TCW

INSIGHT

MONTHLY COMMENTARY

Loan Review – August 2016

DREW SWEENEY | SEPTEMBER 13, 2016

When nature falls into imbalance, volatility follows. When deer, moose or other large herbivories lose natural predators, their populations grow. If not controlled, it can lead to a cycle of deforestation, put other species at risk and contribute to larger scale issues like global warming. Markets are not dissimilar. When they become imbalanced, a loss of risk appreciation can occur and this can lead to periods of volatility.

The supply-demand imbalance that has persisted for most of the year continued throughout August. Triple A spreads tightened for CLO liabilities and this led to a surge in CLO generation. Increased demand, combined with little new issuance, exacerbated the technical disparity.

Given this theme, which has remained consistent for most of 2016, loan prices continued to rise. Rising prices have resulted in borrowers refinancing their bank loans at lower spreads. In fact, the three-year discount margin (DM) for double B issuers reached its tightest levels since prior to the global financial crisis.

LIBOR continued to rise impacting the loan market in a myriad of ways. Rising LIBOR traditionally attracts new investors to both retail mutual funds as well as to new CLOs. The additional demand can lead to tightening spreads of the underlying collateral. However, given the fact that CLO equity has benefited from LIBOR floors during the last several years, the rising LIBOR actually erodes this benefit. The eroding benefit from these floors, combined with tightening spreads, will squeeze interest coverage tests for many CLOs.

The incongruity of double B valuations reaching their most expensive levels since prior to the global financial crisis, while the U.S. economy still struggles to grow more than 2% is difficult to digest. The fact that nearly 50% of the loan market trades above par and that the average price of a double B loan in September is also above par, only suggests spreads are about to take a step function tighter.

Performance

In August 2016, the Credit Suisse Leveraged Loan Index ("CS LLI") was up 0.79% and the S&P Leveraged Loan Index ("S&P/LSTA") was up 0.75%.

- Year-to-date ending August 31, 2016, the CS LLI was up 6.53% and the S&P/LSTA was up 6.80%.
- For the twelve months ending August 31, 2016, the CS LLI was up 3.74% and the S&P/LSTA was up 3.88%.

Drew Sweeney
Senior Vice President
U.S. Fixed Income

Mr. Sweeney is a Senior Vice President in the U.S. 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.

Sector Performance

The top three performing industries for the month were Energy, Metals & Mining, and Consumer Durables, which posted returns of 3.29%, 3.11% and 1.31%, respectively. WTI crude prices surged in the first half of the month before moderating. Conversely, underlying energy loans remained flat during the first half of the month and then began pushing higher at month end as investors looked for loans with higher return profiles.

Total Return by Sector

Sector	August	Sector	YTD	Sector	LTM
Aerospace	0.93%	Aerospace	5.63%	Aerospace	4.89%
Chemicals	0.66%	Chemicals	6.28%	Chemicals	5.41%
Consumer Durables	1.31%	Consumer Durables	7.39%	Consumer Durables	5.73%
Consumer Non-Durables	0.65%	Consumer Non-Durables	4.66%	Consumer Non-Durables	4.44%
Energy	3.29%	Energy	18.92%	Energy	-6.59%
Financial	1.22%	Financial	4.72%	Financial	3.37%
Food and Drug	0.43%	Food and Drug	4.31%	Food and Drug	5.28%
Food/Tobacco	0.39%	Food/Tobacco	4.12%	Food/Tobacco	4.39%
Forest Prod/Containers	0.51%	Forest Prod/Containers	4.50%	Forest Prod/Containers	3.79%
Gaming/Leisure	0.64%	Gaming/Leisure	7.84%	Gaming/Leisure	6.28%
Healthcare	0.42%	Healthcare	5.15%	Healthcare	4.07%
Housing	0.45%	Housing	5.59%	Housing	5.61%
Information Technology	0.85%	I Information Technology	6.24%	Information Technology	4.75%
Manufacturing	0.49%	Manufacturing	5.91%	Manufacturing	4.36%
Media/Telecommunications	0.86%	Media/Telecommunications	6.20%	Media/Telecommunications	4.22%
Metal/Minerals	3.11%	Metal/Minerals	23.4%	Metal/Minerals	6.80%
Retail	0.93%	Retail	6.2%	Retail	2.23%
Service	0.66%	Service	6.3%	Service	5.10%
Transportation	0.90%	Transportation	5.4%	Transportation	3.43%
Utility	-0.21%	Utility	7.2%	Utility	-4.80%

Source: Credit Suisse Leveraged Loan Index

The worst performing sectors in August were Utility, Food/Tobacco and Healthcare with returns of -0.21%, 0.39% and 0.42%, respectively. Underperformance for both food related sectors was driven by the fact that both sectors trade closer to par and the average spread of both sectors is below the average spread for the Index. Consequently, a market rally is less pronounced in these sectors.

The year-to-date returns for all sectors in the CS LLI are positive. Metals & Mining, Energy and Gaming are the top performing industries, with returns of 23.4%, 18.92% and 7.84%, respectively. While energy driven industries have performed very well year-to-date, it is still the poorest performing sector during the last 12 months.

Total Return By Rating

	August	YTD	LTM
Split BBB	0.39%	3.33%	3.98%
BB	0.49%	4.95%	4.40%
Split BB	0.49%	5.80%	3.86%
B	0.84%	6.56%	3.64%
Split B	1.72%	15.54%	0.84%
CCC/Split CCC	2.47%	13.74%	5.41%
Distressed (CC, C and Default)	1.83%	15.73%	-14.28%

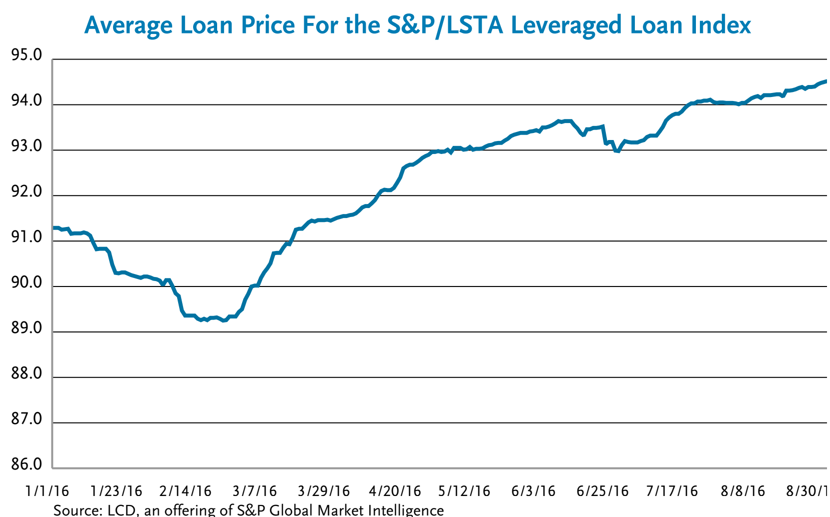
Source: Credit Suisse Leveraged Loan Index

Reflective of risk appetites across all capital markets, lower-rated credits continued to outperform in August. Single-Bs returned +0.84% versus 0.49% for double Bs. Year-to-date, single-B loan returns now stand at +6.56% compared to +4.95% for double-Bs. Despite their underperformance, the 3-year discount margin for double-B loans tightened to new post-crisis lows in August (327bp). The average three-year discount margin for double-B loans since 1992 is 330 bps. Single Bs are still wide of their 24 year average lows (542 bps currently versus 523 bps).

The CCC and distressed portion of the loan market also had strong months, posting returns of +2.47% and +1.83%, respectively. Year-to date CCC and distressed returns are 13.74% and 15.73%.

The rally, which continued throughout August, increased the percentage of the Loan Index trading above par. In fact, the JP Morgan Loan Index registered 46.3%, a one-year high, trading above par.

The average bid price for the S&P LSTA Leveraged Loan Index at month-end was 94.48, which is the highest level since 9/28/2015.



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

Any price weakness demonstrated in June was quickly erased in July and forgotten by August. Loan prices continued to grind higher each week of the month, albeit, on light volumes. The graph above highlights the average bid of the CS LLI, which includes over 1,500 issuers. The average bid of the more liquid performing portions of the market is very close, if not above par.

Technical Conditions

The CLO market continued to post significant issuance in the month of August, particularly when factoring in the impact that August is traditionally a slow month and difficult to source collateral.

CLO volumes were driven by the attractiveness of new lower AAA spreads and lower overall liability costs. U.S. CLO spread compression continued throughout August driven by the addition of several new, large triple A buyers to the market. Investors are being attracted to the asset class as a result of increasing LIBOR and the desire to own floating rate products in a rising rate market.

With nearly $40 billion of new CLO issuance year-to-date through August, volumes have surpassed my expectation for the entire year of 2016.

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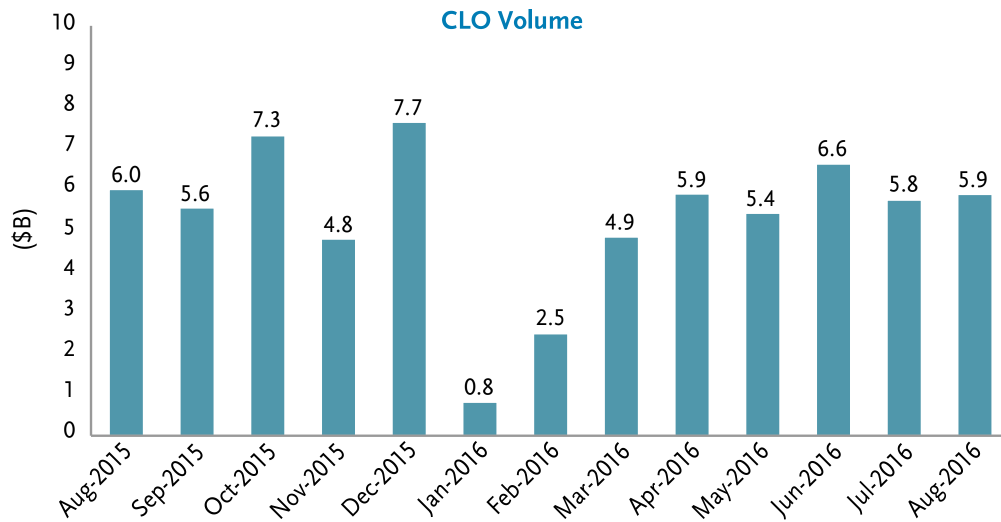
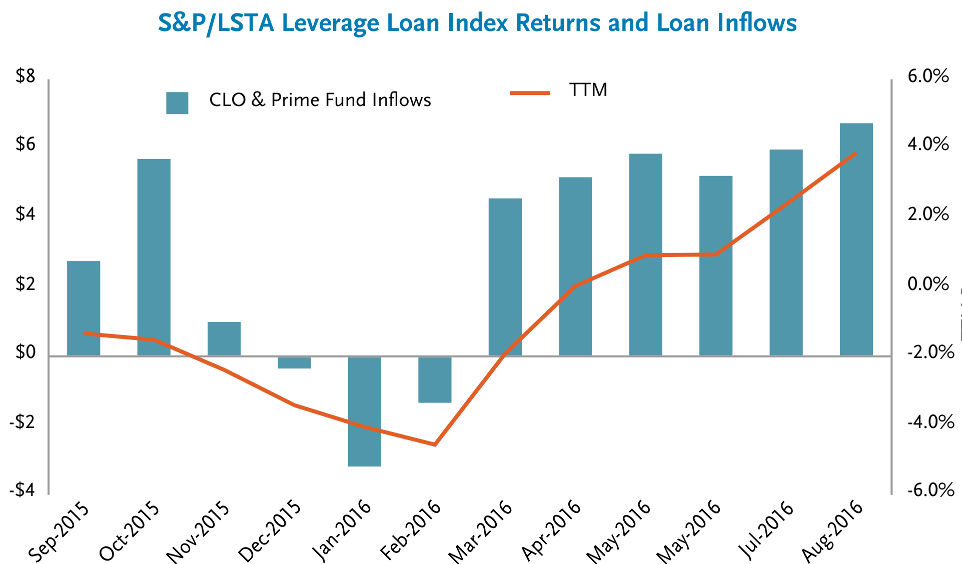


Source: LCD, an offering of S&P Global Market Intelligence

Three-month LIBOR remains notable as it broke through 84 basis points for the first time since May 2009. As LIBOR rises beyond the embedded value of the LIBOR floors, the overall yield on loans increase. In a world where yield is difficult to find, increasing yield and low duration is driving new investment in the loan space.

Retail funds posted five consecutive weeks of positive inflows by the end of August totaling $900 million for the month. Outflows year-to-date for loan mutual funds remain negative at -$5.2 billion compared to a -$9.9 billion in the same period in 2015. However, the combined demand for CLO and retail funds has coincided with increasing loan returns, as can be seen below.



Source: S&P Leveraged Loan Index

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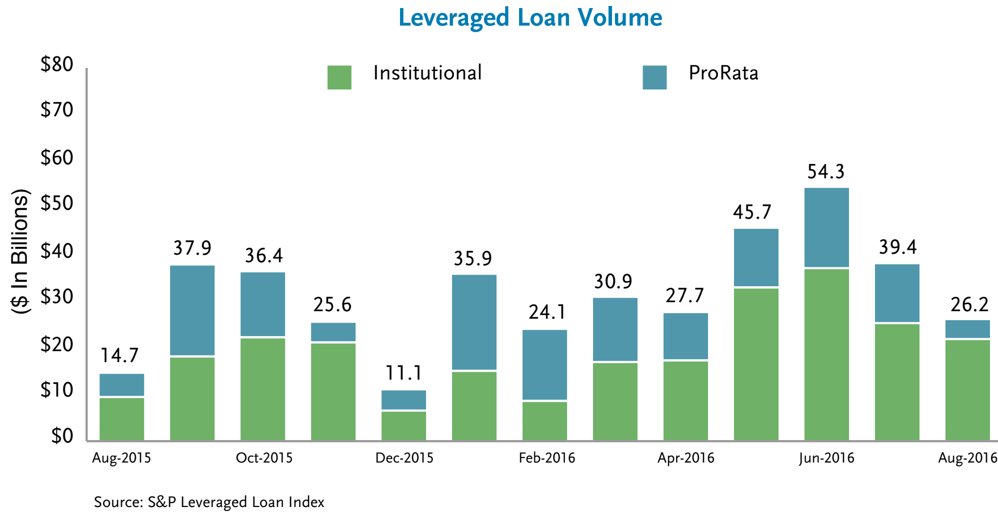
August supply ballooned with opportunistic refinancings and institutional issuance was up 130% year-over-year. Total year-to-date institutional loan issuance is still down roughly 7% from same period in 2015.

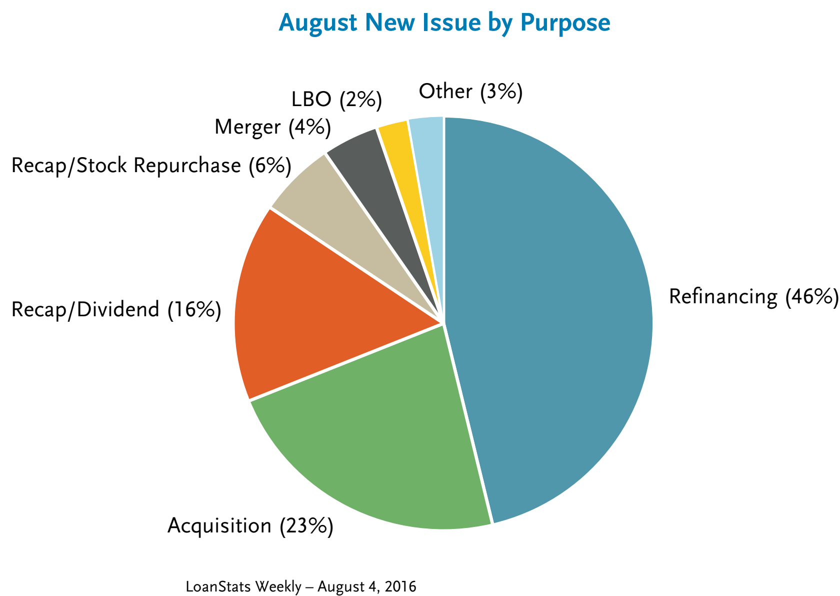
Leveraged Loan Volume



Source: S&P Leveraged Loan Index

Mergers and Acquisitions, which dominated the calendar in the first quarter, dropped dramatically in August as the majority of new issue was related to refinancing or repricing. The percentage of loans trading above par has allowed issuers to refinance, reprice and aggressively pursue opportunistic transactions.

August New Issue by Purpose



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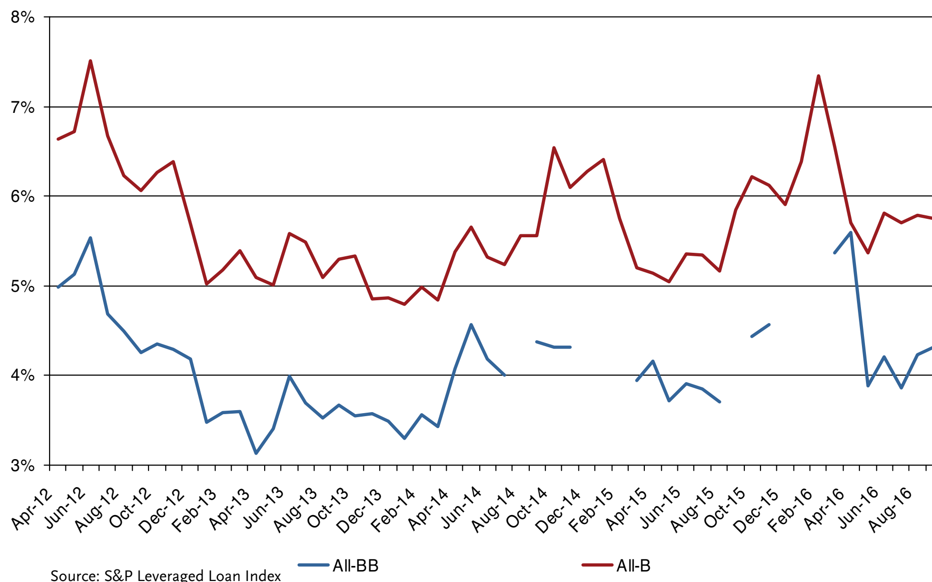
Fundamentals

Single-B new issue yield-to-maturity tightened seven basis points in August from July. There was no double B new issuance in August. However, the average price of a double B loan in the CSLLI approached par and the three-year discount market ended the month at 327 bps. This is quite extraordinary as this is the tightest level double B loans have traded at since prior to the global financial crisis in 2007.

New-Issue First-Lien Yield to Maturity



Source: S&P Leveraged Loan Index

There was only one default in August (PTC Alliance Holdings) that increased the LTM default rate to 1.98% based on a par amount outstanding. The default rate based on unique issuers also remained flat at 2.25%.

Lagging 12-Month Default Rates

Actual	Jun-16	Jul-16	Aug-16	9/1/16
By Number	2.22%	2.22%	2.25%	2.25%
By Principal Amount	1.97%	1.97%	1.98%	1.98%
Shadow Default Rate*				
By Number	0.32%	0.32%	0.42%	0.42%
By Principal Amount	0.17%	0.17%	0.21%	0.21%

Source: S&P Global Market Intelligence

* 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.

Seventeen of the 27 defaults over the last 12 months are in the Energy and Metals sectors. While defaults generally remain low, they have increased and commodity sectors will continue to drive the default rate during the next 12-18 months. Retail contributed the third largest number of sector defaults in the last 12 months and also factors as being a contributor over the next year.

Valuation

Since 1992, the average three-year discount margin for the CS LLI, is 463 basis points. If the global financial crisis (2008 & 2009) is excluded, then the three-year discount margin for the CS LLI is 415 basis points. At month end, the three-year DM was wide of the historical average, at 519 basis points. The three-year DM tightened 18 basis points since July.

The DM spread differential between double Bs and single Bs has tightened from September 2015 to August 2016 by 28 basis points. It is also 22 basis points wide of the historical spread differential.

3-Year Discount Margin Differential Between BBs and Single Bs

1/1992-8/2016 Average	192.5
Sep-15	243.1
Aug-16	214.7

Source: Credit Suisse Leveraged Loan Index

CS LLI Snapshot

	8/31/2016
YTD Total Return*	6.53%
Average Price	94.29
Average Price (excluding defaults)	96.30
Coupon	4.86%
Current Yield	5.11%
Yield (3-year life)	6.19%
Discount Margin (3-year life)	519 bp

* S&P LL Total Return 6.8%.

	Spread	DM (3-year life)
Split BBB	276 bps	278 bps
BB	316 bps	327 bps
Split BB	374 bps	409 bps
B	417 bps	542 bps
Split B	572 bps	1,243 bps
CCC/Split CCC	704 bps	1,435 bps
Distressed (CC, C and Default)	583 bps	2,162 bps

Source: Credit Suisse Leveraged Loan Index

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Summary

As of August 31, the S&P/LSTA Index imputed default rate was 3.88%. That is down from 4.07% at the end of July and considerably below the multi-year high in February of 7.3%. While the imputed rate implies that the market will likely see an increase in defaults, it is not implying a very high overall default rate. Moreover, default activity over the past year has been concentrated within sectors tied to commodities. Therefore, the 3.88% imputed rate likely implies that commodity driven sectors will continue to dominate defaults but the market will not likely experience a spike in defaults from other sectors.

Technical characteristics of the market have been driving the returns for most of the year. The high level of loan repayments coupled with little loan issuance and moderate CLO issuance has pushed loan prices up materially. Anecdotally, cash levels remain high, which means there is still imbedded demand. Therefore, while valuations appear to be stretched at current levels, they are likely to rise further.

Finally, while increasing LIBOR will likely lead to an increase interest in floating rate products, the additional demand is allowing loan borrowers to reduce LIBOR spreads. Increasing LIBOR is also eroding the benefit of LIBOR floors for existing CLOs. Consequently, these two factors could lead to pressure on interest coverage tests for many CLOs during the next 12 months. ■

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865 South Figueroa Street | Los Angeles, California 90017 | 213 244 0000 | @TCWGroup