TCW

INSIGHT

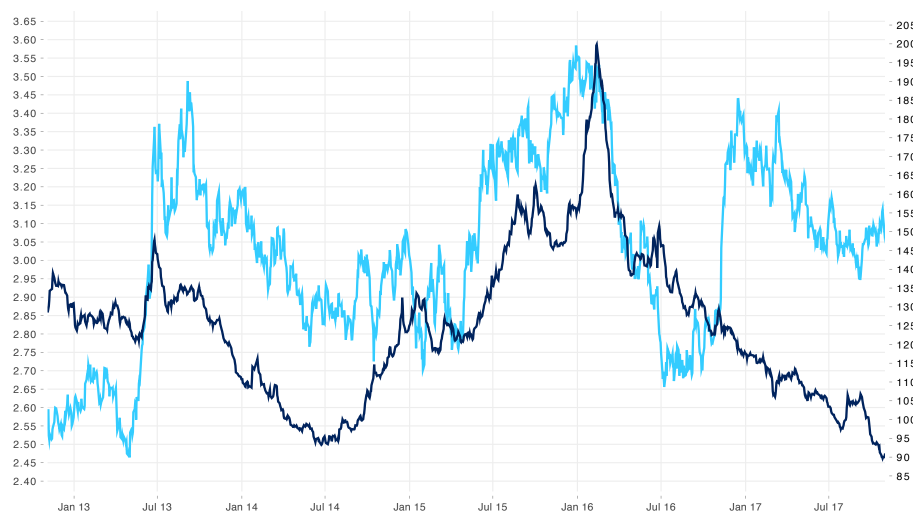
MONTHLY COMMENTARY

October Credit Update

TAMMY KARP | NOVEMBER 3, 2017

The grind tighter in credit spreads continued in October as appetite for risk remained strong. The credit index tightened 5 basis points, ending the month at an OAS of +91 basis points over Treasuries, a post crisis best. A decent third quarter earnings season as well as bullishness over the prospect of tax reforms sent stocks to new highs and IG credit to new (post crisis) tights. As a whole, technicals remained strong as overseas demand for spread product as well as robust inflows into domestic high grade funds continued. However, not all is fine and dandy in the credit universe and cracks have emerged. Spread performance was bifurcated as some big earnings misses resulted in significant spread moves. For example, Mattel spreads widened 110 bps on the heels of disappointing earnings and subsequent ratings downgrades. Additionally, fundamental concerns in sectors like retail as well as M&A related headlines in the healthcare-related sectors caused meaningful underperformance for several credits. The Amazon threat has permeated not only into the big box retail and grocery store arena, but also into the drug retail and distribution space. The announcement that Amazon received approval for wholesale pharmacy licenses in twelve states sent spreads wider in the pharmacy retail, PBM and drug distributor sectors. It has also given rise to M&A risk (CVS/AET acquisition rumor) as companies look to add scale and vertical integration in order to diversify and compete. While it is still unclear how Amazon's potential entrance into the space will affect the drug ecosystem, the implications are negative.

Credit Index Yields and Spreads



Key	Axis	Name	Last	Minimum		Maximum		Mean
■ (dark blue)	Right	U.S. Credit – OAS	90.674	89.685	10/26/2017	199.808	02/12/2016	125.819
■ (light blue)	Left	U.S. Credit – Yield to Worst	3.087	2.464	05/02/2013	3.584	12/29/2015	3.027

Source: Bloomberg Barclays

Tammy Karp
Managing Director
U.S. Fixed Income

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.

Q3 earnings recap: As of 10/27, earnings growth for the IG issuers is +4.4% on a year-over-year basis, down from the 8.2% growth rate in Q2'17. Commodity-related sectors showed the biggest improvement with energy earnings up 71.6% on weak year-over-year comparables. Additionally, the industry benefited from an improvement in oil prices to $51 at the end of the third quarter as well as industry-wide cost improvements and asset rationalizations. Excluding energy, earnings growth for the IG universe was a modest 2%. The technology sector, which is dominated by a handful of large issuers, posted the next best growth rate at + 16.2%.

Bank earnings were a mixed bag for the big 6. Revenue was weak on lower FICC revenues (down 22.4% on average) and NIM improvement was marginal. Additionally loan and deposit growth was weak and credit standards tightened for auto and credit cards. Credit provisioning increased for credit cards though losses remain near cycle lows. On the positive side, banks remain well capitalized and leverage ratios continue to improve (CET1 ratio +.08% on avg).

Third Quarter Earnings Results for IG Universe (as of 10/2)

Sector	Earnings Growth (YoY)	Sales Growth (YoY)
Aerospace/Defense	-6.2%	4.4%
Automobiles	1.6%	-7.2%
Banks/Brokers	8.6%	3.4%
Basic Materials	3.5%	9.8%
Consumer Products	0.6%	2.3%
Energy	71.6%	16.4%
Finance	9.3%	9.2%
Food, Bev, & Bottling	2.0%	0.5%
Health Care	5.2%	4.2%
Industrial Products	16.0%	5.0%
Insurance	-56.9%	-1.3%
Media & Entertainment	4.9%	1.5%
REITs	-2.2%	0.5%
Retail	-1.3%	6.1%
Technology	16.2%	8.6%
Telecom	-1.5%	-0.6%
Transportation	-2.9%	5.3%
Utilities	-3.4%	1.0%
Other	6.5%	6.6%
Total US HG public co's	4.4%	5.1%
Total ex. Financials	8.9%	5.7%
Total ex. Energy	2.0%	3.8%
Total ex. Fin. & Energy	6.0%	4.3%

Source: BofA Merrill Lynch Global Research, FactSet.

US GSIB 3Q17 COMPARABLE ANALYSIS							
3Q17							
($ in Billions) (except per share data)	BAC	JPM	Citi	WFC	GS	MS	Simple Avg.
Revenues	$21.80	$25.30	$18.10	$21.90	$8.30	$9.20	**$17.43**
Revenue Growth YoY	0.94%	3.00%	2.00%	-2.00%	2.00%	3.00%	**1.49%**
NII	$11.20	$12.80	$11.40	$12.50	NA	NA	**$11.98**
NII Growth YoY	9.00%	10.00%	0.00%	4.00%	NA	NA	**5.75%**
NIM	**2.36%**	**2.37%**	**2.72%**	**2.87%**	**NA**	**NA**	**2.58%**
NIM Growth (QoQ)	**0.02%**	**0.06%**	**0.00%**	**-0.03%**	**NA**	**NA**	**0.01%**
Efficiency Ratio	60.00%	57.00%	56.00%	66.00%	65.00%	73.00%	**62.83%**
Pre-Tax Contribution Margin*	275.00%	132.00%	93.00%	-302.00%	68.00%	33.00%	**49.83%**
ROTCE	11.30%	13.00%	8.40%	10.80%	11.40%	11.00%	**10.98%**
Loan Growth YoY	**2.40%**	**3.00%**	**2.00%**	**-1.00%**	**NM**	**NM**	**1.60%**
Loan Growth QoQ	**1.00%**	**1.00%**	**1.00%**	**-1.00%**	**NM**	**NM**	**0.50%**
Deposit Growth YoY	**4.00%**	**5.00%**	**3.00%**	**0.00%**	**NM**	**NM**	**3.00%**
Deposit Growth QoQ	**2.00%**	**0.00%**	**1.00%**	**0.00%**	**NM**	**NM**	**0.75%**
TBV Growth (Sequential)	-3.10%	1.30%	2.00%	1.30%	1.80%	1.80%	**0.85%**
Provisioning	$0.83	$1.40	$2.00	$0.72	NA	NA	**$1.24**
Total Reserves (On+Off B/S)	$11.45	$14.65	$13.60	$12.10	NA	NA	**$12.95**
FICC Trading	**$2.20**	**$3.20**	**$2.80**	**NA**	**$1.45**	**$1.20**	**$2.17**
FICC Trading Growth YoY	**-22.00%**	**-27.00%**	**-16.00%**	**NA**	**-26.00%**	**-21.00%**	**-22.40%**
Equity Trading	$1.00	$1.40	$0.76	NA	$0.58	$1.90	**$1.13**
Equity Trading Growth YoY	2.00%	-4.00%	16.00%	NA	-14.00%	0.00%	**0.00%**
IBanking Revenues	$1.50	$1.70	$1.20	NA	$1.80	$1.38	**$1.52**
IBanking Revenue Growth YoY	1.00%	-2.00%	14.00%	NA	17.00%	13.00%	**8.60%**
Capital & Credit:							
Tangible Book Value Per Share	$17.23	$54.03	$68.55	$31.03	$180.42	$33.86	**NM**
Price/Tangible Book	1.50x	1.77x	1.05x	1.70x	1.30x	1.50x	**1.47x**
TCE Ratio	8.10%	7.40%	10.00%	8.00%	7.60%	7.20%	**8.05%**
TCE Growth (QoQ Change)	0.10%	0.10%	0.00%	0.20%	-0.20%	-0.10%	**0.02%**
Tangible Leverage	12.35x	13.51x	10.00x	12.50x	13.16x	13.89x	**12.57x**
Fully Loaded CET1 Ratio	12.20%	12.80%	13.00%	11.80%	12.00%	16.30%	**13.02%**
Fully Loaded CET 1 Growth (QoQ)	0.20%	0.30%	0.00%	0.20%	-0.50%	0.30%	**0.08%**
Supplementary Leverage Ratio (SLR)	7.10%	6.60%	7.10%	7.94%	6.10%	6.50%	**6.89%**
NCO Rate	**0.39%**	**0.56%**	**1.08%**	**0.30%**	**NA**	**NA**	**0.58%**
Total Reserves/Loans	1.20%	1.50%	1.91%	1.27%	NA	NA	**1.47%**

Source: TCW.
*Contribution Margin is % Change in Pre-Tax /% Change in Revenues. (Different from Pre Tax Pre Provision Contribution Margins)
**WFC SLR is from 2Q17. Pillar 3 Report.

Index Performance: At an OAS of 91 basis points over Treasuries, IG credit spreads ended the month at new post crisis tights. The credit index tightened 5 basis points on the month, posting an excess return of .46% and total return of .34%. Year-to-date total and excess returns remain strong at 5.43% and 2.88% respectively. The best performing sectors were commodity-exposed independent E&P's (-18 bps), metals (-15 bps), refiners (-15 bps) and oil field servicers (-14 bps). Oil prices (WTI) rose to $54 at month end as the global supply-demand imbalance has improved. The OPEC production cuts of 1.8 million bpd (~ 2% of global supply) are expected to get extended through 2018. U.S. crude inventories stood at 457 mln barrels as of Oct. 20, down 2.3% from a year ago and 15% from the peak in March (though still above the 5-year average). U.S. production of 9.5 mln bpd remains at peak levels as OPEC efforts to curb supply have been met by increased production in the U.S. and elsewhere.

The worst performing sectors were health insurers and sovereigns, the only two sectors to post negative excess returns (-17 bps and -5 bps excess returns). For the health insurers, AET was the big underperformer, widening 19 basis points on the month on the heels of unconfirmed reports that CVS was interested in acquiring the company. While the attempt at horizontal M&A in the health insurance sector failed to get regulatory approval, vertical integration should face fewer anti-trust hurdles. A CVS/AET combination could help play defense against the Amazon threat by giving CVS control over more parts of the healthcare chain (insurer, PBM, pharmacy) and thus more influence over its customers. From a credit perspective, a combination could be a good thing in the long term. In the short term, increased leverage and the potential for large acquisition debt issuance will pressure spreads. Additionally, a CVS/AET merger could trigger a wave of M&A as competitors (like WBA and other health insurers) face pressure to consolidate.

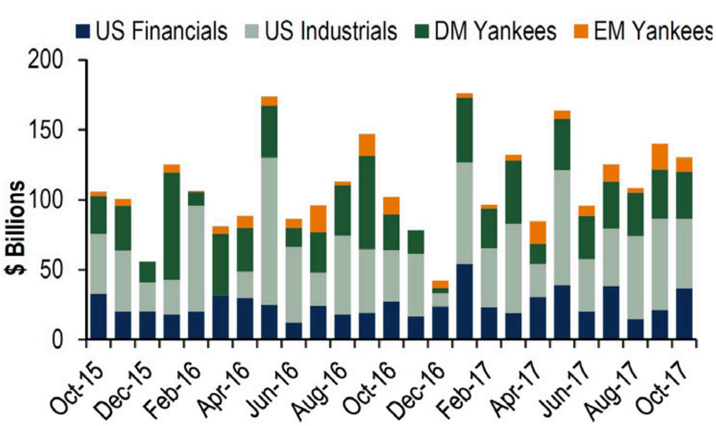
October Credit Index Returns

	Month-to-Date Excess Return	Month-to-Date Total Return	Option-Adjusted Spread	Option-Adjusted Spread Month-to-Date Change
Credit Index	.46%	.34%	91	-5
Industrials	.55%	.43%	99	-6
Financials	.43%	.31%	87	-6
Utilities	.73%	.62%	94	-6
Municipals	.84%	.73%	121	-8
Sovereigns	-.05%	-.17%	110	+1

Source: Bloomberg Barclays

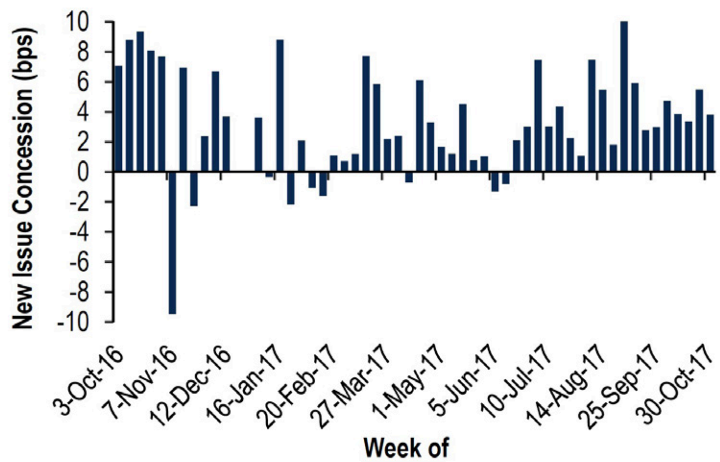
October Investment Grade Supply: New issue volumes were $130 billion, dominated by bank and industrial issuance. Financial supply was $60 bln as several banks came to market post earnings, including Goldman ($7 bln across three tranches, 21NC20 priced at +108/olb), Citigroup ($4.4 bln across three tranches, 11NC10 priced at +115/10yr) and Lloyds (a $4 bln, two-tranche deal, 11NC10 priced at +120, 6NC5 priced at +90/5yr). Issuance in the bank sector has been dominated by the new TLAC-friendly callable structures (6NC5, 11NC10, 31NC30, etc.). M&A-related supply was $14 bln, with the largest deal coming from NOC which issued $8.25 bln across five tranches to fund the Orbital acquisition (5yrs priced at +60, 10yrs at +90, 30yrs at +115). Overall, new issue concessions continue to be negligible and break performance was marginal at best. ■

Monthly IG Issuance



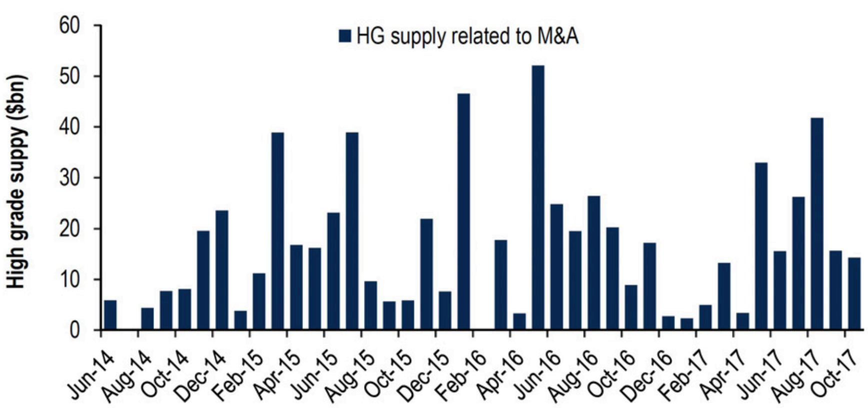
Source: BofA Merrill Lynch Global Research

New Issue Concessions



Source: BofA Merrill Lynch Global Research

M&A-related Supply:



Source: BofA Merrill Lynch Global Research