INSIGHT

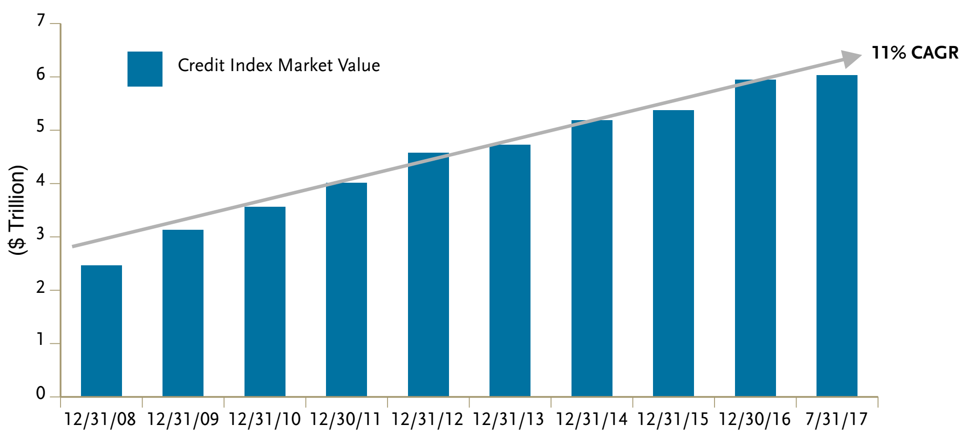
MONTHLY COMMENTARY

July Credit Update

TAMMY KARP | AUGUST 3, 2017

Credit spreads continued to grind tighter in July, rallying another 5 basis points. The OAS of the index is now +98 basis points over Treasuries, a stone's throw away from the cycle tights of +93 touched in June 2014. The market for risk assets remained constructive as investors focused on healthy quarterly earnings and dovish central banks – while paying little attention to policy uncertainly, including the lack of progress on tax and healthcare reform. Technicals have been strong, driven by overseas demand for spread product as well as robust inflows into domestic high grade funds. The QE-driven quest for yield theme has certainly been a dominate force in the market and has superseded deteriorating credit fundamentals. Consider that the U.S. investment grade credit market has grown by a CAGR of 11%, or $3.5 trillion, since 2009. EBITDA growth for the credit universe over the same period was only 1%. As a result, corporate leverage (as defined by net debt/EBITDA) has risen to peak levels, increasing almost a turn from the cycle trough in 2011. In past cycles, massive increases in leverage have generally been associated with recessionary periods, so the fact that we are at peak levels in a growing economy is disconcerting. Moreover, while healthy 2Q earnings growth has been bullish for spreads, we are unlikely to see meaningful improvement in leverage metrics as record debt issuance continues. Even as credit spreads continue to defy gravity, it is important to remain disciplined and cautious. This means positioning in higher quality, more defensive areas of the market.

The size of the IG credit market has grown at an 11% CAGR.



Source: Bloomberg Barclays

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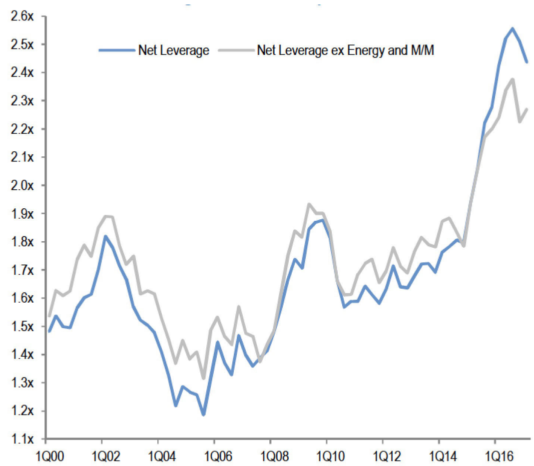
Ms. Karp is a Managing Director in the U.S. Fixed Income group where she trades investment grade and cross over securities. Ms. Karp joined TCW in 2009 during the acquisition of Metropolitan West Asset Management LLC (MetWest). Prior to joining MetWest in 1997, she was with the fixed income department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

Net leverage is 2.44x, Near All-Time Peak



Source: JP Morgan

Q2 S&P Earnings Growth is 10.58%, 66% Into Earnings Season

Sector (GICS)	Reported	Sales Growth	Earnings Growth
11) All Securities	331 / 500	5.72%	10.58%
12) > Energy	22 / 32	15.84%	179.11%
13) > Materials	19 / 26	8.01%	8.70%
14) > Industrials	58 / 68	4.39%	5.91%
15) > Consumer Discretionary	40 / 81	5.32%	1.76%
16) > Consumer Staples	17 / 35	-0.21%	3.29%
17) > Health Care	41 / 61	3.89%	4.72%
18) > Financials	56 / 66	4.73%	10.24%
19) > Information Technology	40 / 67	9.09%	16.55%
20) > Telecommunication Services	2 / 4	-0.94%	6.13%
21) > Utilities	11 / 28	5.20%	7.03%
22) > Real Estate	25 / 32	6.73%	6.87%

Source: Bloomberg Barclays

Index Performance: The investment grade index tightened 5 basis points in July, ending the month at an OAS of +98 basis points. The index yield of 3.04% was 7 basis points lower on the month, resulting in a total return of .73% for July. Year to date, returns are strong at 4.44% as spreads (-20 bps YTD) and Treasury yields rallied. Best performing sectors were metals (-16 bps), munis (-13 bps) and energy (-8 bps). Strong Q2 earnings and a rebound in commodity prices were bullish for spreads. The energy sector as whole rallied 8 basis points (OAS of +136), led by independent E&Ps (-13 bps), refiners (-12 bps) and oil servicers (-10 bps). Oil prices (WTI) rallied back to $50 at month end on the heels of better than expected inventory data and uncertainty in Venezuela (potential sanctions on oil imports to U.S.). The EIA data for the week ending 7/21 showed a larger than expected U.S. crude inventory drawdown of 7.2 mln barrels, bringing total stockpiles down to 483.4 mln barrels. While crude inventories are down ~10% from the peak in March, they are still well above the five year average. U.S. crude production of 9.41 mln bpd remains at peak levels as OPEC efforts to curb supply have been met by increased production in the U.S. and elsewhere. The non-commodity related best performer in July was the muni sector, led by an 86 basis point rally in Illinois spreads. Ratings were affirmed at Baa3/BBB- by both Moody's and S&P after the budget passed. Moody's kept the outlook on negative, however, noting that the underfunded pension issues have not been addressed.

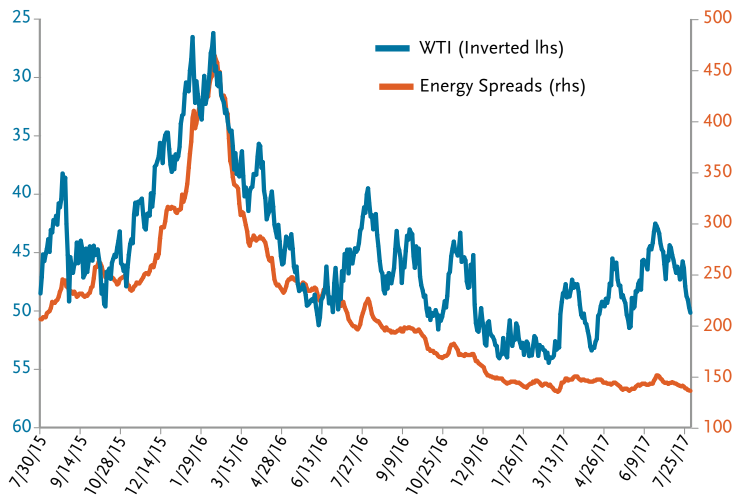
The worst performing sector in July (and YTD) was wirelines (+1 basis point), driven by continued supply technicals that have dominated the space. AT&T's $22.5 billion bond deal to fund the TWX acquisition was larger than the market had anticipated and was also heavily skewed to the long end ($12 bln/$22.5 bln in the long end). The combined ATT/TWX capital structure is massive at ~ $187 billion, with ~ $134 billion in index eligible debt. Combined, ATT/TWX index ticker exposure is now 2.24%, making it the largest issuer in the credit index.

July 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	.59%	.73%	98	-5
Industrials	.61%	.72%	106	-6
Financials	.52%	.73%	96	-7
Utilities	.84%	.83%	101	-9
Municipals	1.57%	1.50%	133	-13
Sovereigns	.81%	.90%	118	-7

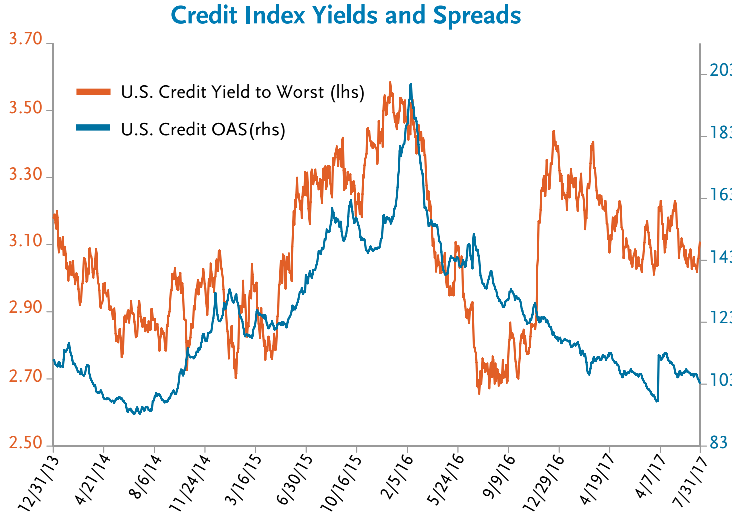
Source: Bloomberg Barclays

Energy Index OAS of +136 at the Recent (since Oct '14) Tights



Source: Bloomberg Barclays

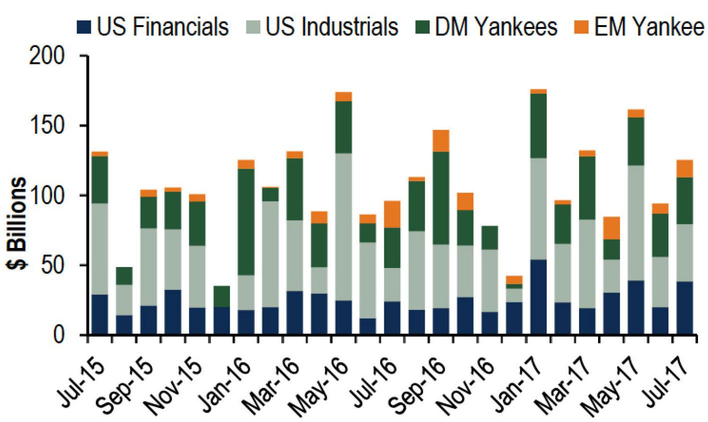
Credit Index Yields and Spreads



Source: Bloomberg Barclays

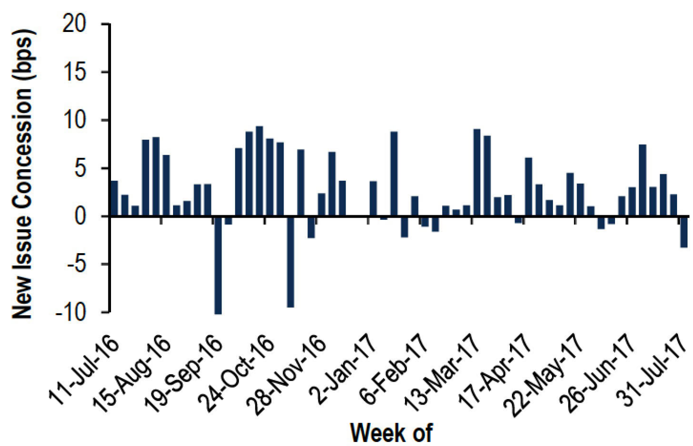
July Investment Grade Supply: New issue volumes were $125 bln, dominated by bank issuance as well as the M&A-related AT&T deal. Financial supply was $70 bln, as several money centers came to market post earnings, including BAC ($7 bln across 4 tranches, 11NC10 priced at +133/10yr), C ($5.75 bln across 3 tranches, 11NC10 priced at +137), MS ($7 bln across 3 tranches, 11nc10 priced at +133/10yr), and WFC ($3.75 bln 5yr bullet @ +80/5yr). Spreads for the Big 6 have converged, with C, BAC, GS and MS all trading within 5 basis points of each other. The biggest deal this month came from AT&T, issuing $22.5 bln across 6 maturities to fund the TWX acquisition (expected to close by year end). The deal came with a roughly 10 basis point new issue concession which isn't bad considering the size of the deal and AT&T's already large capital structure. 10yrs priced at +160/10yrs, 32.5yrs priced @ +225, a 60 bp 10-30's curve which is one of the steepest in the credit universe.

Monthly IG Issuance



Source: BofA Merrill Lynch Global Research

New Issue Concessions



Source: BofA Merrill Lynch Global Research

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