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INSIGHT

MONTHLY COMMENTARY

Loan Review – December 2017

DREW SWEENEY | JANUARY 11, 2017

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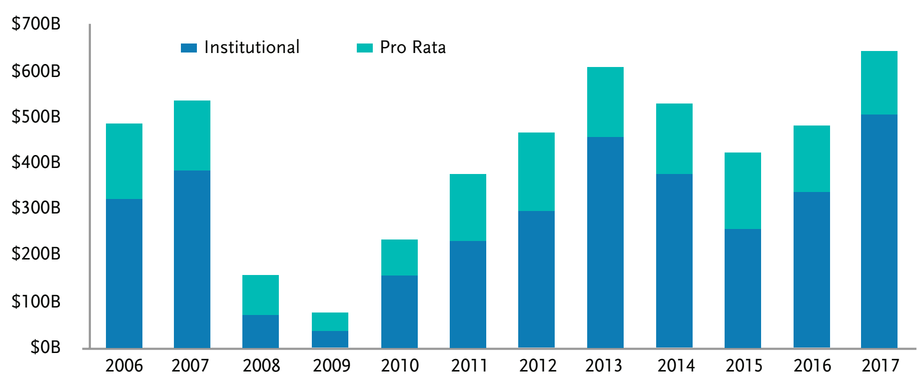
Mr. Sweeney is a Senior Vice President in the Fixed Income group where he trades leveraged loans. Mr. Sweeney joined TCW in 2015 from Bradford & Marzec, LLC where he managed loan strategies for both total return and CLO accounts as well as serving on the investment committee where he helped direct the 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.

2017 was an extremely busy year and market fatigue was readily apparent in the final two weeks of December. Traders took vacations and decision makers were off the desk with the arrival Hanukkah, Christmas and New Year's. As new issue supply eased from November levels, December prices immediately jumped higher. CLO managers scrambled to source supply to fill warehouses and close 2017 deals. In the back half of the month, the CLO machine shut-down and the market essentially went on holiday. November and December continued a pattern that the market had witnessed throughout the year. As new issuance supply hit the market, prices eased. However, because demand remained constant, as soon as supply waned, or once the new issuance was absorbed, prices moved higher again. This also occurred in March/April and June/July. Demand in 2017 remained constant and driven by CLO issuance, which marked its second highest year ever at $116.7 billion. This registered a 60% increase from 2016. Concerns surrounding the impact of risk-retention rules on the CLO market at the outset of 2017 have long since dissipated.

New issuance supply set a new record in 2017, topping $644 billion and beating the previous record, set in 2013, by nearly $45 billion.

Total New-Issue Volume

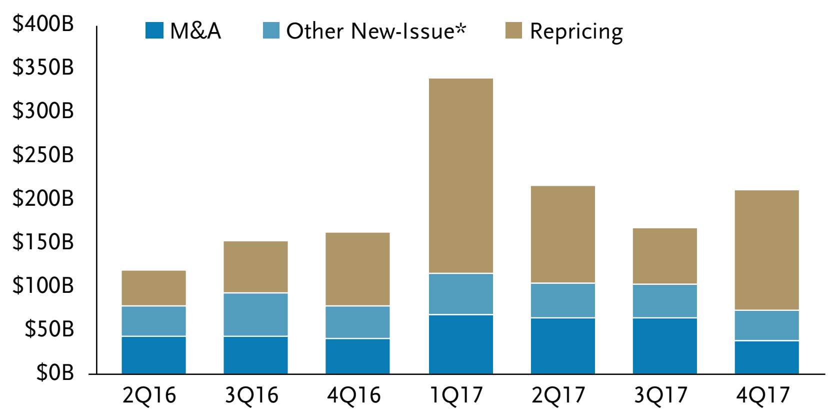


Source: LCD, an offering of S&P Global Market Intelligence

Re-pricing volume totaled $539 billion. Excluding credits that hit the market multiple times, 51% of the loan market re-priced last year. As a result of all this activity spreads have compressed dramatically in 2017.

A full 65% of the institutional issuance was related to repricing activity in Q4 2017. As we begin 2018, it is hard not to notice that despite the massive repricing wave that dominated last year's activity, over 66% of loans still trade above par. This simply suggests that 2018 is set to continue where last year finished.

Institutional New-Issue and Repricing Loan Volume



Source: LCD, an offering of S&P Global Market Intelligence *Not connected to a repricing

Performance

In December 2017, the Credit Suisse Leveraged Loan Index ("CS LLI") and the S&P Leveraged Loan Index ("S&P/LSTA") were both up 0.39% and 0.40%, respectively.

- Quarter-to-date ending December 31, 2017, the CS LLI was up 1.17% and the S&P/LSTA was up 1.11%.
- For the twelve months ending December 31, 2017, the CS LLI was up 4.25% and the S&P/LSTA was up 4.12%.

Triple C loans provided the strongest returns for December and the fourth quarter, followed by split single B and single B loans. On a full-year basis, lower quality loans outperformed higher quality as split single B and triple C led all categories.

Total Return By Rating

	December	YTD	LTM
Split BBB	-0.27%	0.83%	2.61%
BB	0.36%	1.09%	3.47%
Split BB	0.16%	0.99%	3.21%
B	0.44%	1.22%	4.55%
Split B	0.44%	1.85%	8.16%
CCC/Split CCC	1.10%	2.54%	7.98%
Distressed (CC, C and Default)	-1.13%	-3.99%	2.73%

Source: Credit Suisse Leveraged Loan Index

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Sector Performance

In the Credit Suisse LLI 18 of 20 sectors provided a positive return during the month. The top performing sectors in December were Food & Drug (+1.01%), Energy (+0.98%) and Utility (+0.56%).

The worst performing sectors for the month were Consumer Durable (-1.62%), Retail (-0.22%) and Metals (+0.26%).

On a quarter-to-date basis, Food & Drug, Utility and Metals led all sectors with total returns of 2.52%, 2.16% and 2.01%, respectively.

For the calendar year 2017, Metals, Energy and Service led all sectors with total returns of 6.13%, 5.86% and 5.67%, respectively. In addition, Manufacturing, Gaming and Healthcare provided the only other sectors to post returns in excess of 5%.

On a year-to-date basis, Consumer Non-Durables, Consumer Durables and Retail were the worst performing sectors with returns of 2.08%, -0.53% and -3.26%, respectively. All three sectors are being impacted to some degree by e-commerce and Retail and Consumer Durables were the only two segments to post negative 2017 returns.

Total Return by Sector

Sector	December
AEROSPACE	0.44%
CHEMICALS	0.30%
CONSUMER DURABLES	-1.62%
CONSUMER NON-DURABLES	0.43%
ENERGY	0.98%
FINANCIAL	0.37%
FOOD AND DRUG	1.01%
FOOD/TOBACCO	0.38%
FOREST PROD/CONTAINERS	0.38%
GAMING/LEISURE	0.36%
HEALTHCARE	0.42%
HOUSING	0.35%
INFORMATION TECHNOLOGY	0.31%
MANUFACTURING	0.45%
MEDIA/TELECOMMUNICATIONS	0.43%
METALS/MINERALS	0.26%
RETAIL	-0.22%
SERVICE	0.55%
TRANSPORTATION	0.44%
UTILITY	0.56%

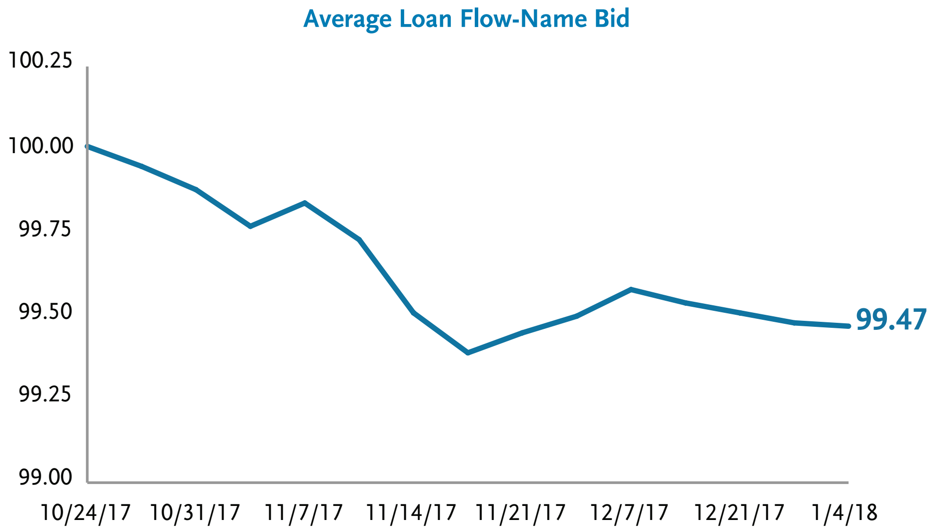
Sector	QTD
AEROSPACE	1.13%
CHEMICALS	1.12%
CONSUMER DURABLES	-1.82%
CONSUMER NON-DURABLES	-0.53%
ENERGY	2.01%
FINANCIAL	1.30%
FOOD AND DRUG	2.52%
FOOD/TOBACCO	0.91%
FOREST PROD/CONTAINERS	1.35%
GAMING/LEISURE	1.27%
HEALTHCARE	1.00%
HOUSING	1.15%
INFORMATION TECHNOLOGY	1.11%
MANUFACTURING	1.44%
MEDIA/TELECOMMUNICATIONS	1.19%
METALS/MINERALS	2.01%
RETAIL	0.55%
SERVICE	1.33%
TRANSPORTATION	1.01%
UTILITY	2.16%

Sector	LTM
AEROSPACE	4.70%
CHEMICALS	4.63%
CONSUMER DURABLES	-0.53%
CONSUMER NON-DURABLES	2.08%
ENERGY	5.86%
FINANCIAL	4.91%
FOOD AND DRUG	2.24%
FOOD/TOBACCO	3.83%
FOREST PROD/CONTAINERS	4.31%
GAMING/LEISURE	5.13%
HEALTHCARE	5.05%
HOUSING	4.49%
INFORMATION TECHNOLOGY	4.77%
MANUFACTURING	5.42%
MEDIA/TELECOMMUNICATIONS	4.06%
METALS/MINERALS	6.13%
RETAIL	-3.26%
SERVICE	5.67%
TRANSPORTATION	3.13%
UTILITY	4.19%

Source: Credit Suisse Leveraged Loan Index

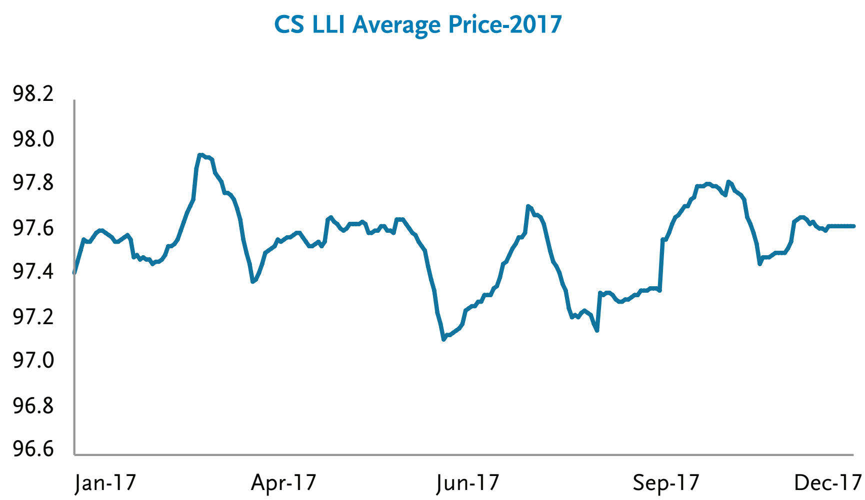
Loan Review – December 2017

The average bid of the S&P LCD's flow-name loan composite came in at 99.47% of par, slightly lower than month-end November (99.50).



Source: LCD, an offering of S&P Global Market Intelligence. As of January, 2018.

The CS LLI was up roughly 21 basis points in 2017. Price rallies in the first quarter and the fourth quarter were immediately met with massive repricing waves and subsequent price weakness.

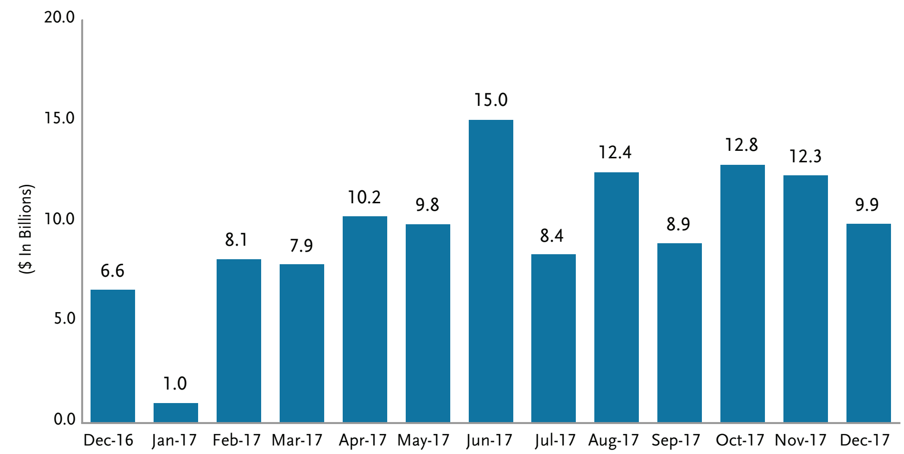


Source: CS LLI

Technical Conditions

CLO new issue supply was $9.9 billion in December, down -19.5% from November. Issuance exceeded all estimates in 2017, registering $116.7 billion of CLO issuance, the second highest on record. Liability spreads continued to grind tighter throughout 2017 and that facilitated asset class growth.

CLO Volume

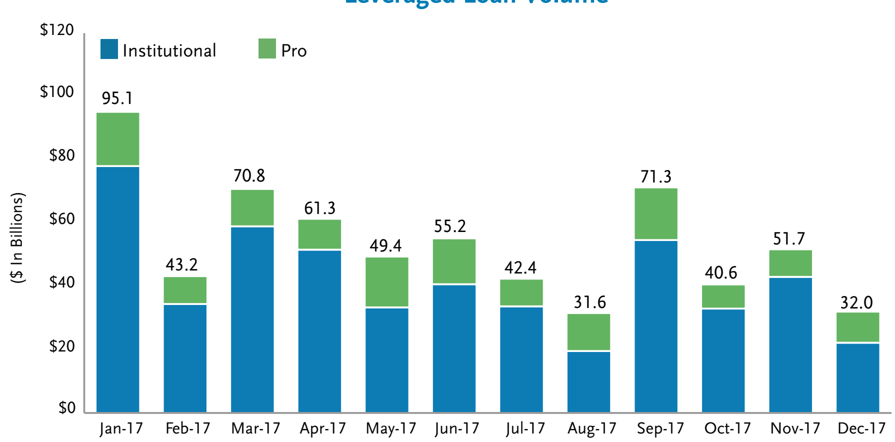


Source: LCD, an offering of S&P Global Market Intelligence

Leveraged loan funds reported an outflow in December of -$1.62 billion. In fact, 19 of the last 22 weeks have registered retail fund outflows. There were $18 billion inflows in the first seven months of the year and -$4.8 billion of outflows since the beginning of August. In 2017 in inflows of +$13.2 billion compared positively to +$9.2 billion in 2016.

Institutional new issue volumes decreased month-over-month by -48.4%. The loan market issued approximately $32 billion of loans in December (the second lowest month of the year) and almost 50% of that was simply repricing or refinancing existing deals. Therefore, the real supply to the market was closer to $15 billion, further contributing to the technical imbalance.

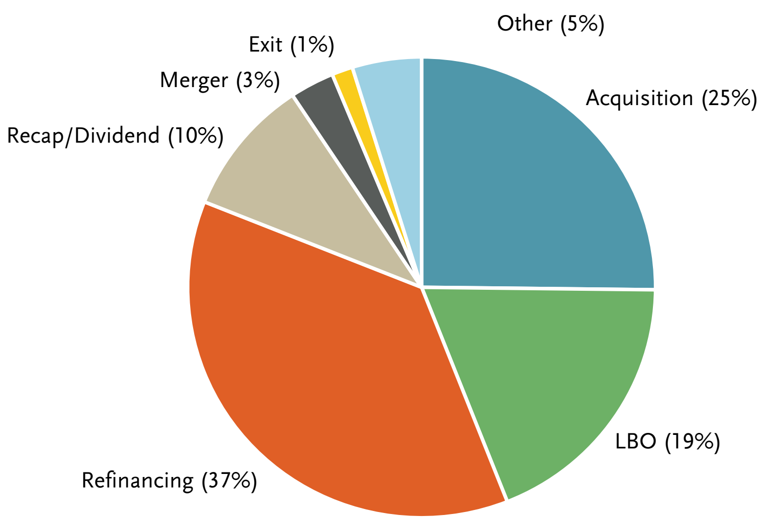
Leveraged Loan Volume



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

In terms of the new issuance, roughly 37% of the primary market was related to refinancing existing deals while acquisitions, mergers and LBOs accounted for 44% of new issuance. If amendment activity is included in total volume then 57.5% of 2017 issuance relates to repricing and refinancing.

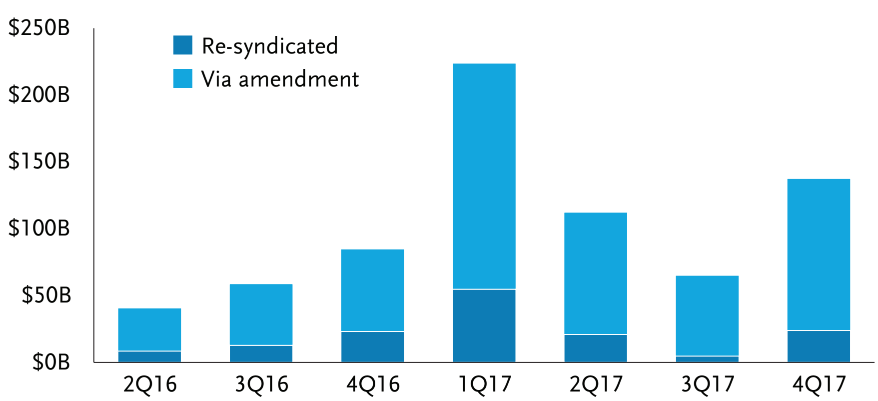
2017 Institutional Volume



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

The repricing volume is still dominated by amendments as compared to syndication and nearly 80% of all repricing activity is completed via amendment. The first quarter and the fourth quarter tallied most of the activity as can be seen below.

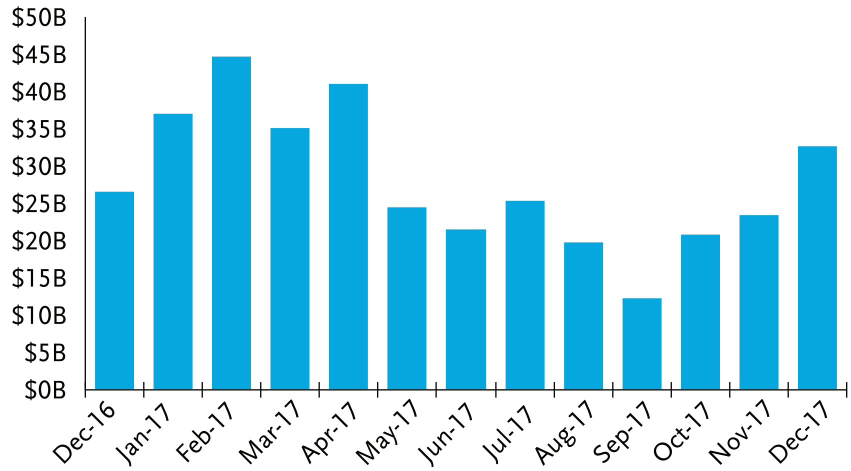
Repricing Loan Volume



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

Monthly repayments increased to the highest levels since April and surpassed December 2016 prepayment levels. The increased level of repayments has contributed to the current market technical imbalance.

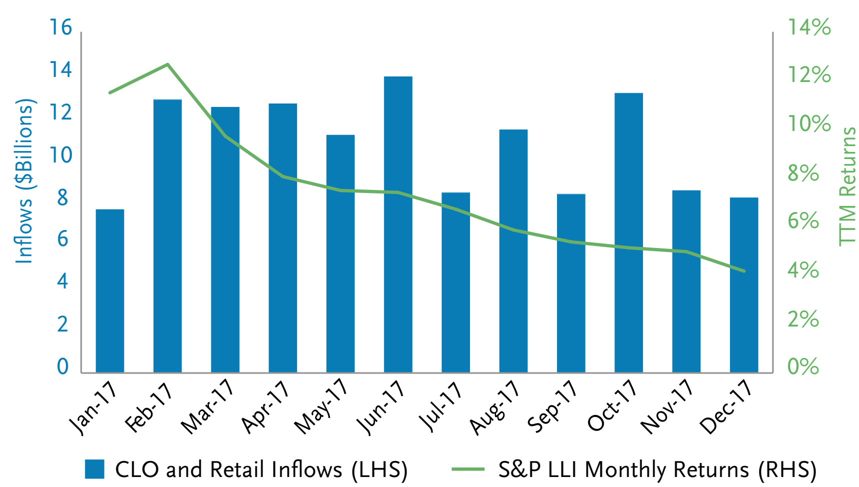
Monthly Repayments in the S&P/LSTA LL Index



Sources: LCD, an offering of S&P Global Market Intelligence; S&P/LSTA Leveraged Loan Index

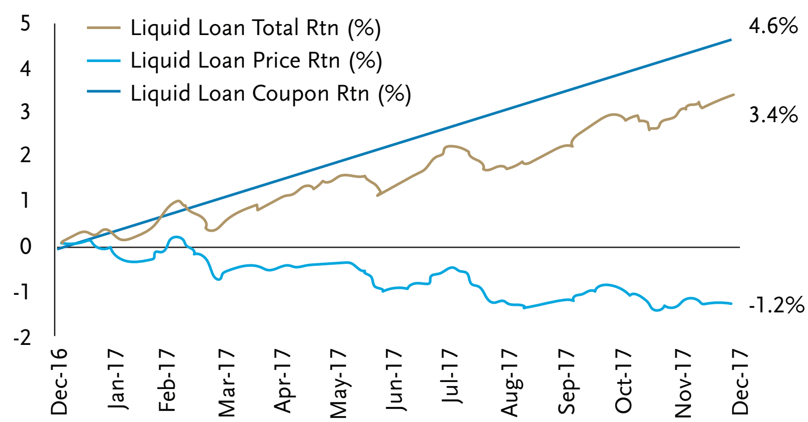
Despite strong inflows, the trailing 12-month returns continued to move lower through the year. The combination of lower LIBOR spreads and price declines resulting from repricing activity weighed on returns.

Inflows and Rolling LTM Returns



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

Negative price returns from heavy refinancing activity during 2017 totaled -1.2%, weighing on carry.



Source: Credit Suisse

New issue spreads in December were -4.3% tighter for double Bs and approximately 0.8% wider for single B issuance from the prior month. The Index spread for the CS LLI ended December at roughly L+375 bps. This is the tightest spreads have been for the CS LLI index since April 2011.

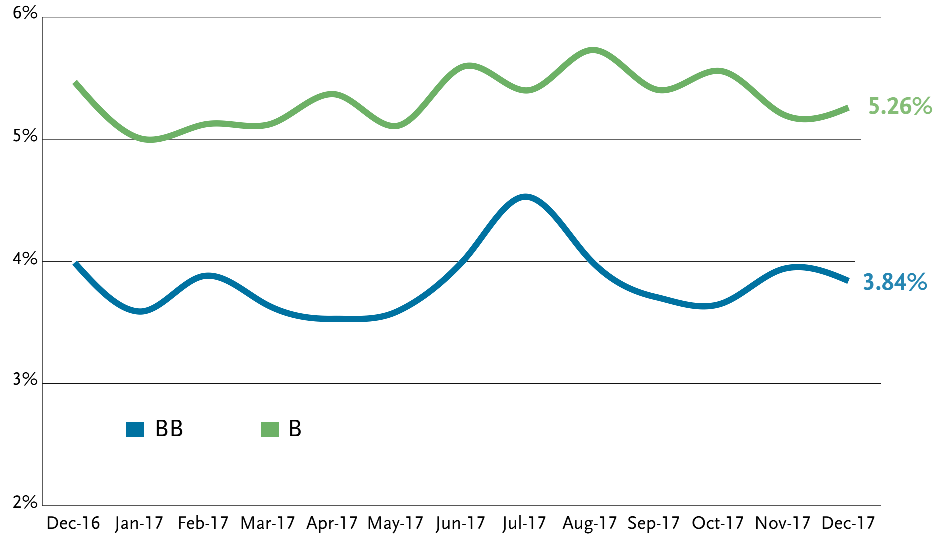
New Issue Spread Changes

	BB/BB-	B+/B
Dec-16	268	388
Mar-17	243	382
Jun-17	240	370
Sep-17	243	373
Dec-17	233	375
Month-Over-Month Change	-4.3%	0.8%
YTD Change	-4.1%	-0.6%
LTM Change	-12.8%	-3.2%

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

Average new issue yields contracted month-over-month for Double Bs (-0.30%) and were 0.24% wider for single Bs. Rising LIBOR has essentially offset tighter LIBOR spreads in 2017.

Average New-Issue Yields



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

There have been 25 defaults in the last 12 months and there were two defaults in December. The LTM default rate remained the same based on the number of defaults (1.72%) and based on par amount outstanding (1.95%).

Lagging 12-Month Default Rates

Actual	Oct-17	Nov-17	Dec-17
By Number	1.41%	1.72%	1.72%
By Principal Amount	1.51%	1.95%	1.95%
Shadow Default Rate			
By Number	0.54%	0.43%	0.43%
By Principal Amount	1.20%	0.99%	0.99%

Source: LCD Loan Stats

* Shadow default rate includes potential defaults, including those companies that have engaged bankruptcy advisors, performing loans with SD or D corporate rating and those paying default interest

Retail and Restaurants account for eight of the 25 defaults while commodity driven loans account for five. Healthcare contributed the third most defaults in the 2017 period with three defaults.

Valuation

Since 1992, the average 3-year discount margin ("DM") for the CS LLI, is 462 basis points. If the global financial crisis (2008 & 2009) is excluded, the 3-year discount margin for the CS LLI is 417 basis points. At month end, the 3-year DM (416 basis points) was wide to the historical average and 5 basis points tighter than the prior month.

The DM spread differential between double Bs and single Bs widened by 18 basis points from January 2017 to December 2017. It is still 41 basis points wide of the historical spread differential.

3-Year Discount Margin Differential Between BBs and Single Bs

1/1992-12/2017 Average	83.8
Dec-16	106.9
Nov-17	124.8

Source: Credit Suisse Leveraged Loan Index

CS LLI Snapshot

YTD Total Return*	4.25%
Average Price (excluding defaults)	98.09
Spread	356.67
Coupon	5.03%
Current Yield	5.15%
Yield (3-year life)	6.33%
Discount Margin (3-year life)	416 bp

*S&P LLI Total Return 3.71%
Source: LCD Loan Stats

	Spread	DM (3-Year Life)
Split BBB	211 bps	214 bps
BB	268 bps	268 bps
Split BB	322 bps	346 bps
B	393 bps	428 bps
Split B	597 bps	891 bps
CCC/Split CCC	650 bps	1,208 bps
Distressed (CC, C and Default)	701 bps	3,244 bps

Source: Credit Suisse Leveraged Loan Index

Summary

As of December 31, the S&P/LSTA Index imputed default rate was 1.6%, one of the lowest levels since December 2007.

December performance was driven by the same characteristics that dominated 2017. CLO issuance and loan demand overwhelmed loan supply. In 2017 CLO issuance reached the second highest level in CLO history. Loan supply was not sufficient to satiate demand. Despite the fact that the CS LLI grew nearly $80 billion, demand was still greater. While loan issuance reached record levels, it was dominated by repricings, refinancings and opportunistic transactions.

LIBOR spreads compressed throughout 2017 and loan yields moved higher. LIBOR was up nearly 70 basis points and the average coupon for the CS LLI was 16 basis points wider. The change in the average coupon and the change in LIBOR suggest that loan index spreads compressed on average 53 basis points.

As the year ended, the technical characteristics that drove spread compression remained in place. CLO liabilities remain attractive and demand for CLO paper will likely remain robust in the first quarter of 2018. The forward new issue calendar is not large enough to meet demand and as a result January will likely see loan prices grind higher and repricing activity recommence. ■

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