TCW

INSIGHT

MONTHLY COMMENTARY

August Credit Update

TAMMY KARP | SEPTEMBER 6, 2017

Some volatility returned to the credit markets in August as geopolitical and idiosyncratic risks were front and center. Those pressures, coupled with already frothy valuations and a heavy primary calendar, resulted in the credit index widening 6 basis points (from +98 to +104), the largest monthly move wider since mid '16. The market had many negatives to contend with: The North Korea ICBM launch over Japan, Hurricane Harvey, a looming U.S. budget deal and raising of the debt ceiling – not to mention the still-contentious and difficult task of passing tax reform. In addition to the political and geopolitical issues, credit markets faced increased idiosyncratic risks across several sectors and issuers, notably cable (M&A headlines), pharma (generic pricing pressure), tobacco (FDA nicotine initiative) and grocers (Amazon threat post Whole Foods acquisition).

The Harvey impact on spreads has been modest thus far, with energy only marginally wider post hurricane and P&C no wider than the overall market. For IG utilities in the area (CNP, ETR, AEP) no major damage appears to have occurred to the main infrastructure (transmission lines etc). Moreover, these are regulated entities that are generally allowed to recover costs via the rate base.

For the P&C insurers (primary and reinsurers), estimates have varied, ranging from $70-$100 bln of total Harvey-related economic losses. Using past storms as a proxy, about 30% of losses are typically insured which would result in $20-$30 bln in losses for insurers (auto claims will be high, as well as commercial/business interruption). The industry as a whole has record high capitalization levels w/ ~ $700 bln in regulatory surplus, which means Harvey should not pose a credit/bondholder issue. Energy spreads marginally underperformed (+11 bps in August vs. industrials +10 bps) and the Harvey impact has been minimal thus far. Refining disruptions, while temporary in nature, have been significant. It is estimated that 3-4 mln bpd of refining capacity was offline the week of the storm (about 20% of total U.S. refining capacity) compared to less than 1 mln bpd of production disruption – causing oil and gasoline prices to diverge as well as the Brent/WTI differential to widen. That has begun to remediate as refining capacity has come back on line.

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Credit Index OAS and VIX

Key	Axis	Name	Last	Minimum		Maximum	
	Right	VIX	12.230	9.360	07/21/2017	16.040	08/10/2017
	Left	U.S. Credit – OAS	105.044	97.413	07/27/2017	117.656	01/11/2017

Source: Bloomberg Barclays

Index Performance: The investment grade credit index widened 6 basis points in August, ending the month at an OAS of +104 bps over Treasuries. Of the broad sectors, industrials underperformed on increased idiosyncratic risks across several sectors and/or issuers. The worst performing sector was cable (+23 bps) as M&A fears negatively impacted spreads. There were unconfirmed reports that issuers Softbank/Sprint and/or Altice – both HY issuers — were considering bidding for Charter Communications. Charter already has a very large capital structure with $56 billion in bonds ($39 billion IG secured, $17 bln HY). A combination of either Sprint/Charter or Altice/Charter would result in a massive capital structure — larger than most sectors in HY. There are many obstacles to getting a deal of this magnitude done including limited debt capacity at the secured/IG box and a pro forma economic ownership structure that would result in substantial dilution. Pharma was the second worst performer in the month (+17), giving back much of its YTD outperformance. The August underperformance was led by the generics, most notably Teva, which widened 90 bps on the month due to weak earnings and subsequent downgrade concerns. Higher quality pharma modestly outperformed with AA/A names wider 8 bps on average while BBBs (x generics) widened 15 bps. The best performing sectors in August were metals and mining (-2 bps), REITs (-2) and sovereigns (+0). Year to date, metals and mining continues to be the best performing sector at -42 bps tighter with an excess return of 6.64%.

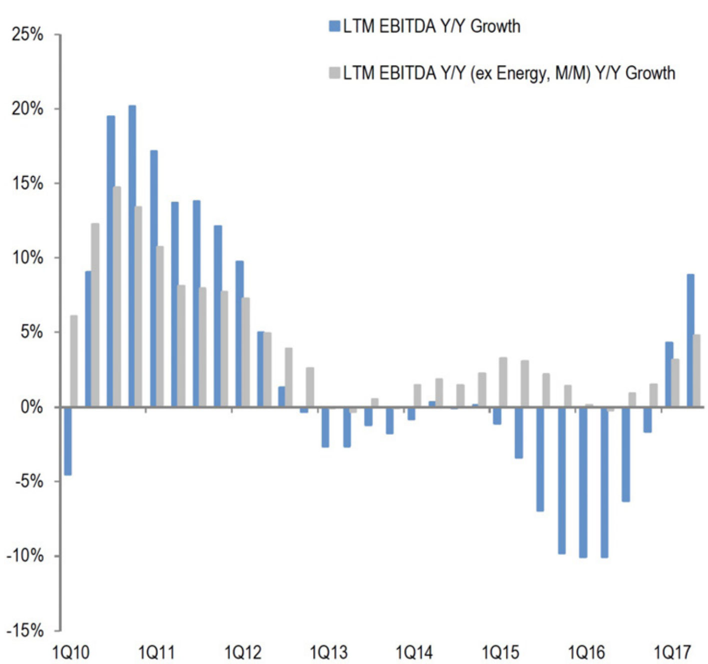
August Credit Index Returns

	Month-to-Date Excess Return	Month-to-Date Total Return	Option-Adjusted Spread	Option-Adjusted Spread Month-to-Date Change
Credit Index	-.50%	.84%	104	+6
Industrials	-.81%	.69%	116	+10
Financials	-.30%	.78%	101	+5
Utilities	-.34%	1.55%	105	+4
Municipals	.15%	2.39%	134	+1
Sovereigns	.03%	1.69%	118	+0

Source: Bloomberg Barclays

Q2 '17 Credit Fundamentals Recap: With 2Q earnings in the rear view mirror, we can now reflect on credit fundamentals for the IG universe. Metrics for the non-fin IG universe improved in the quarter as EBITDA grew +8.8% on an LTM basis (measured as LTM Q2'17 vs LTM Q2'16). Excluding commodities, EBITDA growth was more modest at 4.8%. Net leverage for the IG corporate universe ended the quarter at 2.37x, down .15x on a year-over-year basis but still close to the all-time peak (~ 2.6x in 3Q '16) and almost a turn higher vs. the trough in 2011. The energy and metals sectors accounted for nearly all of the -.15x net leverage improvement. Keep in mind that while we have seen some remediation in energy earnings and metrics, leverage for the sector is still significantly higher than the historical mean.

EBITDA Growth +8.8%, X- Commodities +4.8%



Source: JP Morgan

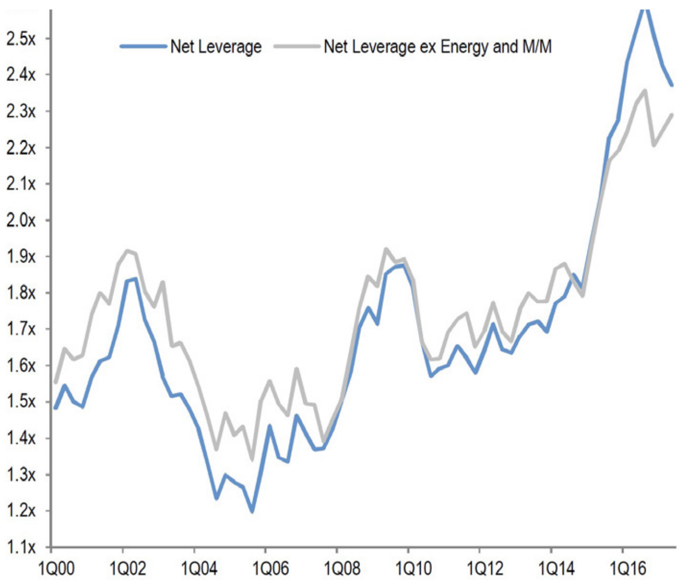
Metals and Energy EBITDA +66% and 25% Respectively (LTM 2Q'17)

	2Q17 change		LTM level
	($mn)	%	($mn)
Automotive	-832	-1.9%	42,567
Diversified Media	-744	-1.9%	39,207
Transportation	-66	-0.2%	39,836
Telecoms - Domestic	132	0.1%	101,109
Technology	469	0.3%	181,392
Food/Beverages	635	0.7%	94,148
Non-Food Retail	488	0.7%	71,448
Food/Drug Retail	1,206	3.0%	41,516
Chemicals	1,281	3.7%	36,279
Pharmaceuticals/Medical Products	9,986	6.2%	169,911
Consumer Products	3,196	8.0%	43,240
Cable/TV	3,284	8.4%	42,328
Utilities	12,324	11.5%	119,661
Capital Goods	9,607	12.0%	89,838
Telecoms - Yankees	10,227	13.4%	86,829
Healthcare/HMOs	6,010	13.4%	50,991
Energy	46,718	25.3%	231,345
Metals/Mining	20,718	66.1%	52,078
Industrials Total (ex Metals/Mining, Energy)	**57,203**	**4.8%**	**1,250,301**
Industrials Total	**124,639**	**8.8%**	**1,533,724**

Second and third column show the change in 2Q17 vs 2Q16. The fourth column shows the 2Q17 level.

Source: JP Morgan

Net Leverage Down – .15x y-o-y, Down .05x q-o-q



Source: JP Morgan

Metals and Energy Leverage Down

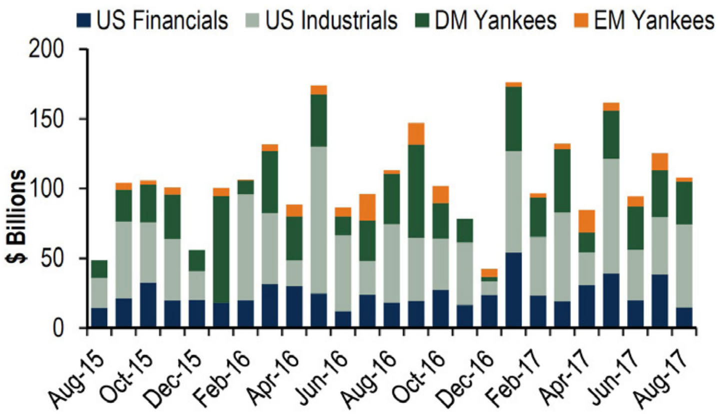
Sector	2Q17 Net Leverage	Y-O-Y change	10 year historical mean	Current vs. Mean
Metals/Mining	1.38x	-1.68x	2.78x	-1.4x
Energy	2.76x	-.91x	1.87x	.89x
Healthcare/HMO	.63x	-.44x	.5x	.13x
Telecom Yankees	2.48x	-.28x	2.4x	.08x
Food/Bev	2.44x	-.13x	1.99x	.45x
Media	2.51x	-.11x	2.02x	.49x
Capital Goods	1.15x	-.07x	.79x	.36x
Autos	-.39x	-.04x	-.21x	-18x
Food/Drug Retail	3.03x	-.04x	2.57x	.46x
Consumer Products	1.52x	-.03x	1.47x	.05x
Utilities	4.64x	.00x	4.05x	.59x
Cable/TV	3.06x	.01x	2.82x	.24x
Non-Food Retail	1.77x	.04x	1.74x	.03x
Transportation	1.92x	.09x	1.58x	.34x
Telecom Domestic	2.44x	.12x	1.8x	.64x
Pharma/Med devices	1.83x	.20x	.8x	1.03x
Chemicals	2.18x	.25x	1.59x	.59x
Technology	-.20x	.29x	-.83x	.63x
Non Fin Total	**2.37x**	**-.15x**	**1.83x**	**.54x**

The metals and energy sectors saw the biggest y-o-y declines in net leverage in August. Biggest increases came from tech, chems and pharma/med devices.

Source: JP Morgan

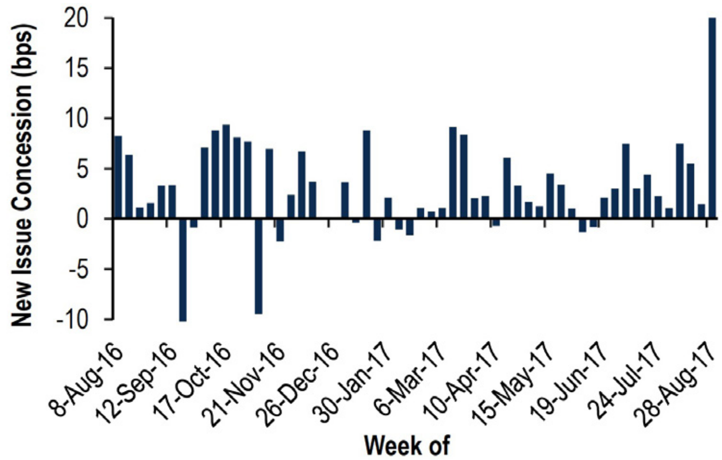
August Investment Grade Supply: At $108 billion, new issue volumes were robust for what is typically a seasonally slow summer month. Industrial issuance dominated at $79 bln, 74% of the total. M&A related supply accelerated to $38 billion and included deals from Amazon ($16 bln across several tranches to fund Whole Foods acquisition; 10yr priced at +90, 30yr at +125) and BATSLN ($17 bln to fund RAI acquisition; 10yrs priced at +130, 30yrs at +170). Heavy supply coupled with overall market weakness caused new issue concessions to widen from an average of 2bps (YTD) to 6 bps in August. New issue performance was mixed though in general, the deals with greater concessions performed better – notably AMZN and BATSLN, both of which priced with about 12-15 bps of concession. Of course the downside to a bigger new-issue concession is that it typically results in wider secondary spreads. ■

Monthly IG Issuance



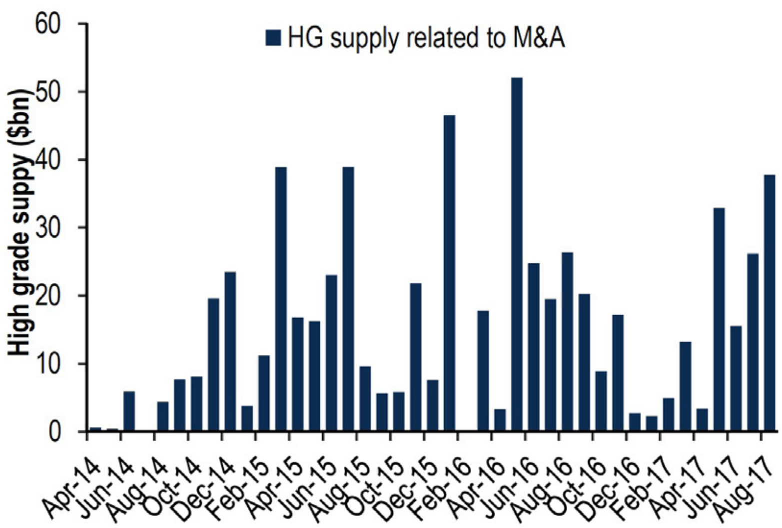
Source: BofA Merrill Lynch Global Research

New Issue Concessions



Source: BofA Merrill Lynch Global Research

M&A Related Supply Volumes



Source: BofA Merrill Lynch Global Research