TCW

# INSIGHT

MONTHLY COMMENTARY

## Loan & CLO Review – July 2019

**DREW SWEENEY & PALAK S. PATHAK** | 13 AUGUST 2019

The loan market chalked up another very strong month in July but just as it is difficult for swimmers to see the riptide that threatens to pull them out to sea, investors may fail to notice the potential dangers associated with the increasing dispersion of performance among loans and industries.

First, as dispersion increases, investors have to ask the question - are some loans and loan industries trading too tight or are other loans trading too wide? If the answer is the former, then we could see the broader loan index weaken in price. A second risk dispersion can play in bank debt is it can understate the number of borrowers who are losing access to the capital markets. This of course plays a risk to the broader economy.

As we navigate our way through this earnings season, a few consistent themes have become more pronounced. Good earnings typically result in a $\frac{1}{8}$th to $\frac{1}{4}$ point gain while an earnings miss can result in a 5+ point drop. Investors do not seem to feel confident enough to hold positions with any degree of "smoke." This is particularly true of cyclical industries, including Energy, Retail, Metals and Consumer Goods. More recently, Healthcare has fallen out of favor as the regulatory environment seems to be changing and doing so quite significantly in certain segments of the sector. Another theme present in July was strong appetite for double B paper. At the end of July, we saw UPC Media, Unitymedia, Las Vegas Sands and First Data all pay off. This resulted in approximately $13 billion of double B paper going away. It is difficult to know whether the demand for double B paper was driven by investor sentiment and a desire if it was simply rating-sensitive structures (CLOs) replacing lost paper. The demand for higher quality loans has been unwavering.

While the loan market has been moving higher, LIBOR has continued to decline. On a net-net basis this is resulting in the lowest average coupon for loans since November 2018. These rate concerns have led to persistent retail outflows, which have been mitigated by strong CLO generation, CLO warehouse demand and crossover high yield investors.


**Drew Sweeney**
Managing Director
Fixed Income


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.


**Palak S. Pathak, CFA**
Senior Vice President
Fixed Income


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.

Often, when new issue supply becomes very strong, we see the secondary market weaken and primary spreads widen. July demand, however, was truly robust. Institutional new issue supply for the month was the largest of 2019. Despite a strong primary market, spreads generally tightened, often inside of original price talk. Demand for double B new issue loans often resulted in syndication books that were two or three times oversubscribed. Finally, despite the large new issue calendar, the secondary market traded higher. Of course, mitigating the strong supply was the number of deals that paid off.

### Performance - Loans

In July 2019, the Credit Suisse Leveraged Loan Index (CS LLI) and the S&P Leveraged Loan Index (S&P/LSTA) were up 0.78% and 0.80%, respectively.

- Year-to-date, ending July 31, the CS LLI was up 6.24% and the S&P/LSTA was up 6.59%.
- For the 12 months ending July 31, the CS LLI was up 4.10% and the S&P/LSTA was up 4.03%.

During the month, higher quality paper outperformed lower quality loans. Triple Bs and double Bs outperformed all other categories. Single Bs only slightly lagged double Bs but split single Bs and triple Cs trailed more dramatically while distressed loans were down on the month. On a year-to-date basis, double Bs, triple Bs and split double Bs have materially outpaced single Bs, triple Cs and distressed loans.

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**

| | July | YTD | LTM |
|---|---|---|---|
| Split BBB | 0.92% | 6.52% | 4.65% |
| BB | 0.83% | 6.84% | 4.33% |
| Split BB | 0.83% | 6.78% | 3.91% |
| B | 0.80% | 6.08% | 4.31% |
| Split B | 0.38% | 8.08% | 5.18% |
| CCC/Split CCC | 0.52% | 3.31% | 0.81% |
| Distressed (CC, C and Default) | -0.79% | 6.19% | -4.55% |

Source: Credit Suisse Leveraged Loan Index

### Sector Performance

Nineteen of 20 sectors provided positive returns in the CS LLI for the month of July. The top performing sectors were Consumer Durables (1.61%), Forest Products/Containers (1.26%) and Financial (1.18%).

The worst performing sectors for the month were Energy (-0.04%), Consumer Non-Durables (0.43%) and Healthcare (0.58%).

On a year-to-date basis, Food & Drug (8.84%), Housing (7.31%) and Media/Telecom (7.16%) were the top performing sectors.

In the last 12 months, Financial, Utility and Food & Drug have led all sectors with total returns of 5.36%, 5.35% and 5.30%, respectively. Energy, Consumer Durables and Metals/Minerals provided the worst performing sectors with returns of 1.82%, 1.81% and 0.15%, respectively.

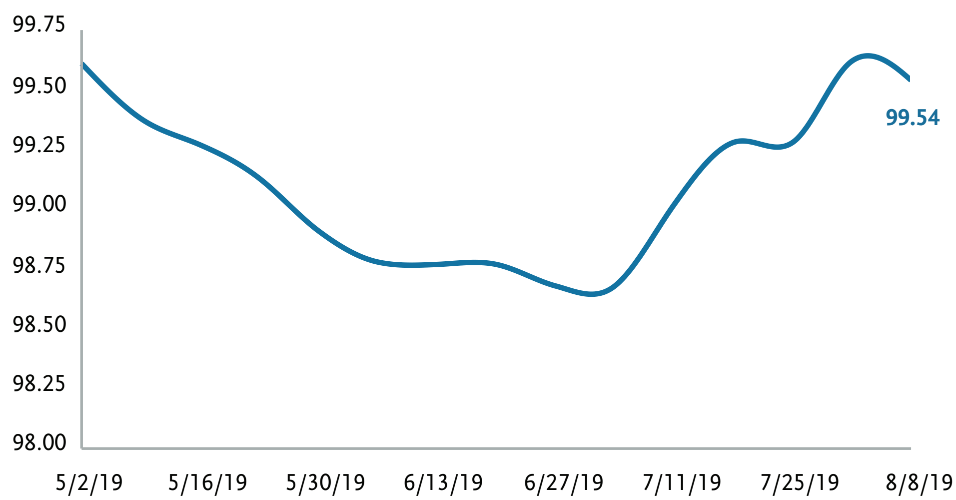
### Industry Returns

| Sector | July | YTD | LTM |
|---|---|---|---|
| Aerospace | 1.08% | 6.63% | 4.67% |
| Chemicals | 0.64% | 6.42% | 4.54% |
| Consumer Durables | 1.61% | 1.91% | 1.81% |
| Consumer Non-Durables | 0.43% | 5.71% | 4.15% |
| Energy | -0.04% | 4.51% | 1.82% |
| Financial | 1.18% | 6.74% | 5.36% |
| Food and Drug | 1.07% | 8.84% | 5.30% |
| Food/Tobacco | 1.05% | 6.33% | 4.35% |
| Forest Prod/Containers | 1.26% | 6.58% | 4.08% |
| Gaming/Leisure | 1.00% | 7.01% | 4.98% |
| Healthcare | 0.58% | 5.91% | 3.81% |
| Housing | 0.95% | 7.31% | 4.59% |
| Information Technology | 0.96% | 6.30% | 4.22% |
| Manufacturing | 0.78% | 5.81% | 3.37% |
| Media/Telecommunications | 0.75% | 7.16% | 4.07% |
| Metals/Minerals | 0.76% | 4.59% | 0.15% |
| Retail | 0.66% | 5.87% | 3.26% |
| Service | 0.62% | 5.66% | 4.06% |
| Transportation | 0.62% | 5.17% | 4.57% |
| Utility | 0.72% | 6.76% | 5.35% |

Source: Credit Suisse Leveraged Loan Index

CS LLI prices (excluding defaults) increased 27 basis points (bps) in July while the average bid of the S&P LCD flow-name loan composite increased 86 bps from 98.68 to 99.54. The average flow name bid is up 424 bps on a year-to-date basis. Large liquid name bids were driven in part by the increased demand from high yield crossover investors.

### Average Loan Flow-Name Bid




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

### Performance - CLOs

CLOs underperformed corporate credit in July with monthly returns totaling 0.28% vs. 0.80% for loans, 0.56% for HY and 0.52% for IG. Spreads widened across the stack with mezzanine tranches the most negatively affected and short AAAs (1-2 years left of reinvestment) the least affected due to higher demand for short duration paper. AAs and As were +5 bps wider, BBBs +15 bps wider and BBs +30-50 bps wider. Weakness in mezz was due to heavy CLO supply in the primary market, low demand for floaters amid a dovish Fed and a decline in Market Value OC (MVOC) levels. YTD performance remains positive, especially for BBs as coupon return outweighed price declines.

BWIC activity decreased during the month with only $2.3 billion out for bid in July vs. $4.3 billion in June. Spread dispersion increased with trading levels dependent on manager, duration, price convexity and MVOC.

CLO equity payments increased by 30-40 bps quarter over quarter. As per Nomura research, "According to Intex, out of the 668 deals that reported, 63% had at least a 25 bps increase in equity distribution in the July 2019 payment."[1] The increase in payments was due to higher collateral WAS (+5 bps YTD) and an inversion of the 1mo / 3mo LIBOR basis with 1 month LIBOR paying more than 3 month LIBOR. The LIBOR basis impacts equity returns as over 75% of loan issuers reference 1-month LIBOR while CLO debt is based off of 3-month LIBOR.

**Secondary CLO 2.0 Total Returns**

| | July | YTD | LTM |
|---|---|---|---|
| **Total** | **0.28%** | **3.88%** | **3.50%** |
| AAA | 0.33% | 3.15% | 3.43% |
| AA | 0.28% | 4.02% | 3.46% |
| A | 0.36% | 5.41% | 3.52% |
| BBB | -0.06% | 6.59% | 3.74% |
| BB | -0.18% | 7.80% | 4.20% |
| B | 0.56% | 6.88% | 3.53% |

Source: JPM CLOIE Index

**Secondary CLO 2.0 Spreads (DM)**

| | July | MoM Change (bps) |
|---|---|---|
| AAA | 95-135 | +5 |
| AA | 160-195 | +5 |
| A | 205-275 | +5 |
| BBB | 310-415 | +15 |
| BB | 650-775 | +50 |
| B | 975-1100 | +50 |

Source: TCW

## Technical Conditions- Demand

July retail loan outflows were approximately -$3.7 billion and the loan market has now reported 37 consecutive weeklyoutflows as expectations for the Federal Reserve to lower rates continued to weigh on retail demand. AUM for the loan mutual fund base is $110 billion, down from a high of $154 billion in October 2018. Year-to-date outflows for loan funds total -$23.2 billion, which compares to +$13.8 billion of inflows for the comparable period in 2018. These are the largest outflows for loans since 2014.

CLO primary issuance decreased slightly over the month with $9.2 billion pricing in July vs $10 billion in June. AAA spreads widened 2-4 bps to 132 dm for tier 1 managers. Mezz spreads also widened 15-30 bps with single As widening the most on an absolute basis. Weaker mezz levels were mainly due to the increase in supply. Many new issues over the month came with AAAs and equity preplaced and/or anchored; thus, the amount of mezz that needed to be issued in order to get these deals done became more difficult to place. In many cases, a portion of AAAs had to be set aside in order to get the mezz sold through linked orders (i.e. investors would get a better AAA allocation if they linked it with a mezz order). Tiering was also evident with the majority of new issue AAAs pricing within a 10 bps range (130-140dm) while BB discount margins differed by over 100 bps (690-820 dm).

Due to wider primary spreads, CLO cost of debt increased from 184 bps to 192 bps over the month. With loan spreads tightening in July, the equity arb decreased by 15 bps.

Refi activity continued to pick up with 12 refis pricing over the month versus 10 in June. Two-year refis (end of reinvestment July 2021) were in the 114-118 dm range for AAAs.

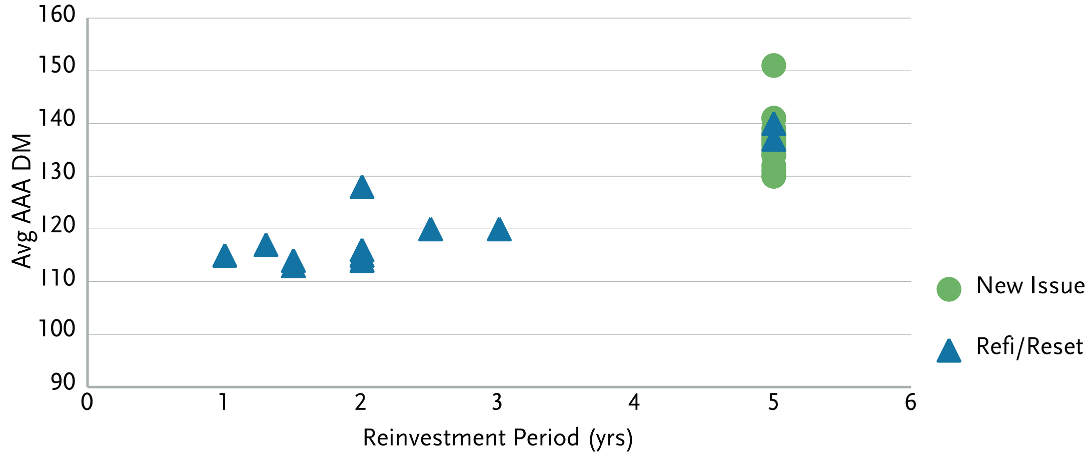
**CLO New Issuance**

| | July | YTD 2019 | YTD 2018 | YoY %Δ |
|---|---|---|---|---|
| New Issue ($bn) | $9.20 | $74.00 | $76.85 | -4% |
| Refi (#) | 12 | 41 | 50 | -18% |
| Reset (#) | 3 | 22 | 144 | -85% |

Source: TCW

1 Nomura Global Markets Research, Securitized Products Weekly (July 26, 2019): 18-20.

### New Issue BSL AAA DM – July




Source: TCW

### Tier 1 New Issue Spreads (5 yr reinv)

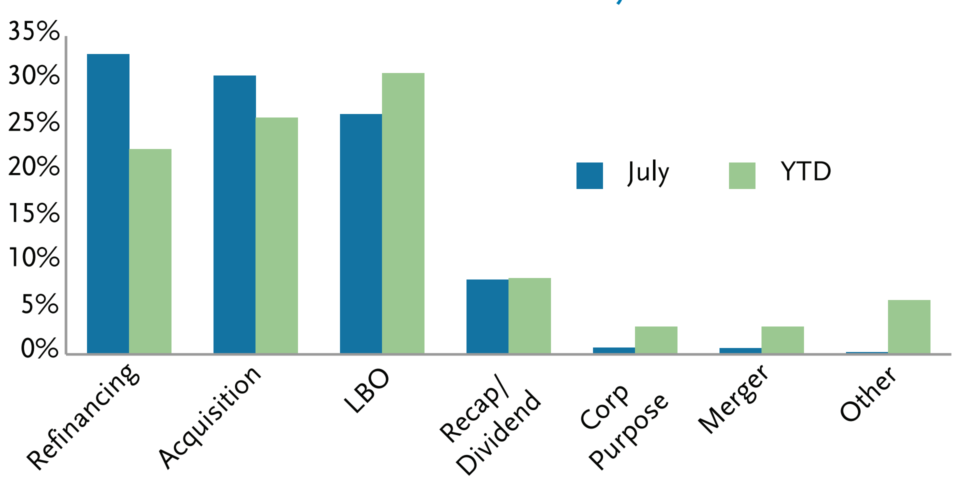
| | July | MoM Changes | YTD Changes |
|---|---|---|---|
| AAA | 132 | +4 | +4 |
| AA | 180 | +5 | -20 |
| A | 250 | +10 | -50 |
| BBB | 385 | +15 | -15 |
| BB | 700 | +25 | -20 |

Source: TCW

## Technical Conditions- Supply

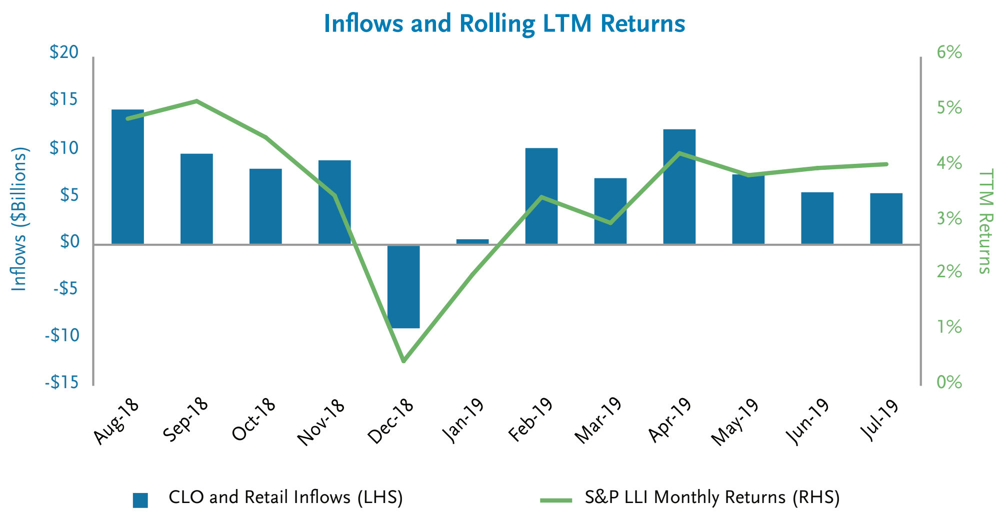
July acquisitions, mergers and LBOs represented 56% of primary issuance, which was slightly below the 60% mark set year-to-date. Interestingly, as we saw demand grow for loans during the month, we also saw investment banks roll out more opportunistic refinancings. This is a trend we have seen over the last three years. The moment the market seems open, issuers hit it. In July, refinancing activity grew to over 30% versus the year-to-date average, which is closer to 20%.

### Institutional New Issue Volume by Use




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

New issue spreads in July tightened month-over- month and were -14.0% tighter on a year-to-date basis. New issuance spreads remain 1.0% wider than 12 months prior.

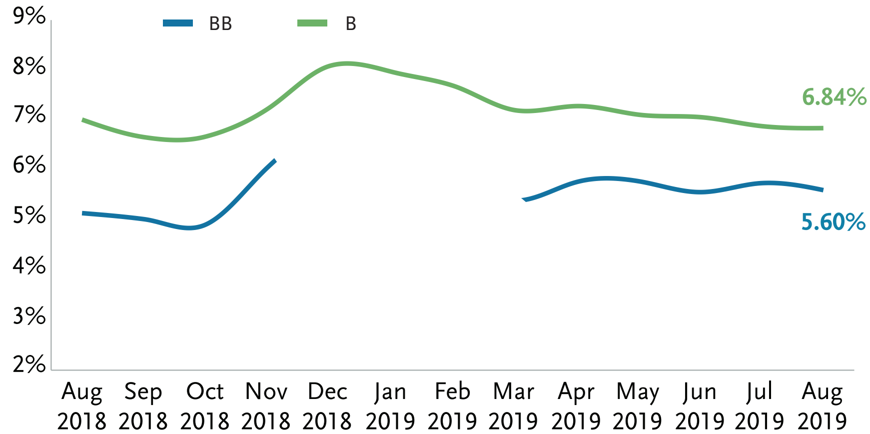
**New Issue Spread Changes**

| | All Loans |
|---|---|
| July-18 | 398 |
| Sep-18 | 377 |
| Dec-18 | 452 |
| Mar-19 | 404 |
| June-19 | 404 |
| July-19 | 389 |
| Month-Over-Month Change | -3.72% |
| YTD Change | -14.03% |
| LTM Change | 1.04% |

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

For new issues, yields remained essentially flat month-over-month. Double B yielded 132 bps year-to-date while single B spreads tightened 108 bps.

Average New-Issue Yields




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

## Fundamentals – Loans

There were two loan defaults in July: Weatherford (Energy) and Blackhawk Mining (Metals). The default rate changed from 1.56% in June to 1.54% in July, based on par outstanding.

The last 12-month default tally for the S&P/LSTA is 23. Retail leads all categories with six defaults while Services & Leasing is just behind it with four defaults. Oil & Gas is the third leading category with three defaults.

Lagging 12-Month Default Rates

| Actual | May-19 | June-19 | July-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 outnumbered upgrades, CLO WARF levels continued to increase. Per Moody's, median Caa holdings increased to 3.63% (+23 bps) due to loan facility downgrades in April and May. Loans rated B3 on the issuer level also increased to 26% in CLOs.

Overcollateralization (OC) and WAS levels remained stable with the median Sr. OC cushion at 10%, median Jr OC cushion at 4.3% and WAS at 343 bps. BB MVOC levels decreased over the month by 0.4% to 106.5%

## Valuation

Since 1992, the average 3-year discount margin ("DM") for the CS LLI is 460 bps. If the global financial crisis (2008 and 2009) is excluded, the 3-year discount margin for the CS LLI is 417 bps. The 3-year DM finished the month at 449 bps, which tightened 11 bps from the prior month.

The DM spread differential between Double Bs and Single Bs is 48 bps wider from August 2018 to July 2019 and 10 bps wider than the historical spread differential since inception.

**3-Year Discount Margin Differential Between BBs and Single Bs**

| | |
|---|---|
| 1/1992-7/2019 Average | 189.6 |
| Aug-18 | 151.5 |
| Jul-19 | 199.1 |

Source: Credit Suisse Leveraged Loan Index

**CS LLI Snapshot**

| | |
|---|---|
| YTD Total Return* | 6.24% |
| Average Price | 97.02 |
| Spread | 352 bp |
| Coupon | 5.93% |
| Current Yield | 6.14% |
| Yield (3-year life) | 6.33% |
| Discount Margin (3-year life) | 449 bp |

*S&P/LSTA was up 6.59%

| | Spread | DM (3-Year Life) |
|---|---|---|
| Split BBB | 197 bps | 203 bps |
| BB | 256 bps | 277 bps |
| Split BB | 312 bps | 363 bps |
| B | 384 bps | 476 bps |
| Split B | 538 bps | 970 bps |
| CCC/Split CCC | 673 bps | 1,209 bps |
| Distressed (CC, C and Default) | 457 bps | 3,074 bps |

Source: Credit Suisse Leveraged Loan Index

## Summary and Looking Forward

As of July 31, the S&P/LSTA Index imputed default rate was 2.17%, down from 2.28% in the prior month.

The loan market was up throughout the month despite the heavy new issue calendar. Offsetting the supply was an enormous amount of loan repayments. Loans were prepaid for a variety of reasons. Some companies were acquired, others used proceeds from investment grade or high yield bonds to repay their bank debt. Either way, the repayments, which were heavily skewed to double B paper, left most investors looking to replace those high-quality exposures. Given the fact that new issuance slows down in August and the fact that CLOs have continued to be very active and that CLO warehouses continue to ramp, one could assume that loan prices will grind higher in the back half of August. However, the macroeconomic environment is creating a significant amount of uncertainty for all risk markets. If we see crossover sellers and continued retail outflows, it could certainly overwhelm the near-term demand from CLOs

We are also seeing a greater dispersion among returns as some sectors (Energy) traded very heavily throughout the month and other single B issuers that missed earnings expectations were penalized significantly, often with prices dropping dramatically. We would expect this trend to continue in August regardless if the broader loan market grinds higher in the back half of the month. JP Morgan recently highlighted that the number of issues trading below $90 and $80 has grown by 54 and 25 issues, respectively, since September 2018 to 104 and 43. In other words, both segments have doubled over the past nine months. The number of loans trading below $96 has also risen by 122% since September to 278.

For CLOs, August is typically a slow month in the secondary and primary markets. If this holds true, then spreads should remain range-bound given limited supply. Demand should also hold steady as CLO spreads remain attractive on a relative value basis as they have underperformed credit and securitized products over the past couple of months. However, global macro volatility from the ongoing trade war with China could lead to decreased demand for credit products, especially CLO mezz. In addition, if loan downgrades continue, OC cushions could deteriorate along with MVOC levels which would also be a headwind for CLO spreads. ■