4Q 2020 - COVID-19 Haves and Have-Nots

- At the end of 2020, uncertainty is still elevated with respect to both the short-term path of the recovery as well as the long-term transformation of the post-pandemic economy. We know that the pandemic has bifurcated the economy and markets into the "haves" and "have-nots." Sectors that have been aided by stay-at-home orders have done well, as have large companies with market access. Conversely, sectors hard hit by the pandemic (retail, travel, entertainment), workers in middle/low wage occupations, and small business have seen staggering losses.

Thematic Divergence Across the Economy – What is Temporary and What is Structural?

	Temporary	Long Term Supply / Demand Rebalance	Structural
'Haves'	• Pantry Loading / Shift to "Comfort Brands" • Personal Computers / Tablets • Home Improvement	• Suburban Economy • Housing	• Online Retail / Logistics • Technology • Streaming Content
Investment approach:	Hold / Reduce as prices rally	Hold / Reduce as prices rally	Long term hold
'Have Nots'	• Elective Surgeries • Leisure / Local Gaming • Personal Travel • Assisted Living	• Restaurants • Hotels • Airlines • Energy • Urban Economy	• Brick and Mortar Retail • Commercial Real Estate • Business Travel
Investment approach:	Add on weakness	Selective opportunities Extremely detailed analysis required	Avoid / cautious

Our view: The divergent fortunes of specific sectors and issuers during the pandemic and the uneven recovery of those sectors has created winners and losers in the corporate credit world. While some of these shifts are likely to be temporary, others will be permanent, and still others have accelerated longer-term trends that were already in place. Our goal is to identify those companies and issues that stand to benefit from longer-term changes and take advantage of any temporary dislocation in the near-term. We anticipate that in the uncertain environment ahead, there will be more of these opportunities and we look forward to more dispersion in markets.

TCW

4Q 2020 – Market Outlook: The Fed, Stimulus Hopes, and Vaccines Keep the Party Going

- Fiscal stimulus combined with early and sweeping Fed intervention created the easiest financial conditions on record and flooded the market with liquidity, driving the recovery for the better part of 2020. The fourth quarter saw the introduction of several high efficacy COVID-19 vaccines as well as enhanced prospects for additional fiscal stimulus, propelling risk assets to new heights to close out the year.

  - **Equity Markets:** U.S. stock indexes hit new all-time highs. The S&P 500 was up over 16% for the year, with 91% of the index constituents trading above their 200-day moving averages in December. In the third quarter alone, there were 81 IPOs, representing $28.5 billion (highest since 2000). Recent IPOs for Airbnb and Door Dash saw their stock prices skyrocket 113% and 86%, respectively, on the day of offering despite both companies having generated net losses for the year.
  - **Investment Grade Credit:** Investment-grade firms issued more than $1.7 trillion in 2020, a new record that is over 54% higher than last year's level. Despite record issuance, investment grade credit yields hit an all-time low of 1.7%, translating to a negative real yield after adjusting for inflation.
  - **High Yield Credit:** High yield borrowers also sold a record amount of bonds at nearly $275 billion. Lower quality credit rallied, with CCC-rated bonds returning 6.3% in November, the highest monthly return since 2016. Further, CCC-rated yields have dropped to six-year lows (4.5%), as some issuers realized unprecedented 5% coupons on newly issued bonds.
  - **Global Bond Markets:** Negative yielding debt hit a new all-time high of $18 trillion, as now over one-third of global fixed income trades with negative yields. This now includes negative yields on previously risky sovereign credit such as Spain, Portugal, and Greece. At the same time, while U.S. Treasury yields modestly rose in the 4th quarter, yields across the curve remain below their pre-2020 lows.

Our View: Markets are pricing in a degree of optimism and certainty regarding the path forward that does not appear to reflect the underlying challenges facing the economy. The pandemic shock has likely been transformational for the economy, with a recovery that may take years. It is still too early to estimate the long-term effects, for instance whether the temporary surge in demand for stay-at-home sectors will be maintained, if employment will snap back in the lower-wage services sectors, and if small businesses have been permanently lost. With equities at all-time highs and credit spreads near historically narrow levels, market prices largely do not reflect this basic uncertainty. As such, we have been reducing risk overall while we carefully evaluate the shifting environment.

4Q 2020 – Policy Outlook: Central Banks Do Whatever It Takes

- In December, the FOMC stated that they would maintain monthly bond purchases of at least $120 billion until they see "substantial further progress" in reducing unemployment and increasing inflation. Some analysts had expected a shift in the maturity of purchases or more definitive language around QE targets, but the Fed opted for a flexible approach. While their economic projections were slightly upgraded, most officials see rates on hold until 2023, with inflation still stuck below 2% over their forecast period.

- The dollar weakened significantly in 2020, falling by 7% after reaching record highs in March. Improving market sentiment due to the resolution of election uncertainty and the prospect of improved global growth has aided dollar weakness, but it has been the Fed's extraordinary policy actions that have contributed most to the dollar's decline. Looking at monetary aggregates, the Fed has engineered a 24% increase in M2 since March, far surpassing other global central banks.

- Global central banks continue to provide additional stimulus, including new rounds of asset purchases. The European Central Bank (ECB) announced a €500 billion increase in QE along with a nine-month extension and indicated that they will reinvest in bonds at least through the end of 2023. Combined, the G-4 central banks (the Fed, ECB, Bank of Japan, and Bank of England) have added a staggering $5.6 trillion to their collective balance sheet this year.

- Central banks have maintained they will take whatever steps are needed to sustain the recovery, but with financial conditions already extremely accommodative, the effectiveness of those steps is unclear. Further, concerns are rising about the long-term effects of central bank involvement on bond market functionality, with the ECB set to own nearly 50% of Germany's sovereign bond market by end-2021 and the Bank of Japan owning nearly half of the Japanese bond market, and as much as 90% of some issues.

Our view: With the global economy operating well below potential and inflation pressures muted, central banks are likely on hold for the foreseeable future. This combined with the recent change in the Fed's inflation response function, with the 2% target being an average rather than a ceiling, we expect they will be slow to lift rates and end QE. Pre-emptive action to stave off inflation is less likely now; instead, we expect to see inflation running at or ahead of the 2% target before any significant increase in the level of policy rates (Fed Funds).

TCW

4Q 2020 – Economic Outlook: A Bumpy Road on The Way to Economic Recovery

- There are worrying indications that U.S. economic activity is beginning to slow in the face of the latest COVID-19 wave. November's non-farm payroll report was weaker than expected with 245,000 jobs added, down from 610,000 in October. Notably, hiring was concentrated in fewer industries with transportation and warehousing (i.e., couriers and warehouse workers) sectors comprising the majority of new hires as businesses shift to online holiday shopping.

- While the unemployment rate at 6.7% has improved from the peak of 14.7% in April, this overstates the recovery as the total share of people either working or looking for a job has declined meaningfully. The U.S. labor force is 2.2% smaller than in February and the participation rate, or the share of Americans 16 years and over working or seeking work, was only 61.7% in October, down from 63.4% in February. At these levels, the participation rate is near the lowest that it has been since the 1970s.

- Despite market optimism regarding vaccine developments, business sentiment has also deteriorated. The NFIB Small Business Optimism Index decreased by more than expected in November, as fewer small business owners believed that business conditions would improve over the next six months. There was also a significant decline in economic expectations, with only 8% seeing an improvement in growth ahead, down from 32% in September versus a recession low of 5% in March.

- Spending improvements to date have been driven by fiscal stimulus. But with stimulus waning in the fourth quarter, retail sales came in much weaker than expected in November, with broad-based declines across sectors. The next fiscal package, which was just approved by Congress, is much smaller (less than $1 trillion) than economists believe is necessary to sustain the recovery. In addition, the significant contraction in consumer credit suggests ongoing weakness in consumer spending.

Our View: Economic growth in the U.S. has picked up after the sharp drop earlier in the year; however, the recovery remains weak and uneven, with overall levels still below the end of 2019. Fundamental challenges such as high unemployment, large debt burdens, and behavioral changes are likely headwinds, with overall growth continuing at a disappointing pace, particularly if the vaccine rollout hits any snags. In that environment, dramatically higher inflation is not anticipated in the next couple of years but does remain a longer-term concern given the tremendous amount of money available in the system as a result of various stimulus efforts.

TCW

4Q 2020 – Global Outlook: Two Speed Recovery

- The size and speed of the monetary policy response and fiscal stimulus helped avoid an even larger output contraction in Q2 and paved the way for a healthy activity rebound in early Q3 2020. Many economies dipped into contraction again in the fourth quarter, due to a second wave of COVID-19 infections. While most analysts forecast economic expansion in 2021, it will be uneven across economies and dependent on the speed with which vaccines can be deployed.

- Preliminary December PMIs indicated improvements in global activity. On the manufacturing side of the economy, the share of countries with an expanding industrial sector increased to 83% from 67%, while 100% of the "flash" readings revealed an acceleration in momentum. However, services continue to struggle due to the virus — only 33% of economies have reported a services expansion (down from 50% last month).

- Amid the news that surging COVID-19 cases in the US and Europe has slowed economic activity, the recovery in China continues. Chinese industrial production outstripped expectations and ended the year at 6.9% vs 6.7%, and retail sales showed gains over the year as did exports, which surged 21% year over year. While manufacturing activity has recovered to pre-COVID levels, the service sector has also shown recent gains for the year, putting China on pace to achieve full recovery in 2021.

- Despite China's recovery in economic activity, pandemic induced stresses are challenging financial markets. China has recently experienced a series of payment defaults by large state-owned enterprises in the onshore bond market. Corporate bond defaults reached 18.5 billion yuan in November, prompting commercial banks to reduce holdings of non-financial credit bonds by 70 billion yuan ($10.7 billion) to 3.36 trillion yuan, the biggest contraction since May 2019.

Our view: The global economy has bounced back quickly due to unprecedented monetary and fiscal stimulus. The outlook for vaccine development and distribution is also positive, which should continue to support consumer and business sentiment in the short-term. However, the pandemic has led to a significant deterioration of public and private sector balance sheets, which should warrant caution among investors.

4Q 2020 - Investment Grade Credit Outlook: Fundamental Deterioration, Does it Matter?

- Risk assets have recovered sharply since the March sell-off, even as COVID-19 cases rise globally and lockdowns resume for a second time. Investment grade corporate spreads ended the year at 95 bps over Treasuries (having peaked at 357 bps in March). As a result, investment grade corporate credit has returned 9.8% this year and spreads have tightened over 260 bps since the March sell off.

- Policy support and resulting risk appetite has allowed companies to raise liquidity at spread levels that were tighter than they were when balance sheet conditions were significantly better. This year, we have seen leverage mount, quality deteriorate, and the duration of the corporate credit index extend. Adjusting current spread levels for ratings, duration, and dollar price, spreads are only 4 bps wider than the past 20-year tights, which is remarkable considering the underlying fundamentals.

- While increased borrowing has helped most companies weather the challenges from COVID-19, the combination of higher debt and weaker earnings has also contributed to a steady deterioration in credit metrics. Despite the ability to borrow at record low interest rates, interest coverage, the measure of a company's ability to pay interest on outstanding debt, has declined to the lowest level since 2003.

- The challenging fundamental picture has not gone unnoticed by the rating agencies. S&P has taken over 2,000 negative ratings actions this year. In addition, there have been over $190 billion of fallen angels, a record for the market, and only $22 billion of rising stars. Moreover, downgrade risks remain high going forward, as over 50% of investment grade companies have leverage consistent with a high yield rating and, of these, 36% have total debt that is over four times annual earnings.

Our view: Historically, narrow yield premiums in investment grade credit mean that compensation for risk is extremely low, while risks themselves are abundant. Expectations for ongoing policy support and hopes for a successful vaccine roll-out have driven risk appetite and have allowed markets to look past the rise in COVID-19 cases, subsequent lockdowns, and signs that the economy may take years to fully recover. Nevertheless, even if forward-looking markets are correct, current valuations portend a challenging environment for prospective returns given the limited scope for future spread compression. As such, we favor a modestly defensive posture overall with particular emphasis on selective idiosyncratic opportunities.

4Q 2020 – High Yield Credit Outlook: Optimism is the Name of the Game

- Against the risk-on backdrop that has propelled the market since this spring, high yield bonds have gained 7.1% for the year after a more than 11% decline in March alone. In a sign that investor exuberance has reached even the lowest quality cohorts, CCCs had their best monthly returns on record, with some select CCC-rated borrowers issuing bonds with an unheard of 5% coupon this quarter. At the same time, investor demand drove high-yield bond yields to a record all-time low of 4.1% (vs a 20-year average of 8%).

- In addition, average high yield credit spreads of 360 bps are well inside of long-term averages of 467 bps. Optimism in the market, combined with investors' insatiable appetite for yield, has meant that higher nominal yielding parts of the market – energy, CCC credits, and credits that stand to improve due to a vaccine – have seen significant inflows, which has also compressed CCC/BB spreads to historically tight levels.

- Despite the robust market averages, this strong recent performance masks significant dispersion among high yield issuers. While some credits have been slow to recover from the COVID-19 shock, and hence carry wider spreads, nearly half of the market is trading with yields under 4%. At the other end of the extreme, around 7% of the market is trading at distressed levels (i.e., yields > 10%) with "higher" yields that may never be realized due to material risk of default.

- While not as high as initially feared, the current default rate for high yield issuers stands at 6.7%, the second highest annual default total since 2009. Defaults are heavily concentrated in retail and energy, sectors that were already experiencing challenges prior to COVID-19. More tellingly, perhaps, while there are fewer defaults, losses are more severe as recovery rates have fallen to 15%, substantially lower than the 25-year historical average around 40%.

Our view: Tight spreads, low yields, high leverage, prospects for elevated defaults, and an uncertain macro-economic environment suggest that future returns for high yield overall are going to be challenged. While caution is warranted given the broader weakening of market fundamentals, the dispersion created by an uneven recovery and disparate effects of COVID-19 on different sectors suggest there will be meaningful credit-specific opportunities to add value.

TCW

4Q 2020 – Residential MBS Outlook: Strong Housing Market & The Fed Drive Recovery

- Low rates and a significant increase in demand due to the pandemic driven desire for more space has bolstered the housing market this year. Notable data points include a rise in purchase applications to an 11-year high in November, and historically high new and pending home sales. This strength in housing activity is occurring in the context of challenging longer-term issues such as affordability, given price appreciation over the last several years, and historically low levels of inventory available for sale.

- Healthy housing metrics, continued improvement in delinquency rates, and elevated prepay speeds boosted non-agency MBS returns, which saw gains of over 9.1% for the year. While delinquencies remain above pre-COVID-19 levels across residential credit, 50% of credit risk transfer (CRT) and non-QM (Qualified Mortgage) loans that first fell delinquent in April are now current or have prepaid. Despite this improvement, it is still unclear whether existing delinquencies will cure, be extended through additional forbearance, or simply default.

- Agency MBS outperformed comparable Treasuries in 2020, with spreads having recovered dramatically since the wide levels seen in March. The sector benefitted from the twin sponsorship of the Fed and the banks, which countered the negative effects from increased supply this quarter due to improved originator capacity, as originators increased hiring and utilized fintech solutions to boost origination, and historic levels of prepayment due to low rates. Within the sector, further performance gains have been driven by the Fed's purchase of current coupon To Be Announced (TBA) securities *(See Sector Highlight*).

- At the same time, underscoring the fundamental stress for some, mortgage delinquencies in agency MBS pools are rising and the share of homes in forbearance remains elevated. Currently, 1 in 6 FHA loans is delinquent and over 4.5% of agency MBS loans are in active forbearance, which is significantly elevated when compared to pre-COVID-19 levels.

Our view: The Fed's sizable purchases provide a strong tailwind to the agency MBS market, and in particular current coupon TBAs, which we believe represents the most attractive opportunity in the sector. While there has been some improvement in overall delinquency rates across non-agency MBS, levels remain elevated, and it is unclear at this point how many borrowers in forbearance will extend or ultimately default. The legacy non-agency MBS market has fairly conservative assumptions for losses and prepays priced in already, while newer issues are priced based on much more aggressive assumptions. Given the uncertainty and the potential for prices in new issues to move lower as assumptions change, we favor legacy holdings and will wait for better opportunities in new issue non-agency MBS.

4Q 2020 – CMBS & ABS Outlook: Not Out of the Woods Yet

- Despite the rising wave of COVID-19 cases and renewed lockdown measures, CMBS market pricing has largely recovered, with spreads tightening across the CMBS capital structure between 200-900 bps from the March levels. Although spreads are tighter across the spectrum, the recovery has been uneven, with lower quality still lagging. Conduit BBB- and BB spreads for instance, are still 100 – 125 bps wider from January levels, reflecting the potential for rising losses and downgrade risk.

- Loan modifications and increased forbearance (i.e., removing loans from the delinquency pipeline) have helped delay the impact on the CMBS market, particularly within the retail and hotel segment. Overall, the 30+day delinquency rate, while elevated at 8.2%, declined towards the end of the year due to increased forbearance, though the special servicing rate increased to 9.2% and looks likely to continue rising as forbearance modifications expire.

- More broadly, stress in the commercial real estate market is apparent at varying degrees across all major property types. Property prices for retail, hotel, and office properties have declined this year, registering negative year-over-year growth for the first time in 10 years. Additionally, transaction volumes continued to decline, dropping 60% last quarter and 66% in Q2 2020.

- So far this year, consumer ABS fundamentals remained strong, largely because consumers have benefitted from government stimulus. This has helped support returns in ABS, with the sector realizing gains of 4.5% for the year. However, as stimulus has waned and policy measures are set to expire, credit stress has begun to surface. Of note, there was an increasing number of subprime auto loans that saw contract extensions or were moved to active deferral status, in addition to an increase in borrowers that were 30+ day delinquent.

Our view: We see growing signs of stress in commercial real estate – in the near term from small business and retail closures, and in the medium term from potentially lower demand for office space. We anticipate these stresses will gradually filter through the system and impact CMBS, resulting in losses in certain deals, primarily in lower-rated tranches. The same concerns carry over to ABS sectors where less fiscal support and a weak recovery may challenge underlying collateral. As a result, we anticipate that collateral performance will start to deteriorate next year, highlighting the importance of security selection but also presenting ample investment opportunities, particularly down the capital structure, which we will look to actively exploit.

TCW

4Q 2020 Core and Core Plus Fixed Income Positioning Summary

After substantial opportunistic additions to corporate and agency MBS positions at attractive levels amidst volatility in March, risk was trimmed as yield spreads remediated across sectors. Portfolios are again positioned with ample levels of liquidity to respond to rapidly changing market valuations.

Characteristic	Positioning	Comments
Duration	Ended the quarter approximately six-tenths of a year short versus the benchmark	Remain shorter than the Index with yields hovering near historically low levels
Curve	Underweight intermediate and longer maturities	The curve is likely to steepen as the Fed anchors short-intermediate rates, while longer rates drift higher on increased Treasury funding needs and potential longer term inflation risks
Governments	Slight underweight, with an emphasis on on-the-run securities	• On-the-run Treasury securities and Treasury futures provide much greater liquidity • No exposure in TIPS given relatively wide and unattractive breakeven inflation rates
MBS	• Agency MBS – overweight • Non-Agency MBS – maintain allocation, with bias to add on pricing dislocations	• Preference for current coupon agency MBS TBAs which remain attractive given relatively high carry of TBAs versus specified pools • Maintain emphasis on higher quality, shorter duration, currently amortizing non-agency MBS bonds • Look to add exposure in heavily discounted senior legacy non-agency MBS bonds with solid fundamentals
ABS	Small Overweight, bias to trim	• Look to trim FFELP student loan exposure given tight spreads • Prefer AAA CLOs given better liquidity, robust structures, and reasonable spreads
CMBS	Neutral	• Agency CMBS yield premiums have narrowed, resulting in a reduced position in favor of other opportunities • Non-agency CMBS holdings focused on super senior single asset single borrower deals but beginning to look down the capital structure for opportunities
Credit	Underweight	• Remain underweight given very low yield premiums and ongoing tightening • Positioning remains concentrated in high conviction names and defensive sectors like communications and non-cyclicals, particularly healthcare, and food & beverage • Avoid cyclical credit sectors and non-corporate credit, except for municipals
High Yield	Small allocation, with a bias to add selectively	• Anticipate further opportunities to add more substantially to high yield exposures as downgrades swell the volume of available debt and dispersion remains elevated • Emphasize defensive credits and select, high conviction idiosyncratic issuers
International	Small allocation, with a bias to add high quality names on weakness	Like high yield, expectations are for an uneven pandemic recovery to create more attractive entry points in the future for higher quality issuers

Portfolio characteristics and holdings are subject to change at any time. Past performance is no guarantee of future results. The views and forecasts expressed in this quarterly review are as of December 31, 2020, are subject to change without notice and may not come to pass. TCW reserves the right to change its investment perspective and outlook without notice as market conditions dictate. Source: Bloomberg, TCW

This material is for general information purposes only and does not constitute an offer to sell, or a solicitation of an offer to buy, any security. Any issuers or securities noted in this document are provided as illustrations or examples only, for the limited purpose of analyzing general market or economic conditions and may not form the basis for an investment decision, nor are they intended to serve as investment advice. Any such issuers or securities are under periodic review by the portfolio management group and are subject to change without notice. TCW makes no representation as to whether any security or issuer mentioned in this document is now in any TCW portfolio. TCW, its officers, directors, employees or clients may have positions in securities or investments mentioned in this publication, which are subject to change without notice. Any information and statistical data contained herein derived from third party sources are believed to be reliable, but TCW does not represent that they are accurate, and they should not be relied on as such or be the basis for an investment decision.

An investment in the strategy described herein has risks, including the risk of losing some or all of the invested capital. An investor should carefully consider the risks and suitability of an investment strategy based on their own investment objectives and financial position. There is no assurance that the investment objectives and/or trends will come to pass or be maintained. The information contained herein may include preliminary information and/or "forward-looking statements." Due to numerous factors, actual events may differ substantially from those presented herein. TCW assumes no duty to update any forward-looking statements or opinions in this document. This material comprises the assets under management of The TCW Group, Inc. and its subsidiaries, including TCW Investment Management Company LLC, TCW Asset Management Company LLC, and Metropolitan West Asset Management, LLC. Any opinions expressed herein are current only as of the time made and are subject to change without notice. The investment processes described herein are illustrative only and are subject to change. Past performance is no guarantee of future results.