INSIGHT

LOAN & CLO REVIEW

A Virtuous but Backward Cycle

DREW SWEENEY & PALAK S. PATHAK | 14 NOVEMBER 2019

The loans market has clearly entered a period of volatility and October represented a month of price declines, price dispersion and ratings declines. And yes, sometimes in that order. Please don't misunderstand, missed earnings and fundamental declines in a business necessitate a ratings decline and a price decline. However, lines are getting blurred and it often feels like there is a virtuous circle of price declines begetting ratings declines, which beget further price declines. This dynamic has been on full display during the last few months as we have seen a spike in downgrade activity.

Overall loan prices declined nearly 1 point in October amid a continued increase in dispersion. Demand for lower single Bs and triple Cs virtually evaporated. After the last several years of lower single B issuance, CLOs seem to be 'full' on lower rated deals. And it feels as if the agencies, which were once willing to stretch to arrive at a single B rating are no longer willing to extend that courtesy. Another dynamic, which has contributed to price dispersion, is that some investors are looking to essentially arbitrage CLO rules. Some hedge funds, which know that demand for a triple C loan at 85 or lower is not available from most of the buyer universe (CLOs), will opportunistically put forward bids 10-15 points lower than the last traded price. Investment banks, desperate for trading volumes, seem willing to circulate the bids even if they know there will be no sellers. The thought or hope is that eventually, a forced seller will emerge and the hedge fund/investment bank will start price discovery at a much lower level.

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Mr. Sweeney is a Managing Director 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 firms 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.

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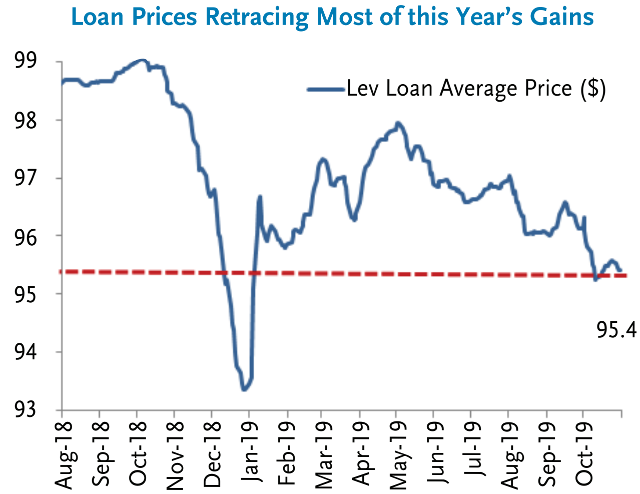


Source: Credit Suisse

Performance – Loans

In October 2019, the Credit Suisse Leveraged Loan Index (CS LLI) and the S&P Leveraged Loan Index (S&P/LSTA) were down -0.49% and -0.45%, respectively.

- Year to date, ending October 31, the CS LLI was up 5.87% and the S&P/LSTA was up 6.33%.
- For the 12 months ending September 30, the CS LLI was up 2.61% and the S&P/LSTA was up 2.67%.

During the month, only triple B and double B loans were able to produce positive returns. Single B loans were down -65 basis points while triple Cs and distressed loans were down -146 and -257 basis points, respectively.

On an LTM basis, higher quality outperformed lower quality as triple Bs and double Bs produced returns of 4.76% and 4.25%, respectively. Single Bs provided a 2.38% return while triple Cs and the distressed categories posted negative returns.

Total Return by Rating

	October	YTD	LTM
Split BBB	0.23%	7.72%	4.76%
BB	0.03%	7.66%	4.25%
Split BB	-0.43%	6.83%	3.06%
B	-0.65%	5.45%	2.38%
Split B	-1.71%	2.40%	-1.89%
CCC/Split CCC	-1.46%	0.00%	-3.90%
Distressed (CC, C and Default)	-2.57%	0.26%	-6.03%

Source: Credit Suisse Leveraged Loan Index

Sector Performance

Four of 20 sectors provided positive returns in the CS LLI for the month of October. The top performing sectors were Retail, 0.28%; Aerospace, 0.11%; and Housing, 0.05%.

The worst performing sectors for the month were Metal/Minerals, -4.43%; Energy, -2.75% and Forest Products/Containers, -0.80%. There was a 471 basis point difference between the top and bottom sectors in October, which was the third highest level of industry dispersion since 2017.

In the last 12 months, Housing, Gaming/Leisure and Financials have led all sectors with total returns of 4.72%, 4.69% and 4.57%, respectively. Metals/Minerals, Energy, and Consumer Durables provided the worst performing sectors with returns of -7.96%, -6.55% and -2.34%, respectively.

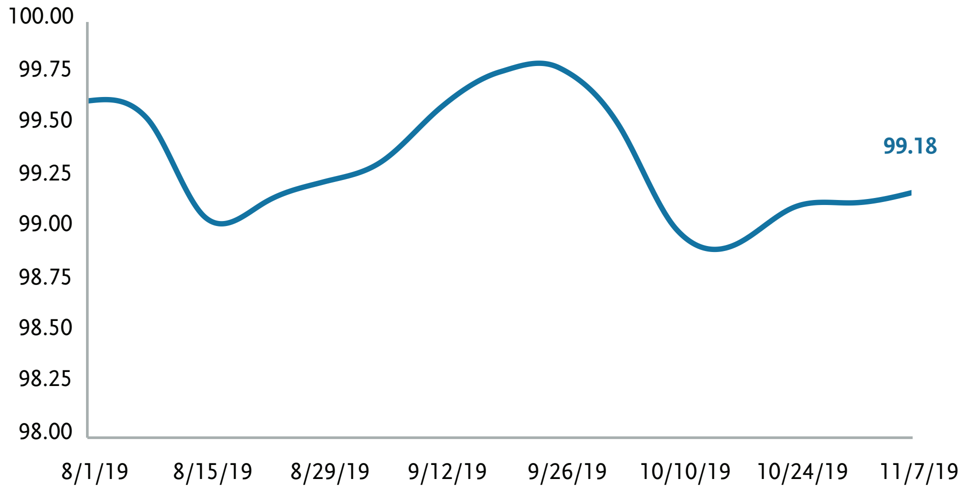
Industry Returns

Sector	October	YTD	LTM
Aerospace	0.11%	7.72%	4.53%
Chemicals	-0.07%	6.89%	3.88%
Consumer Durables	-0.52%	0.55%	-2.34%
Consumer Non-Durables	-0.49%	5.39%	2.22%
Energy	-2.75%	-2.33%	-6.55%
Financial	-0.18%	7.38%	4.57%
Food And Drug	-0.48%	9.18%	4.23%
Food/Tobacco	0.01%	6.52%	3.60%
Forest Prod/Containers	-0.80%	6.21%	2.55%
Gaming/Leisure	-0.12%	7.78%	4.69%
Healthcare	-0.39%	5.56%	2.39%
Housing	0.05%	8.49%	4.72%
Information Technology	-0.51%	6.01%	2.61%
Manufacturing	-0.68%	4.86%	1.46%
Media/Telecommunications	-0.63%	7.14%	3.33%
Metals/Minerals	-4.43%	-4.92%	-7.96%
Retail	0.28%	5.27%	1.19%
Service	-0.30%	5.67%	2.95%
Transportation	-0.46%	4.91%	2.53%
Utility	-0.73%	6.12%	3.76%

Source: Credit Suisse Leveraged Loan Index

CS LLI prices (excluding defaults) decreased -97 basis points in October while the average bid of the S&P LCD flow-name loan composite decreased 33 basis points from 99.51 to 99.18. The average flow name bid is up 389 basis points on a year-to-date basis

Average Loan Flow-Name Bid



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

Performance – CLOs

CLO performance declined in October logging its first negative monthly return since December 2018. CLOs returned -0.22% during the month, outperforming Leveraged Loans and underperforming Investment Grade (IG) and High Yield (HY) Corporates. On a year-to-date basis, CLOs have returned 4.2%, underperforming Loans, HY and IG credit.

One contributor to lower returns in October was the widening of AAA spreads in secondary. AAAs were one of the few tranches that were flat to tighter throughout most of the year, until this past month when a weaker loan and CLO mezzanine market caused CLO AAA spreads to finally capitulate and reverse their rally. In addition to wider spreads across all CLO debt, credit dispersion within tranches has widened and is gradually moving up the capital stack.

AAAs widened 10-15 basis points over the month. Short AAAs were not spared, as amortizing bonds traded in the mid to high 90s dm vs. low 80s dm throughout the third quarter. Longer duration AAAs ended the month in the 130-140dm context, closing the previously wide basis between secondary and primary spreads. AAs and As also widened in sympathy with AAAs with spreads wider 10-15 bps on each tranche. Single A tiering increased to over a 50 bps dispersion between cleaner deals and those with lower coverage.

BBB weakness continued from September with spreads wider +30 bps. BBBs with better MVOC coverage (>110%) traded in the mid to high 300s dm while BBBs that had MVOCs < 110% were in the 400s dm. A similar story with BBs as tier 1, well covered BBs traded in the high 700s dm while the weakest names (lowest MVOC coverage) traded at or wide of 1000 dm.

Equity NAVs were down 8-10 pts with loan prices down over the month. Average quarterly equity distributions remain flat with the average quarterly payment ranging from 3.5%-4%.

BWIC activity increased by over 30% in October, reaching levels not seen since June with over $4 billion in auction volume. A little under half of the bonds out for bid were AAAs followed by AAs and BBs. An increasing trend towards the end of the month was not to disclose cover levels on bonds, especially on mezz tranches which made it difficult to ascertain trading levels.

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Secondary CLO 2.0 Total Returns

	Oct-19	YTD	LTM
Total	**-0.22%**	**4.19%**	**2.84%**
AAA	0.14%	3.93%	3.38%
AA	0.07%	4.86%	3.37%
A	-0.37%	5.21%	2.30%
BBB	-1.10%	5.34%	1.25%
BB	-3.22%	4.11%	-1.27%
B	-11.07%	-4.68%	-10.11%

Source: JPM CLOIE Index

Secondary CLO 2.0 Spreads (DM)

	Oct-19	MoM Change (bps)
AAA	100-140	10
AA	175-210	15
A	235-300	15
BBB	360-460	30
BB	750-900	100
B	1000-1300	75

Source: TCW

Technical Conditions – Demand

Leveraged loan fund flows briefly turned positive in September and broke the 43 weeks of consecutive outflows; however, funds flows have been negative subsequently. The loan market has experienced outflows in 49 of the last 50 weeks. Outflows since the beginning of 4Q18 total $53.8 billion or 35% of beginning period AUM. AUM for the loan mutual fund base is down to $100 billion from as high as $154 billion in October 2018. For context, loan retail funds now hold 8% of outstanding versus a peak of 20% in 2013. Outflows for Loan funds total -$33.1 billion which compare to +$15.2 billion of inflows YTD18.

CLO new issue volume increased in October by 25% from September. October saw 22 deals price for a total of $10.3billion in new issuance. Of the 22 deals, three were middle market deals. In addition, two Collateralized Bond Obligations (CBOs) priced during the month.

Primary AAA spreads were flat m-o-m and ranged from 130 to 145 dm, with the majority of tier 1 names pricing in the 132-134 dm range. AA spreads were also unchanged with single As to BBs significantly wider. Single As were 20 bps wider as this tranche has increasingly become more sensitive to underlying loan performance. BBBs are 40-50 bps wider and many deals continue to utilize a split Sr./Jr BBB structure with the Senior BBBs pricing in the H 300s/L 400s dm and Jr BBBs in the H400s/M500s dm generating a blended BBB spread in the low to mid 400s dm. BBs were the most difficult tranche to place during the month as the tranche is highly correlated to loan fundamentals. As a result, BB spreads widened and OIDs increased in order to get deals done. BB spreads ranged from 675 – 700dm at the start of the month to 800-900dm by the end of October.

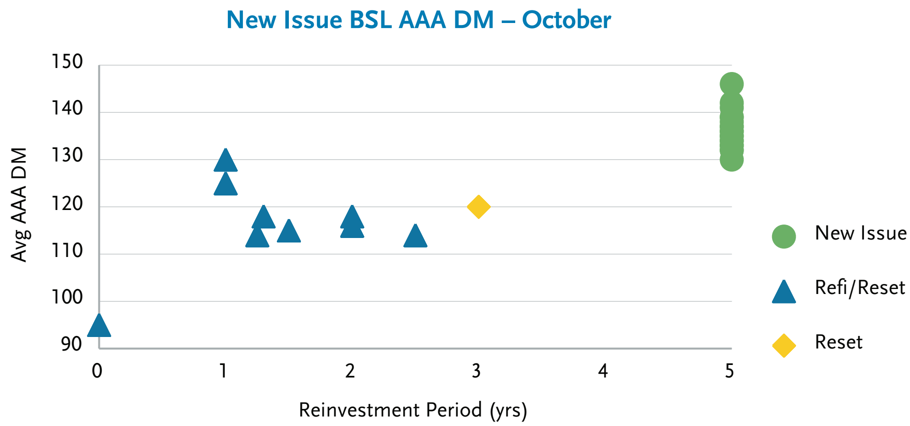
Refi activity almost doubled with nine refis pricing over the month. Refi AAA spreads were in the 114-130 dm range for 1-3 year reinvestment period deals. Reset activity remained low with only one reset pricing. As mentioned last month, five year resets are tough to get done especially as the appetite for seasoned mezz is low. In addition, many deals would need to be re-capitalized in a reset due to par erosion.

CLO cost of debt increased by 10 bps to 203 bps due to wider spreads across the stack. Equity arb also declined with current arbitrage inside 180 bps

CLO New Issuance

	October	YTD 2019	YTD 2018	YoY %Δ
New Issue ($bn)	$10.30	$99.90	$107.90	-7%
Refi (#)	9	59	69	-14%
Reset (#)	1	29	208	-86%

Source: TCW



Source: TCW

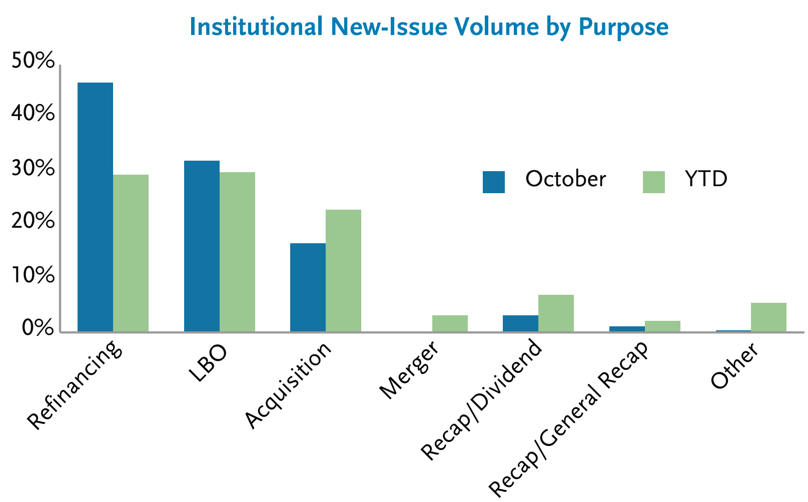
Tier 1 New Issue Spreads (5 yr reinv)

	October	MoM Changes (bps)	YTD Changes (bps)
AAA	134	1	5
AA	195	15	-5
A	270	20	0
BBB	425	40	25
BB	800	85	80

Source: TCW

Technical Conditions – Supply

October continued to see an increase in refinancing activity despite the broad based weakness felt in the market. Quite simply, while single B loans and lower have struggled, double B loans are largely trading above par. Demand for double B loans has increased from a number of technical factors: 1) There have been many prepayments of double B borrowers. 2) CLOs need to replace that exposure with more double B paper. 3) There has been crossover demand from high yield investors where double B bonds are also trading very tight. 4) An increase in downgrade activity has pressured WARF scores for CLOs, necessitating further double B purchase. All of these factors have allowed double B borrowers to continue to reprice their deals while most of the market trades lower. On a year-to-date basis, M&A and LBO activity has accounted for roughly 60% of new issues while in October, M&A and LBO activity only accounted for 52% of new issuance.



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

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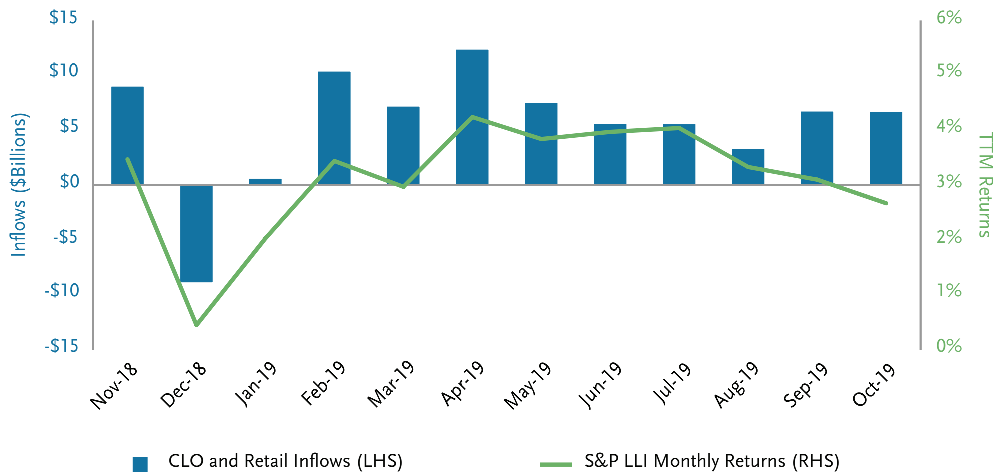
YTD US CLO new issue supply of $100 billion is now down -7% year-over-year but pacing to produce the third strongest year in CLO history. October saw $10.4 billion of issuance, the highest since Q2 2019. Despite solid CLO inflows and mild retail outflows, returns were weak.

Inflows and Rolling LTM Returns



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

New issue spreads in October tightened -9.7% month over month and were -21.3% tighter on a year-to-date basis. New issuance spreads remain -12.8% tighter than 12 months prior. It is important to understand the change in mix. The calendar in October had higher double B issuance and therefore the spreads were tighter on average. However, if you look just at the single B new issue spread, it was actually 14.4% wider than the prior year.

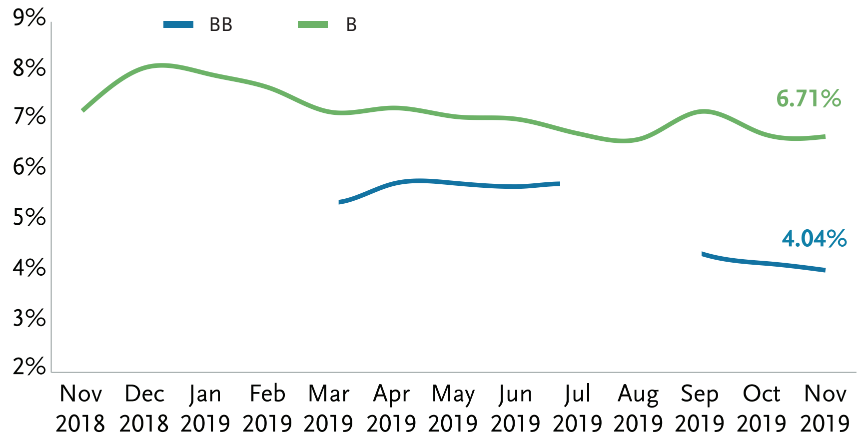
New Issue Spread Changes

	All Loans
Nov-18	408
Dec-18	452
Mar-19	404
Jun-19	404
Sep-19	394
Oct-19	356
Month-Over-Month Change	-9.70%
YTD Change	-21.3%
LTM Change	-12.8%

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

In terms of new issue yields, yields continued decline primarily as a result of a declining LIBOR rate and tightening double B spreads.

Average New-Issue Yields



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

Fundamentals – Loans

There were four loan defaults in October, the largest monthly number of defaults since April. The default rate changed from 1.29% in September to 1.43% in October, based on par outstanding.

The last 12-month default tally for the S&P/LSTA is 24. Retail leads all categories with six defaults while Services & Leasing and Oil & Gas are just behind it with four defaults each.

Lagging 12-Month Default Rates

Actual	19-Aug	19-Sep	19-Oct
By Number	1.54%	1.58%	1.64%
By Principal Amount	1.24%	1.29%	1.43%
Shadow Default Rate			
By Number	0.58%	0.47%	1.09%
By Principal Amount	0.52%	0.40%	1.35%

*Shadow default rates includes potential defaults, including those companies that have engaged bankruptcy advisors, performing loans with SD or D corporate rating and those paying default interest
Source: LCD, an offering of S&P Global Market Intelligence

Fundamentals – CLOs

CLO fundamentals were weaker over the month with WARF levels increasing as four loans defaulted over the month and rating agency downgrades continued. The weighted average price of CLO collateral decreased and the percentage of assets trading below $80 and $90 increased to 4.8% and 12% respectively. The jump to 12% in loans trading <$90 is notable, given it increased by 50% month over month and over 3x during the last 12 months.

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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 418 basis points. The 3-year DM finished the month at 512 basis points, which widened 34 bps from the prior month.

The DM spread differential between Double Bs and Single Bs is 105 basis points wider from November 2018 to October 2019 and 67 basis points wider than the historical spread differential since inception.

3-Year Discount Margin Differential Between BBs and Single Bs

1/1992-10/2019 Average	190.0
Nov-18	151.9
Oct-19	257.0

Source: Credit Suisse Leveraged Loan Index

CS LLI Snapshot

YTD Total Return*	5.87%
Average Price	95.22
Spread	356 bp
Coupon	5.66%
Current Yield	6.00%
Yield (3-year life)	6.61%
Discount Margin (3-year life)	512 bp

*S&P LLI Total Return 5.74%

	Spread	DM (3-Year Life)
Split BBB	204 bps	207 bps
BB	257 bps	283 bps
Split BB	309 bps	380 bps
B	386 bps	540 bps
Split B	533 bps	1,302 bps
CCC/Split CCC	659 bps	1,415 bps
Distressed (CC, C and Default)	664 bps	4,421 bps

Source: Credit Suisse Leveraged Loan Index

Summary and Looking Forward

As of October 31, the S&P/LSTA Index imputed default rate was 3.1%, up from 2.7% in the prior month.

October continued a volatile pattern. Some loans seem to have been abandoned from the largest buyer base (CLOs) and just lost sponsorship. This is typically due to price or ratings action or threat of ratings action. Higher quality loans continued to outperform and the distress ratio for loans (loans trading below 80) reached 6.1%, its highest level in recent years. Coinciding with market stress, October also saw the second heaviest monthly issuance of the year, which means the loan market was also trying to digest a very active primary. Thus far in November, we have seen this technical ease, meaning less net new issuance. As the primary market has slowed we have seen loan prices finding stronger support.

Some of this is due to supply but we are also seeing crossover investors buying loans as they offer compelling value relative to high yield. The one word of caution for November is that it also brings the heart of earnings season and we all know that earning misses are not tolerated.

In CLOs, we don't foresee any sector specific catalyst for change in November and December. The primary pipeline for the rest of the year looks manageable with most dealers trying to price one to three deals by year end. Warehouse lines are open, but many are not being utilized as managers wait until a more opportune time to buy loans and thus we don't see a big push for warehouses to get termed out over the next couple of months. Spreads have been widening and much of the deterioration in loan fundamentals has been priced in, especially in lower mezz tranches. With the HY to CLO BB spread ratio at post crisis highs, BB spreads should remain range bound in the near future barring any macro news. ■