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INSIGHT

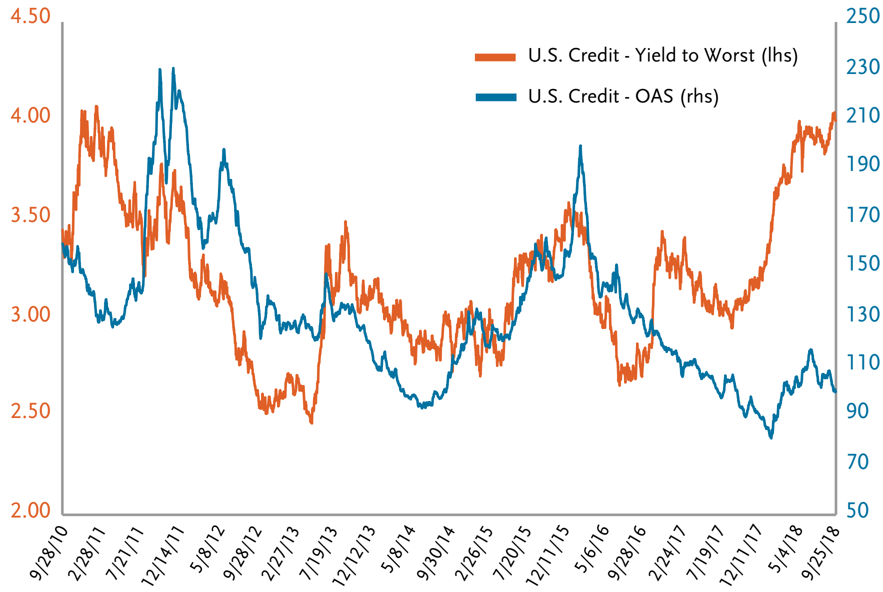
MONTHLY COMMENTARY

September Credit Update

TAMMY KARP | OCTOBER 4, 2018

Credit spreads rallied 8 basis points in September, reversing all of the widening experienced in August – and then some. At an OAS of +100 basis points over Treasuries, spreads are now at the midpoint of the YTD range of +81 to +118. From a longer term perspective however, spreads are trading well through historical averages (20 year mean of +150, post crisis mean of +135). September was marked by higher yields and tighter spreads. The credit index yield of 4% rose 12 bps in September and is 81 bps higher YTD. The YTD total return of the credit index is -2.12%, on pace to be the worst annual return since 2008. Looking back historically, there were only five years of negative total returns for the credit index going back to 1994. Rising interest rates resulting in negative returns for the IG credit index did not derail the spread rally in September as spreads continued to tighten with higher yields. The technical backdrop was strong this month, underpinned by overseas demand for spread product, inflows into high grade funds and light dealer inventories. Fundamentally, late cycle signals like diverging performance between U.S. and EM, a flatter yield curve, higher corporate leverage and stretched valuations should remain a concern. While the recent tax cuts and repatriation have been tailwinds for the equity markets, they have also led to more aggressive behavior on the part of corporations, including record M&A transactions and other shareholder friendly activity. Debt funded acquisitions and record share buybacks have continued to pressure credit metrics.

Credit Index Spreads and Yields: Credit Index Yield of 4% is the Highest Since Feb 2011



Source: Bloomberg Barclays

Tammy Karp
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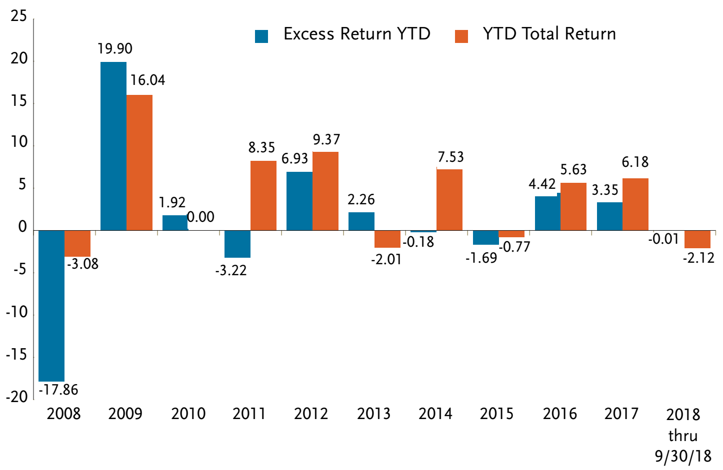
Ms. Karp is a Managing Director in the Fixed Income group where she trades investment grade and cross over securities. Ms. Karp joined TCW in 2009 during the acquisition of Metropolitan West Asset Management LLC (MetWest). Prior to joining MetWest in 1997, she was with the fixed income department at The Capital Group. Ms. Karp earned her BS in Business from University of Arizona.

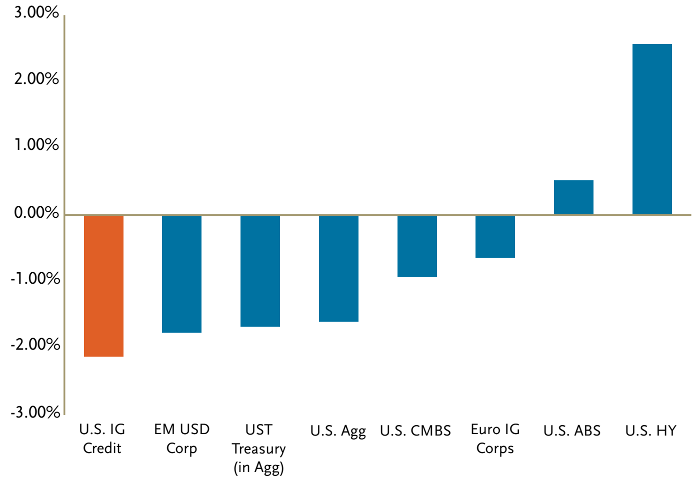
September Credit Update

Annual Returns: Annual Returns Have Been Positive 7 Out of the Last 10 Years



Source: Bloomberg Barclays

YTD Returns for Various Asset Classes. U.S. IG Credit has Underperformed, U.S. HY has Outperformed



Source: Bloomberg Barclays

Index Performance: The IG credit index tightened 8 basis points in September, ending the month at an OAS of +100 basis points over Treasuries. The index yield of 4.00% was 12 basis points higher on the month, resulting in a total return of -.34% as spread tightening was offset by higher Treasury yields. The YTD total return of the credit index stands at -2.12% while the excess return is flat YTD. Of the broad sectors, sovereigns outperformed (-17 bps), recouping most of the YTD underperformance as the rally in oil prices and the U.S./Mexico trade deal led to a rebound in spreads. Industrials were the second best performing major sector, led by higher beta sectors like wirelines (-18 bps), midstream energy (-14 bps), and metals (-14 bps). The midstream sector is also one of the best performing sectors YTD, as credit-friendly structural simplifications have improved cash flow and accelerated de-leveraging by re-sizing distributions and eliminating IDR payments. The worst performing sectors YTD are life insurers, autos, cable and food and beverage. The latter two sectors have underperformed on debt financed M&A-related activity. For the food and beverage sector, there have been multiple debt funded M&A transactions, including GIS, DPS, CPB and Bacardi. The acquisition multiples are notable, averaging 20x EV/EBITDA, including CPB's acquisition of Snyder at a 20x, GIS's purchase of Blue Buffalo at 25x, Keurig's purchase of DPS at 16x and Bacardi's acquisition of Patron at 19x. For cable, Comcast's recent bidding war for the Fox assets ended with Comcast buying SKY for $40 bln (debt funded). While leverage for Comcast increases 1x pro forma, the rating agencies affirmed the low single A ratings given the company's ability and commitment to de-lever.

September Credit Index Returns

	Month-to-Date Excess Return	Month-to-Date Total Return	Year-to-Date Excess Return	Year-to-Date Total Return	Option-Adjusted Spread	Option-Adjusted Spread Month-to-Date Return
Credit Index	0.75%	-0.34%	-0.01%	-2.12%	100	-8
Industrials	0.94%	-0.29%	0.07%	-2.36%	108	-9
Financials	0.50%	-0.34%	-0.32%	-1.94%	102	-6
Utilities	0.66%	-0.94%	-0.79%	-3.94%	106	-6
Municipals	0.68%	-1.12%	1.08%	-2.66%	114	-5
Sovereigns	1.51%	0.10%	0.71%	-2.02%	117	-17
AA	0.46%	-0.51%	0.28%	-1.53%	59	-5
A	0.60%	-0.54%	-0.48%	-2.69%	85	-7
BBB	1.05%	-0.11%	0.27%	-2.04%	136	-11

Source: Bloomberg Barclays

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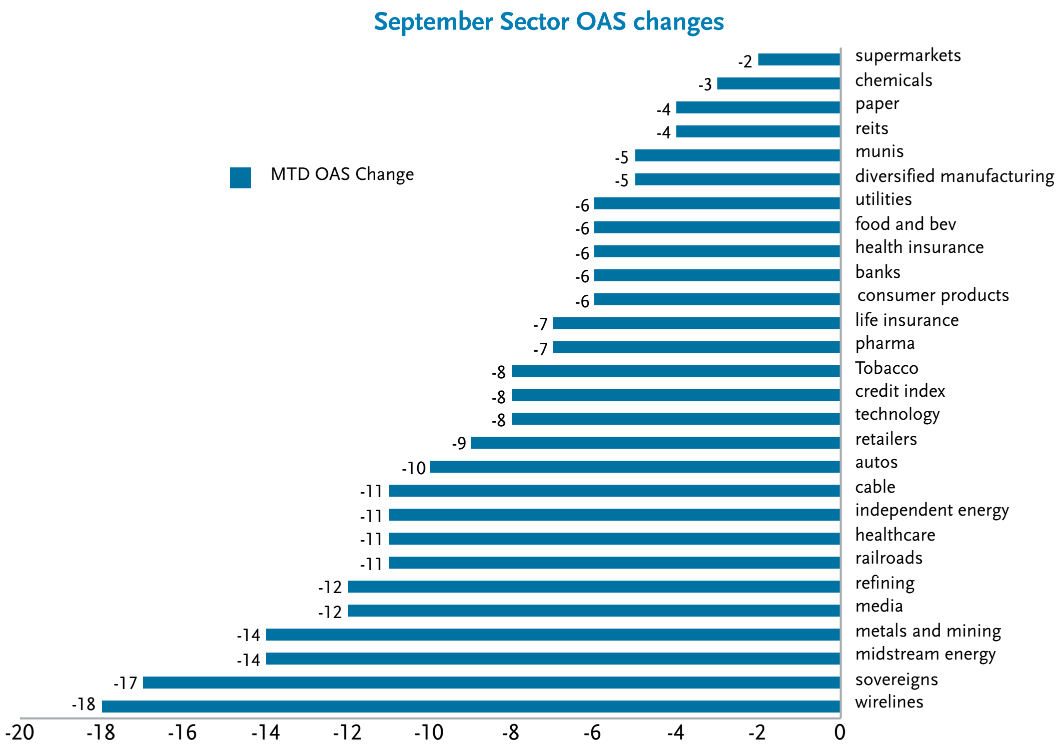
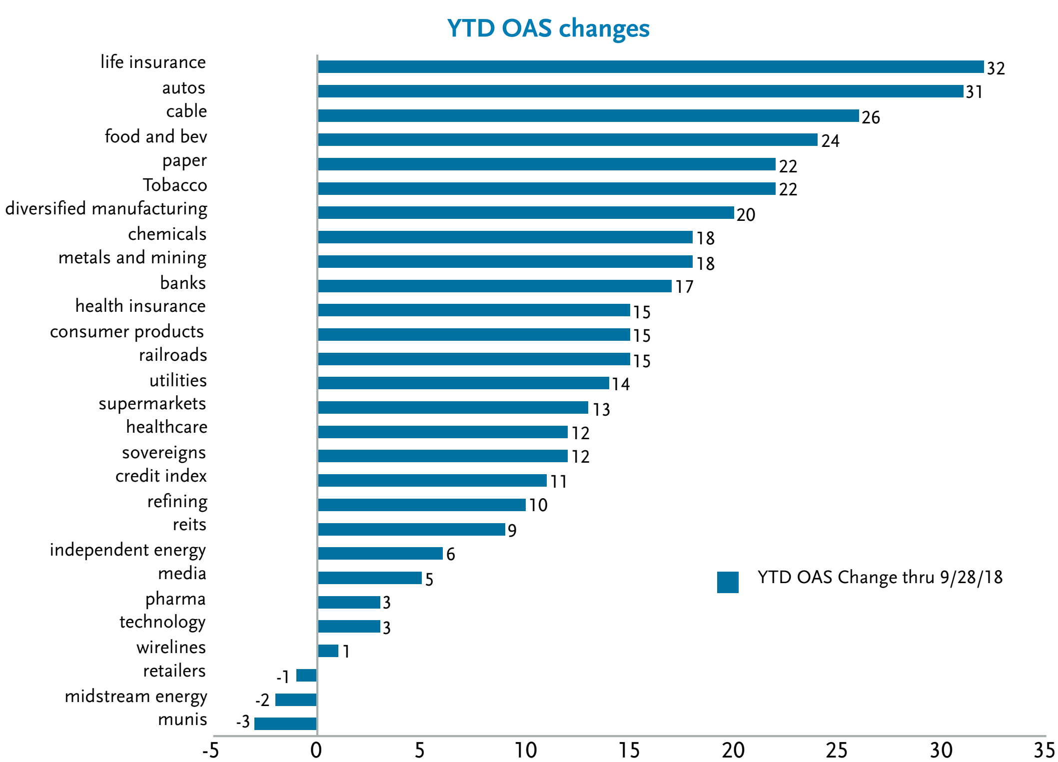


Source: Barclays Capital



Source: Barclays Capital

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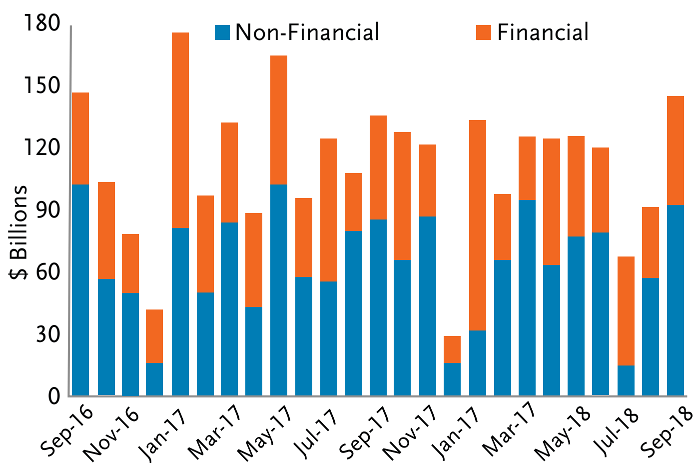
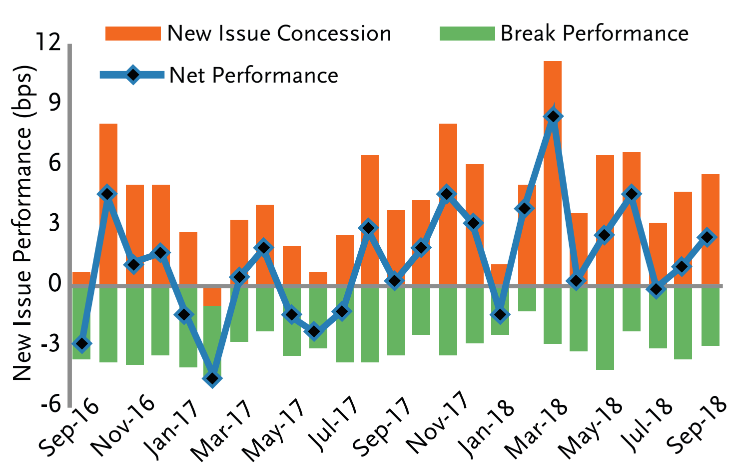
September Investment Grade Supply: IG supply volumes were $145 bln in September, a 58% increase vs. August. Industrial supply totaled $93 bln, including $37 bln in M&A-related issuance. The largest deal came from Cigna, issuing $20 bln across seven maturities to fund the acquisition of Express Scripts; 10yrs priced @ + 152/10yr, 30yrs priced @ +187/olb. The sector is undergoing a significant amount of (vertical) consolidation, as companies look to have greater control over healthcare services and costs, top to bottom. The CVS/AET deal announced in 2017 is still pending regulatory approval. Recall CVS issued $40 bln in debt earlier this year to fund the acquisition. The other large M&A-related deal in September came from Nestle, which issued $8 bln in bonds across six maturities, to fund the acquisition of Starbucks retail business; 5yrs priced at +47, 10yrs @ +70, 30yrs @ +95. Nestle is a AA rated credit.

Monthly New Issue Volumes



Source: BofA Merrill Lynch Global Research

New Issue Concessions and Performance



Source: BofA Merrill Lynch Global Research