

MONTHLY COMMENTARY

August Credit Update

TAMMY KARP | 10 SEPTEMBER 2019

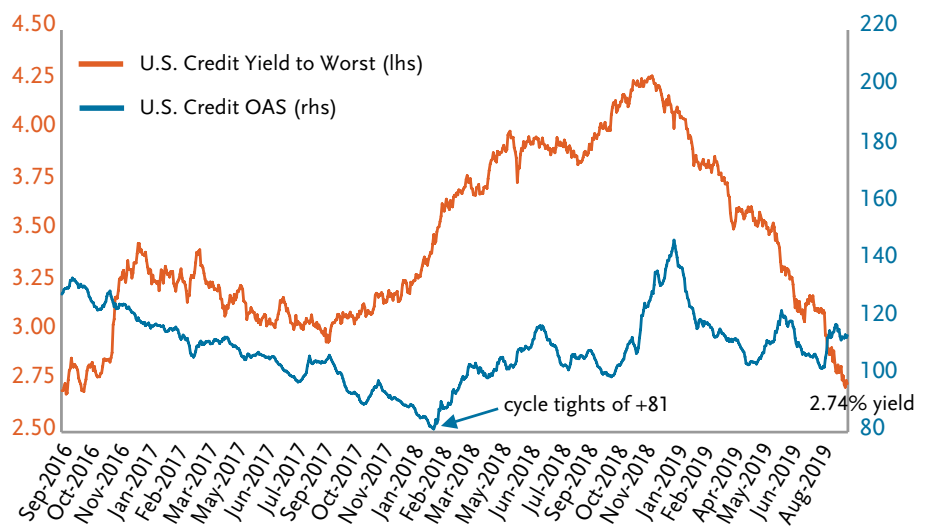
August was a rough month for risk assets as a new round of trade tariffs took effect on September 1. While the protracted trade war was the main catalyst for market volatility, idiosyncratic risks emanating from the U.K. (Brexit) and Argentina (bonds in the \$30's, capital controls) put further pressure on an already tenuous market. The macro weakness and increased recession risk led to an inversion of U.S. 2yr/10yr Treasury yields for the first time since before the financial crisis (2007). Credit continues to be vulnerable to a changing cycle after years of fundamental erosion via re-leveraging transactions. As we know, that has not been the driver of spread performance YTD. The driver has been the central bank-led risk grab from yield-starved investors in the wake of dropping global yields and \$17 trillion of negative yielding debt. However, it was the macro that drove spreads wider in August as the market digested the implications of a prolonged trade war on economic growth and an increased probability of a hard Brexit. The credit index OAS of +114 basis points (bps) over Treasuries was 11 bps wider in August, resulting in a monthly excess return of -0.92%. While spreads widened, returns were strong (+3.13% on the month) as yields dropped 35 bps to 2.74% (compared to cycle lows of 2.46% in May 2013). Year-to-date, the total return of the credit index is 13.35%, its strongest annual return since 2009.



Tammy Karp
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Fixed Income

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.

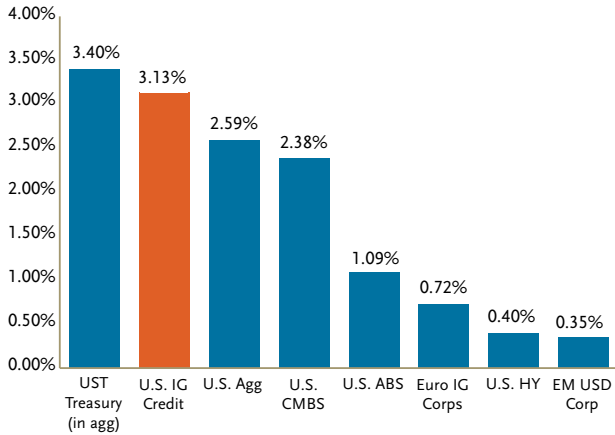
Credit Index Yields Fell 35 bps While Spreads Widened 11 bps



Source: Bloomberg Barclays

August Credit Update

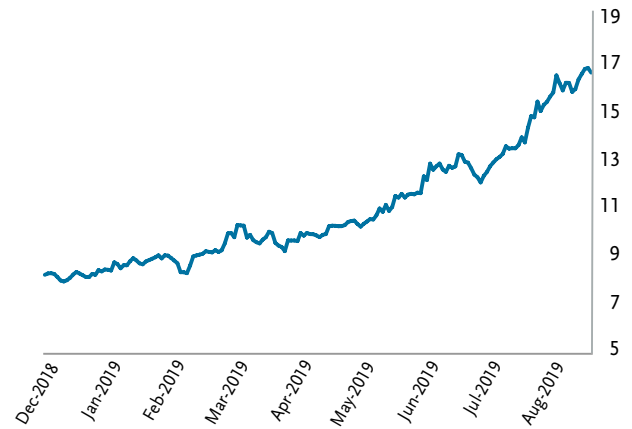
August Total Returns for Various Fixed Income Asset Classes



Source: Bloomberg

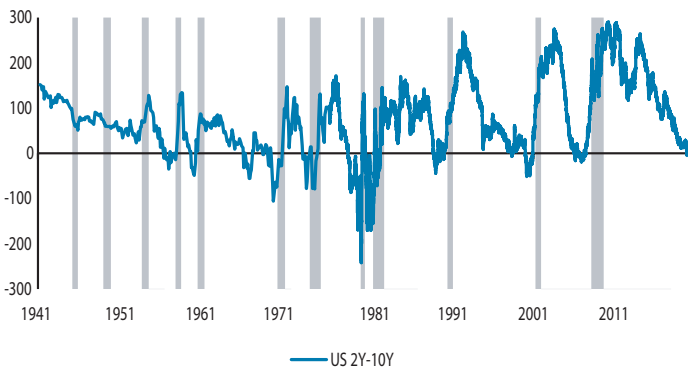
Yield Grab:

MARKET VALUE OF NEGATIVE YIELDING BONDS GREW TO \$17 TRILLION



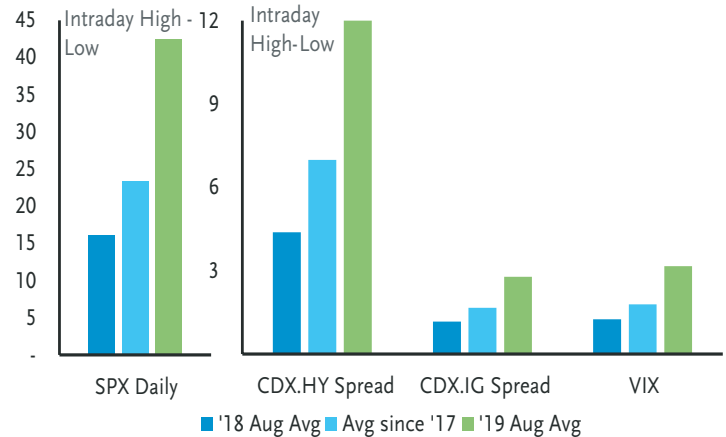
Source: Bloomberg

US 2/10's Yield Curve (bps) and Recessions



Source: Deutsche Bank, Bloomberg Finance LP, GFD, NBER

Volatility Spiked in August (Intraday Vol)



Source: Barclays

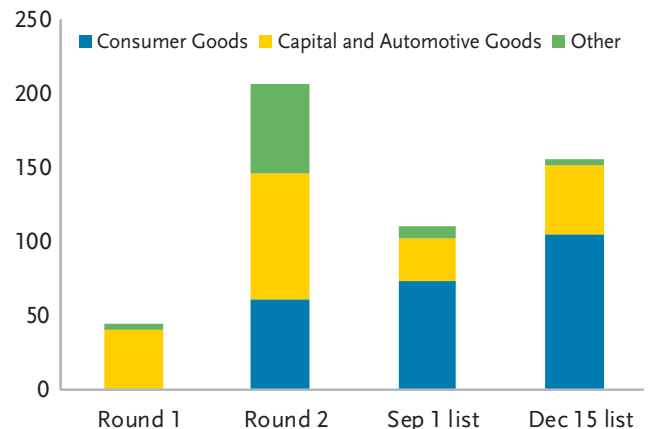
U.S. Tariffs on Chinese Imports

Effective	Description	Coverage (2018 Imports)	Tax
In effect	Steel and Aluminum (25% for steel, 10% for aluminum)	\$26bn	\$5bn
	Solar panels and washing machines (30%)	\$10bn	\$3bn
	Round 1 against China (25%)	\$45bn	\$11bn
	Round 2 against China (10%)	\$205bn	\$21bn
	Round 2 escalation (+15%)	\$205bn	\$31bn
	Round 3 against China, part 1 (15%, Sep 1)	\$110bn	\$17bn
Planned	Round 1 and Round 2 escalation (+5%, Oct 1)	\$250bn	\$13bn
	Round 3 against China, part 2 (15%, Dec 15)	\$155bn	\$23bn
Threatened	\$346bn Mexico Goods (25%)	\$346bn	\$87bn
	Autos (25%)	\$317bn	\$79bn

Source: BofA Merrill Lynch Global Research, Census Bureau, USTR

Note: Estimated coverage and tax are based on import data from the Census Bureau for 2018 and the product lists published by the USTR.

Tariffs by Bucket



Source: BofA Merrill Lynch Global Research

August Credit Update

Index Performance

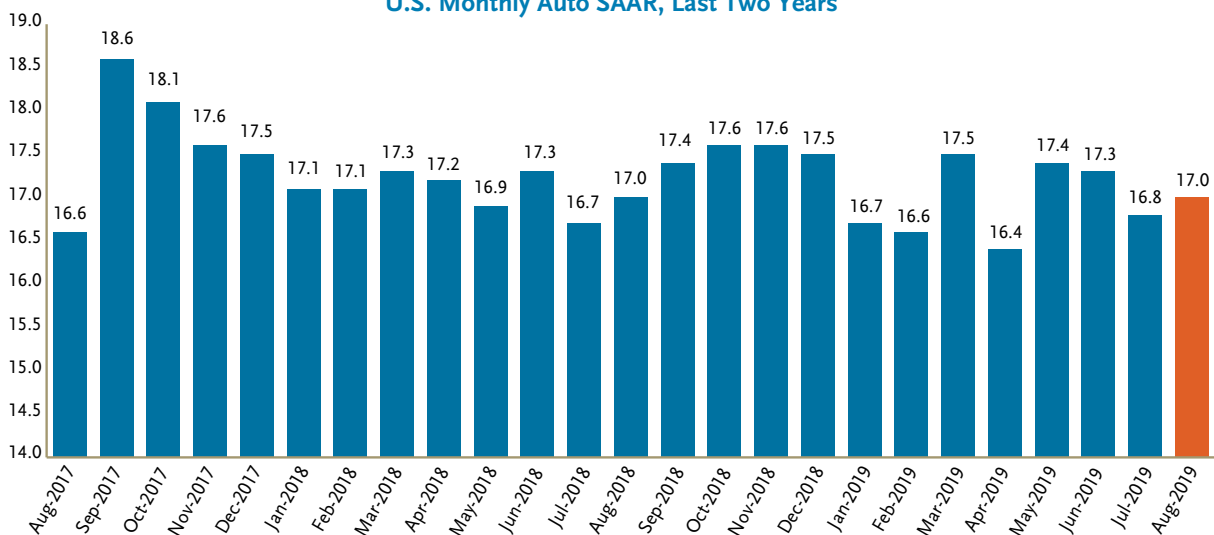
Global growth risks and the escalating U.S.-China trade war against the backdrop of lingering late cycle fears and relatively stretched valuations led to a big reversal in risk sentiment. The 11 bp move wider in spreads reversed all of July's move tighter (and then some), though lower Treasury yields produced positive total returns of 3.13% on the month and 13.35% YTD. Spread performance was generally weak across the board though we saw some decompression with BBBs underperforming, led by cyclical sectors like oil field services (+32 bps), independent energy (+23 bps), midstream energy (+23 bps), refiners (+21 bps) and metals (+21 bps). While energy prices (WTI and natural gas) recovered in the latter part of August, spreads did not as the intra month price volatility underscored fears of an economic slowdown and/or recession and its potential impact on demand. Best performing sectors were munis (+3 bps) and consumer products (+5 bps), both lower beta, higher rated/quality sectors. Year-to-date, autos (-46 bps) and banks (-43 bps) are the two best performing sectors. Banks, domestic banks in particular, are viewed as a safe place to hide in the face of continued re-leveraging and ratings degradation within the industrial sectors. Moreover, issuance out of the banking sector has been modest as banks have generally fulfilled their TLAC (total loss absorbing capacity) requirements. Auto spread remediation has occurred on the heels of better than feared auto sales (SAAR) and some progress on the cost restructuring side.

August Index Returns

	August Excess Return	August Total Return	YTD Excess Return	YTD Total return	8/30/19 OAS	Monthly OAS Change	YTD OAS Changed
Credit Index	-0.92%	3.13%	3.36%	13.35%	114	11	-29
Industrials	-1.23%	3.33%	3.78%	14.83%	128	14	-29
Financials	-0.63%	2.48%	3.67%	11.86%	107	10	-40
Utilities	-1.39%	4.53%	2.13%	15.84%	116	12	-28
Municipals	-0.50%	5.77%	3.10%	17.84%	121	3	-18
Sovereigns	-0.45%	4.63%	5.04%	17.24%	122	7	-39
AA	-0.59%	3.27%	1.77%	11.17%	63	6	-18
A	-0.88%	3.31%	2.88%	13.13%	91	9	-27
BBB	-1.15%	3.09%	4.60%	15.10%	158	15	-39

Source: Bloomberg Barclays

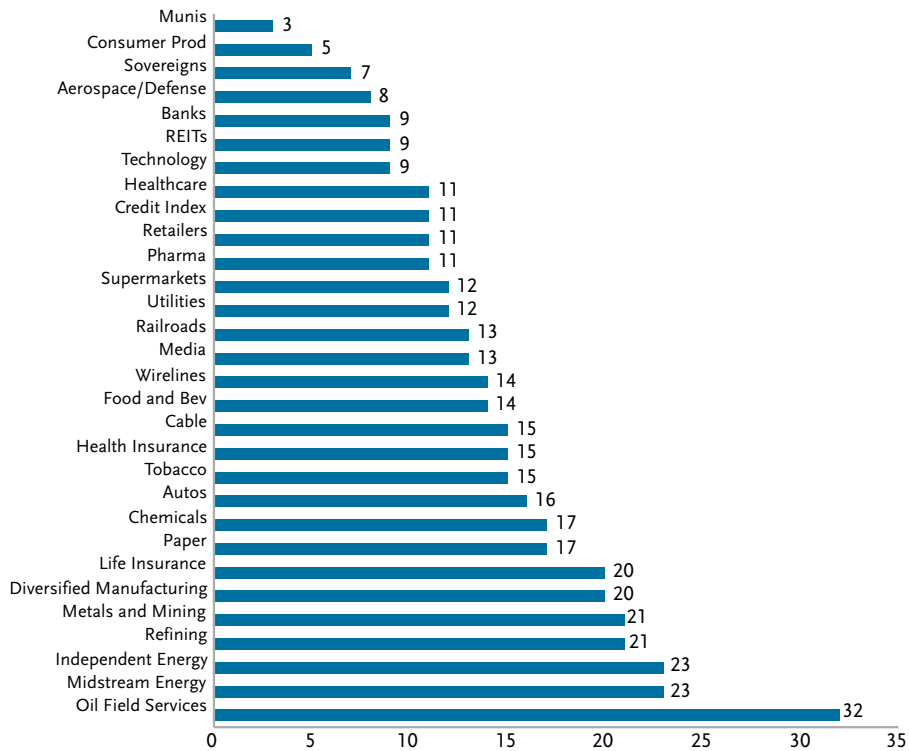
U.S. Monthly Auto SAAR, Last Two Years



Source: TCW

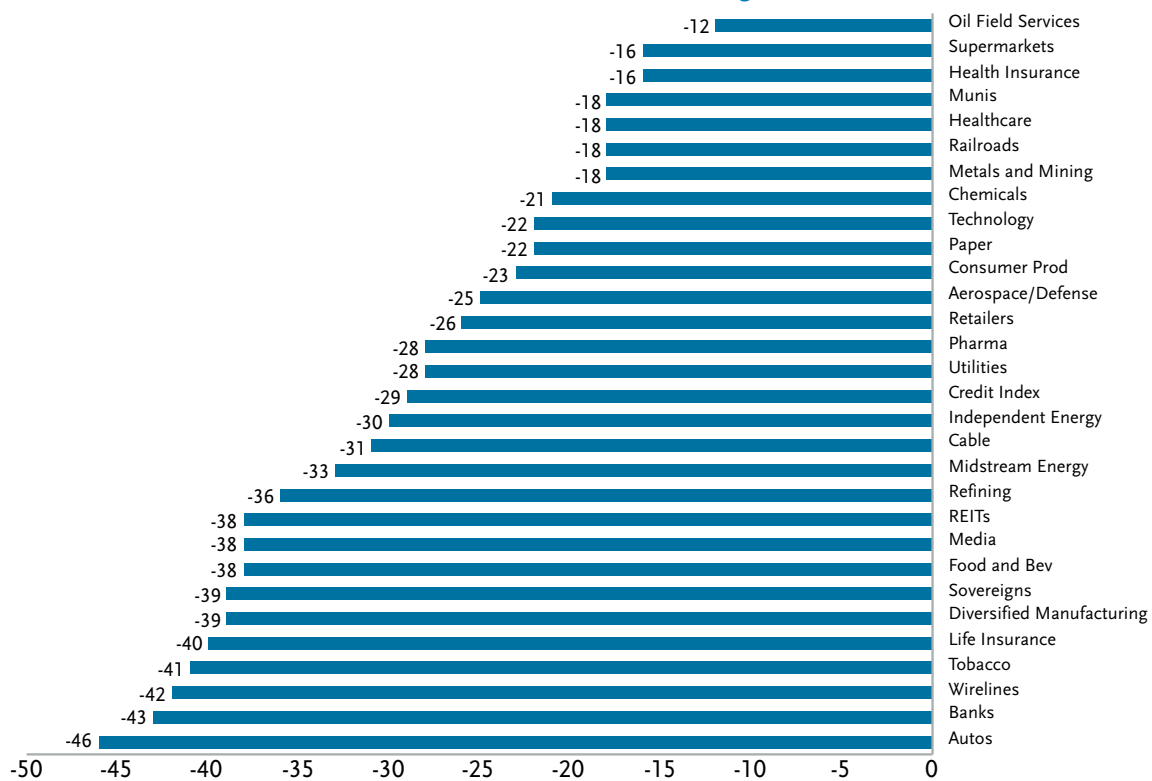


August Sector OAS Changes



Source: Barclays Capital

YTD Sector OAS Changes

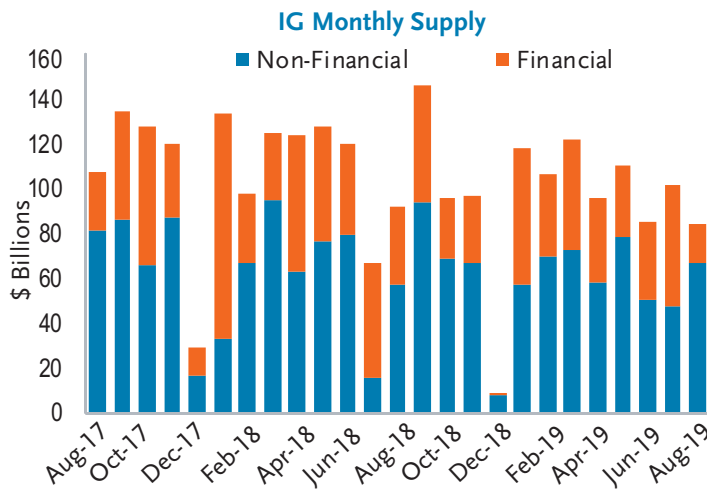


Source: Barclays Capital

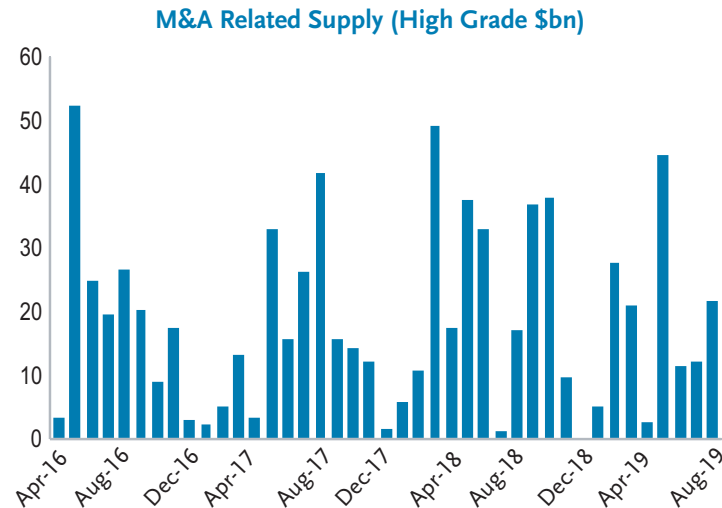
August Credit Update

August Investment Grade Supply

August Investment Grade Supply: August supply volumes of \$84 bln were dominated by industrial issuance of \$66.5 bln vs. only \$17.6 bln from financials. Thematically, the de-leveraging of the banking system and the re-leveraging of industrial issuers has resulted in a divergence in issuance and spread performance between the two sectors. Industrial issuance has outpaced financials in a material way since the crisis, which helps explain the relative outperformance of financials over the cycle. We are also seeing an increase in longer dated issuance as lower rates/yields compel companies to borrow long term. The share of 10yr and longer debt issuance has risen to 63% Ytd compared to the 54% average since 2010. M&A related supply in August totaled \$22 bln. The largest deal came from Oxy, issuing \$13 bln across seven maturities to fund the Anadarko acquisition; 10yrs priced @ +185, 30yrs @ +225. This was the first large M&A transaction in the E&P sector in several years. We have seen smaller deals across the sector, including several private equity transactions in the midstream space (BPL, ENLK, Rockies for example). The absence of change of control language in the midstream space makes bondholders more vulnerable to LBO transactions. Change of control provisions are quite common among industrial issuers that are considered susceptible to leveraged buyouts. An estimated 45% of industrial issuers have COC language. Investors should demand the same from midstream issuers.



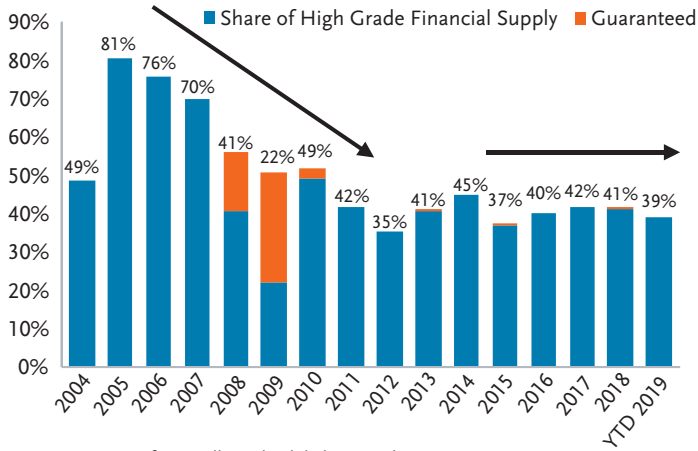
Source: BofA Merrill Lynch Global Research



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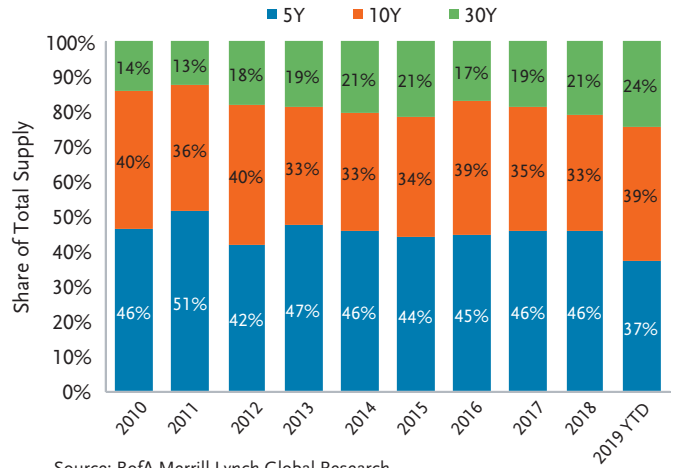
August Credit Update

Share of Financial Supply



Source: BofA Merrill Lynch Global Research

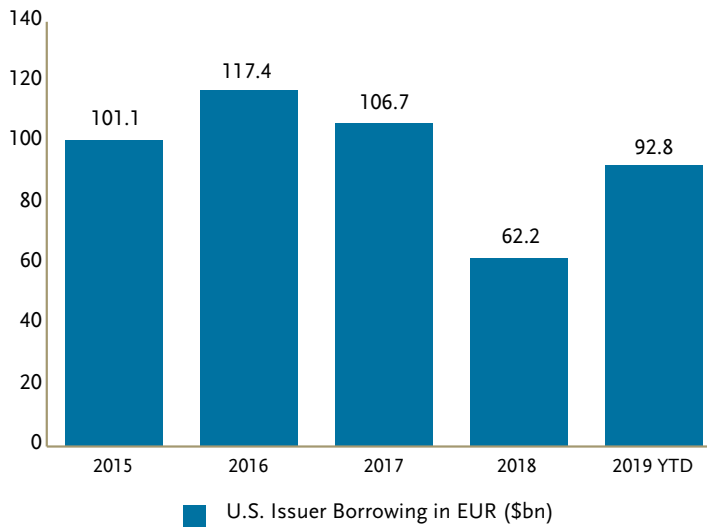
Maturity Distribution of Supply



Source: BofA Merrill Lynch Global Research

Reverse Yankee Issuance:

LOWER EUROPEAN YIELDS RESULTING IN MORE EURO ISSUANCE FROM U.S. COMPANIES



Source: BofA Merrill Lynch Global Research

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