TCW

INSIGHT

MONTHLY COMMENTARY

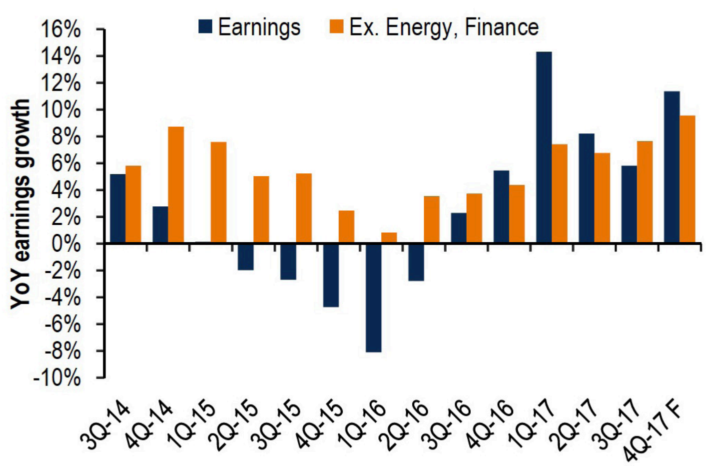
January Credit Update

TAMMY KARP | FEBRUARY 6, 2018

The markets kicked off the new year in risk-on mode as strong Q4 earnings and the impact of tax cuts and overseas earnings repatriation were bullish for credit spreads. Higher interest rates, resulting in negative returns for the IG credit index, did not derail the spread rally (for now) as spreads continued to tighten with higher rates. The credit index OAS ended the month at a new post crisis tight of 82 basis points over Treasuries while returns were -.93%, the largest negative return since November 2016. Despite the negative returns, demand for credit persisted and inflows into high grade funds remained strong ($19 bln YTD inflows).

Fourth quarter earnings season is well underway with about half of the companies in the investment grade universe having reported. Expectations are for an 11% y-o-y growth rate, an increase vs. Q3 and the sixth consecutive quarter of growth. The energy sector is expected to show the biggest year-over-year increase with 56% earnings growth. Energy was the best performing credit sector in January as oil prices improved to $65 (2.5 year highs). Stronger demand for crude coupled with production cuts out of OPEC has eased the supply/demand imbalance. The Energy Information Administration (EIA) data for the week ending 1/26 showed U.S. crude stockpiles at 418 mln barrels, down more than 100 mln from the peak in March 2017 and in line with the five-year average. U.S. crude production, however, remains at peak levels of 9.9 mln bpd as OPEC efforts to curb supply have been met by increased U.S. production. On a relative value basis, energy spreads are now trading 15 basis points wide to industrials (OAS of 104 vs. 89), which is in line with the mean historical relationship.

Earnings Growth for IG Issuers



Note: 4Q17 based on the actual results when available ad consensus estimates otherwise.
Source: BofA Merrill Lynch Global Research, FactSet.

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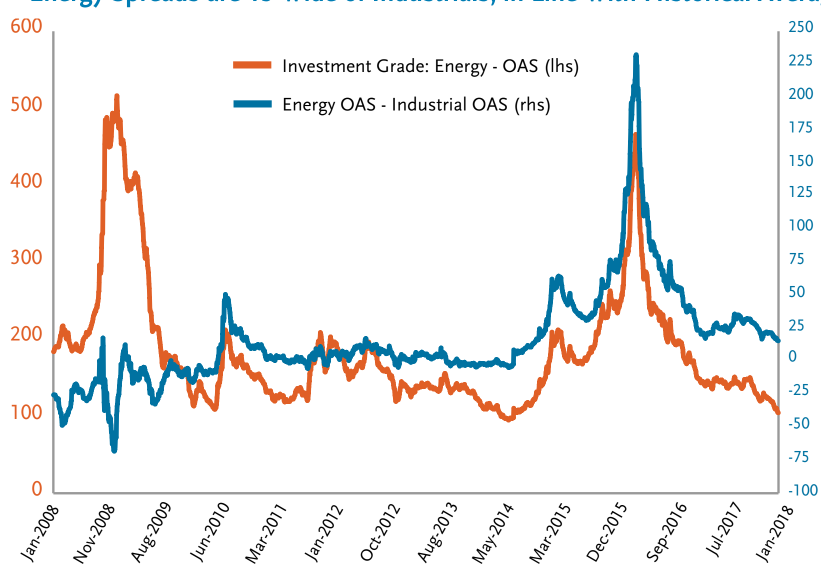
Ms. Karp is a Managing Director in the Fixed Income group where she trades investment grade and cross over securities. Ms. Karp joined TCW in 2009 during the acquisition of Metropolitan West Asset Management LLC (MetWest). Prior to joining MetWest in 1997, she was with the fixed income department at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

Earnings Growth Estimates for IG Issuers

Sector	Earnings growth (YoY)	Sales growth (YoY)
Aerospace/Defense	11.5%	7.9%
Automobiles	15.8%	-1.8%
Banks/Brokers	10.1%	5.4%
Basic Materials	34.8%	12.5%
Consumer Products	6.3%	3.7%
Energy	56.0%	17.3%
Finance	16.3%	11.7%
Food, Bev, & Bottling	4.9%	0.9%
Health Care	5.5%	5.0%
Industrial Products	22.9%	14.1%
Insurance	11.8%	-0.3%
Media & Entertainment	-3.0%	3.0%
REITs	-8.5%	3.0%
Retail	6.2%	8.5%
Technology	13.6%	10.6%
Telecom	2.0%	1.7%
Transportation	8.5%	7.1%
Utilities	7.1%	5.6%
Other	7.1%	6.9%
Total US HG public co's	**11.4%**	**7.1%**
Total ex. Financials	12.1%	7.8%
Total ex. Energy	9.3%	6.1%
Total ex. Fin. & Energy	9.5%	6.7%

Source: BofA Merrill Lynch Global Research, FactSet.

Energy Spreads are 15 Wide of Industrials, in Line With Historical Average



Source: Bloomberg Barclays

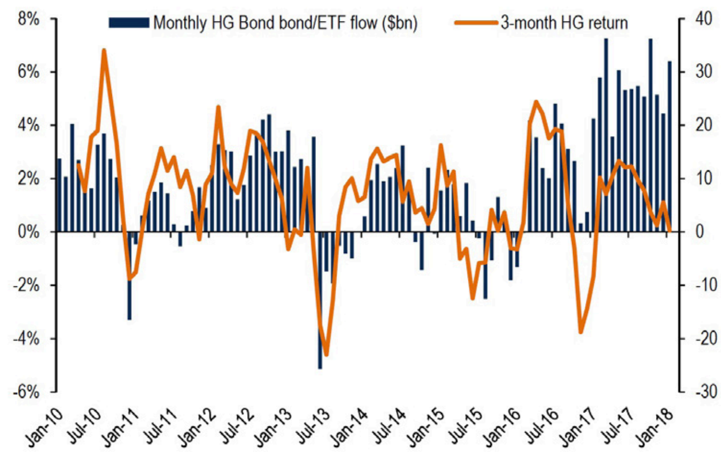
	1/31/2018	10 Year Mean
Investment Grade Industrial OAS	89	168
Investment Grade Energy OAS	104	184
Industrials – Energy OAS	-15	-16.27

YTD Mutual Fund Flows

Asset Class	YTD ($bln)	YTD as % of AUM
High Grade	18.8	0.70%
High Yield Total	-0.2	-0.10%
High Yield ETFs	-2.4	-4.90%
Loans	0.5	0.30%
EM	11.8	1.90%
Munis	0.6	0.10%
All Fixed Income	26.2	0.60%
Money Markets	-50.3	-1.70%
Equities	54.7	0.40%

Source: Epfr Global, BofA Merrill Lynch Global; Research

Flows Typically Follow Returns



Source: Epfr Global, BofA Merrill Lynch Global; Research

Index Performance: Credit spreads tightened 7 bps in January, ending the month at an OAS of +82 bps, a new post crisis tight. The 30 bp move in 10 yr. Treasury yields more than offset the 7 bps of spread tightening, resulting in a total return of -.93%. Spread performance was strong across the board, with every sector in the index posting positive excess returns. Of the five broad sectors, industrials and sovereigns outperformed, driven by the rally in cyclicals (energy, metals) as well as positive technicals due to lack of supply. Industrial supply volumes in January were down 59% from a year ago while financial supply was the highest on record. The $100 bln in financial supply was well received by the market and priced with little to no concessions. The bank-industrial relationship currently stands at -15 bps (banks spread are 15 bps tighter vs industrials) with a cycle range of -70 bps in 2/16 to 278 bps in 3/09.

Best performing sectors on the month were metals (-22 bps), midstream (-21 bps), independent energy (-19 bps) and wirelines (-16 bps). After lagging in 2017, AT&T and VZ spreads played a bit of catch up, tightening ~ 20 bps in January. Earnings generally met expectations, driven by healthy wireless subscriber adds and lower churn. Additionally, both companies projected significant increases in free cash flow due to tax reform – to the tune of $3.5 - $4 bln additional annual cash flow for VZ, $3 bln for AT&T. For bondholders, the roughly 20% improvement in free cash flow should support debt reduction/de-leveraging efforts.

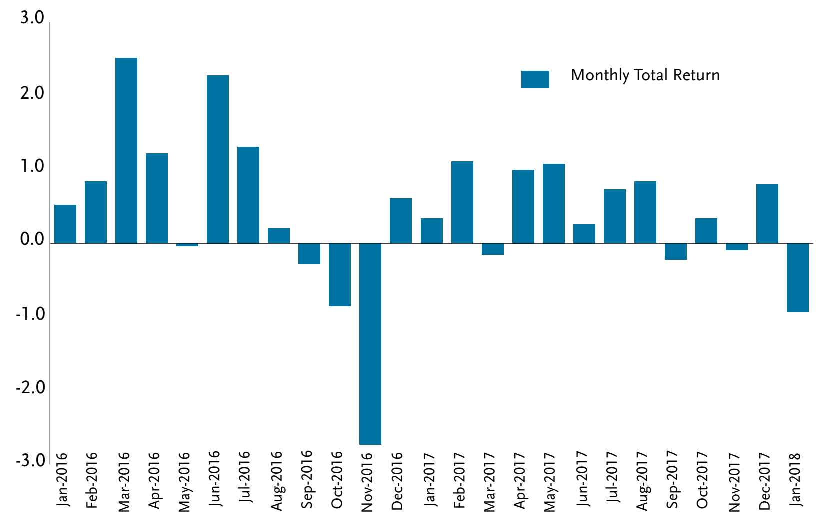
Worst performing sectors in January were diversified manufacturing (- 1 bp) – led by GE which widened 14 bps on the month, and autos (-2 bps). GE widening came on the heels of the $6.2 bln charge related to its legacy insurance business and subsequent SEC accounting probe. The auto sector experienced marginal underperformance on concerns over softening demand, increasing incentives and higher commodity costs now that the cycle has peaked.

January 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	.69%	-.93%	82	-7
Industrials	.88%	-.90%	89	-9
Financials	.41%	-.96%	80	-5
Utilities	.71%	-1.43%	85	-7
Municipals	.91%	-1.53%	109	-8
Sovereigns	1.18%	-.75%	95	-10

Source: Bloomberg Barclays

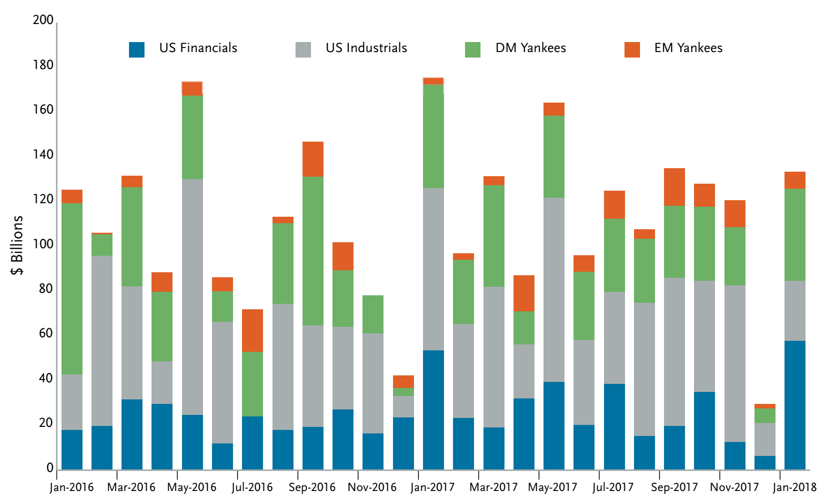
Monthly Index Returns



Source: BofA Merrill Lynch Global Research

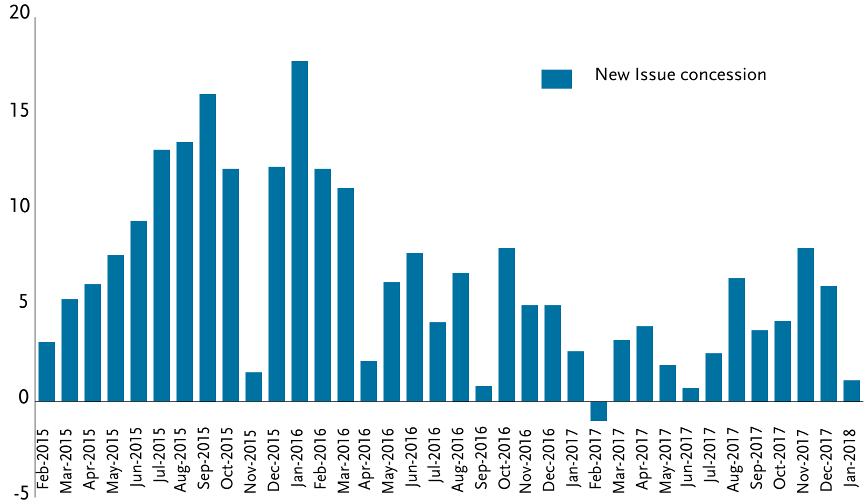
January Investment Grade Supply: New issue volumes of $133 bln were dominated by financials, which accounted for 75% of total issuance. Of the $100 bln in financial issuance, $36 bln came from the U.S. money centers, including $7.5 bln from MS (5yr bullet priced at +77, 11NC10 @ +117), $6.75 bln from BAC (8NC7 @ +82, 31NC30@ +105/olb) and $6.25 bln from JPM (11NC10 @ +97, 31NC30 @ +107/olb). New issue concessions were negligible, averaging 1 basis point in January.

Monthly IG Supply



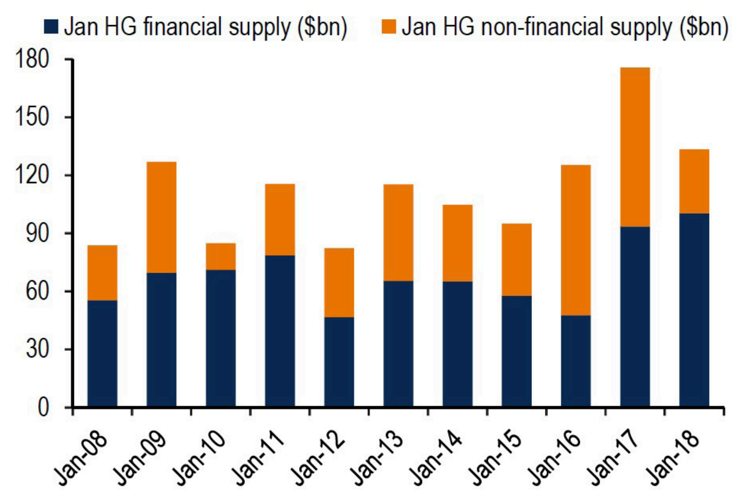
Source: BofA Merrill Lynch Global Research

New Issue Concessions



Source: BofA Merrill Lynch Global Research

Record Financial Supply



Source: BofA Merrill Lynch Global Research

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