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MONTHLY COMMENTARY

Loan Review – July 2017

DREW SWEENEY | AUGUST 5, 2017

In late June several investment banks called, canvassing the market. They wanted to see if there was still enough demand to syndicate lower Single-B rated deals. July quickly erased any concern, not only surrounding hung syndications but also that there would be sustained weakness in the loan market. Demand overwhelmed supply and the percentage of loans trading above par shot up from 56.1% at the end of June to 72.2% by the month end.

July loan returns were the strongest of the year, driven primarily by a lack of new issuance. In fact, less than $13 billion of loans allocated in the month, which marks a 17-month low. The market has averaged approximately $40 billion per month during the last six months.

Performance

In July 2017, the Credit Suisse Leveraged Loan Index ("CS LLI") was up 0.78% and the S&P Leveraged Loan Index ("S&P/LSTA") was up 0.69%.

- Year-to-date ending July 31, 2017, the CS LLI was up 2.76% and the S&P/LSTA was up 2.62%.
- For the twelve months ending July 31, 2017, the CS LLI was up 6.83% and the S&P/LSTA was up 6.64%.

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Mr. Sweeney is a Senior Vice President in the U.S. 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.

Lower quality continued to outperform higher quality throughout the month with distressed loans netting a return close to 2.2% in July. Double B and Single B loans returned 0.71% and 0.82%, respectively. Larger, more liquid loans slightly outperformed smaller term loans during the month.

Total Return By Rating

	July	YTD	LTM
Split BBB	0.46%	1.45%	3.61%
BB	0.71%	2.00%	4.41%
Split BB	0.71%	2.18%	5.13%
B	0.82%	2.98%	6.77%
Split B	1.19%	5.41%	15.55%
CCC/Split CCC	0.93%	5.50%	19.41%
Distressed (CC, C and Default)	2.18%	5.99%	19.25%

Sector Performance

Every sector posted a positive return in July, led by Energy (+2.51%), Food & Drug (+1.69%) and Utility (+1.27%).

WTI crude oil was up 8.4% in July and began to move higher on the heels of Saudi Arabia announcing that it would make deep cuts to exports in August. Energy loans caught a bid in the back half of the month and led all sectors.

News of Amazon entering the bricks and mortar retail grocery business with the acquisition of Whole Foods sent shock waves through the industry in June. However, investors thought the selloff was overdone and July saw Food & Drug move higher as several of these borrowers bounced back.

Finally, Utilities also moved higher despite natural gas dropping nearly 8%. Rumors of mergers & acquisitions surrounded many of the larger players in the industry. This combined with small acquisitions in the space, led to some optimism surrounding valuations.

Metals/Minerals, Consumer Non-Durables and Consumer Durables were the three worst performing sectors with total returns of 0.52%, 0.44% and 0.09%, respectively.

On a year-to-date basis, Energy, Metals/Minerals, and Services led all sectors with total returns of 4.51%, 4.14% and 3.77%, respectively.

On a year-to-date basis, Food & Drug, Utility and Retail were the worst performing sectors with returns of 1.70%, 1.29% and -1.67%, respectively. Retail was the only sector to have negative performance on a year-to-date basis as well as on a trailing 12 month basis.

Total Return by Sector

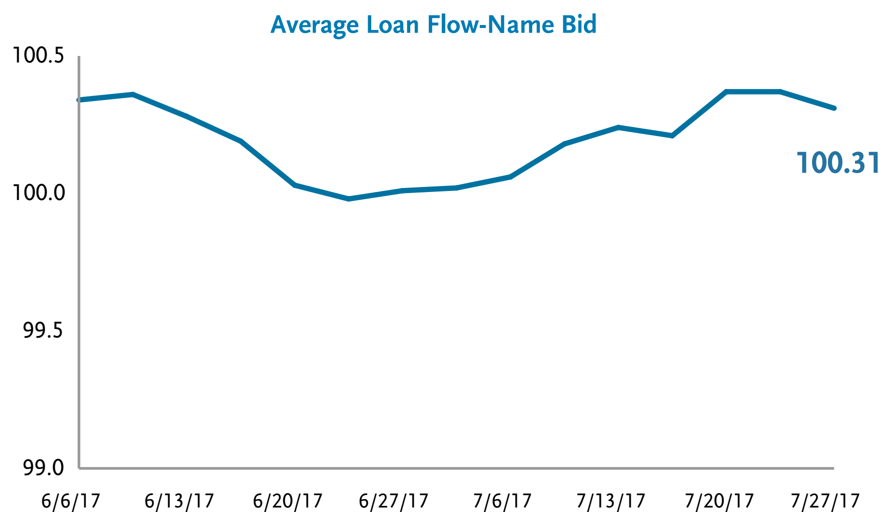
Sector	July
Aerospace	0.65%
Chemicals	0.63%
Consumer Durables	0.09%
Consumer Non-Durables	0.44%
Energy	2.51%
Financial	0.64%
Food And Drug	1.69%
Food/Tobacco	0.67%
Forest Prod/Containers	0.71%
Gaming/Leisure	0.71%
Healthcare	0.73%
Housing	0.75%
Information Technology	0.75%
Manufacturing	0.87%
Media/Telecommunications	0.61%
Metals/Minerals	0.52%
Retail	0.75%
Service	0.77%
Transportation	0.63%
Utility	1.27%

Sector	YTD
Aerospace	2.86%
Chemicals	2.82%
Consumer Durables	2.73%
Consumer Non-Durables	2.10%
Energy	4.51%
Financial	2.70%
Food And Drug	1.70%
Food/Tobacco	2.30%
Forest Prod/Containers	2.38%
Gaming/Leisure	3.35%
Healthcare	3.42%
Housing	2.68%
Information Technology	3.11%
Manufacturing	3.48%
Media/Telecommunications	2.65%
Metals/Minerals	4.14%
Retail	-1.67%
Service	3.77%
Transportation	1.81%
Utility	1.29%

Sector	LTM
Aerospace	6.44%
Chemicals	5.84%
Consumer Durables	6.88%
Consumer Non-Durables	5.53%
Energy	24.56%
Financial	7.43%
Food And Drug	4.41%
Food/Tobacco	4.70%
Forest Prod/Containers	5.38%
Gaming/Leisure	7.20%
Healthcare	5.71%
Housing	5.41%
Information Technology	7.76%
Manufacturing	7.56%
Media/Telecommunications	6.36%
Metals/Minerals	21.41%
Retail	-0.66%
Service	7.51%
Transportation	5.90%
Utility	2.56%

Source: Credit Suisse Leveraged Loan Index

The flow-name prices in the S&P Index (below) increased during the month before very slight weakness crept in during the final week.



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

The average bid of the broader loan Index is up materialy during the last year. By the end of July prices returned to the same levels found in May and early June.

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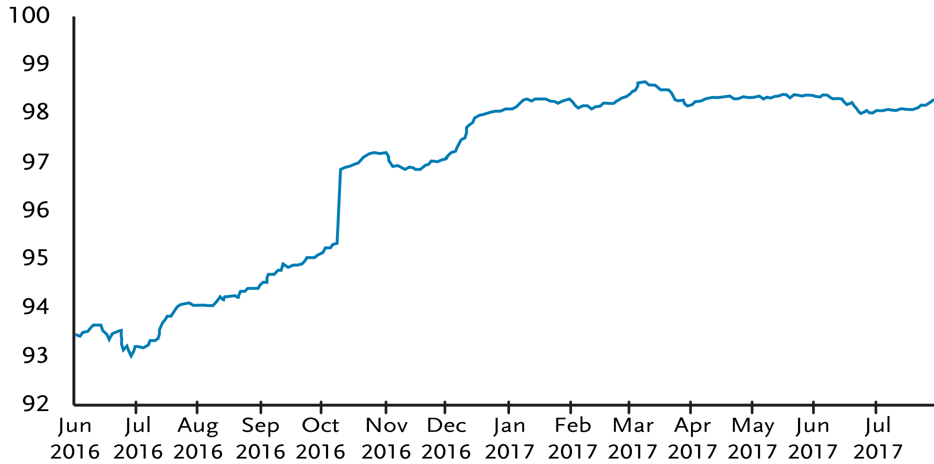
Average Bid of the S&P/LSTALL Index

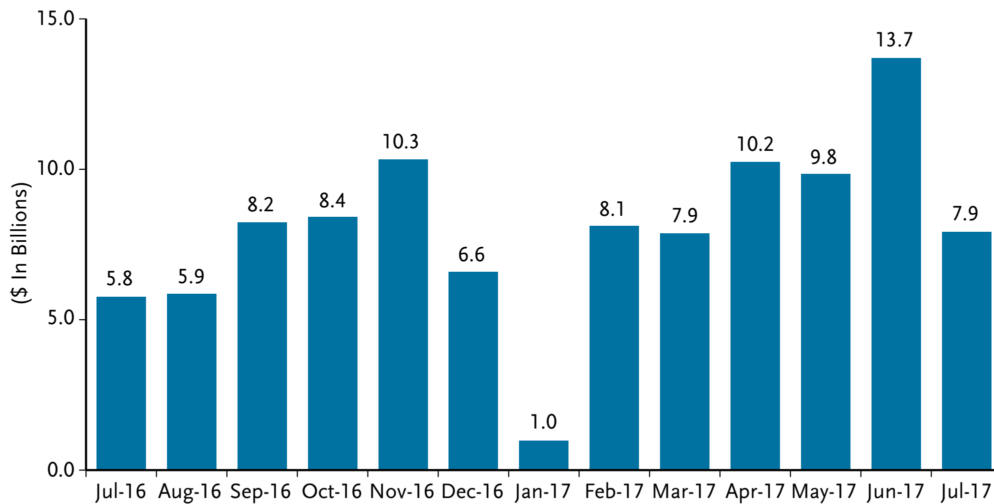


Source: CS, LLI, LCD, an offering of S&P Global Market Intelligence; S&P/LSTA Leveraged Loan Index

Technical Conditions

CLO new issue supply was $7.9 billion in July down 42% from June, which was the largest inflow in the last 12 months. While CLO issuance declined, it was evident that CLOs printed in June and July were actively ramping and pushing prices higher. Year-to-date, over $58 billion of CLOs have been issued, exceeding most estimates for 2017.

CLO New Issue Volume



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

Institutional new issue volumes decreased month-over-month by nearly 20% while pro rata new issuance declined over 80%. This, combined with approximately $25 billion in index loans repaying, left investors scrambling to invest growing levels of cash. For the first month since January, the amount of par outstanding loans shrank, in this case by $7.0 billion.

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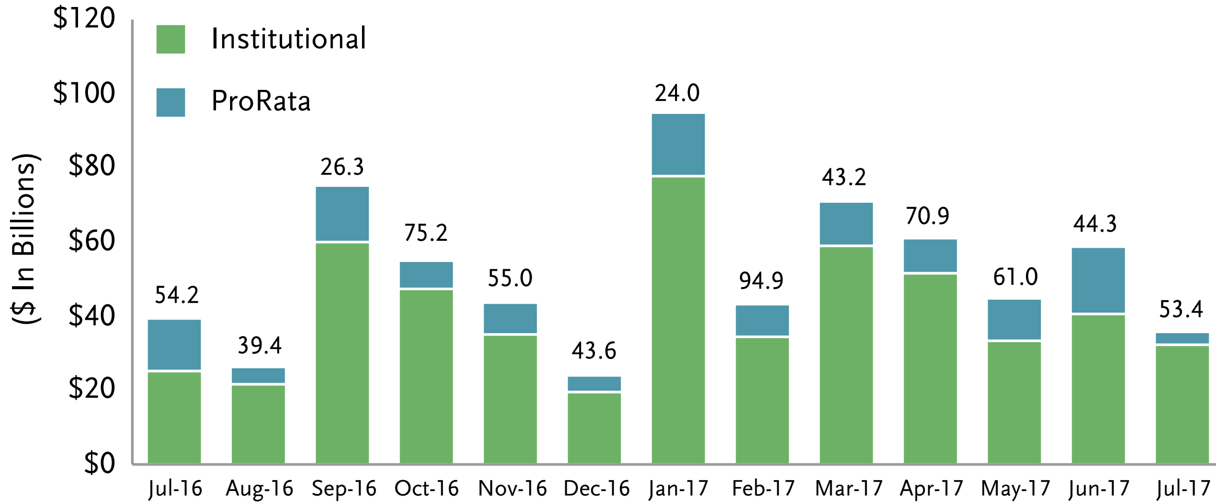
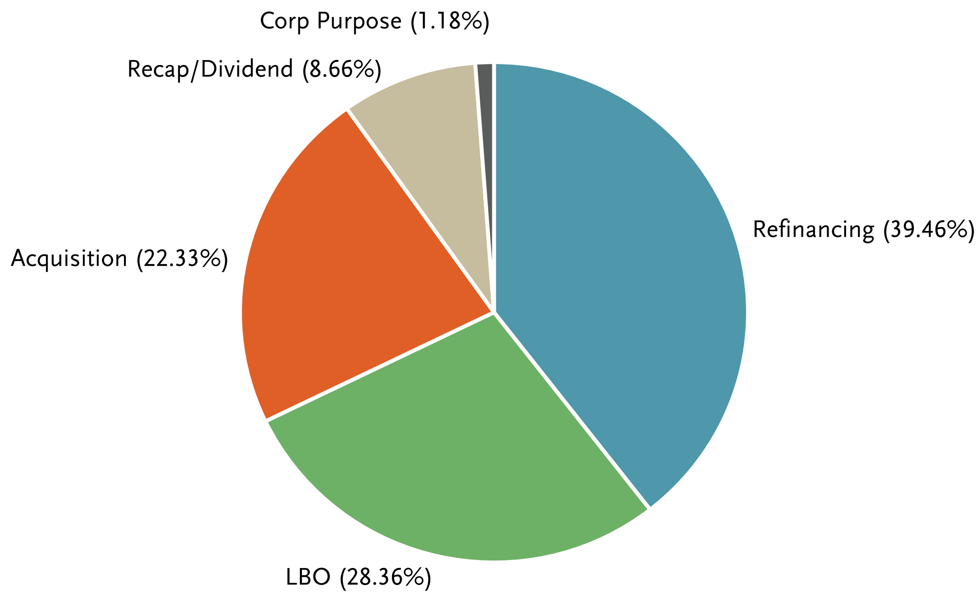


Source: LCD, an offering of S&P Global Market Intelligence

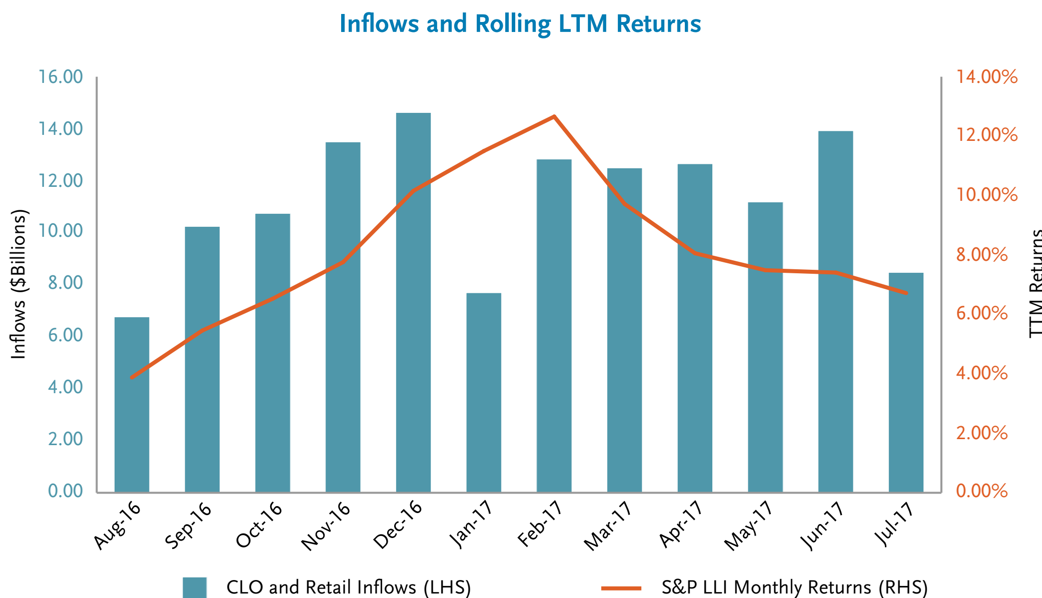
50% of institutional issuance was driven by opportunistic financings (dividends, refinancing/repricing) while 50% of the issuance was driven by M&A activity.



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

Consistent demand has pushed over 70% of loan borrowers above par. With prices reaching recent highs, and coupons shrinking via re-pricings and refinancings, the trailing 12-month return has begun to decline..

Inflows and Rolling LTM Returns



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

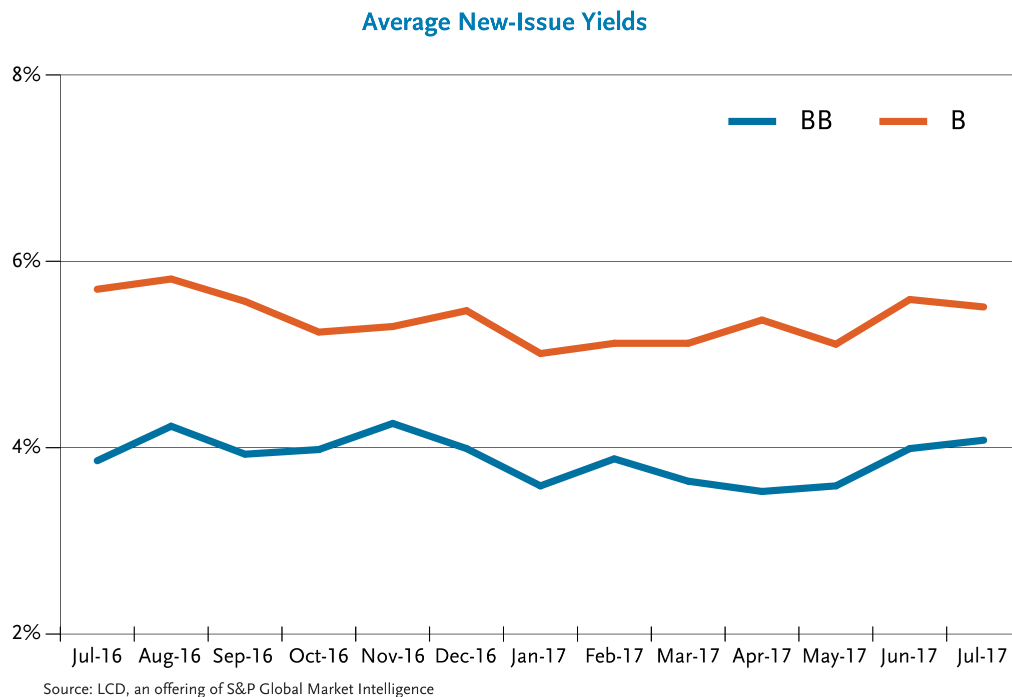
Single B spreads in July widened from the prior month although remain 10.2% tighter than 12 months ago. It is important to note that mix plays a factor in the average spread and that a solid Single B loan, that is a repeat issuer, would price at a tighter level than the prior month. Double B spreads also reflected a slight widening based on asset mix. Double B loans remain nearly 7% tighter on a YTD basis and 21% tighter on a y-o-y basis.

New Issue Spread Changes

	BB/BB-	B+/B
Jun-16	305 bps	42 bps
Sep-16	285 bps	410 bps
Dec-17	268 bps	388 bps
Mar-17	243 bps	382 bps
Jun-17	240 bps	370 bps
July	249 bps	404 bps
Month-over-Month Change	3.91%	9.24%
Year-over-Year Change	-20.73%	-10.24%
YTD Change	-6.83%	4.36%

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

Average new issue yields widened month-over-month for Double Bs while Single Bs tightened slightly.



There have been 22 defaults in the last twelve months with one in July: True Religion. The LTM default rate increased from 1.17% to 1.29%, based on a number of defaults while the default rate increased from 1.29% to 1.36% based on par amount outstanding. Regardless of measurement, default rates remain very low on a historical basis.

Lagging 12-Month Default Rates

Actual	Apr-17	May-17	Jun-17	7/27/17
By Number	1.17%	1.17%	1.17%	1.29%
By Principal Amount	1.29%	1.29%	1.29%	1.36%
Shadow Default Rate				
By Number	0.53%	0.53%	0.53%	0.54%
By Principal Amount	1.54%	1.54%	1.54%	1.56%

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 Restaurant loans provided seven defaults in the last 12 months while commodity driven loans provided five. This is the first reading in the last several years when commodity driven loans were not the leading default contributor. The shadow default activity remains low, suggesting that there will not be any broad-based increase in the next 12 months.

Valuation

Since 1992, the average 3-year discount margin ("DM") for the CS LLI, is 463 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 was tight to the historical average, at 423 basis points and 19 basis points tighter than the prior month.

The DM spread differential between double Bs and single Bs has widened from August 2016 to July 2017 by 13 basis points and is still 31 basis points wide of the historical spread differential.

3-Year Discount Margin Differential Between BBs and Single Bs

1/1992-7/2017 Average	83.0
Aug-16	101.5
Jul-17	114.5

Source: Credit Suisse Leveraged Loan Index

CS LLI Snapshot

YTD Total Return*	2.76%
Average Price (excluding defaults)	98.21
Spread	368.67
Coupon	4.94%
Current Yield	5.06%
Yield (3-year life)	5.94%
Discount Margin (3-year life)	423 bp

*S&P LLI Total Return 2.62%
Source: LCD Loan Stats

	Spread	DM (3-Year Life)
Split BBB	225 bps	218 bps
BB	285 bps	278 bps
Split BB	346 bps	348 bps
B	400 bps	429 bps
Split B	562 bps	788 bps
CCC/Split CCC	646 bps	1,251 bps
Distressed (CC, C and Default)	488 bps	1,541 bps

Source: Credit Suisse Leveraged Loan Index

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Summary

As of July 31, the S&P/LSTA Index imputed default rate was 1.64%, the lowest level since December 2007. While this is shocking, it also contrasts with the multi-year high in February 2016 of 7.3%.

Technical conditions remained as imbalanced as they have been since the first quarter 2017. Growing CLO demand and stagnant retail fund flows dwarfed an anemic new issuance calendar. The overwhelming demand is leading to higher leverage levels and tighter spreads. While the new issue calendar is expected to pick up, it will not likely occur until after Labor Day. In the interim, loans are likely to continue to grind higher, absent a larger credit risk event.

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