TCW

INSIGHT

MONTHLY COMMENTARY

September Credit Update

TAMMY KARP | OCTOBER 5, 2017

Credit spreads rallied 8 basis points in September, reversing all the widening experienced in August – and then some. The OAS of the Barclays US Credit Index ended the month at +96 basis points over Treasuries, just 3 bps away from the cycle tights of +93 in June 2014. Geopolitical risks took a backseat as the market focused on the prospect of fiscal stimulus (via tax reform). Higher Treasury yields and a rebound in oil prices (to above $50) were supportive of spreads. The strong technical backdrop resumed, underpinned by overseas demand for spread product, continued inflows into high grade funds and light dealer inventories.

The "Big Six" negotiators outlined their framework for tax reform. The plan included consolidating individual tax brackets to three, cutting the corporate tax rate from 35% to 20%, and allowing the immediate expensing of depreciable assets (for a five-year period). Repatriation of overseas cash and the partial elimination of interest deductibility on debt were also highlighted, though no specific details were outlined. The border tax adjustment was a notable omission from this recent proposal, which means it may not include enough revenue generating mechanisms to offset the proposed tax cuts. Paying for the tax cuts remains a big impediment to passing tax reform as the reconciliation process demands a revenue-neutral outcome. Both a partisan (getting 52 House Republicans to agree) and/or a bi-partisan (grand bargain w/ Democrats) deal seems difficult to achieve in the current political environment, yet the market seems quite optimistic. For credit, the implications of a reduction in corporate taxes could be accretive to free cash flow. Moreover, a reduction or removal of interest deductibility could mean less corporate debt issuance, as the after-tax cost of issuing debt would increase. A repatriation tax holiday could also reduce debt issuance needs, but that would benefit a relatively small number of issuers and sectors –with about 25 IG companies (mainly in the tech and healthcare sectors) accounting for 50% of the overseas cash/marketable securities. While a good portion of that cash, if repatriated, would likely be used for share buybacks, dividends, and/or M&A, it could still reduce debt issuance needs for these issuers. The flip side to this expansionary agenda of corporate tax cuts, is the re-stoking of animal spirits, which would also have the effect of prolonging the credit cycle at time when leverage metrics are already at peak levels and valuations are stretched.

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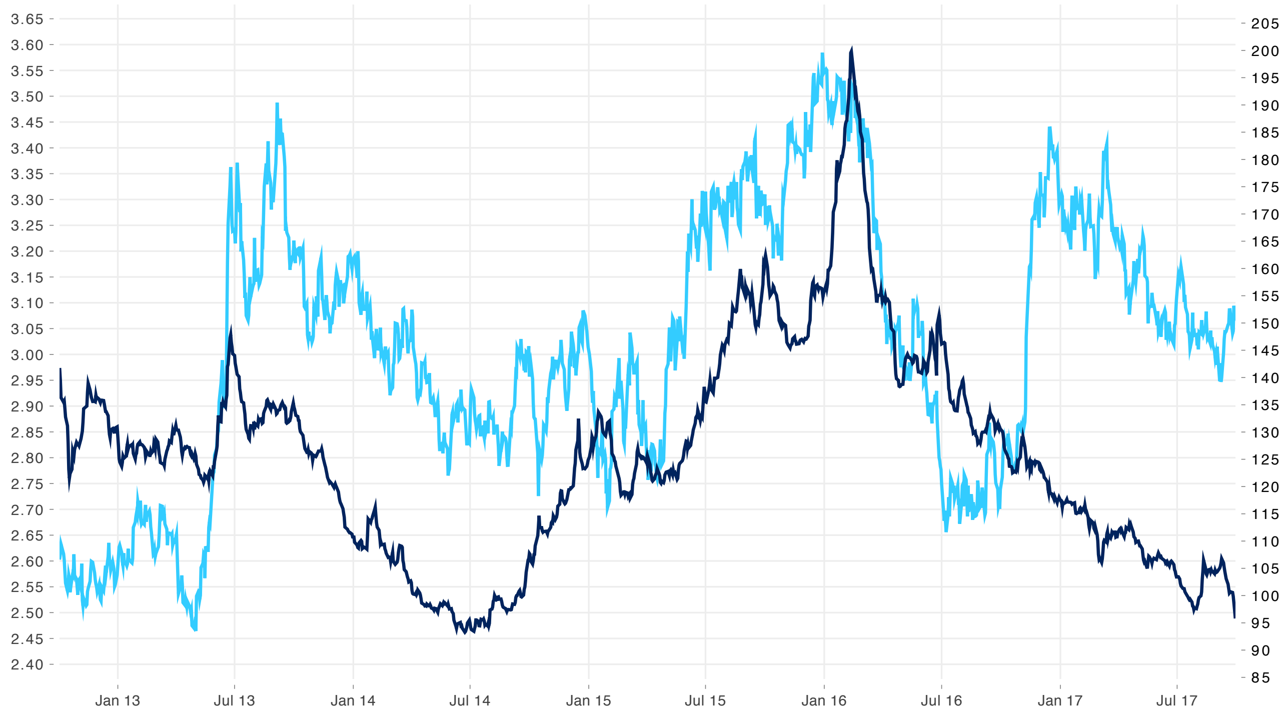
Ms. Karp is a Managing Director in the U.S. Fixed Income group where she trades investment grade and cross over securities. Ms. Karp joined TCW in 2009 during the acquisition of Metropolitan West Asset Management LLC (MetWest). Prior to joining MetWest in 1997, she was with the fixed income department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

Credit Index Yields and Spreads

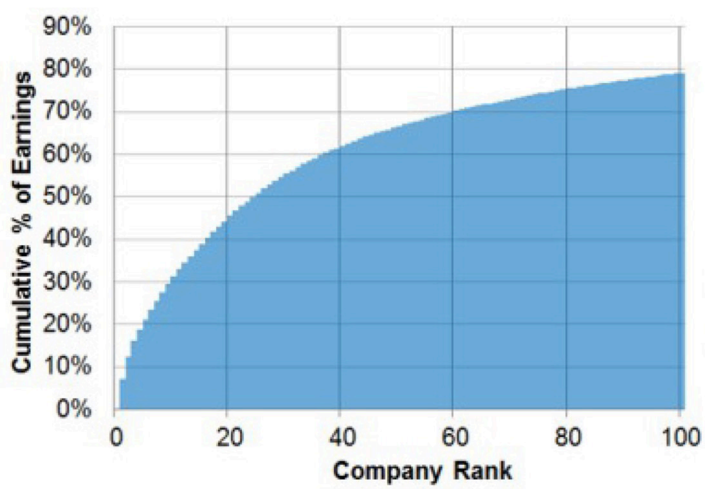
Spreads near the cycle tights. Yields near the midpoint.



Key	Axis	Name	Last	Minimum		Maximum		Mean
	Right	U.S. Credit – OAS	96.103	93.271	06/23/2014	199.808	02/12/2016	125.814
	Left	U.S. Credit – Yield to Worst	3.078	2.464	05/02/2013	3.584	12/29/2015	3.019

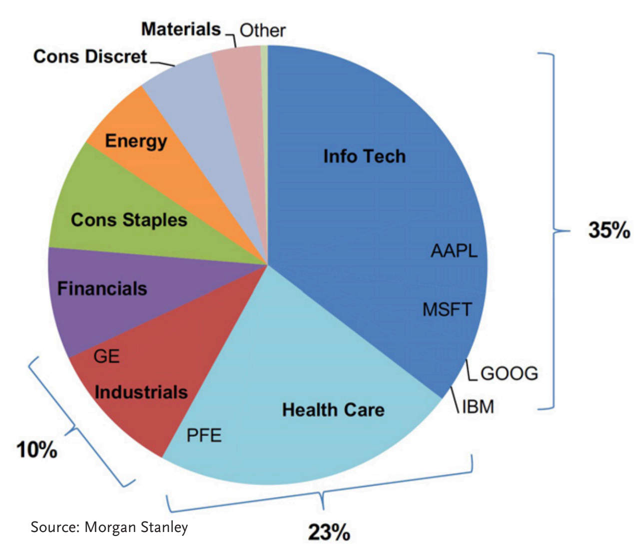
Source: Bloomberg Barclays

Accumulated Unremitted Foreign Earnings for IG Issuers 50% Held in Top 25, 87% in Top 100



Source: Morgan Stanley

Breakdown of Unremitted Earnings by Sector



Source: Morgan Stanley

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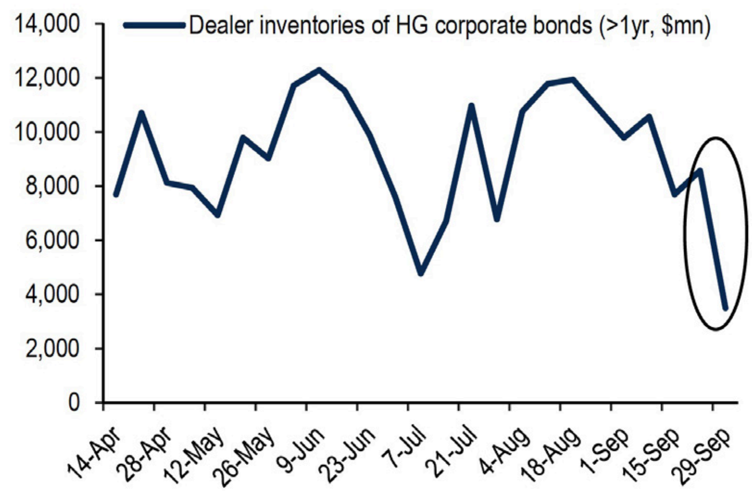
YTD Fund Flows Thru 9/27/17

Asset Class	YTD Flows ($bln)	YTD % off all AUM
High Grade	225.5	9.70%
High Yield	-8.5	-2.40%
High Yield: ETF only	3.6	8.10%
Loans	16.1	12.10%
EM	67.3	15.10%
Munis	23.4	3.40%
All Fixed Income	289.6	7.20%
Money Markets	26.1	0.90%
Equities	126.3	1.30%

BofA Merrill Lynch Global Research, EPFR Global

Demand For Spread Product has Depleted Dealer Inventories



Note: The recent decline (9-21-9/29) is estimated using Bloomberg's TFLO data
Source: Federal Reserve, Bloomberg, Trace, BofA Merrill Lynch Global Research

Index Performance: The investment grade index tightened 8 basis points in September, ending the month at an OAS of +96 basis points over Treasuries. The index yield of 3.08% was 10 basis points higher on the month, resulting in a total return of -.22% as spread tightening was offset by higher Treasury yields. Year-to-date total and excess returns remain strong at 5.08% and 2.41% respectively (on 22 bps of spread tightening). Of the broad sectors, industrials outperformed, led by cable (-16 bps), wirelines (-15), pharma (-13) and energy (-13). The energy sector rallied 13 basis points in September, led by independent E&P's (-19 bps), refiners (-17 bps), and oilfield servicers (-15). Oil prices (WTI) rose to > $50 on the heels of reduced stockpiles, OPEC compliance and increased global demand forecasts. U.S. crude stockpiles stood at 465 million barrels as of 9/29/17, down 13% from the peak in March but still above the five-year average of 414 mln barrels. U.S. crude production of 9.56 million bpd remains at peak levels as efforts by OPEC to curb supply have been met with increased production in the U.S. At an OAS of +134, energy spreads are now 14 bps tighter YTD, underperforming the overall credit index by 8 bps.

Cable and wirelines were the best performing sectors, led by Charter (-26 bps, reversing all of August's widening) and VZ (- 23 bps), as the market's perception of event risk diminished. Specifically, comments from VZ and Charter management downplayed the odds of imminent M&A. From a relative value perspective, VZ trades 50 basis points wide of the index in the long end while Charter (secured bonds) trades 80 basis points wide vs. the index.

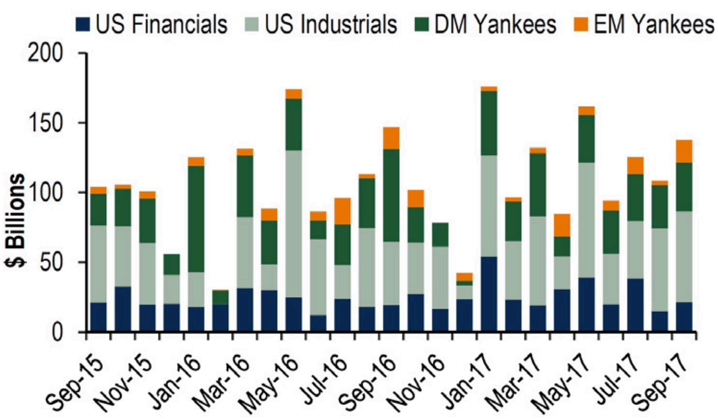
September Credit Index Returns

	Month-to-Date Excess Return	Month-to-Date Total Return	Option-Adjusted Spread	Option-Adjusted Spread Month-to-Date Change
Credit Index	.78%	-.22%	96	-8
Industrials	1.03%	-.08%	105	-11
Financials	.64%	-.22%	93	-8
Utilities	.53%	-.81%	100	-5
Municipals	.63%	-.92%	129	-5
Sovereigns	.93%	-.28%	109	-9

Source: Bloomberg Barclays

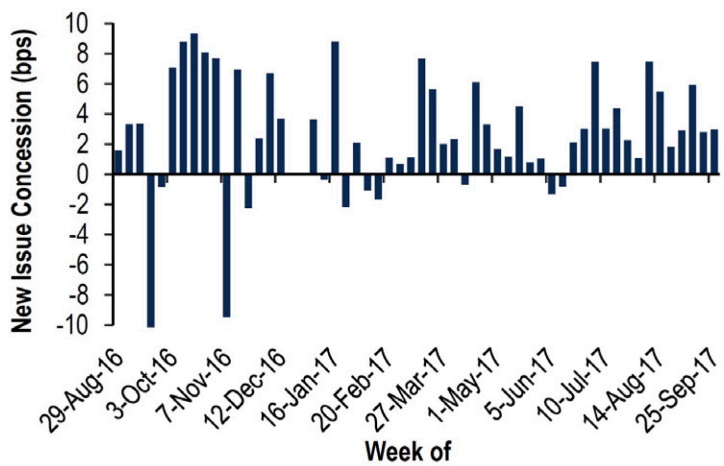
September Investment Grade Supply: With $138 bln in IG supply, the pace of new issuance remained elevated in September. Industrial supply dominated at $78 bln, or 57% of the total. EM issuance increased to $16 bln (12% of total) from $3 bln in August and included deals from Sinopec ($3.25 bln multi-tranche deal, 10yrs priced at +120, 30yrs at +128), and Mexico City Airport ($4 bln to fund airport construction, 10yrs priced at +175, 30yrs at +275). M&A related issuance decelerated to $15.7 bln from $38 bln in August , including deals from Discovery ($6.3 bln deal to fund SNI acquisition, 10yrs priced at 195, 30yrs at +255), and EQT ($3 bln to fund Rice acquisition, 10yrs priced at +160). Demand was strong and most deals were several times oversubscribed, resulting in de-minimis concessions. As has been the case for most of this year, initial price talk gets whispered with 10-15 basis points of concession but then ultimately prices with zero. We also saw several deals price with negative concessions. ■

Monthly IG Issuance



Source: BofA Merrill Lynch Global Research

New Issue Concessions



Source: BofA Merrill Lynch Global Research