TCW

INSIGHT

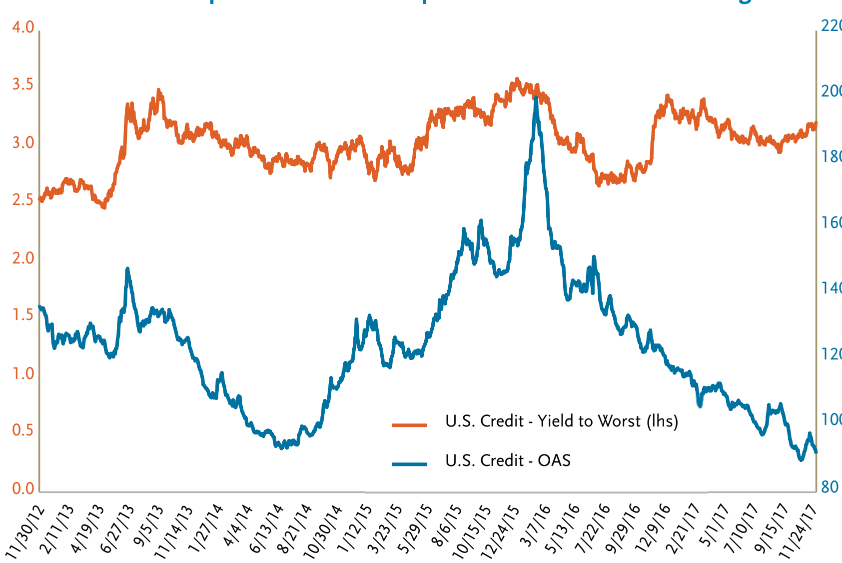
MONTHLY COMMENTARY

November Credit Update

TAMMY KARP | DECEMBER 8, 2017

Credit markets experienced some volatility in November, widening 7 basis points in the first half of the month, then tightening almost all the way back to end the month at an OAS of +92 basis points over Treasuries – just 1 bp wider on the month. Continued heavy supply, including a combined $17 bln in Apple and Oracle debt issuance right out the gates, led to bigger new issue concessions and a subsequent increase in dealer inventories. Progress on tax reform – as the House bill passed and the Senate bill headed to the Senate floor at month end (and was passed during the weekend) - was one of the catalysts for the sharp reversal in spread performance. In terms of the effect on corporate credit, lowering the corporate tax rate to 20% (from 35%) would have a positive impact on earnings and free cash flow. The one-time tax on all un-repatriated foreign earnings – at a rate of 14%/14.5% (House/Senate) for liquid assets and 7%/7.5% for illiquid assets - will mainly benefit a handful of sectors and credits. Of the estimated $3 trillion of unremitted foreign earnings, about 50% is held by 25 issuers (87% in the top 100 issuers) with about 58% residing in two sectors, tech and healthcare. The big question is how that cash (tax cuts and repatriation) gets deployed. M&A, share buybacks and dividends are likely to supersede debt paydowns and de-leveraging, thereby prolonging the credit cycle at a time when leverage metrics are already at peak levels and valuations are already stretched.

IG Credit Spreads vs. Yields. Spread Near the Post Crisis Tights



Key	Axis	Name	Last	Minimum		Maximum	
	Right	U.S. Credit – OAS	92.108	89.685	10/26/2017	199.808	02/12/2016
	Left	U.S. Credit – Yield to Worst	3.204	2.464	05/02/2013	3.584	12/29/2015

Source: Bloomberg Barclays

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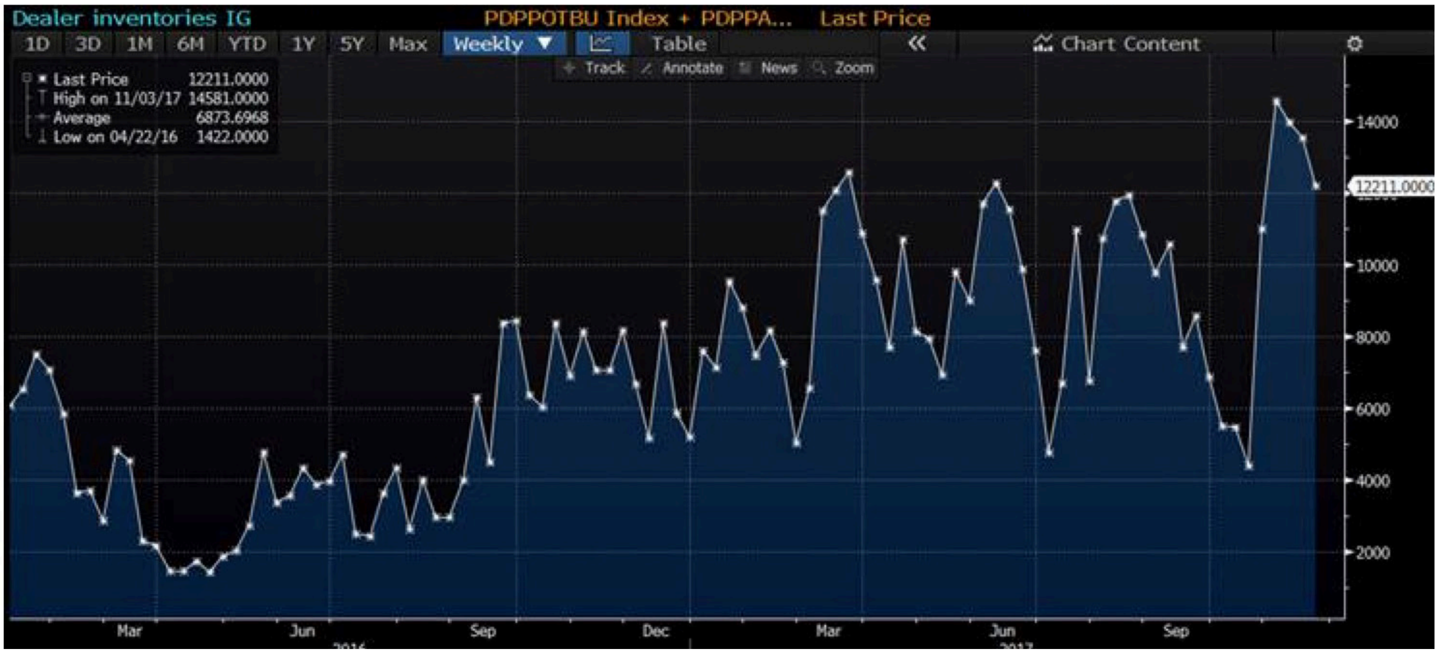
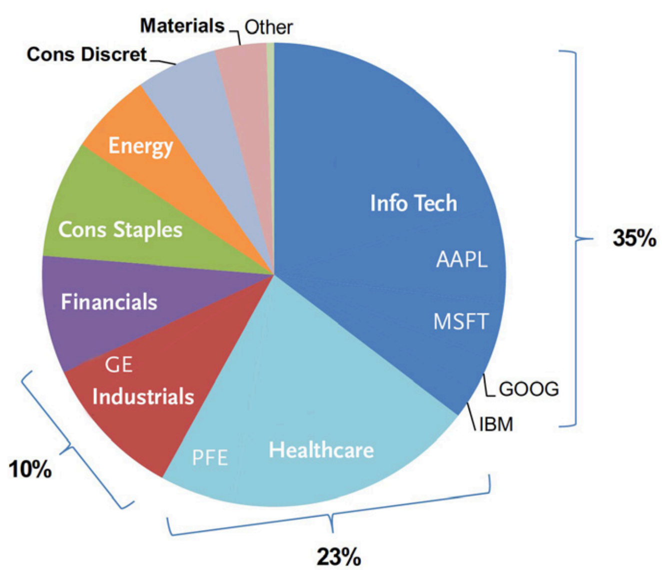
Ms. Karp is a Managing Director in the Fixed Income group where she trades investment grade and cross over securities. Ms. Karp joined TCW in 2009 during the acquisition of Metropolitan West Asset Management LLC (MetWest). Prior to joining MetWest in 1997, she was with the fixed income department at The Capital Group. Ms. Karp earned her BS in Business from University of Arizona.

Dealer Inventories (IG Corporate Bond Greater Than 13 Months) Have Climbed to Multi-Year Highs



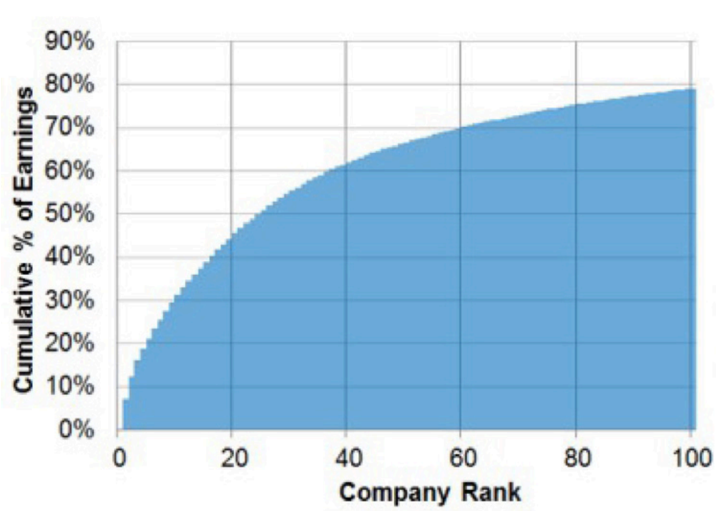
Source: Bloomberg Barclays

Repatriation Helps a Handful of Sectors and Credits



Source: Calcbench, Company Data, Morgan Stanley Research. As of March 31, 2016. Morgan Stanley Research. For important disclosures regarding companies that are the subject of this screen, please see the Morgan Stanley Research Disclosure Website at www.morganstanley.com/researchdisclosures

The Top 25 Companies Comprise 50% of Unremitted Earnings



Source: Calcbench, Company Data, Morgan Stanley Research. As of March 31, 2016. Morgan Stanley Research.

November Credit Update

Index Performance: The credit market experienced a bit of a whipsaw in November as the index OAS traded in a 7-basis point range. Heavy supply, elevated dealer inventories and political risks (Flynn plea) caused some spread volatility in the first half of the month. As tax reform progressed and supply moderated, spreads rallied almost all the way back to end the month at an OAS of +92 basis points over Treasuries. The excess return of .03% was modestly positive due to the carry component. Year-to-date total and excess returns remain strong at 5.34% and 2.92% respectively. The best performing sectors in November were sovereigns (-10 bps), metals (-4 bps) and supermarkets (-4 bps). Sovereigns have a large EM component, which rallied as commodity prices improved. Metals have tightened as lack of issuance and commodity price stability has resulted in balance sheet remediation/de-leveraging in the sector. The supermarket sector is comprised of three names, with Kroger accounting for 80% of the sector by market value. Kroger spreads tightened 6 basis points on the month after the company reported better than expected earnings as cost initiatives and price investment gained traction.

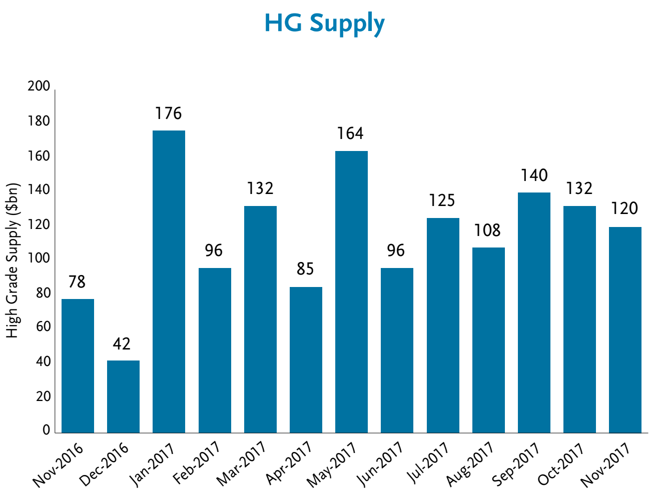
The worst performing sectors were oil field servicers (+9 bps), tech (+7 bps), pharma (+7 bps), midstream (+6) and cable (+5 bps). Event risk and/or supply technicals were a common theme among most of the underperformers. For tech, heavy supply impacted the higher quality names as Oracle priced its new issue with a 25-basis point concession. Event risk negatively impacted QCOM (+38 bps) and AVGO (+55 bps) spreads after AVGO made an offer to purchase QCOM – which the QCOM board rejected. AVGO responded by nominating a new set of QCOM board members – so the story is not over. Pharma spread underperformance was led by the BBB biotech names as some earnings and guidance disappointments brought event/M&A risk back to the forefront. Bondholders are concerned that M&A in the sector will pick up again after a year of inactivity as companies look to buy growth.

November Credit Index Returns

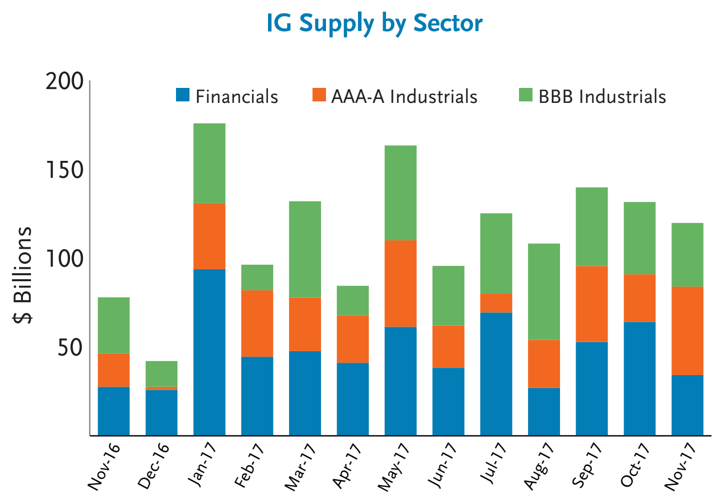
	Month-to-Date Excess Return	Month-to-Date Total Return	Option-Adjusted Spread	Option-Adjusted Spread Month-to-Date Change
Credit Index	.03%	-.09%	92	+1
Industrials	-.11%	-.19%	103	+4
Financials	.09%	-.12%	87	0
Utilities	.08%	.14%	94	0
Municipals	.45%	.73%	121	-0
Sovereigns	.93%	.88%	100	-10

Source: Bloomberg Barclays

November Investment Grade Supply: There was no respite from the heavy primary calendar as new issue volumes of $120 billion were significantly above the November average over the last five years. Gross supply will hit another record level in 2017 as the YTD total of $1.37 trillion has already surpassed issuance for all of 2016. Industrial supply dominated, led by the tech sector, with three issuers accounting for $24 bln (20%) of total supply. On November 6, Apple issued $7b bln in bonds across six maturities (5yrs priced at +42, 10yrs @ +72, 30yrs @ +100). The very next day, Oracle printed a $10 bln multi-tranched deal that priced with a large new issue concession (10yr priced at +95, 30yr @ +125/olb). The market had not anticipated supply out of a sector awash with overseas cash – at least not prior to certainty over tax reform/repatriation. That, coupled with overall market weakness, resulted in a significant new issue concession for the Oracle deal – to the tune of 25 basis points. The market had not seen a new issue concession of this magnitude - for a high quality issuer, in quite some time. New issue concessions remediated in the latter half of November, bringing the monthly average concession to 8 basis points. ■



Source: BofA Merrill Lynch Global Research



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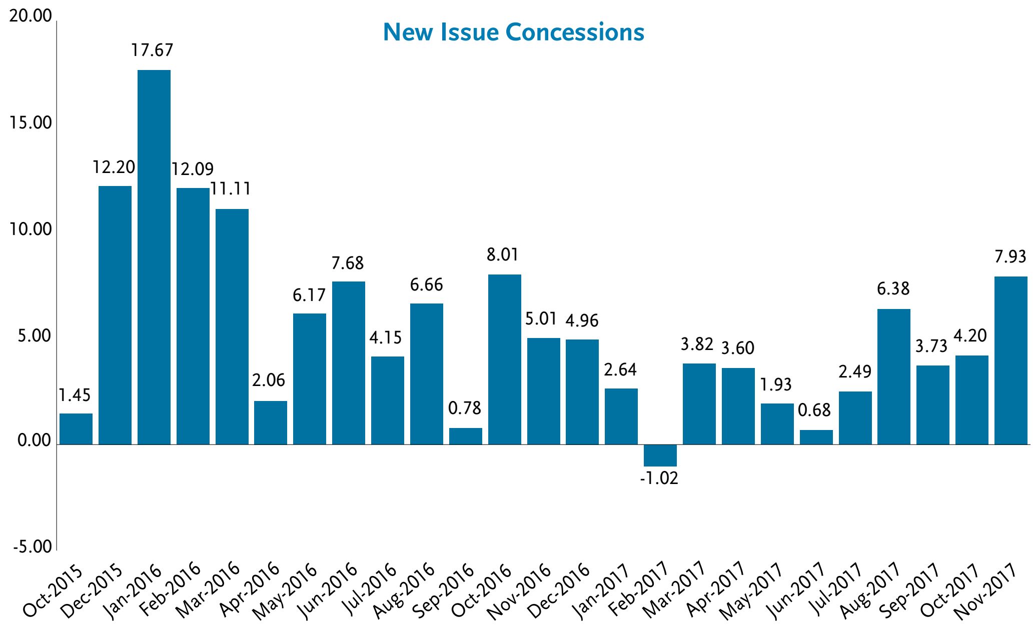

Source: BofA Merrill Lynch Global Research