INSIGHT

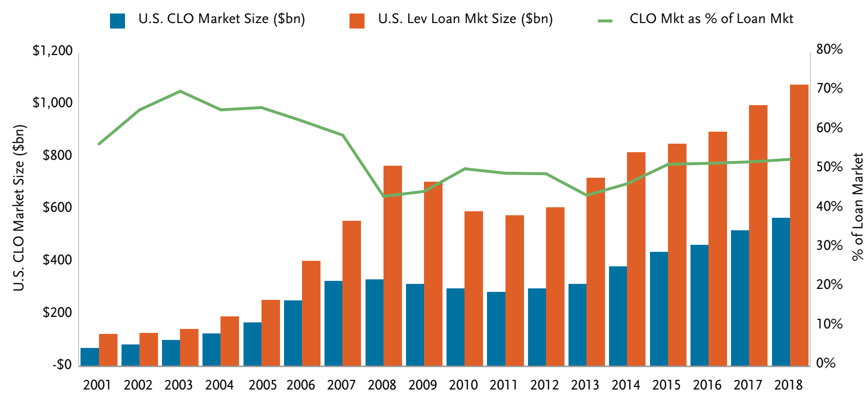
MONTHLY COMMENTARY

Loan Review – June 2018

DREW SWEENEY | JULY 10, 2018

There is a symbiotic relationship between the loan market and the CLO market. The loan market could not grow without CLO growth and CLO growth could not occur without overall loan growth. Obviously, there is a bit of a chicken and egg issue. The overall size of the CLO market is roughly 53% of the entire size of the institutional loan market. During the last 17 years, CLOs represented anywhere from 43% to 70% of the entire loan market. If 1 of every 2 dollars buying leveraged loans is being bought by a CLO, then the health of one market is inextricably linked to the other market.

Growth of the CLO & Loan Market



Source: US High Yield and Leveraged Loan Strategy – JP Morgan

This relationship was evident in June as the monthly CLO issuance was the largest of the year. In fact, on a year-to-date basis, 2018 has had more CLO issuance (including new issue and refinancings) than the first six months of 2017 (second largest issuance year on record) and the first six months of 2014 (the largest CLO issuance year on record). Even if you ignore refinancing, the first six months of 2018 produced larger CLO issuance volumes than the first six months of either 2017 or 2014.

As CLO investors were overwhelmed with issuance, CLO liabilities widened. Triple A CLO liabilities priced 20-25 bps back of where they were pricing a few months ago. To put this in context, the weighted average cost of capital is basically where it was 12 months ago. Loan investors exhibited more discipline as a result of the wider CLO liabilities, which necessitate wider collateral spreads. The loan market also saw secondary prices decline and lower coupon loans repriced at the beginning of the year were particularly in the crosshairs of investors. The percentage of loans trading above par declined to 20.1% to end the month, which is near the lowest level since November 9, 2016. In February 2018, over 80% of loans were priced above par. There has been a relatively dramatic price decline in May and June as CLO investors require higher returns on the collateral with widening liabilities. The institutional loan new issuance calendar remained quite full, allowing investors to be selective and disciplined in what they wanted to purchase.

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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.

Performance

In June 2018, the Credit Suisse Leveraged Loan Index (CS LLI) and the S&P Leveraged Loan Index ("S&P/LSTA") were up 0.10% and 0.12%, respectively.

- 2Q18, the CS LLI was up 0.78% and the S&P/LSTA was up 0.70%
- Year-to-date, ending June 30, 2018, the CS LLI was up 2.36% and the S&P/LSTA was up 2.16%
- For the twelve months ending June 30, the CS LLI was up 4.67% and the S&P/LSTA was up 4.37%

Split Single Bs outperformed in June, followed by distressed loans. Split Double B and Single B loans both registered an 8 basis point decline and neither category provided a return close to the average coupon on the index. On a year-to-date basis, lower quality has continued to outperform higher quality with distressed loans registering the best returns and Split Triple Bs registering the worst.

Total Return By Rating

Rating	Jun-18 (%)	YTD (%)	LTM (%)
Split BBB	-0.07	1.66	3.29
BB	0.00	1.76	3.96
Split BB	0.08	1.86	3.61
B	0.08	2.35	4.77
Split B	1.60	5.51	9.63
CCC/Split CCC	0.10	5.06	8.58
Distressed (CC, C & Default)	0.27	7.09	6.06

Source: Credit Suisse Leveraged Loan Index

Sector Performance

Ten of 20 sectors in the CS LLI provided a positive return during the month. The top performing sectors in June were Retail (+1.61%), Utility (+0.47%) and Food and Drug (+0.45%).

The worst performing sectors for the month were Gaming and Leisure (-0.11%), Transportation (-0.28%) and Consumer Durables (-0.92%).

On a year-to-date basis, Retail (+5.31%), Metals/Minerals (+5.12%) and Energy (+4.30%) outperformed.

In the last 12 months, Energy, Metals and Utility have led all sectors with total returns of 8.34%, 7.72% and 7.14%, respectively. In contrast, Gaming/Leisure, Consumer Non-Durables and Consumer Durables were the worst performing sectors with returns of 4.12%, 2.62% and -4.58%, respectively. Gaming's underperformance relates primarily to relative value as most of the gaming sector has repriced at tight spreads relative to the broader index. The consumer driven sectors have been impacted largely based on concerns surrounding the fundamental change in the way consumers buy products. These concerns have weighed on both sectors. Specifically, within the durable category, one borrower represents a substantial portion of the sector and that company's underperformance has weighed on the entire sector returns.

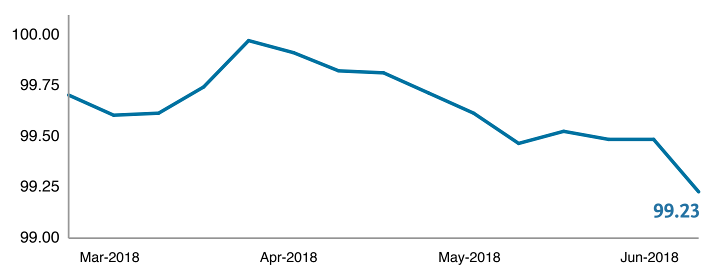
Total Return By Sector

Sector	Jun-18 (%)	YTD (%)	LTM(%)
Aerospace	0.04	1.84	4.34
Chemicals	-0.03	2.04	4.49
Consumer Durables	-0.92	-1.47	-4.58
Consumer Non-Durables	0.41	2.17	2.62
Energy	0.45	4.30	8.34
Financial	-0.07	2.09	4.95
Food And Drug	0.45	3.49	5.82
Food/Tobacco	-0.05	1.90	4.12
Forest Prod/Containers	-0.08	1.56	4.21
Gaming/Leisure	-0.11	1.63	4.11
Healthcare	0.13	2.43	4.81
Housing	-0.04	2.07	4.65
Information Technology	0.09	2.26	4.70
Manufacturing	-0.03	2.28	5.11
Media/Telecommunications	-0.06	2.12	4.15
Metals/Minerals	0.25	5.12	7.72
Retail	1.61	5.31	4.44
Service	0.00	2.03	4.70
Transportation	-0.28	2.50	4.49
Utility	0.47	2.83	7.14

Source: Credit Suisse Leveraged Loan Index
Green Returns= Best Performing Sector; Red Returns= Worst Performing Sector.

Credit Suisse Leveraged Loan prices declined 36 basis points in June while the average bid of the S&P LCD flow-name loan composite started the month at 99.47 and ended the month lower at 99.23.

Average Loan Flow-Name Bid



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

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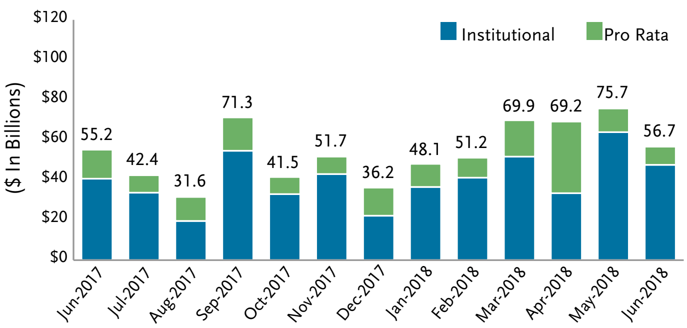
Technical Conditions

Leveraged loan funds reported an inflow totaling $1.40 billion in June for actively managed funds. This was down over $1.0 billion from May fund flows. Inflows year-to-date for loan mutual funds totaled $11.9 billion compared to a +$13.1 billion in 2017. Assets under management totaled $146 billion for the dedicated loan mutual fund base compared to an all-time high of $154 billion in April 2014.

CLO inflows remained quite heavy as June became the second highest monthly total of 2018 and the fourth largest monthly issuance in history. On a year-to-date basis,CLO issuance is up approximately 34% from the prior year.

Institutional new issuance declined 26% in June from May but was up 17% on a year-over-year basis. On a year-to-date basis, institutional new issue is down 7.4% from the first six months of 2017.

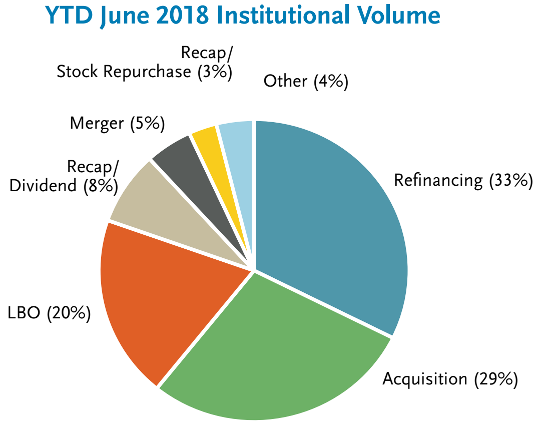
Leveraged Loan Volume



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

Repricing activity slowed to a trickle and most repricing efforts fell on deaf ears as loan prices declined in June. Nearly 33% of the new issue year-to-date was used for refinancing purposes while Acquisitions, LBOs, Spinoffs and Mergers largely accounted for the remainder.

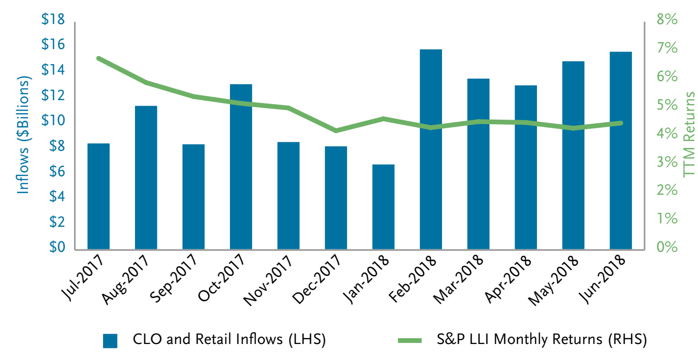
YTD June 2018 Institutional Volume



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

Amid strong inflows, the trailing 12-month returns continued to pace close to 4.5%. The combination of lower LIBOR spreads and the resulting price declines in May and June have weighed on returns.

Inflows and Rolling LTM Returns



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

The end of May and all of June saw a reversal of the spread tightening that had taken place during the last 12 months. On a year-to-date basis, new issue spreads in June were -0.6% tighter for double Bs and 1.0% wider for single Bs. The spread for the CS LLI ended June at roughly L+345 basis points. This is the tightest spreads have been for the CS LLI since September 2010.

New Issue Spread Changes

New Issue Spread Changes	BB/BB-	B+/B
Jun-17	240	370
Sep-17	243	373
Dec-17	233	375
Mar-18	224	341
Apr-18	217	344
Jun-18	232	379
Month-Over-Month Change (%)	6.9	10.2
YTD Change (%)	-0.6	1.0
LTM Change (%)	-3.3	2.3

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

New issue LIBOR spreads during the last 12 months for new issue Double B loans have tightened -3.3%. New issue Single B loans have widened 2.3% during the last twelve months. Rising LIBOR has contributed to higher yields for Double B and Single B loans as yields are roughly 14 bps and 114 bps wider than 12 months prior at 4.7% and 6.5%.

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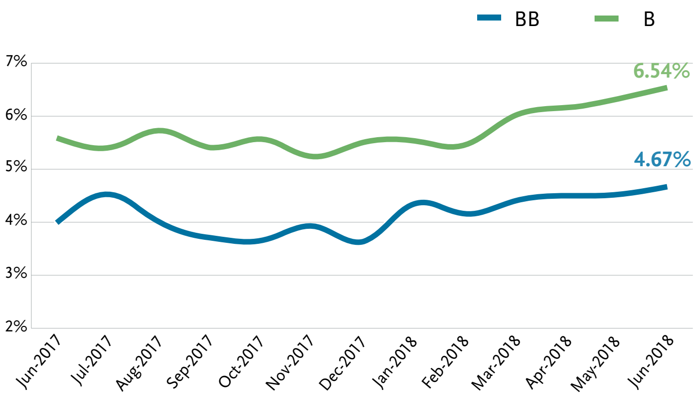
Average New Issue Yields



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

The default rate for the S&P/LSTA Leveraged Loan Index continued to fall in June, declining 17 basis points to 1.95% by principal amount. There was one default (Westmoreland Coal).

Lagging 12-Month Default Rates

	Mar-18 (%)	Apr-18 (%)	May-18 (%)	June-18 (%)
Actual				
By Number	1.93	1.95	1.72	1.59
By Principal Amount	2.42	2.37	2.12	1.95
Shadow Default Rate*				
By Number	0.54	0.65	0.97	0.96
By Principal Amount	0.65	0.80	0.84	0.81

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

* 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.

The last 12-month default tally is 19. Oil & Gas defaults lead all categories with 6 while Retail is close behind with 5.

Valuation

Since 1992, the average 3-year discount margin (DM) for the CS LLI is 461 basis points. If the global financial crisis (2008 & 2009) is excluded, the 3-year discount margin for the CS LLI is 416 basis points. At month end, the 3-year DM (400 basis points) hovers close to the same levels it has been at for all of 2018, which is the tightest level for the 3-year discount margin since October 2007.

The DM spread differential between double Bs and single Bs has tightened from July 2017 to June 2018 by 3 basis points and is still 42 basis points tighter than the historical spread differential.

3-Year Discount Margin Differential Between BBs and Single Bs

1/1992-5/2018 Average	190.4
Jul-17	151.4
Jun-18	148.1

CS LLI Snapshot

YTD Total Return*	2.36%
Average Price (excluding defaults)	97.85
Spread	344.52
Coupon	5.79%
Current Yield	5.90%
Yield (3-year life)	6.86%
Discount Margin (3-year life)	400 bp

*S&P LLI Total Return 2.16%

	Spread (bps)	DM 3-Yr Life (bps)
Split BBB	201	216
BB	258	274
Split BB	315	339
B	380	422
Split B	523	797
CCC/Split CCC	657	1,029
Distressed (CC, C and Default)	799	6,668

Source: Credit Suisse

Summary & Looking Forward

As of June 30, the S&P/LSTA Index imputed default rate was 1.28%, the highest level in 2018 but still very close to the levels last seen in November 2007.

Volumes for CLO and institutional loan issuance were large during the last month and high volumes led to wider pricing levels for both CLO liabilities and leveraged loans. Ramping CLOs stepped in and provided support to the market throughout the month and the market remained very orderly despite declining prices. In fact, we saw several OWICs (Offers Wanted in Competition) from CLOs accelerating their ramps and taking advantage of lower secondary prices.

This all occurred in a month with lots of headline news and concerns surrounding global trade and tariffs. While trade concerns created volatility in equity and other credit markets, loan weakness felt most attributable to market indigestion. If true, we should see loans begin to show signs of strength in July as the loan forward calendar shrinks and managers' process quarter end amortization payments, which will increase cash balances.

June's weakness felt healthy for the market as repricing activity ceased. Loan spread widening reflected CLO liabilities and lower prices allowed investors to more easily trade. While prices declined for the second consecutive month, the market has remained balanced between buyers and sellers – just at lower levels.

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