INSIGHT

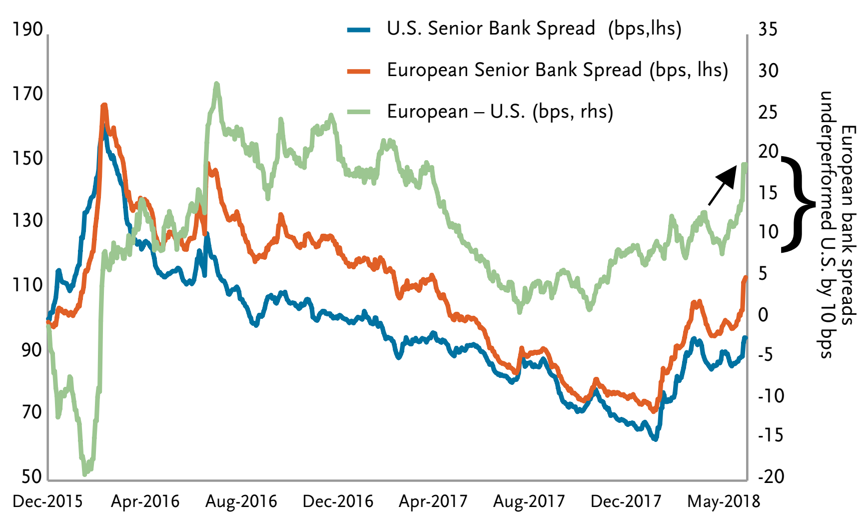
MONTHLY COMMENTARY

May Credit Update

TAMMY KARP | JUNE 6, 2018

May was another volatile month for risk assets, this time driven by rising political uncertainty out of Italy and Spain. The spillover to the broader markets was most acutely felt by European credit, namely European banks, which underperformed their U.S. counterparts by a factor of two. Credit spreads were already under pressure from increased M&A/event risk, rising rates, USD strength and subsequent EM weakness. Tighter liquidity conditions on the heels of shrinking central bank balance sheets have been a source of volatility for the credit markets. The forces that propped up the market and triggered consecutive years of QE-led spread tightening have also masked vulnerabilities, including peak levels of corporate leverage and the massive growth in the credit markets. Tax cuts and repatriation have boosted earnings (by an estimated 40%) and cash flow, though we have not seen that translate into debt reduction. If anything, it has provoked animal spirits by encouraging companies to engage in M&A and other shareholder-friendly activities to the detriment of bondholders. North American M&A volumes ($620 bln YTD) and share buybacks ($155 bln thru Q1) are on pace to set new records. M&A-related bond issuance has increased, accounting for 30% of May new issue volumes. The four large M&A-related bond deals in May were all leveraging transactions, but perhaps the most notable was that of Keurig-Dr. Pepper ($8 bln) which saw debt/EBITDA increase three turns to 5.8x. Despite this considerable rise in leverage, credit ratings were limited to only a one-notch downgrade (to Baa2/BBB) on the expectations of aggressive post deal de-levering. Emblematic of this part of the credit cycle, the consequences for these massive re-leveraging transactions, at least as measured by the ratings impacts, have been minimal.

European senior bank spreads widened 17 basis points in May. That compares to 7 basis points of widening for U.S. banks.



Source: Bloomberg Barclays Indices, Barclays Research

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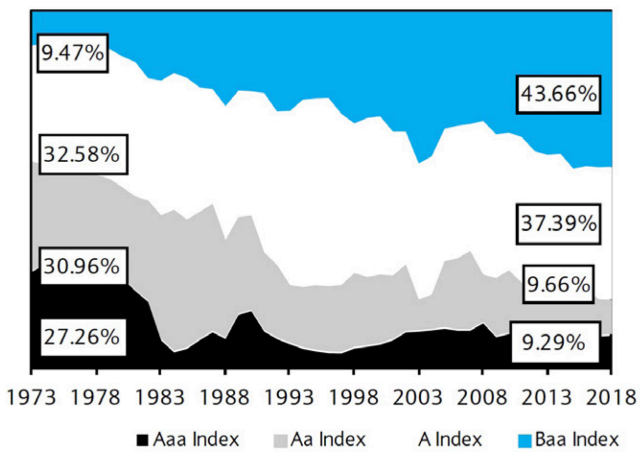
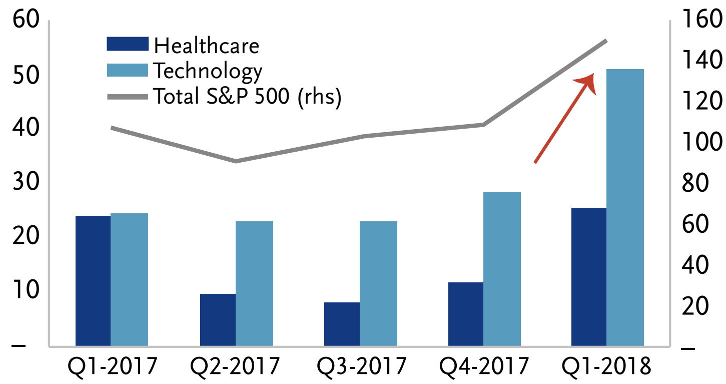
Ms. Karp is a Managing Director in the Fixed Income group where she trades investment grade and cross over securities. Ms. Karp joined TCW in 2009 during the acquisition of Metropolitan West Asset Management LLC (MetWest). Prior to joining MetWest in 1997, she was with the fixed income department at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

Quality Analysis of Barclays Credit Index, 1973-2018



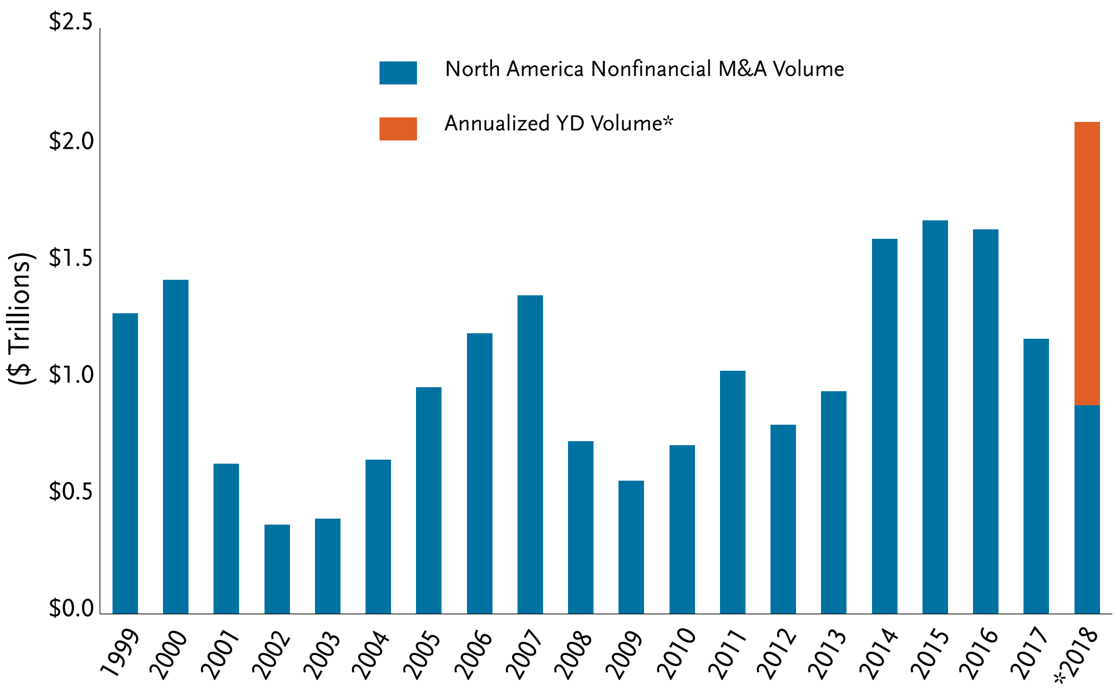
Source: Bloomberg Barclays Indices, Barclays Research

Share Buybacks Surge in Q1



Source: Credit Suisse S&P

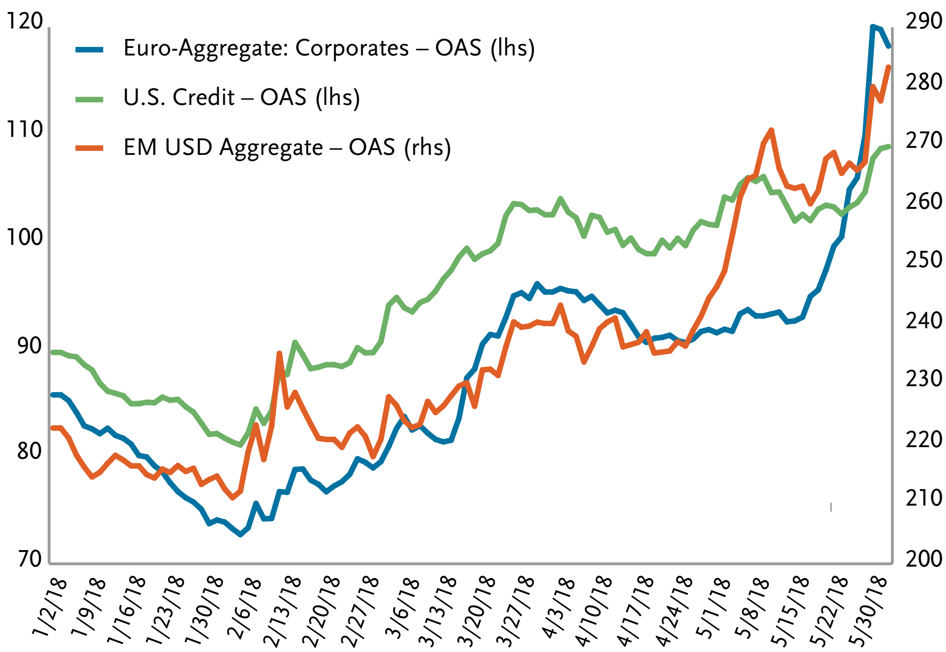
2018 North America M&A Volumes Expected to Hit New Record



Source: Wells Fargo

Index Performance: The credit index OAS of +109 basis points over Treasuries was 7 bps wider on the month, resulting in a negative excess return of -0.45%. While returns were positive (+.50%) in May due to lower Treasury yields, YTD returns are still negative at -2.53%. 2018 is shaping up to be a more volatile year for spreads vs. 2017. The range in spreads year-to-date is 28 basis points (tights of 81, wides of +109) which compares to a range of 29 basis points for all of 2017. The worst performing sectors in May were those tied to EM, Europe or M&A risk. Sovereigns were +22 bps wider on the heels of EM weakness, cable (+21) on elevated event risk, wirelines (+19) led by the eurotel names like Telefo, and metals(+18) which are correlated to EM risk. Cable is the worst performing sector ytd (+45 bps), led by Comcast (+51 bps) due to elevated event risk. Comcast confirmed it is in "advanced stages" of outbidding Disney for Fox's assets. The rumored all cash bid, if coupled with the existing SKY bid, could take leverage to 4.1x, an increase of 2x. Both Moody's and S&P placed CMCSA's ratings (currently A3/A-) on watch downgrade, citing not only deal risk but also the apparent change in the company's financial policy – which is clearly one that is willing to take on significant leverage for the "right" transaction.

U.S. Credit Has Outperformed Europe and EM



Key	Axis	Name	Last	Minimum		Maximum		Mean
	Left	Euro-Aggregate: Corporates – OAS	118.240	72.722	02/02/2018	120.049	05/29/2018	87.401
	Left	U.S. Credit – OAS	108.876	81.068	02/02/2018	108.876	05/31/2018	95.622
	Right	EM USD Aggregate – OAS	283.309	211.090	02/01/2018	283.309	05/31/2018	235.433

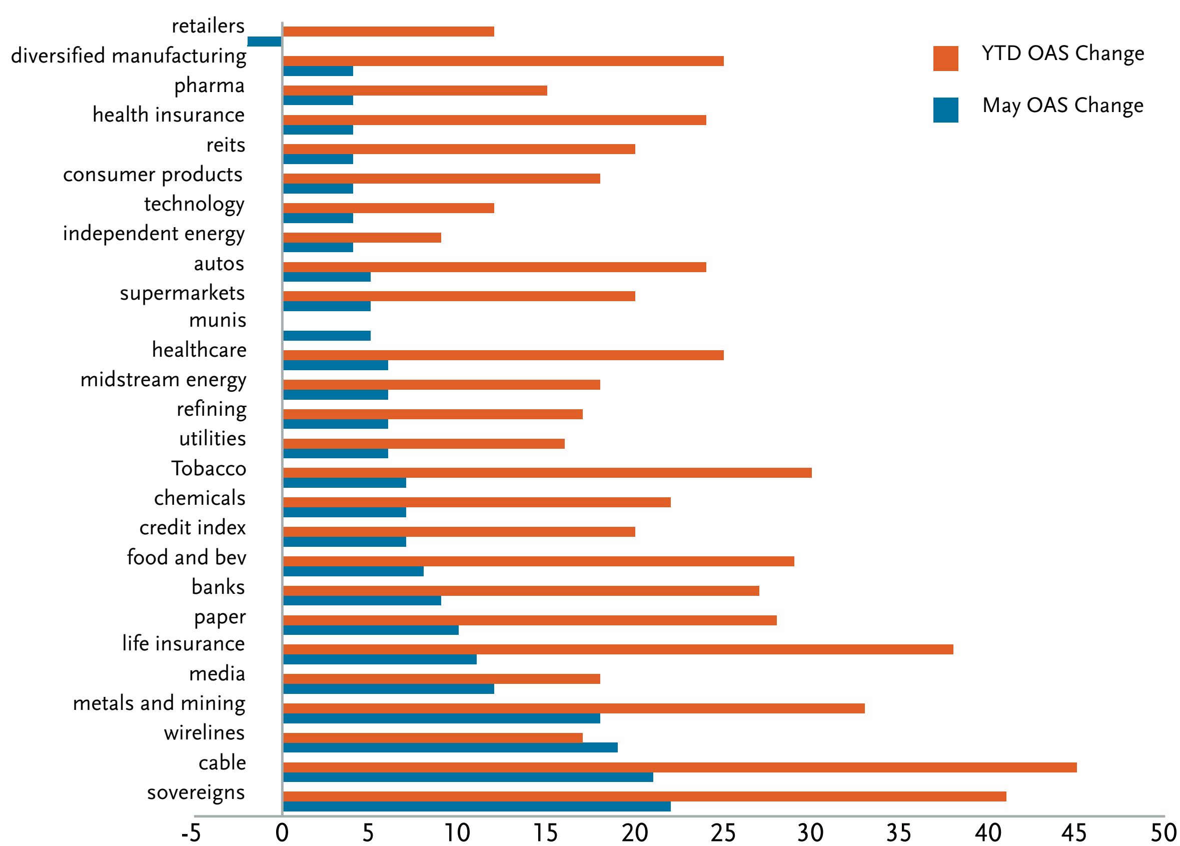
Source: Bloomberg Barclays Indices, Barclays Research

May 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	-0.45%	0.50%	109	+7
Industrials	-0.46%	0.58%	117	+7
Financials	-0.40%	0.42%	112	+9
Utilities	-0.55%	0.69%	108	+6
Municipals	-0.35%	0.99%	117	+5
Sovereigns	-1.58%	-0.44%	146	+22
AA	-0.18%	0.70%	66	+4
A	-0.39%	0.59%	94	+6
BBB	-0.64%	0.35%	149	+10

Source: Bloomberg Barclays

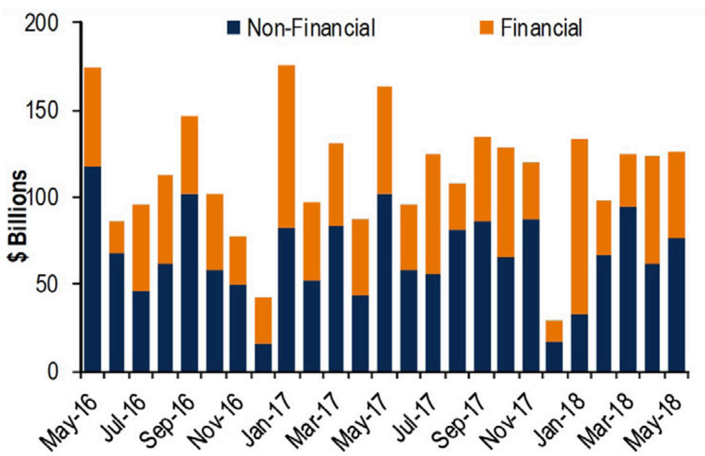
YTD and MTD OAS Change



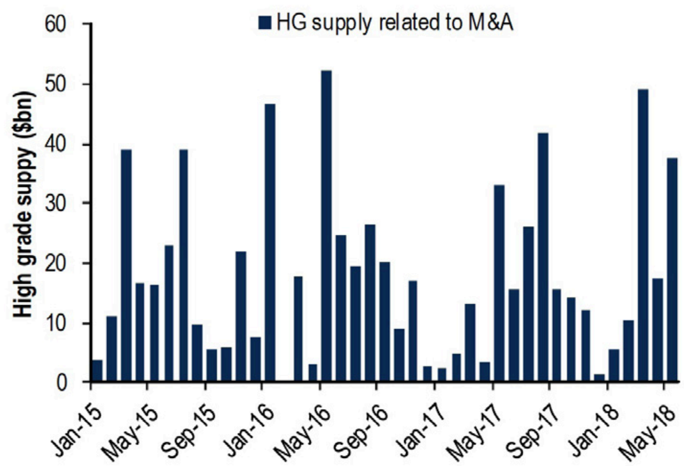
Source: Bloomberg Barclays

May Investment Grade Supply: Another heavy month of primary issuance with $125.7 bln pricing in May. Industrial supply of $77 bln was dominated by M&A-related issuance ($38 bln) with the largest deals coming from DPS-Keurig ($10.5 bln across five tranches, 5yr priced at +85, 10yr @ +160, 30yr @ +195), GD ($7.5 bln across four maturities, longest tranche was a 10yr which priced at +85) and VOD (to fund Liberty Global, $10.5 bln across five tranches, 10yr priced @ +155, 30yr @ +215). Despite significant new issue concessions, ranging from 5-25 bps, deal performance was weak – which is not a healthy sign for the market. We are in a market where primary issuance is having a negative impact on secondaries, re-pricing entire sectors.

Monthly Supply Volumes



Source: BofA Merrill Lynch Global Research



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