TCW

INSIGHT

MONTHLY COMMENTARY

Loan Review – August 2017

DREW SWEENEY | SEPTEMBER 13, 2017

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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 firm's 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.

As the summer comes to an end and kids go back to school, the long days get noticeably shorter. We get ready for the sights and sounds of fall and what is in store for us post Labor Day. Saturday mornings mean the return of college football, specifically Nebraska football in my house. Others will be more excited about the return of the NFL, the first morning chill in the air, apple cider and the beauty of fall foliage. Regardless, this year the fall brings as much uncertainty to my outlook as I have had in nearly a decade. The world, which is always full of tumult, seems particularly unsettled today. Kim Jung Un has repeated threats and escalated the probability of war. While North Korean rhetoric has always been high, their success in intercontinental ballistic missiles (thanks to some outside assistance from former Soviet states) makes the world less safe. Syrian war crimes have no end in sight. Closer to home, the U.S. has put sanctions on Venezuela, labeling the president a dictator. If instability in the Middle East and the Far East and parts of Latin America are too tough to process, then we need look no further than our fractured nation. Hate groups have created a polarization not felt since the 1960s.

If I put blinders on, and keep life simple, GDP was just revised to 3%, the fastest rate of growth since Q1 2015. But then I think surely an increase in dissident groups signals something else. Surely a rapid rise in hate groups means there is a forgotten economy, one lost and not reflected simply by looking at unemployment rates and non-farm payrolls.

So what will the fall really bring? Will it be continued optimism born of recent growth or will it produce something darker, arising from geopolitical instability, terrorist groups, hurricanes or something more traditional...like the end of an economic expansion? The behavior we have seen thus far in the loan market is an extremely skittish buyer base that is willing to chase risk but that is also easily spooked. While leveraged loans have not traded poorly year to date, there has been a growing list of taboo sectors and taboo loans. First Energy and Metals were the "uninvestable" sectors. In August, investors began to hold their breath in regard to the future of Wirelines, but fortunately there was a collective exhale and a sigh of relief as the Utility/Power sector improved.

In this market it is imperative that companies do not disappoint. If expenses rise unexpectedly or margins drop – dealers lower their bids 1 point and increase their bid-ask spreads dramatically. Then they look to process the magnitude of the earnings miss.

Perhaps July and August provided a roadmap of what we will see in the fall. July delivered the strongest returns of the year while August provided the weakest returns of the year. Little changed between the two months but volatility has increased.

Performance

In In August 2017, the Credit Suisse Leveraged Loan Index (CS LLI) was down -0.14% and the S&P Leveraged Loan Index (S&P/LSTA) was down -0.04%.

- Year to date, ending August 31, 2017, the CS LLI was up 2.62% and the S&P/LSTA was up 2.57%.
- For the twelve months ending August 31, 2017, the CS LLI was up 5.85% and the S&P/LSTA was up 5.80%.

Higher quality loans were the only category to post positive returns in August while Triple C loans netted a return close to -0.77%. Double B and Single B loans returned -0.06% and -0.13%, respectively. Larger, more liquid, loans (loans over $1 billion) materially underperformed loans below $1.0 billion. For example, loans between $201 million and $300 million posted returns of 31 basis points for the month while loans over $1.0 billion posted returns down 42 basis points. This is a result of two items: First, the larger, liquid loans were sold by mutual funds and crossover investors to manage fund outflows. Second, the less liquid loans did not trade and dealers did not mark them down in sympathy with the weakening market.

Total Return By Rating

	August	YTD	LTM
Split BBB	-0.08%	1.54%	3.29%
BB	-0.06%	1.94%	3.84%
Split BB	-0.24%	1.93%	4.37%
B	-0.13%	2.85%	5.74%
Split B	-0.03%	5.37%	13.55%
CCC/Split CCC	-0.77%	4.69%	15.63%
Distressed (CC, C and Default)	-0.33%	5.64%	16.72%

Source: Credit Suisse Leveraged Loan Index

Sector Performance

Interestingly, only six of the 20 sectors posted negative returns during the month. The top performing sectors in August were Utility (+0.59%), Financial (+0.25%) and Aerospace (+0.12%). This was the second consecutive month where Utility was a top returning industry, aided by improving conditions in several regions as well as several M&A transactions, which substantiated debt/kWh valuations.

The worst performing sectors were Energy, Retail and Food & Drug. Energy loans were weighed down by WTI crude declining over 3% on the month. Retail continued to be hurt by concerns surrounding secular changes as well as a number of very weak results posted during the month. Food & Drug borrowers continued to trade heavy post the news that Amazon entered the bricks and mortar business.

On a year-to-date basis, Services, Healthcare, and Gaming led all sectors with total returns of 3.89%, 3.49% and 3.41%, respectively.

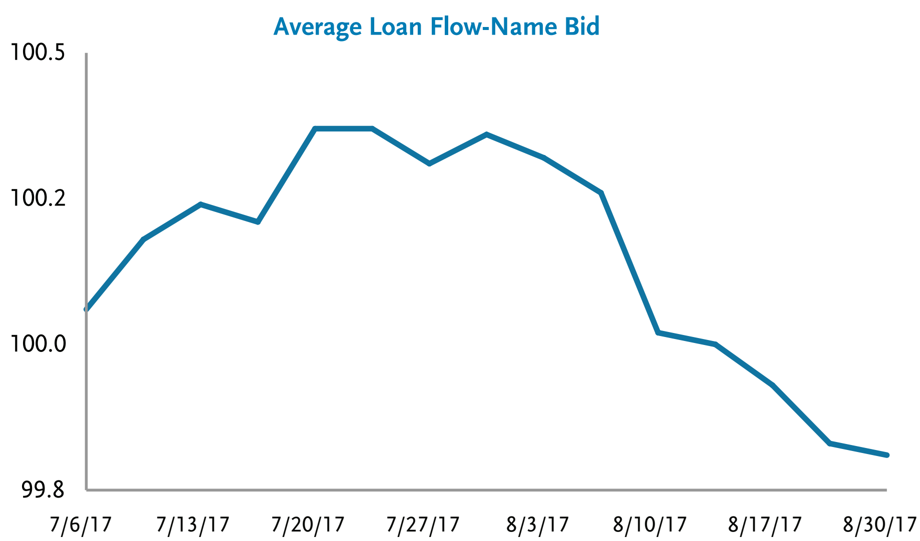
On a year-to-date basis, Retail, Food and Drug and Consumer Durables were the worst performing sectors with returns of -3.81%, -0.07% and 1.55%, respectively. All three sectors are being impacted to some degree by e-commerce. Bricks and mortar businesses are losing market share to on-line competitors. Now investors are beginning to be concerned about Amazon's entrance into the grocery segment, increasing competition within the grocery segment. Finally, the Consumer Durables segment, which includes several mattress companies, has also been impacted somewhat by new on-line entrants.

Total Return by Sector

Sector	August	Sector	YTD	Sector	LTM
Aerospace	0.12%	Aerospace	2.99%	Aerospace	5.59%
Chemicals	0.11%	Chemicals	2.94%	Chemicals	5.26%
Consumer Durables	-1.15%	Consumer Durables	1.55%	Consumer Durables	4.29%
Consumer Non-Durables	0.07%	Consumer Non-Durables	2.17%	Consumer Non-Durables	4.92%
Energy	-2.29%	Energy	2.11%	Energy	17.83%
Financial	0.25%	Financial	2.97%	Financial	6.41%
Food & Drug	-1.73%	Food & Drug	-0.07%	Food & Drug	2.16%
Food/Tobacco	0.06%	Food/Tobacco	2.36%	Food/Tobacco	4.36%
Forest Prod/Containers	0.00%	Forest Prod/Containers	2.38%	Forest Prod/Containers	4.86%
Gaming/Leisure	0.06%	Gaming/Leisure	3.41%	Gaming/Leisure	6.58%
Healthcare	0.07%	Healthcare	3.49%	Healthcare	5.34%
Housing	0.02%	Housing	2.70%	Housing	4.95%
Information Technology	0.10%	Information Technology	3.22%	Information Technology	6.96%
Manufacturing	-0.14%	Manufacturing	3.34%	Manufacturing	6.88%
Media/Telecommunications	0.01%	Media/Telecommunications	2.66%	Media/Telecommunications	5.46%
Metals/Minerals	-0.99%	Metals/Minerals	3.11%	Metals/Minerals	16.58%
Retail	-2.17%	Retail	-3.81%	Retail	-3.72%
Service	0.11%	Service	3.89%	Service	6.92%
Transportation	0.03%	Transportation	1.84%	Transportation	4.99%
Utility	0.59%	Utility	1.88%	Utility	3.37%

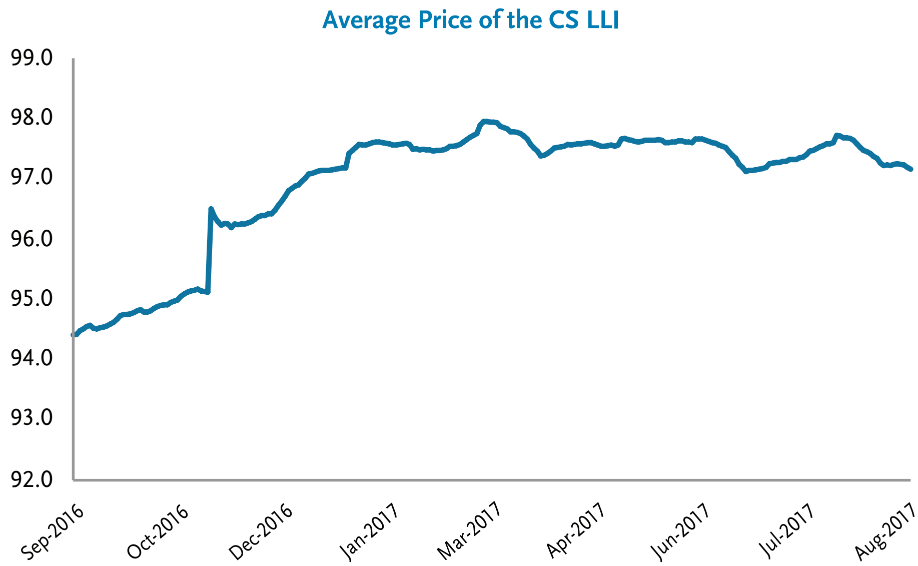
Source: Credit Suisse Leveraged Loan Index

The flow-name prices in the S&P Index (below) decreased during the month in excess of 40 basis points. More-liquid names sold off more as retail funds sustained outflows and larger, liquid loans allowed managers to raise cash more easily.



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

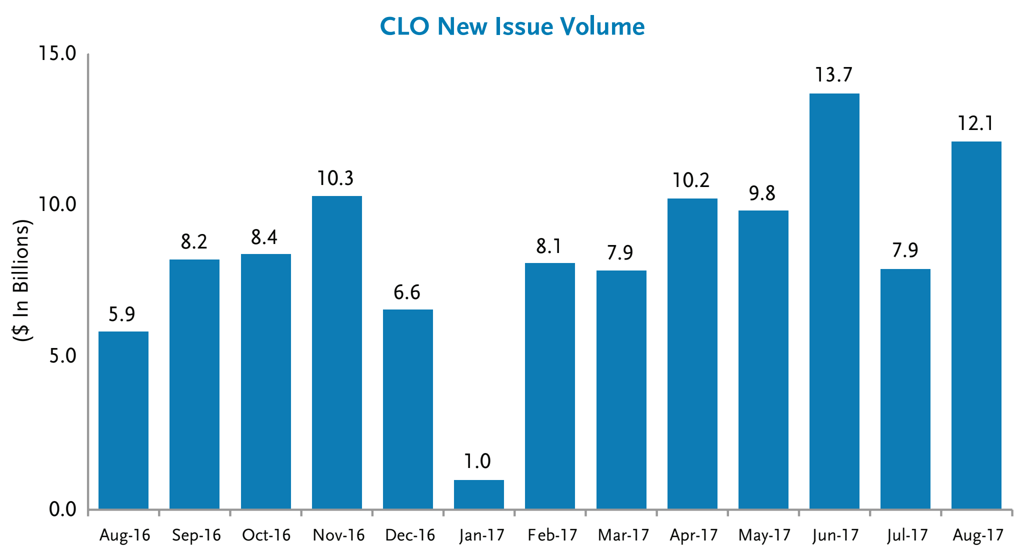
The average bid of the broader loan Index is up materially during the last year. August prices declined to levels last seen in June.



Source: CS, LLI, LCD, an offering of S&P Global Market Intelligence; S&P/LSTA Leveraged Loan Index

Technical Conditions

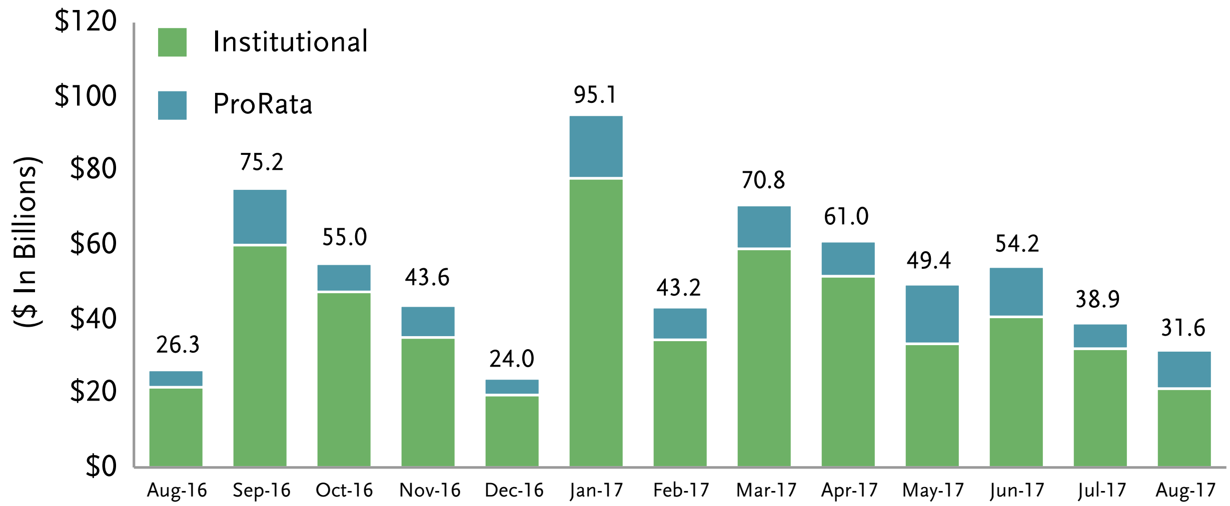
CLO new issue supply was $12.1 billion in August, up 53% from July, representing the second largest inflow of the year. Despite the large CLO print, macro concerns, a weak high yield market and cross-over sellers all contributed to loan price declines. Year to date, over $70.8 billion of CLOs have been issued, far exceeding estimates for 2017.



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

Institutional new issue volumes decreased month over month by nearly 34% while pro rata new issuance increased almost 50%. August is traditionally a very slow issuance month. In 2017 the calendar was very robust during the first two weeks of the month and then essentially closed until post Labor Day.

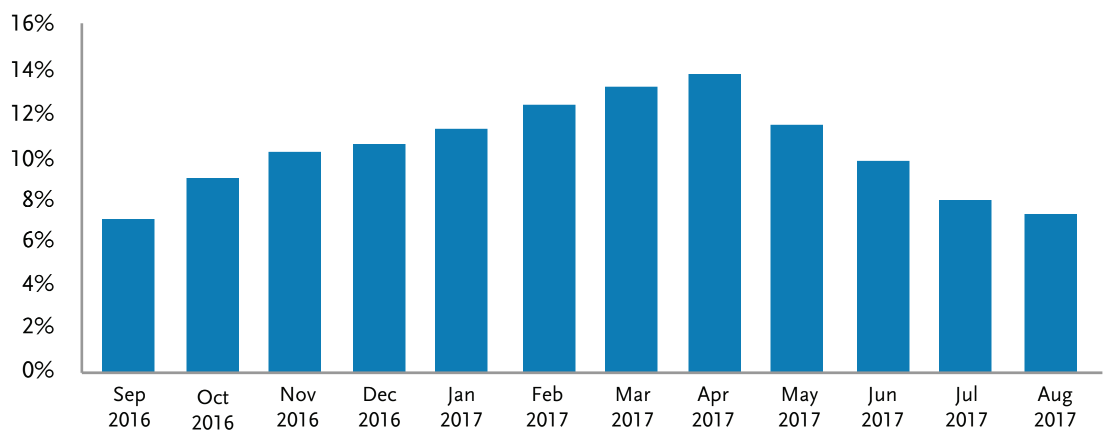
Leveraged Loan Volume



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

Repayments dropped to $19.7 billion in August, the lowest level in 13 months. The repayment rate for the lagging three months was 7.3% compared to 8.0% in July.

Lagging Three-Month Repayment Cycle



Source: LCD, an offering of S&P Global Market Intelligence; S&P/LSTA Leveraged Loan Index

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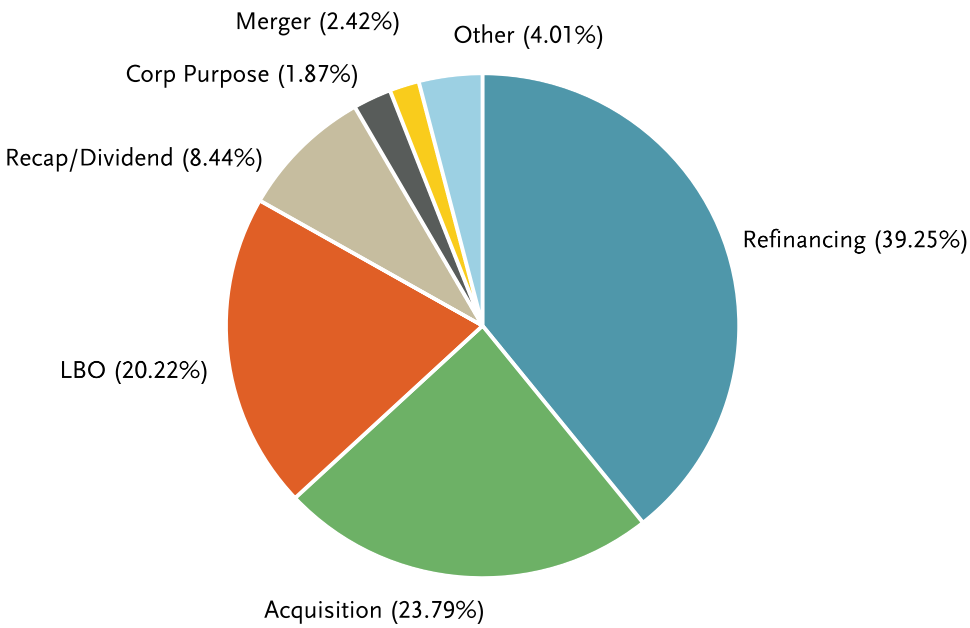
While for most of the year the calendar has been dominated by repricings and refinancing activity, August was unique with over 80% of institutional issuance driven by new paper being issued in the market (leveraged buyouts, acquisitions, dividends). The combination of lower repayments, retail fund outflows and a higher percentage of actual new paper hitting the market all offset the CLO issuance for the month.

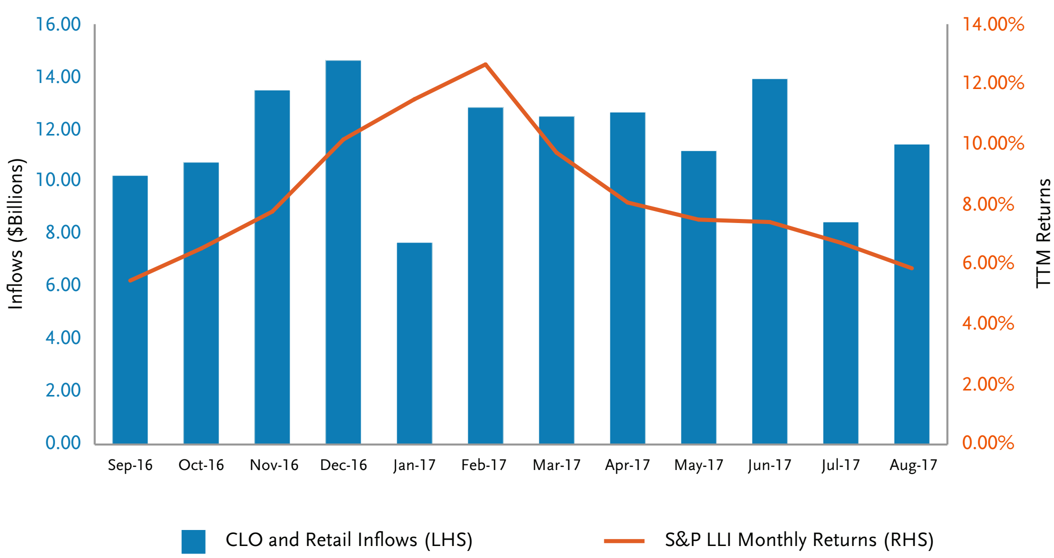
August Institutional Volume



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

The percentage of loans trading above par dropped from above 70% to roughly 62% in August. With an overwhelming percentage of coupons repriced this year, the trailing 12-month return has begun to decline.

Inflows and Rolling LTM Returns



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

Single B spreads in August tightened -4.89% from the prior month and -6.28% from 12 months prior. On a year-to-date basis, Double B spreads reflected slight widening based on asset mix. Double B loans remain -3.4% tighter when compared to 12 months prior.

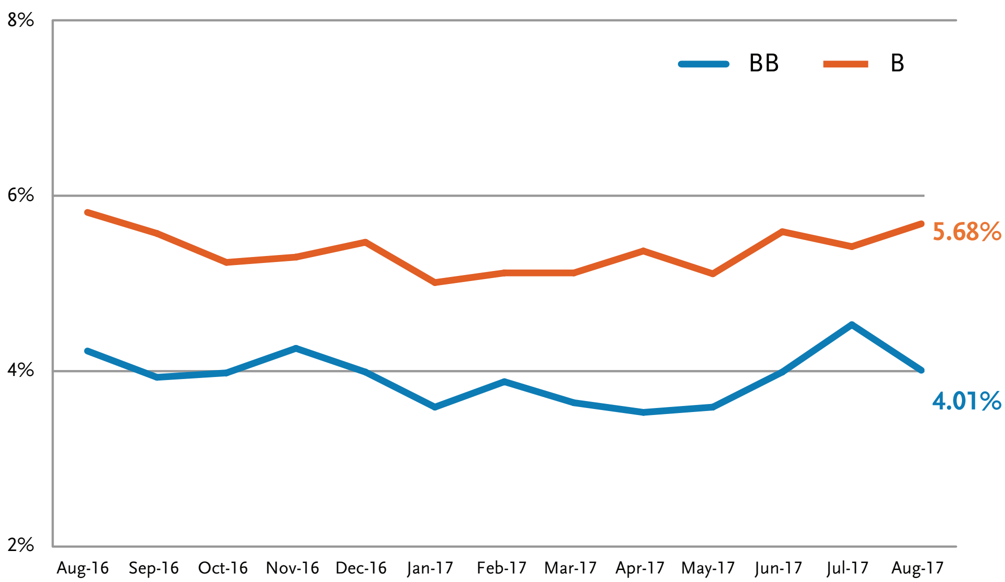
New Issue Spread Changes

	BB/BB-	B+/B
Jun-16	305	429
Sep-16	285	410
Dec-16	268	388
Mar-17	243	382
Jun-17	240	370
Aug-17	275	385
Month-Over-Month Change	10.28%	-4.89%
YTD Change	2.75%	-0.75%
LTM Change	-3.38%	-6.28%

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

Average new issue yields widened month over month for Single Bs while Double Bs tightened slightly.

Average New-Issue Yields



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

While there had been 20 defaults in the last 12 months, there were none in August. The LTM default rate essentially remained flat, based on a number of defaults (1.31%) and based on par amount outstanding (1.36%). Regardless of measurement, default rates remain very low on a historical basis.

Retail loans provided six defaults in the last 12 months while commodity driven loans provided four. Given the secular changes in purchase patterns of consumers, it is likely that we see Retail defaults increase. The shadow default activity remains low, suggesting that there will not be any broad-based increase in the next 12 months.

Lagging 12-Month Default Rates

Actual	May-17	Jun-17	Jul-17	Aug-17
By Number	1.28%	1.49%	1.29%	1.31%
By Principal Amount	1.42%	1.54%	1.36%	1.36%
Shadow Default Rate				
By Number	0.53%	0.53%	0.53%	0.54%
By Principal Amount	1.54%	1.56%	1.44%	1.45%

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

3-Year Discount Margin Differential Between BBs and Single Bs

1/1992-8/2017 Average	83.3
Sep-16	106.3
Aug-17	118.0

Source: Credit Suisse Leveraged Loan Index

CS LLI Snapshot

YTD Total Return*	2.62%
Average Price (excluding defaults)	97.73
Spread	366.55
Coupon	4.96%
Current Yield	5.11%
Yield (3-year life)	5.98%
Discount Margin (3-year life)	436 bp

*S&P LLI Total Return 2.62%

Source: LCD Loan Stats

	Spread	DM (3-Year Life)
Split BBB	224 bps	222 bps
BB	284 bps	290 bps
Split BB	337 bps	354 bps
B	402 bps	449 bps
Split B	563 bps	789 bps
CCC/Split CCC	631 bps	1,269 bps
Distressed (CC, C and Default)	488 bps	1,543 bps

Source: Credit Suisse Leveraged Loan Index

Valuation

Since 1992, the average 3-year discount margin ("DM") for the CS LLI, is 463 basis points. If the global financial crisis (2008 & 2009) is excluded, the 3-year discount margin for the CS LLI is 417 basis points. At month end, the 3-year DM was tight to the historical average, at 423 basis points and 19 basis points tighter than the prior month.

The DM spread differential between double Bs and single Bs has widened from August 2016 to July 2017 by 13 basis points and is still 31 basis points wide of the historical spread differential.

Summary

As of August 31, the S&P/LSTA Index imputed default rate was 1.79%, still one of the lowest levels since December 2007. While this is shocking, it also further contrasts with the multi-year high in February 2016 of 7.3%.

Demand has generally overwhelmed supply for most of 2017. August was unique because investors not only had to digest significant geopolitical news but also the new issue calendar was actually driven more by M&A than repricing/refinancings. This change in the technical dynamic combined with a large natural disaster and increased global headline news flow contributed to increased volatility. July represented the best performing month for loans during the year and August represented the worst performing month. Looking forward to the fall, perhaps July and August represent a good guide of what to expect. This pattern of volatility maybe repeated as investors remain skittish but driven by a need to keep fund cash levels low.

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