TCW

INSIGHT

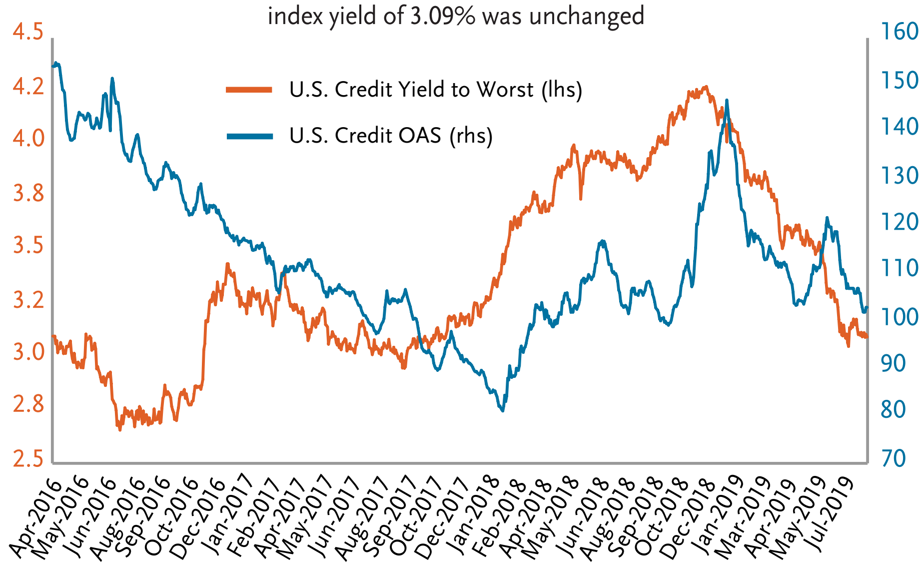
MONTHLY COMMENTARY

July Credit Update

TAMMY KARP | 7 AUGUST 2019

The rally in credit spreads continued in July as the strong technical backdrop resumed, underpinned by overseas demand for IG credit, robust inflows into high grade funds and light dealer inventories. Central bank policy and the resulting reach for yield fueled a risk-on environment that outweighed the macro risks, including recessionary fears, the escalation of trade wars and earnings softness. The Fed delivered its 25 basis point (bp) rate cut (the first cut since 2008) on the last day of the month just as trade tensions escalated, notably the threat of a 10% tariff on the remaining $300 billion of China imports. Investor sentiment turned more negative after the tariff headlines, but the impact on IG spreads was relatively contained and the widening that did occur spilled over into August. Global yields continued to drop and the amount of negative yielding debt increased to a record of $14 trillion. This tug of war between yield-starved investor demand for credit on one hand and macro weakness on the other will continue to be a source of volatility. Fundamentally, late cycle signals like flatter yield curves, increased volatility and high corporate leverage should remain a concern. Furthermore, the credit market has undergone fundamental changes since the start of the cycle: Dealers' ability to add risk and absorb volatility has been severely hampered by regulatory constraints, corporate leverage is at all-time peak levels of 2.53x net debt/EBITDA, the size of the credit market has nearly tripled, and the downward ratings migration has been notable with BBBs now accounting for almost half of the IG credit universe.

Stable Yields and Tighter Spreads:
Credit Index OAS of +103 was 6 bps tighter while the index yield of 3.09% was unchanged



Source: Bloomberg Barclays

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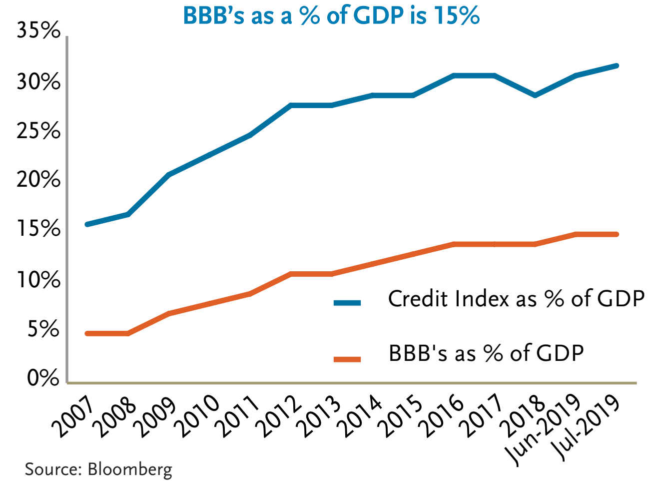
Ms. Karp is a Managing Director in the Fixed Income group where she trades investment grade and cross over securities. Ms. Karp joined TCW in 2009 during the acquisition of Metropolitan West Asset Management LLC (MetWest). Prior to joining MetWest in 1997, she was with the fixed income department at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

Yield Grab:
Market value of Negative Yielding Bonds grew to $14 trillion

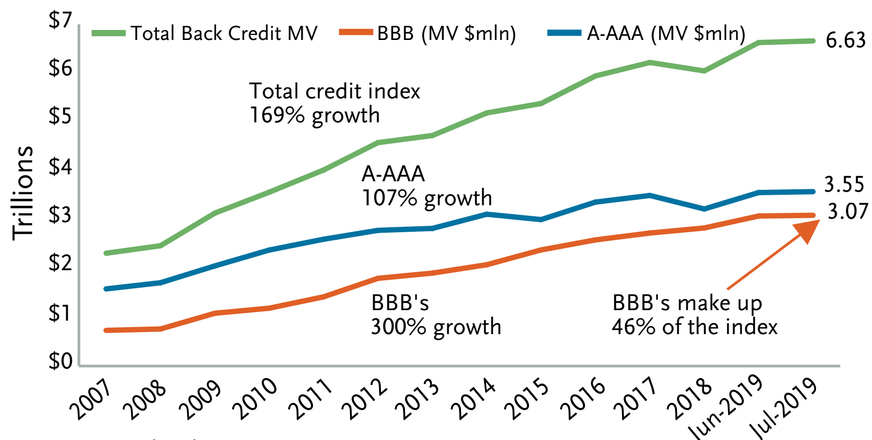
Source: Bloomberg

Credit Index of $6.6 trillion is 31% of GDP.
BBB's as a % of GDP is 15%



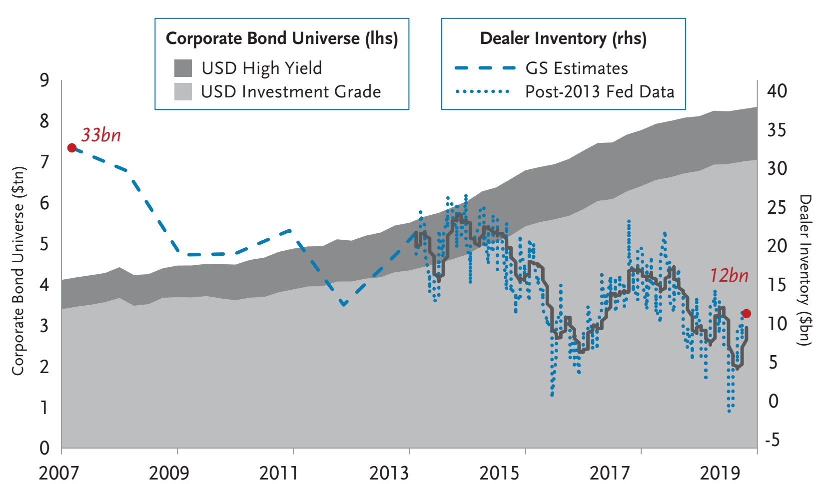
Source: Bloomberg

IG Credit Market has experienced massive growth and downward ratings migration with BBB's accounting for almost half the index.



Source: Bloomberg

Dealer Inventories are a Fraction of What They Were Pre-Crisis:
Liquidity has been hampered by regulatory changes.

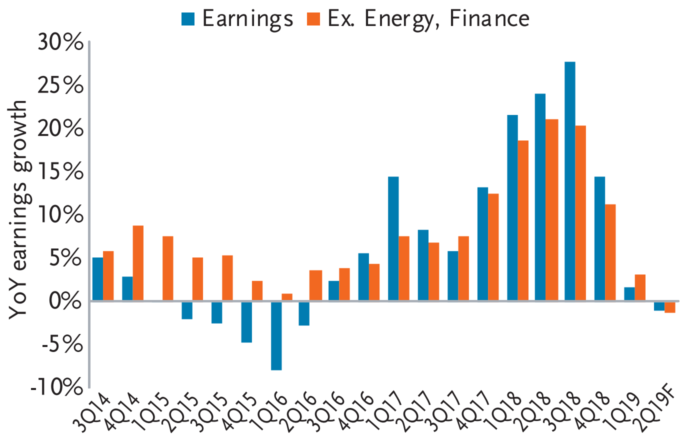


Source: Bloomberg

July Credit Update

A Lackluster Quarter:

Actual and expected Q2 earnings growth for IG universe



Note: 2Q19 based on the actual results when available and consensus estimates otherwise
Source: BofA Merrill Lynch Global Research, FactSet

2Q Earnings Growth by Sector

Sector	Earnings growth (YoY)	Sales growth (YoY)
Aerospace/Defense	-59.8%	-2.2%
Automobiles	-8.8%	-0.6%
Banks/Brokers	1.8%	2.6%
Basic Materials	-12.2%	5.4%
Consumer Products	1.8%	1.6%
Energy	-5.8%	-0.5%
Finance	-7.6%	-3.7%
Food, Bev, & Bottling	-3.3%	2.3%
Health Care	8.2%	12.2%
Industrial Products	-3.4%	-1.5%
Insurance	5.8%	2.1%
Media & Entertainment	7.1%	18.5%
REITs	1.6%	3.2%
Retail	-3.4%	4.3%
Technology	-2.6%	2.0%
Telecom	7.6%	8.6%
Transportation	1.2%	2.6%
Utilities	3.8%	1.9%
Other	5.9%	3.8%
Total US HG public co's	**-1.1%**	**3.9%**
Total ex. Financials	-1.8%	4.3%
Total ex. Energy	-0.8%	4.4%

Note: 2Q19 based on the actual results when available and consensus estimates otherwise. Source: BofA Merrill Lynch Global Research, FactSet

Index Performance

The credit index OAS of +103 bps over Treasuries tightened 6 bps on the month, bringing spreads closer to the cycle tights of +81 reached in February 2018. Stable Treasury yields and tighter spreads resulted in positive total and excess returns of 0.52% and 0.59%, respectively. The total return of the IG credit index stands at 9.92% YTD, its strongest return since 2012. Best performing sectors were diversified manufacturers (-12, led by GE), life insurers (-12), and utilities (-11).

California utilities EIX and SRE outperformed after AB1054 passed earlier in the month. The legislation provides a mechanism for utilities to recover wildfire costs in a more timely manner via a $21 billion insurance fund (half to be contributed by ratepayers and half by the utilities). Additionally, the strict liability standard could be moderated by a more reasonable standard in conjunction with a safety certification process. While shifting the burden of proof away from the utilities is positive on paper, the practical applicability remains untested. The bill's passage overall is a big step towards mitigating the impacts of wildfire exposure and as a result, EIX's holdco ratings were affirmed at low investment grade by all three rating agencies.

The worst performing sector in July was independent energy (+6 bps), as both pending supply from the OXY/APC merger and a drop in natural gas prices hurt valuations. Names most exposed to natural gas underperformed as the underlying commodity price has been under pressure. The front contract ended the month at $2.23, a 24% YTD drop, as ~9-10 bcf/d of added supply has outpaced 5 bcf/d of demand growth. Incremental demand for natural gas will come from LNG facilities coming online – 1.3 bcf/d in 2H19 and another 2.6 bcf/d in 2020 – which could help mitigate the imbalance.

July Index Returns

	July excess return	July total return	YTD excess return	YTD total return	7/31/19 OAS	Monthly OAS Change	YTD OAS Changed
Credit Index	0.59%	0.52%	4.20%	9.92%	103	-6	-40
Industrials	0.61%	0.56%	4.93%	11.13%	114	-6	-43
Financials	0.51%	0.41%	4.23%	9.16%	97	-6	-50
Utilities	1.25%	1.24%	3.47%	10.82%	104	-11	-40
Municipals	0.40%	0.44%	3.44%	11.41%	118	-1	-21
Sovereigns	0.68%	0.64%	5.27%	12.05%	115	-7	-46
AA	0.42%	0.35%	2.32%	7.65%	57	-5	-24
A	0.54%	0.47%	3.69%	9.51%	82	-5	-36
BBB	0.74%	0.68%	5.64%	11.65%	143	-8	-54

Source: Bloomberg Barclays

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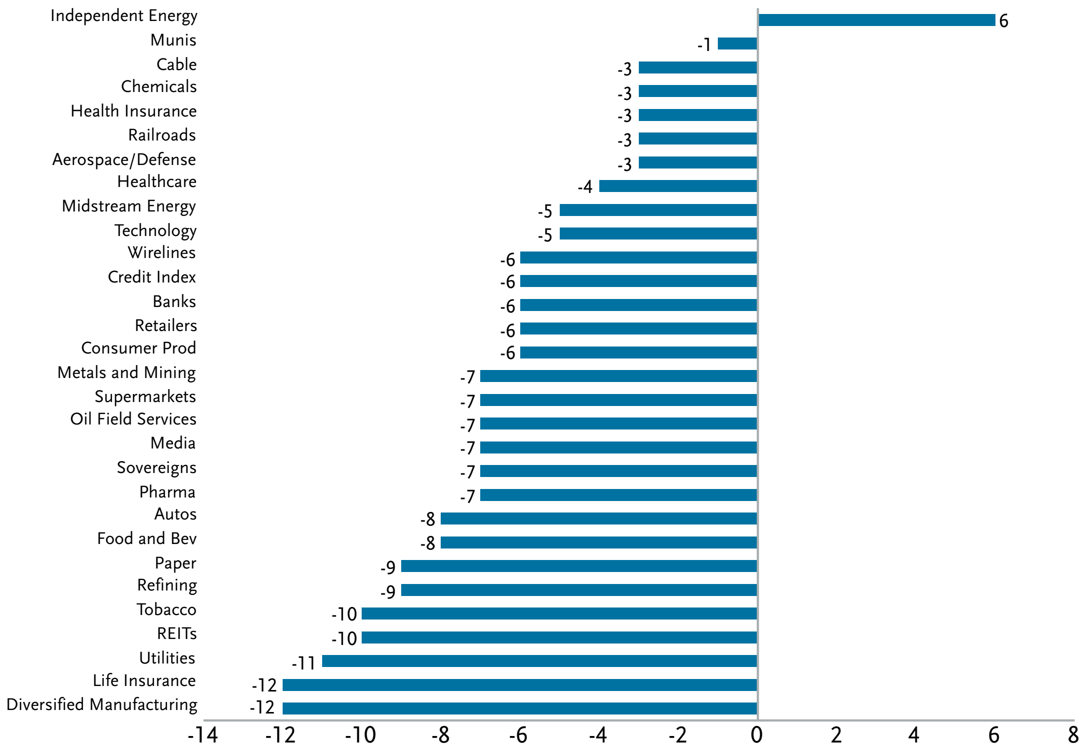
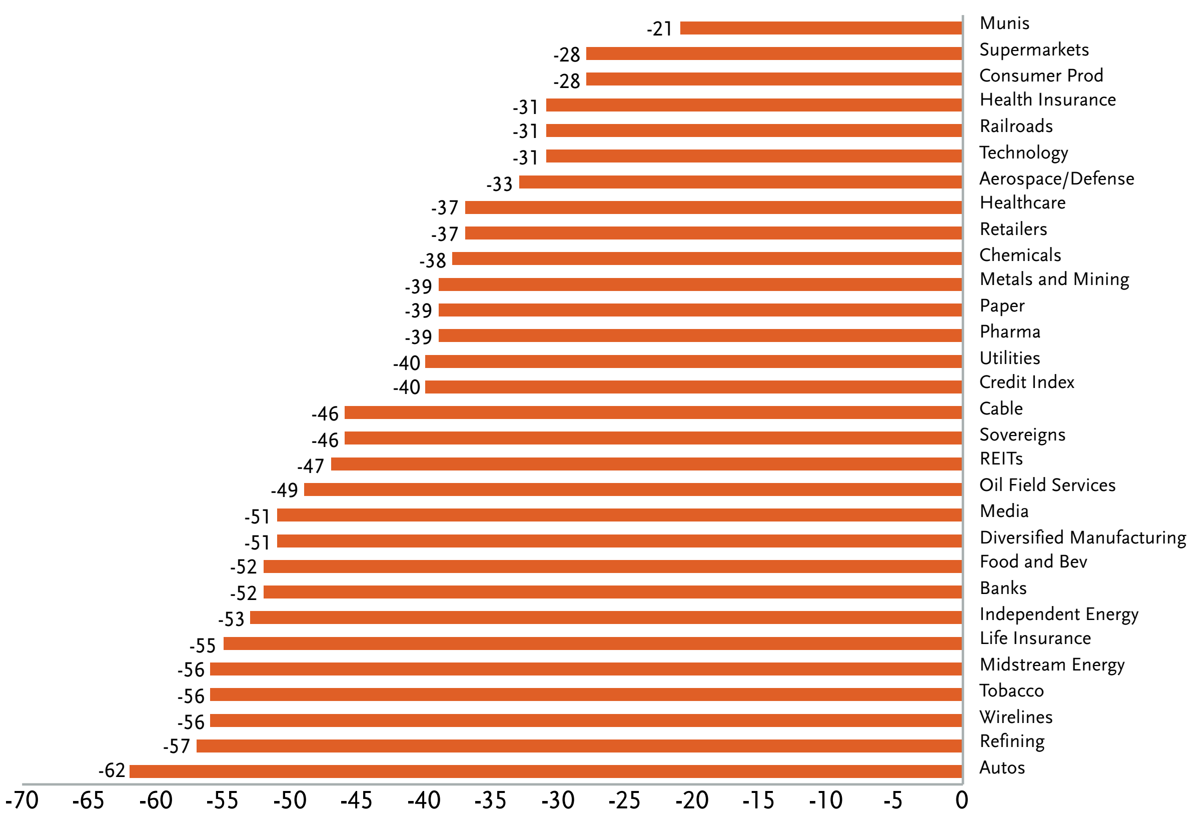
July OAS Sector Changes



Source: Barclays Capital

YTD Sector OAS Change

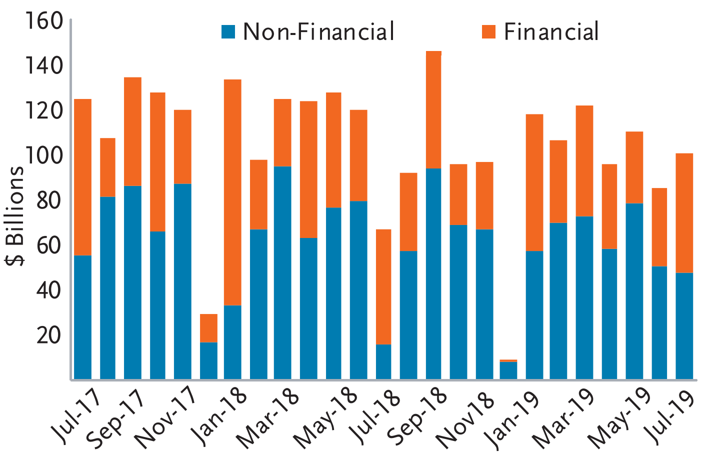


Source: Barclays Capital

July Investment Grade Supply

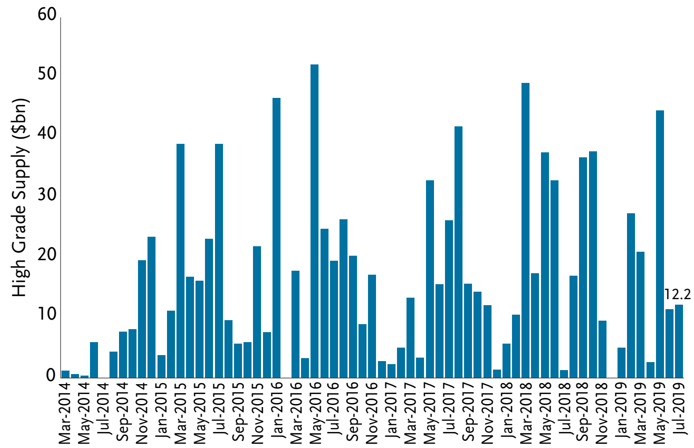
Attractive funding costs yielded heavy new issue volumes of $101 billion, balanced between industrials ($48 billion) and financials ($53 billion). M&A-related supply was a relatively modest $12.15 billion, comprised of four acquisition related deals, including Boeing ($5.5 billion across six tranches to help fund Embraer joint venture), Total ($4 billion across four maturities to fund asset purchases from Anadarko, 10yrs priced at 78, 30yrs at +93) and Micron Tech ($1.75 million, 10yrs priced at 260). New issue concessions were modest with a few exceptions, namely Boeing, which tapped the market on two other occasions this year, likely to plug the cash burn related to the 737-Max issues. The largest non M&A related deal came from United Health ($5.5 billion across five maturities, 10yrs priced at +80, 30yrs at +110). ■

IG Monthly Supply



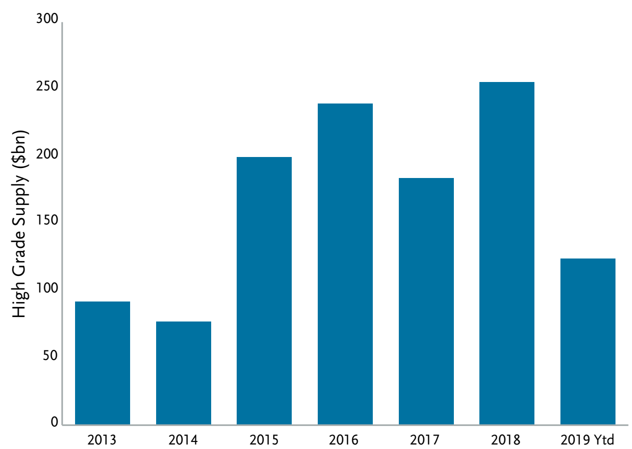
Source: BofA Merrill Lynch Global Research

M&A Related Supply (High Grade)



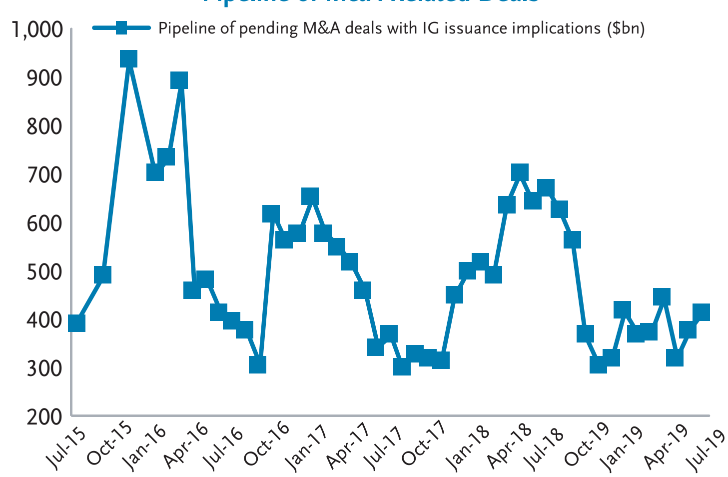
Source: BofA Merrill Lynch Global Research

Annual M&A Related Supply (High Grade)



Source: BofA Merrill Lynch Global Research

Pipeline of M&A Related Deals



Source: BofA Merrill Lynch Global Research, Bloomberg