

CREDIT UPDATE

Technical vs. Fundamental Divergence

TAMMY KARP | 4 OCTOBER 2019

In the tug of war between the QE-led reach for yield and fundamental weakness, technicals got the upper hand in September as the Fed delivered another rate cut and the ECB restarted QE. It was an eventful month as market risks mounted – weak global economic data, trade wars, Brexit, impeachment, Hong Kong protests, Saudi oil facility bombings and repo market funding stress. The spike in short term secured funding rates was generally viewed by the markets as technical in nature (T-bill issuance, quarter end funding needs) though in our view it underscores the structural pressures on dollar liquidity resulting from Fed QT and bank capital buffer constraints. There appears to be no easy solution. The easing of capital requirements for banks might alleviate some funding pressures but poses systemic risk (we need better capitalized banks this late in the cycle) while another round of Fed QE could further drive up asset prices/bubbles.

While the macro risks, combined with deteriorating credit fundamentals, stretched valuations, massive growth in the credit markets, worsening liquidity conditions and rising idiosyncratic risks are warning signs of the troubles that lie ahead, the central bank put was the overriding factor for risk asset performance this month. The ECB announced a resumption of its asset purchase program at Euro 20 bln per month starting in November with no set end date. While no explicit details on the composition of bond purchases were given, expectations are for it to resemble previous QE exercises. That implies ~ 10-12% of purchases (or ~ 2 bln euros/month) will be designated for the Corporate Sector Purchase Program.

Accommodative central bank policies kept spreads in check and the appetite for risk assets intact in September. On the demand side, inflows into IG credit remained robust (near record YTD inflows) as the market digested heavy new issue volumes. Attractive funding costs encouraged issuers to borrow record amounts of long term debt. Five issuers priced 30yr bonds with two handle coupons, including Disney, which issued a 30yr at 2.75%, the lowest 30yr coupon on record.

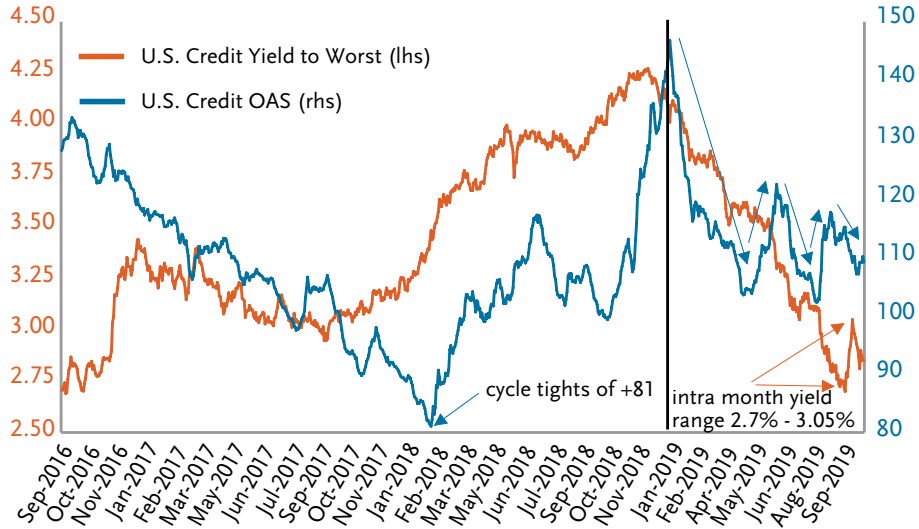


Tammy Karp
Managing Director
Fixed Income

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.

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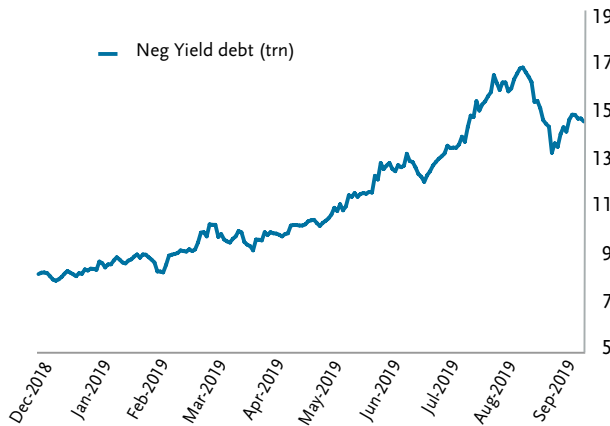
The Whipsaw Continued:
 CREDIT INDEX YIELD ENDED THE MONTH 11 BPS HIGHER (35 BP RANGE)
 WHILE SPREADS ENDED THE MONTH 5 BPS TIGHTER



Source: Bloomberg Barclays

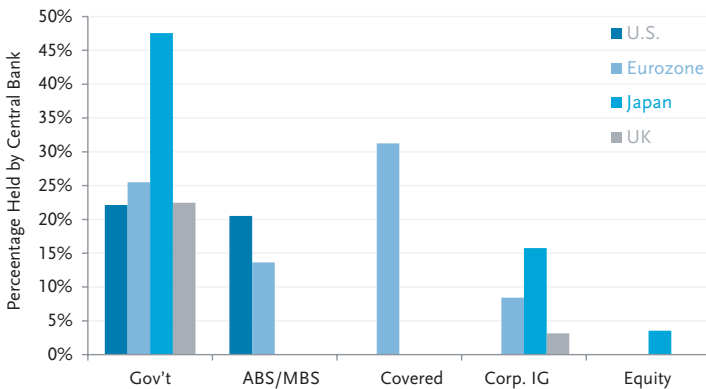
Yield Scarcity:

MARKET VALUE OF NEGATIVE YIELDING BONDS OFF VS. THE PEAK BUT STILL \$14 TRILLION



Source: Bloomberg Barclays

QE: Central Bank Holdings by Asset Class



		Central bank holdings/market capitalisation				
		Gov't	ABS/MBS	Covered	Corp. IG	Equity
US	Fed holdings (\$bn)	2,272	1,683			
	US market size (\$bn)	10,275	8,200			
	% of market	22.1%	20.5%			
Eurozone	ECB holdings (€bn)	1,688	27	269	173	
	Eurozone market size (€bn)	6,620	200	862	2,047	
	% of market	25.5%	13.6%	31.3%	8.4%	
Japan	BoJ Holdings (¥tn)	464			3.2	23
	Japan market size (¥tn)	975			20.2	637
	% of market	47.6%			15.8%	3.5%
UK	BoE holdings (£bn)	435			10	
	UK market size (£bn)	1,935			312	
	% of market	22.5%			3.1%	
Fed, ECB, BoJ & BoE QE Holdings (\$bn)		11,334				

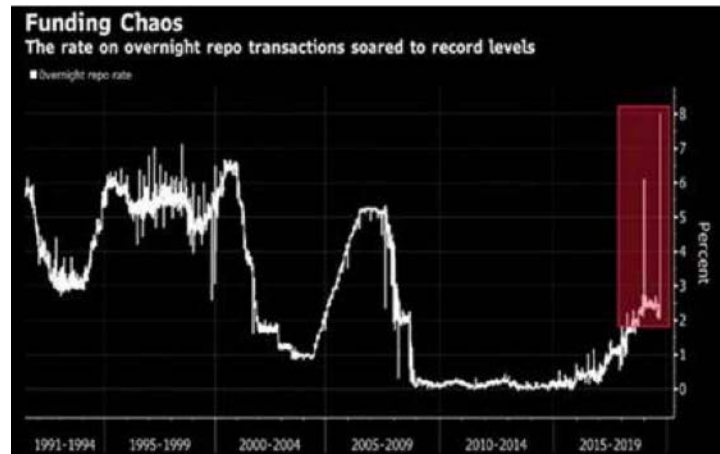
Additionally, ECB holds €400bn (\$450bn) of supras, agency & local gov't bonds.

Source: Deutsche Bank, ECB, BoE, Fed, BoJ, Bloomberg Finance LP, SIFMA

Technical vs. Fundamental Divergence

Short Term Funding Stress:

THE IDEA THAT SOFR (SECURED OVERNIGHT FUNDING RATE) DOES NOT EMBED BANK CREDIT RISK CALLED INTO QUESTION



Source: Bloomberg

Index Performance

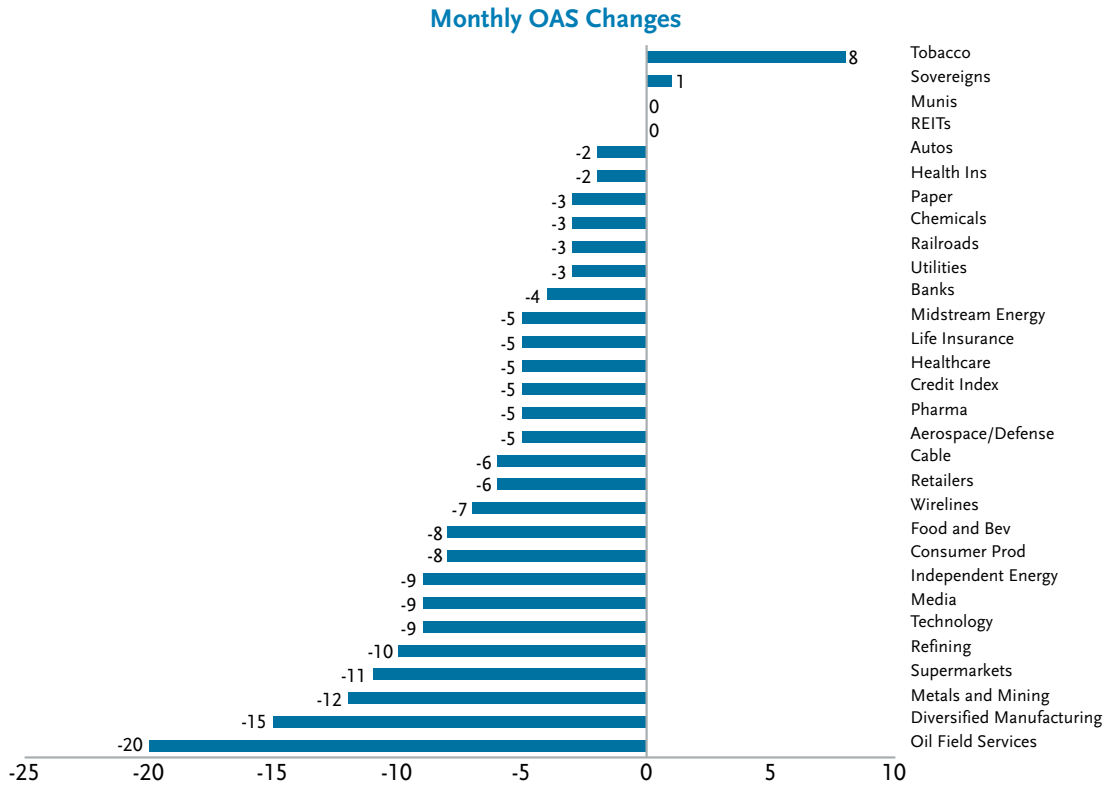
After 11 bps of widening in August, IG credit spreads posted a partial recovery in September as the QE- led technicals outweighed a weakening fundamental backdrop. The reach-for-yield theme remained intact as higher beta outperformed with a few exceptions. The credit index OAS of +109 bps over Treasuries tightened 5 bps on the month as BBBs (-6 bps) and cyclicals outperformed. Tighter spreads produced positive excess returns of .38% on the month while higher risk free rates resulted in negative total returns of -.65%. YTD returns remain strong at 3.75% (excess returns) and 12.61% (total returns). The best performing sectors in September were some of the worst performers in August as commodity-related names reversed much of last month's widening. This cyclical cohort was comprised of oil field servicers (-20 bps), metals and mining (-12 bps), refiners (-10 bps) and independent energy (-9 bps). The remaining outperforming sectors included diversified manufacturing (-15 bps) led by GE (-45 bps), supermarkets (-11 bps), tech (-9 bps) led by BBB names, and media (-9 bps). GE bonds rallied as the company made further deleveraging progress from more asset sale realizations and a subsequent \$5 bln bond tender announcement. The worst performing sector in September was tobacco (+8 bps), driven by MO (Altria) after PM/MO merger talks ended. Other underperformers included sovereigns (+1), autos (-2 bps) driven by an ongoing UAW strike at GM, and health insurers (-3 bps). Healthcare related sectors have generally underperformed YTD as proposed changes to the healthcare system have weighed on spreads. The most radical of the proposals is Medicare for all, which is supported by both Senators Warren and Sanders. From a practical standpoint, the high costs of the plan (estimated at \$32 trillion over a 10-year period) would require massive taxation to foot the bill. In addition, a proposal to wipe out an entire health insurance industry would cause major disruption to our healthcare system and economy. As a result, this plan will likely face strong opposition. More moderate proposals like an expansion of Medicare (lowering the eligibility age) would still be difficult to pass but would not be as destructive.

September Index Returns

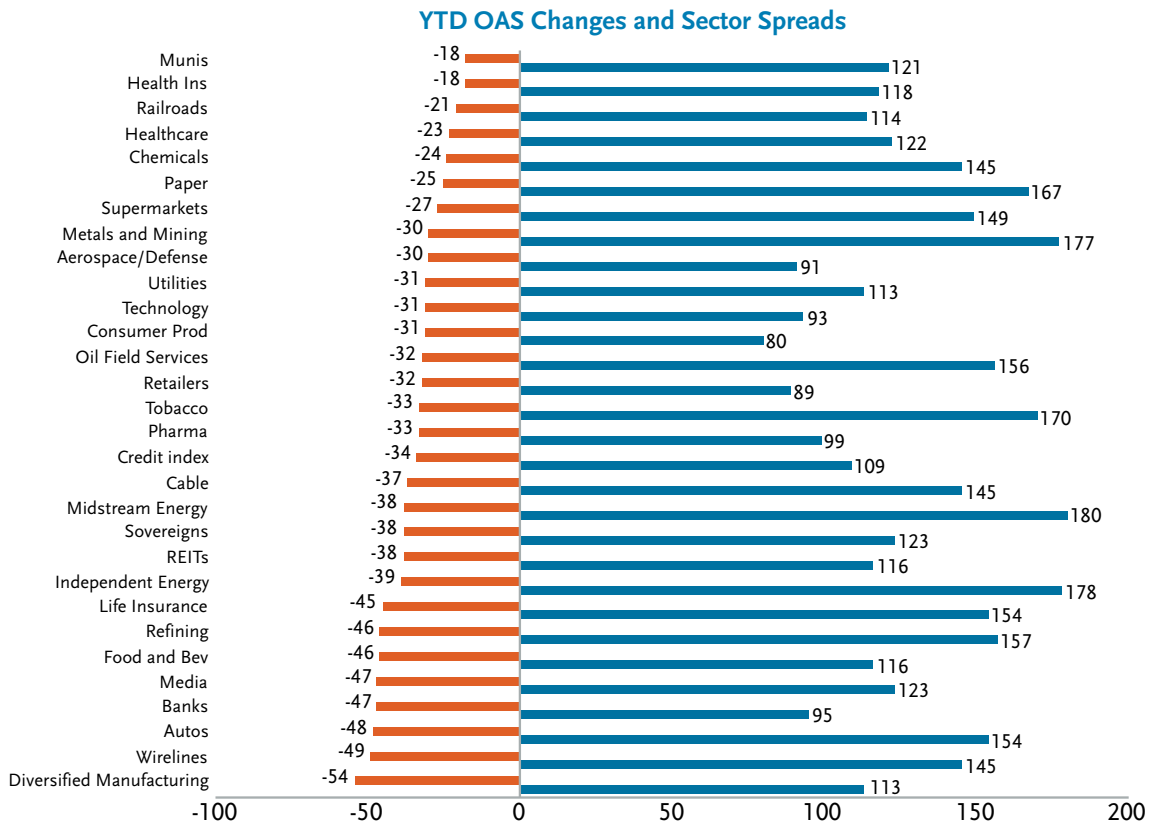
	September Excess Return	September Total Return	YTD Excess Return	YTD Total return	9/30/19 OAS	Monthly OAS Change	YTD OAS Changed
Credit Index	0.38%	-0.65%	3.75%	12.61%	109	-5	-34
Industrials	0.54%	-0.62%	4.36%	14.11%	121	-7	-36
Financials	0.24%	-0.55%	3.91%	11.25%	103	-4	-44
Utilities	0.21%	-1.29%	2.35%	14.34%	113	-3	-31
Municipals	-0.04%	-1.67%	3.00%	15.86%	123	2	-16
Sovereigns	-0.06%	-1.38%	4.89%	15.61%	123	1	-38
AA	0.22%	-0.76%	2.00%	10.32%	59	-4	-22
A	0.23%	-0.84%	3.11%	12.18%	88	-3	-30
BBB	0.58%	-0.51%	5.22%	14.52%	152	-6	-45

Source: Bloomberg Barclays

Technical vs. Fundamental Divergence



Source: Barclays Capital



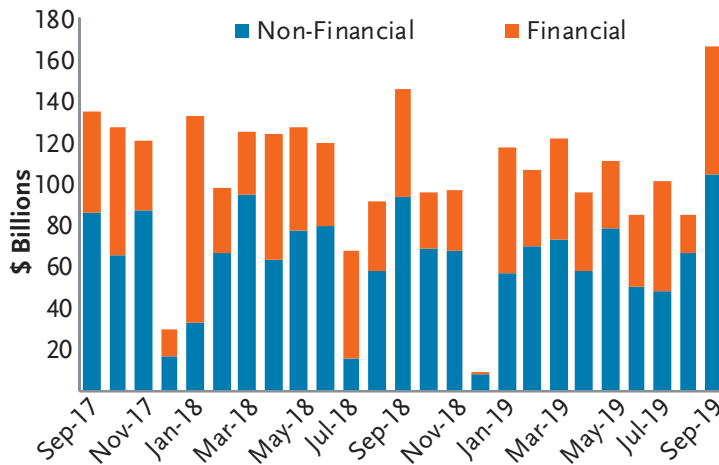
Source: Barclays Capital

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September Supply

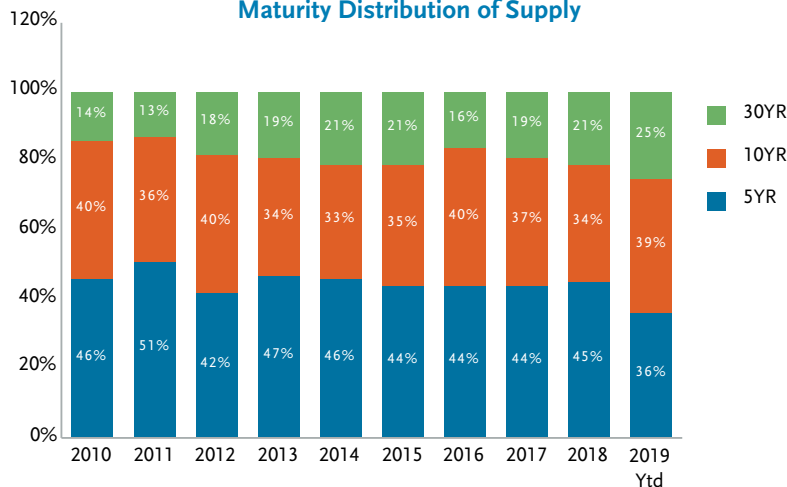
September gross supply volumes of \$166 bln were the third largest on record as issuers took advantage of the rally in corporate bond yields. Five issuers priced 30yr bonds with 2 handle coupons, including Disney, which issued a 30yr at 2.75%, the lowest 30yr coupon on record. About two-thirds of new issue proceeds in September were used to refinance maturing debt and/or term out front end debt. As such, the percentage of long dated issuance (10yr and 30yr) climbed to 70% in September, compared to the 10 year average of 54%. The largest deals came from Pemex (\$7.5 bln across 3 tranches, 10yrs priced @ +507, 30yrs at +545), Apple (issued \$7 bln in a drive by, 10yrs priced at +78, 30yrs @ +103) and Disney (issued \$7 bln with use of proceeds for bond tender, 10yrs priced @ +70, 30yrs @ +95). Supply related to M&A was a modest \$6.8 bln while the pipeline of pending M&A-related issuance remained stable. The three large pending M&A deals are Tmus/Sprint (merger is still in the negotiating stage with the various regulatory federal and state bodies, ~ \$20 bln debt issuance if approved), ABBV/AGN (\$30 bln potential funding needs) and Mylan/Pfizer off patent drug business (\$12 bln issuance implications).

Monthly Supply Volumes



Source: BofA Merrill Lynch Global Research

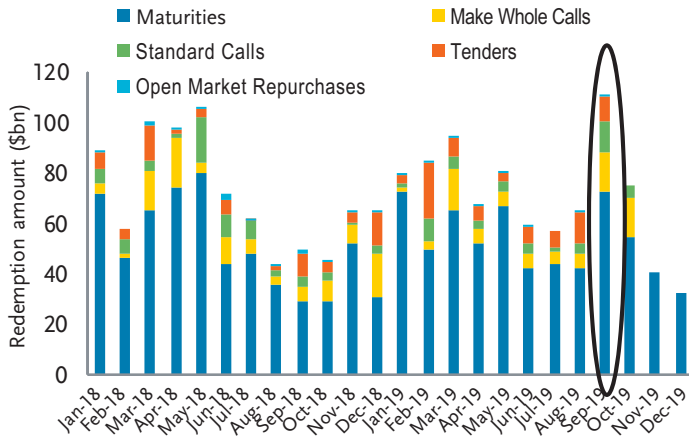
Maturity Distribution of Supply



Source: BofA Merrill Lynch Global Research

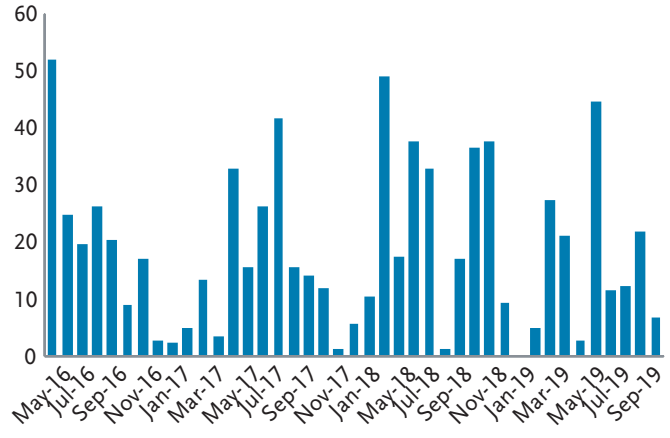
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U.S. IG Maturities and Additional Redemptions



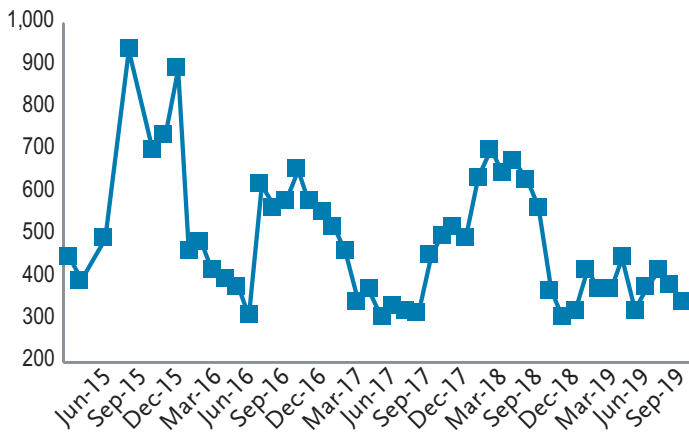
Note: Detailed redemption amounts data by type is grouped by effective dates.
 Source: Bloomberg, ICE Data Indices, LLC, BofA Merrill Lynch Global Research

USD IG Supply Related to M&A (\$bn)



Source: BofA Merrill Lynch Global Research

Pipeline of Pending M&A Deals With IG Issuance Implications (\$bn)



Source: BofA Merrill Lynch Global Research, Bloomberg

Disney Issues Lowest 30yr Coupon on Record

TickerBond	Cusip	Maturity Date	Coupon	Issuance Date
DIS	245687FM	9/1/2049	2.75	9/3/2019
DE	244199BG	9/7/2049	2.875	9/3/2019
XEL	665772CR	3/1/2050	2.9	9/3/2019
AAPL	037833DQ	9/11/2049	2.95	9/4/2019
WMT	931142EP	9/24/2049	2.95	9/19/2019

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