TCW

INSIGHT

MONTHLY COMMENTARY

Loan Review – October 2018

DREW SWEENEY | 14 NOVEMBER 2018

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Mr. Sweeney is a Senior Vice President in the 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.

"Taking stock." What does that mean? Occasionally, we have to step back, look at our lives, our jobs or our markets and think about bigger questions. What does it all mean? Well, let's just focus on the loan market for now and take stock of what has transpired in the last four months. Does it portend anything for the remainder of 2018 or even 2019?

In July, loan new issuance was 91 basis points wider than May. That seems to be a big data point. In August, a very light month for primary activity, new issuance only tightened 6 basis points from July. In fact, August new issue spreads required the second widest levels since November 2016 in order to get deals syndicated. As discussed in last month's monthly commentary, this set the stage nicely for September's mega-issuance month to struggle. But it did not struggle and what we have heard through the grapevine is that one Japanese bank may have contributed nearly $30 billion to a group of loan managers. Loan separate accounts do not have monthly reporting like mutual funds, so details are always vague. However, several investment banks have provided some confirmation of this massive investment. Separate account dollars are generally invested quickly at the market levels as opposed to the way a CLO is ramped over several months. Obviously, without that massive contribution, the loan market had been poised for more weakness.

That leads us to October and just as soon as a threat of a repricing wave materialized, it vanished. Broader global market weakness led to retail fund outflows and crossover selling of loans from high yield accounts. Loan prices sagged... again. That is a staggering thought. First that a single bank invested $30 billion in September and second, that one month post such a massive contribution prices sagged. One last data point: only three months in 2018 have actually provided loan price appreciation.

October also brought an earnings season of mixed results. Volatility increased and companies that underperformed expectations were severely penalized. Loans with high yield bonds in the capital structure, loans in more cyclical businesses and higher beta loans all traded materially lower.

During the last few years, loan spreads have generally tightened when primary issuance was low. The remainder of 2018 has very little loan issuance planned, and most investment banks are more focused on their first quarter of 2019. While loans have performed quite well versus other fixed income products, there has been an undeniable tone of weakness underlying the back half of 2018. While we suspect you could see prices slightly higher by the end of the year, it feels like this broader market volatility will prevent loans from bouncing too much.

Performance

In October, the Credit Suisse Leveraged Loan Index (CSI LLI) and the S&P Leveraged Loan Index (S&P/LSTA) were up 0.01% and down -0.03%, respectively.

- Year-to-date, ending October 31, the CS LLI was up 4.33% and the S&P/LSTA was up 4.00%
- For the 12 months ending October 31, the CS LLI was up 4.89% and the S&P/LSTA was up 4.54%

Lower quality loans underperformed as Triple Cs and Split Single Bs provided the worst performance during the month while Split Triple Bs and Single Bs led all categories.

Total Return by Rating

	October	YTD	LTM
Split BBB	0.10%	3.38%	3.66%
BB	-0.01%	3.43%	3.97%
Split BB	-0.01%	3.59%	3.96%
B	0.07%	4.43%	5.05%
Split B	-0.50%	7.88%	8.74%
CCC/Split CCC	-0.12%	8.52%	9.94%
Distressed (CC, C and Default)	-3.05%	5.33%	1.68%

Source: Credit Suisse Leveraged Loan Index

Sector Performance

Thirteen of the 20 sectors in the CS LLI provided a positive return during the month. Top performing sectors in October were Transportation (+0.31%), Forest Products/Containers (+0.21%) and Service (+0.20%).

The worst performing sectors for the month were Housing (-0.22%), Retail (-0.72%) and Metals/Minerals (-1.35%).

On a year-to-date basis, Retail (+8.15%), Energy (+7.18%) and Food & Drug (+5.70%) outperformed.

In the last 12 months, Retail, Energy and Food & Drug have led all sectors with total returns of 8.22%, 8.19% and 7.47%, respectively. In contrast, Food/Tobacco, Consumer Non-Durables and Consumer Durables were the worst performing sectors with returns of 3.88%, 3.50% and -0.88%, respectively.

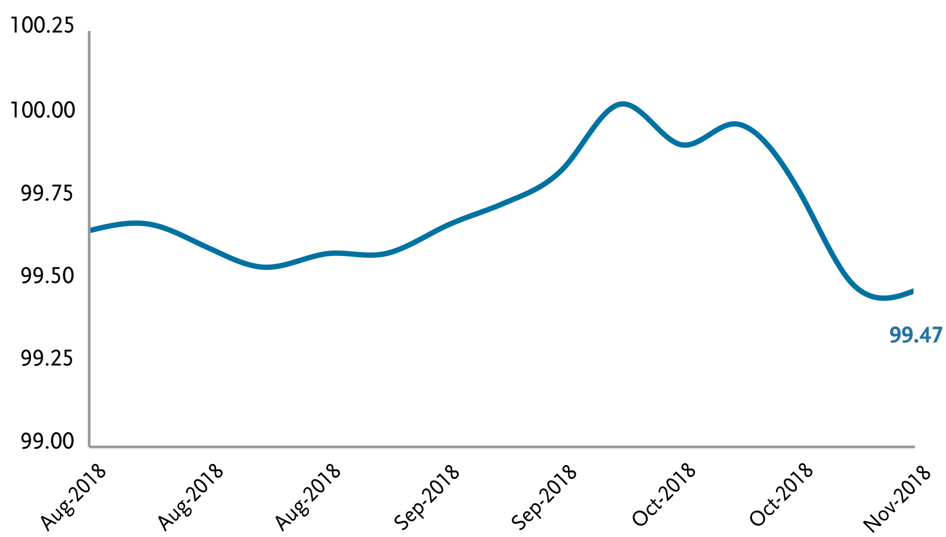
Industry Returns

	October	YTD	LTM
AEROSPACE	0.15%	3.56%	4.21%
CHEMICALS	0.06%	4.03%	4.63%
CONSUMER DURABLES	0.19%	1.74%	-0.88%
CONSUMER NON-DURABLES	-0.10%	4.27%	3.50%
ENERGY	0.02%	7.13%	8.19%
FINANCIAL	0.15%	4.19%	4.75%
FOOD AND DRUG	0.10%	5.70%	7.47%
FOOD/TOBACCO	0.10%	3.54%	3.88%
FOREST PROD/CONTAINERS	0.21%	3.46%	4.09%
GAMING/LEISURE	0.11%	3.52%	4.17%
HEALTHCARE	-0.05%	4.32%	4.87%
HOUSING	-0.22%	3.84%	4.30%
INFORMATION TECHNOLOGY	0.10%	4.46%	4.99%
MANUFACTURING	-0.13%	4.01%	4.85%
MEDIA/TELECOMMUNICATIONS	-0.06%	3.63%	4.13%
METALS/MINERALS	-1.35%	5.06%	6.56%
RETAIL	-0.72%	8.15%	8.22%
SERVICE	0.20%	3.97%	4.81%
TRANSPORTATION	0.31%	5.47%	5.79%
UTILITY	0.09%	4.64%	5.73%

Source: Credit Suisse Leveraged Loan Index

Credit Suisse Leveraged Loan prices decreased -48 basis points in October while the average bid of the S&P LCD flow-name loan composite drifted 10 basis points from 99.58 to 99.48.

Average Loan Flow-Name Bid



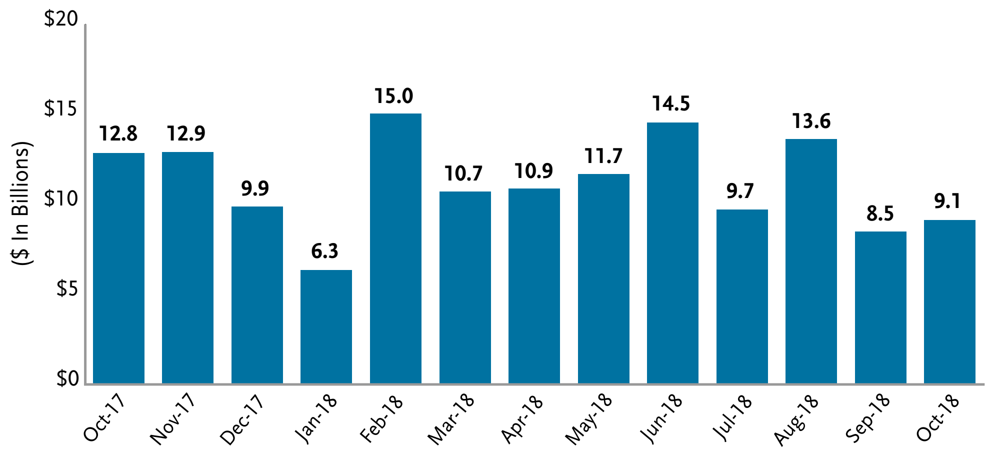
Source: LCD, an offering of S&P Global Market Intelligence

Technical Conditions

Leveraged loan funds reported an outflow of -$680 million for the four-week period ending October 31. While assets under management remain close to record high levels, three of the four weeks in October registered outflows. For context, the loan asset class has reported inflows in 37 of the past 41 weeks. Inflows for loan mutual funds total +$15.2 billion on a YTD basis.

There were $9.12 billion of CLOs issued in October, which brings year-to-date issuance to an astounding $110 billion.

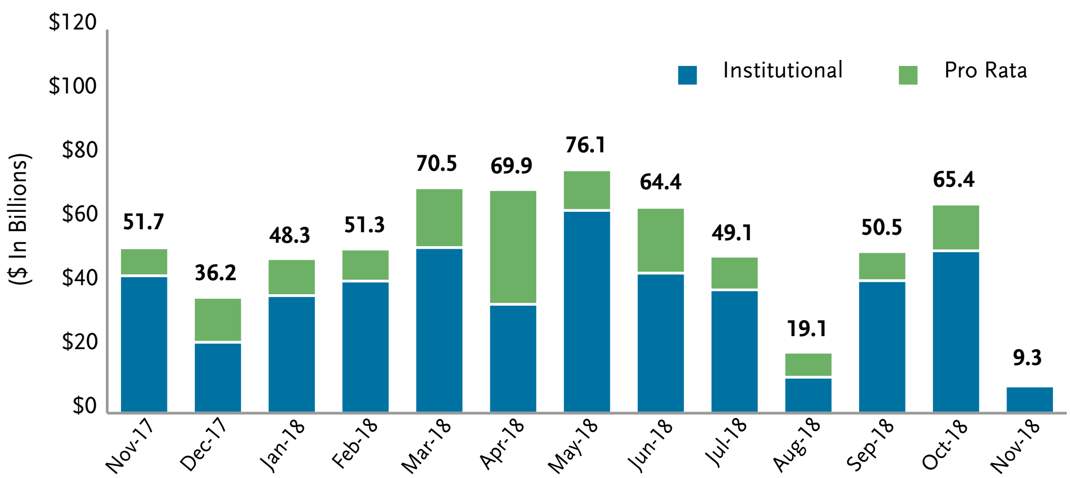
CLO Volume



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

Institutional new issuance increased in October to $50.8 billion, the third largest monthly volume of 2018. On a year-to-date basis, institutional new issue is down -4.1% from the first 10 months of 2017.

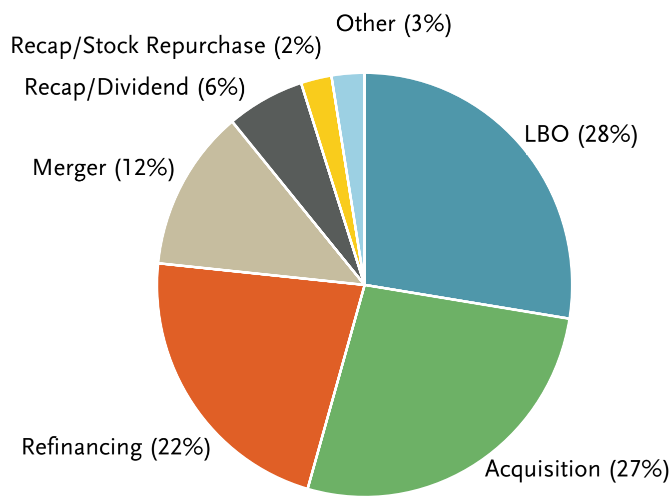
Leveraged Loan Volume



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

Repricings have declined in significance since the end of May. In fact, repricings represented approximately 22% of total new issuance since then, while acquisitions, mergers and LBOs represented 67%. On a YTD basis, acquisitions, mergers and LBOs represented 61% of new issuance.

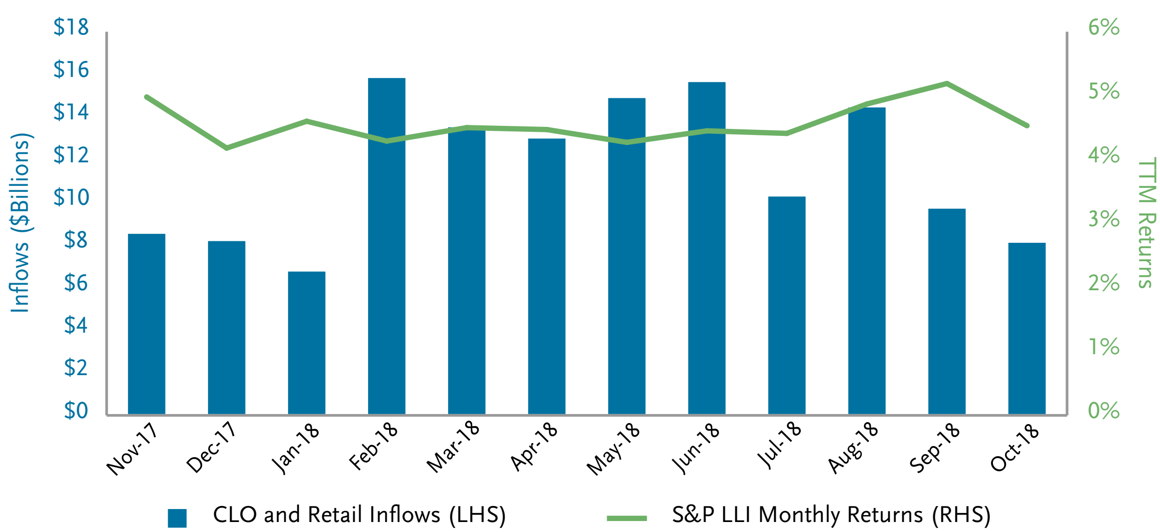
October New Issue by Purpose



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

Amid October retail outflows, we saw gross CLO and retail issuance decline to the lowest level since January 2018. The lower issuance contributed to the decline in the trailing 12-month returns of roughly 4.5%.

Inflows and Rolling LTM Returns



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

October saw new issue spreads tighten month-over-month. On a year-to-date basis, new issue spreads in October were 3.1% wider for double Bs and -6.0% tighter for single Bs. Spreads during the last 12 months were -1.3% tighter for double Bs and -5.2% tighter for single Bs. While average spreads have been in this range since April, these levels are the tightest spreads have been for the CS LLI since October 2010.

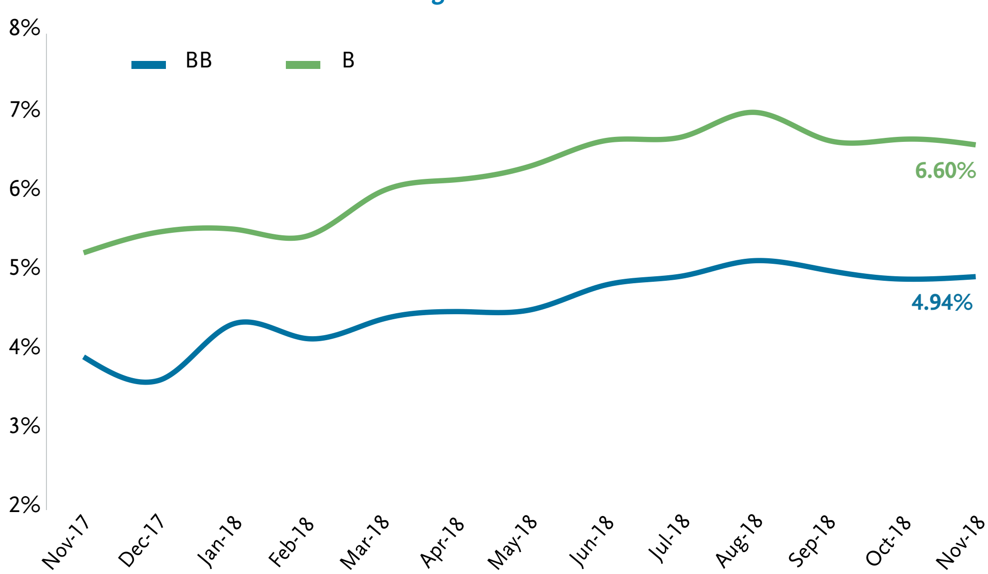
New Issue Spread Changes

	BB/BB-	B+/B
Dec-17	233	375
Mar-18	210	336
Jun-18	232	379
Jul-18	258	383
Aug-18	236	369
Sep-18	274	386
Oct-18	240	353
Month-Over-Month Change	-12.22%	-8.67%
YTD Change	3.06%	-5.99%
LTM Change	1.3%	-5.2%

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

In terms of new issue yields, double Bs tightened -12 basis points while single Bs widened 1 basis point. On a year-to-date basis, double B yields and single Bs are 57 and 112 basis points wider, respectively. Most of this was driven by 3-Month LIBOR as it was up 86 basis points during the year.

Average New Issue Yields



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

There were three defaults in October and the default rate changed from 1.81% in September to 1.92% in October.

The last 12-month default tally for the S&P/LSTA is 20. Oil & Gas defaults lead all categories with six while Retail is close behind with four.

Lagging 12-Month Default Rate

Actual	Aug-18	Sep-18	Oct-18
By Number	1.71%	1.59%	1.79%
By Principal Amount	1.99%	1.81%	1.92%
Shadow Default Rate			
By Number	0.75%	0.95%	0.75%
By Principal Amount	0.46%	0.61%	0.50%

Source: LCD Loan Stats

* Shadow default rate includes potential defaults, including those companies that have engaged

Valuation

Since 1992, the average 3-year discount margin ("DM") for the CS LLI is 460 basis points. If the global financial crisis (2008 & 2009) is excluded, the 3-year discount margin for the CS LLI is 416 basis points. At month end, the 3-year DM of398 basis points, while close to the same levels it has been at for all of 2018, is actually at its highest for 2018.

The DM spread differential between double Bs and single Bs has widened from November 2017 to October 2018 by 7 basis points and is still 43 basis points wider than the historical spread differential.

3-Year Discount Margin Differential Between BBs and Single Bs

1/1992-10/2018 Average	85.0
Nov-17	120.7
Oct-18	127.7

CS LLI Snapshot

YTD Total Return*	4.33%
Average Price	98.04
Spread	346.91
Coupon	5.84%
Current Yield	5.96%
Yield (3-year life)	711%
Discount Margin (3-year life)	398 bp

*S&P LLI YTD Total Return 4.00%
Source: Credit Suisse Leveraged Loan Index

	Spread	DM (3-Year Life)
Split BBB	195 bps	201 bps
BB	253 bps	267 bps
Split BB	308 bps	325 bps
B	381 bps	418 bps
Split B	510 bps	801 bps
CCC/Split CCC	673 bps	1,000 bps
Distressed (CC, C and Default)	713 bps	4,068 bps

Source: Credit Suisse Leveraged Loan Index

Summary & Looking Forward

As of October 31, the S&P/LSTA imputed default rate was 1.34%, up from 1.13% in the prior month. While this is a lower imputed rate for the loan market than existed from November 2007 through December 2017, it is the highest rate in 2018. Broader credit concerns regarding cyclical business have certainly emerged.

The massive investment into the loan market in September hurt the CLO arbitrage and while prices backed up in October, it did not relieve all arbitrage issues. October also witnessed a spike in LIBOR. While increasing LIBOR is generally positive for loans, the widening 1-month, 3-month LIBOR gap poses a near-term drag to CLO equity.

Looking forward, loans seem poised to have a slight improvement in prices for the remainder of the year simply because the new issue calendar is very light. However, earnings results have been mixed thus far for loans, and borrowers that have missed have been severely penalized. We have seen bifurcation in issuers as high beta borrowers and cyclical borrowers have not seen any bounce in price in the beginning days of November. Any potential spread tightening the market experiences during the last two months of the year, may be quickly readdressed as new issuance recommences in the first quarter 2019. ■