TCW

INSIGHT

MONTHLY COMMENTARY

October Credit Update

TAMMY KARP | NOVEMBER 3, 2016

October was marked by higher yields and negative returns among most asset classes. Returns were negative on higher risk-free rates, but spreads were firm for most of the month, though ended on a weak note as large ETF redemptions in HYG and LQD, more M&A announcements, commodity price weakness and disappointing earnings in the healthcare space weighed on the market. The yield on the IG credit index rose 23 bps in October, the first meaningful monthly back up in credit yields we've seen this year. At 2.85%, the yield on the credit index is 70 bps lower YTD and still near all-time lows. If we look back historically, there were only five years of negative total returns for the credit index going back to 1994. With rates/yields at near historical lows, returns going forward seem quite vulnerable.

While the QE-led quest for yield theme certainly has been a dominant force in the market, valuations are stretched and fundamentals are deteriorating. Weak earnings, record debt-funded M&A, share buybacks and dividends have caused corporate leverage to rise – with net leverage for industrial issuers up .44 turns year-over-year to 2.41x, a new historic peak. Q3 earnings are shaping up for another lackluster quarter though on a positive note, EPS growth is expected to be modestly positive (+1% y-o-y EPS growth) after 5 consecutive quarters of negative growth. Among Financial companies 75% beat expectations as U.S. bank earnings were respectable on strong FICC revenues, an improvement in debt and equity underwriting profits, and decent loan growth (partially offset by continued pressure on net interset margins). The mean CET1 (common equity tier 1) ratio for the Big 6 improved 15 basis points to 12.4% - with all above the minimum regulatory threshold.

M&A: A lot of activity in October brought the M&A deal backlog up to $460 bln after two quarters of declines (see chart next page). The three large M&A announcements were ATT/TWC, QCOM/NXP and BHI/GE. AT&T announced its intent to buy TWX for $84.5 bln ($108.7 bln including TWX debt) comprised of 50/50 cash-to-stock. The deal is expected to close "before year end 2017," implying an onerous and lengthy regulatory process. When you include the $40 billion in debt AT&T will need to issue to fund the cash portion of the deal, combined debt for the two companies will be ~ $185 billion - making it the largest industrial IG debt issuer by a wide margin. Pro forma leverage increases about .6x turns to 3x but the company is committed to reducing leverage back to 2.5x within one year after deal closing. All three agencies subsequently put AT&T's ratings on watch downgrade (from Baa1/BBB+/A-) with 0-1 notch downgrades expected.

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Ms. Karp is a Managing Director in the U.S. 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.

Consensus 3Q16 Earnings and Sales Growth Expectations for S&P 500 Sectors

	Earnings		Sales	
	YoY%	QoQ%	YoY%	QoQ%
Consumer Disc.	(0.3%)	0.2%	7.7%	3.7%
Consumer Staples	5.0%	4.1%	2.7%	3.0%
Energy	(67.6%)	102.8%	(15.5%)	1.8%
Financials	7.8%	4.9%	2.4%	0.4%
Health Care	5.5%	0.5%	6.7%	0.2%
Industrials	(3.5%)	1.7%	(0.3%)	(1.7%)
Technology	6.7%	6.1%	5.2%	3.9%
Materials	4.4%	(19.7%)	(0.9%)	(2.6%)
Real Estate	6.8%	(0.9%)	7.2%	0.3%
Telecom Services	(1.2%)	4.0%	0.7%	0.9%
Utilities	8.5%	48.9%	6.6%	26.1%
S&P 500	**1.0%**	**4.4%**	**2.3%**	**2.1%**
ex. Financials	**(0.5%)**	**4.3%**	**2.2%**	**2.4%**
ex. Energy	**4.2%**	**3.7%**	**4.1%**	**2.2%**
ex. Fins & Energy	**3.4%**	**3.4%**	**4.3%**	**2.4%**

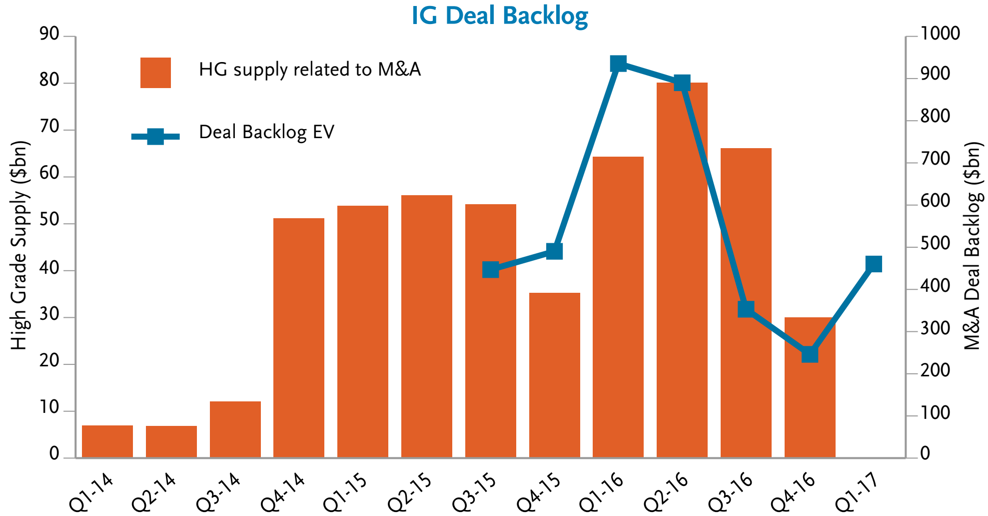
Source: FactSet, BofAML U.S. Equity & U.S. Quant Strategy

% of S&P Companies Beating on EPS and Sales for 3Q16

Sector	Total companies	Number Reported	% with EPS beat	% with Sales beat	% EPS & Sales beat
Cons. Discretionary	83	39	49%	45%	31%
Cons. Staples	36	18	83%	50%	50%
Energy	37	17	59%	28%	24%
Financials	64	52	75%	67%	52%
Health Care	59	32	63%	66%	50%
Industrials	67	51	61%	43%	33%
Tech	66	38	82%	76%	71%
Materials	27	16	56%	38%	31%
Real Estate	28	20	35%	55%	25%
Telecom	5	2	50%	0%	0%
Utilities	28	7	100%	29%	29%
S&P 500	**500**	**292**	**65%**	**53%**	**42%**

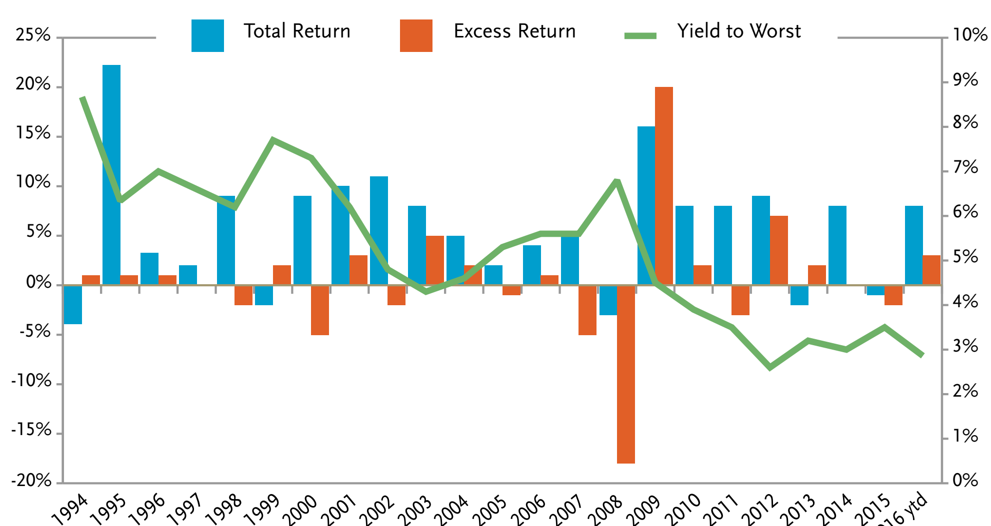
Source: FactSet, BofAML U.S. Equity & U.S. Quant Strategy

IG Deal Backlog



Source: BofA Merrill Lynch

Historical Credit Index Returns



Source: Bloomberg Barclays Live

October Credit Update

Yields and Spreads

Key	Axis	Name	Last	Minimum		Maximum	
	Right	U.S. Credit - OAS	125.376	122.507	10/19/2016	199.808	02/12/2016
	Left	U.S. Credit - Yield to Wors...	2.856	2.656	07/08/2016	3.552	01/04/2016

Source: Bloomberg Barclays Live

Credit Index Performance: Credit index spreads tightened 6 basis points in October, ending the month at an OAS of +125 basis points over Treasuries. Tighter spreads resulted in positive excess returns of .47% while higher risk-free rates had a negative impact on returns at -.85%. Commodity related sectors were again the best performers, tightening another 16 basis points for the metals and mining sector and 17 basis points for energy. M&A in the sector was a positive catalyst for spread tightening as GE and Baker Hughes announced the merger of their oil and gas businesses. The combination will increase scale and reduce leverage and ratings upgrades for the existing BHI bonds are expected post deal closing.

While energy spreads tightened significantly in October, bullish sentiment around an OPEC output-cut agreement began to fade at the end of month as disagreements between the members emerged – one of the disagreements being Iraq and Iran's request to be exempted from any production cuts. As the prospects for a deal diminished, oil prices followed suit with WTI ending the month at $46.86, $5 off the intra month highs. The resilience of energy spreads in the face of lower oil prices has been impressive if not perplexing. It seems unlikely that energy spreads can stay immune from oil prices forever.

Outside of the commodity sectors, life insurers were the best performing sector, tightening 17 basis points on the month to an OAS of +164 – with higher rates/yields being the catalyst. Worst performing sector was telecommunications(excess return of -.59%) – on the heels of AT&T's announced acquisition of Time Warner Inc. While regulatory approval is far from certain and expected to take a very long time (12-18 months), the prospect of $40 billion of additional ATT/TWC debt – on top of an already heavy pro forma $140+ billion debt capital structure - sent spreads 20-30 basis wider across the AT&T and TWX debt complex.

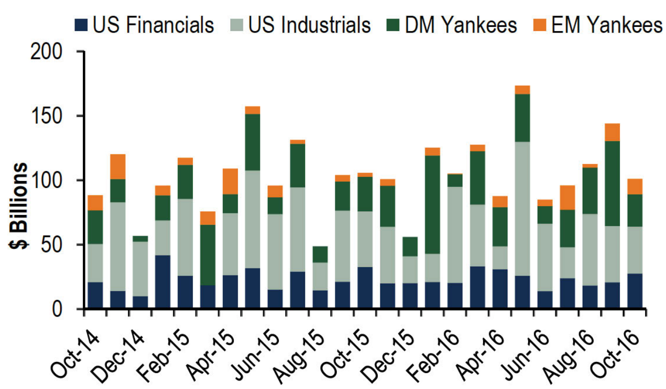
October Credit Update

October Credit Index Returns

	Month-to-Date Excess Return	Month-to-Date Total Return	Option-Adjusted Spread	Option-Adjusted Spread Month-to-Date Change
Credit Index	-.47%	-.85%	125	-6
Industrials	.49%	-1.01%	135	-5
Financials	-.64%	-.32%	129	-8
Utilities	-.74%	-1.25%	125	-7
Municipals	-.19%	-2.19%	157	-1
Sovereigns	-.10%	-1.78%	148	+1

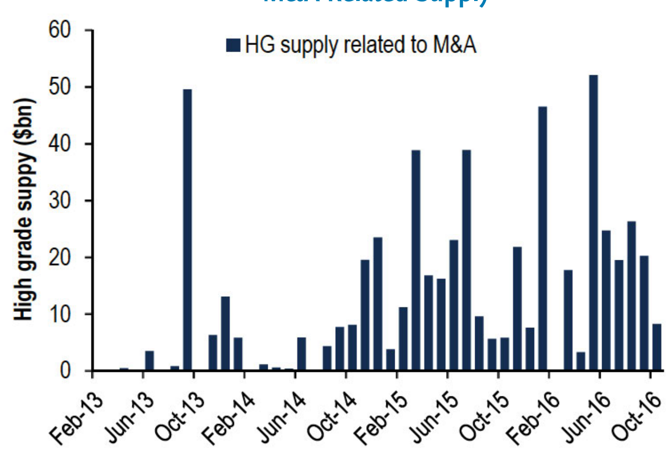
Supply: Another $100+ billion dollar month of supply in October ($101 billion to be exact). Supply related to M&A declined to about $8 billion, down from the roughly $20-$30 billion pace the previous four months. New issue concessions were again de minimus, with several deals printing inside of secondary levels (negative concessions). As such, deal performance was mixed, at best.

IG Monthly Supply



Source: BofA Merrill Lynch Global Research

M&A Related Supply



Source: BofA Merrill Lynch Global Research

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