit Suisse Leveraged Loan Index

Summary & Looking Forward

As of June 30, the S&P/LSTA Index imputed default rate was 2.28%, up from 2.14% in the prior month.

The loan market felt weak for most of the month and wider new issue spreads indicated where loan buyers were interested in picking up new exposure. Dispersion increased and while higher quality BB loans in more favored sectors did not decline in price at all, lower rated/ lower spread deals were hit hard. Loans in Healthcare, which faced prospective regulatory change, dominated activity and were quite volatile during the month. Cyclical sectors such as Consumer Durables, Retail, Metals and Oil & Gas felt weaker and had little support throughout the month.

It feels as if CLOs are full on B3/B- corporate family rated loans and to introduce a new B3/B- loan to a CLO requires either a concurrent B3/B- sale. The consequence of this is interesting. It means that LBO activity could be impacted. If demand for B3/B- deals is dramatically reduced, it means LBOs will either have to be done with more moderate leverage or much wider pricing…or possibly both.

As we look forward to July, new issuance looks to be dramatically lighter. Most June deals completed their syndication prior to the July 4 holiday week. New deals in July will be launched post the holiday week and since most syndications take roughly two weeks to complete, allocations will not occur until the end of the month. Secondary prices feel a bit buoyed by this fact and accounts have been adding secondary loans to replace Q2 2019 amortization payments.

In CLOs, the bear case is that CLO spreads leak wider as all-in yields for floating rate assets decrease with lower rate expectations. In addition, as loan downgrades and fundamentals continue to deteriorate, CLO mezz will have more sellers vs. buyers and equity will continue to remain challenged from the tight arb.

The bull case is with tighter new issue AAA spreads and loan spreads unchanged, the arb will improve. In addition, the recent increase in domestic demand should tighten AAA spreads further, increasing new issuance. Also, the tightening of HY and IG spreads has increased the relative value of CLOs and could be another catalyst for spreads to tighten in the coming months. ■