TCW

INSIGHT

MONTHLY COMMENTARY

December High Yield Credit Update

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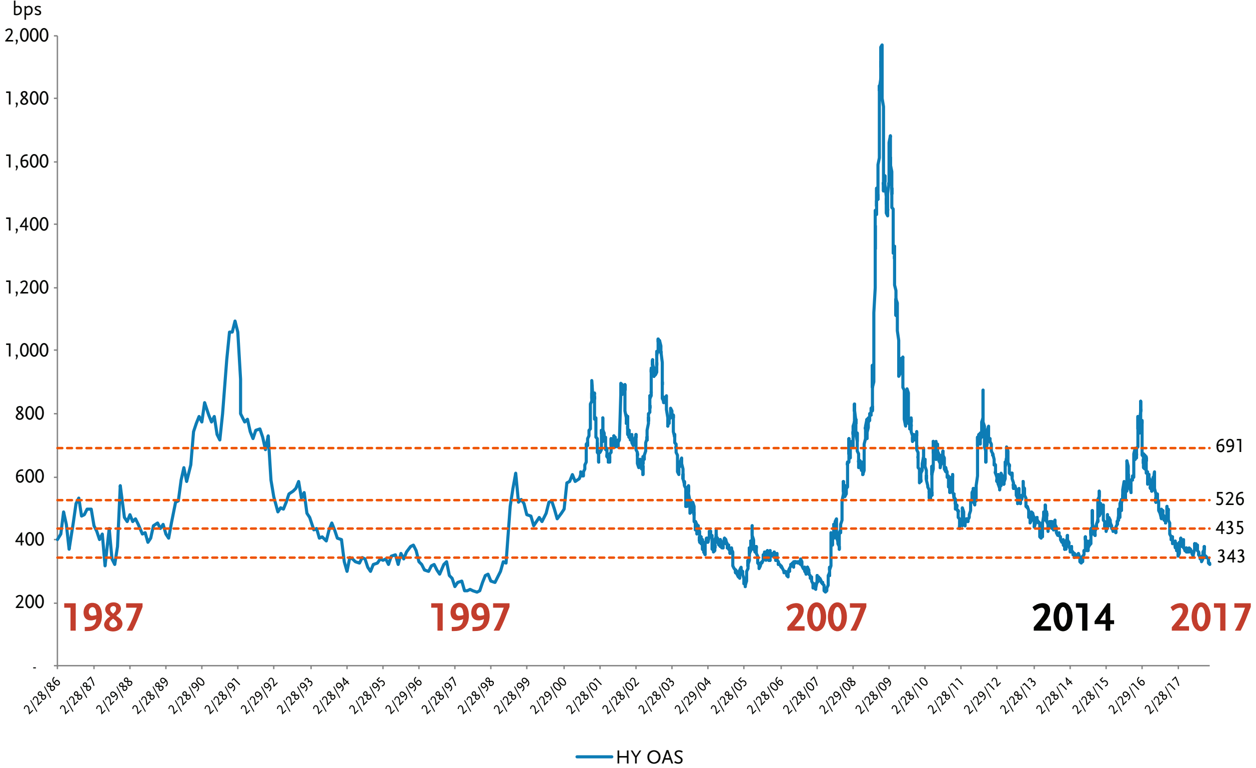
Mr. Gelfand is a Vice President in the Fixed Income group, where he trades high yield securities. Mr. Gelfand joined TCW in 2014 as a Credit Analyst responsible for research in the telecom, technology, and media sectors. Prior to joining TCW, he interned at PIMCO in the Portfolio Management Group and Kayne Anderson Capital Advisors as a Research Analyst. Previously, Mr. Gelfand was an Associate in the Client Management / Business Development Group at Canyon Capital Advisors, helping manage the firm's institutional and high net worth relationships. Mr. Gelfand holds a BA from the University of Pennsylvania and an MBA from the UCLA Anderson School of Management.

Another year has passed and as we look to the scoreboard it's clear it was a good year for risk assets. One need not look further than the double digit returns earned by domestic and international stocks (in the U.S., the S&P 500 gained +22% while the NASDAQ returned +30%), as well as the universal collapse in volatility *(fear)* across sectors. The year marked decade lows in implied (VIX) and realized equity volatility and very tight trading ranges for corporate credit spreads. As for high yield bonds, though returns were dwarfed by the +17% gain realized in 2016, the asset class returned a solid +7.5% this year, as ~6pts of carry was enriched by low default volumes and declining risk premiums.

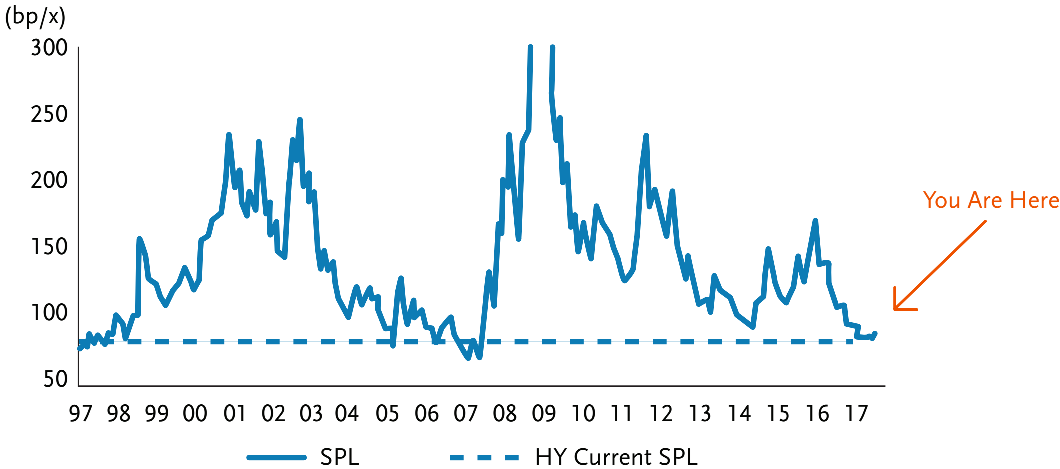
As we think prospectively about the broader investment landscape, with December and 2017 in the rearview mirror, Buffet's adage comes to mind – *be fearful when others are greedy [and greedy when others are fearful]*. Sure, the most egregious example is the crypto-currency mania (almost comically consistent with late-cycle behavior on a grand scale). A slight variant of the Buffett maxim feels appropriate for the high yield market – *be cautious when others are complacent*. The average risk premium in the high yield market now sits below +320bps (the absolute tights of this cycle), with over 40% of the market priced inside of +250bps (also a post-crisis extreme). While absolute spreads appear compressed in a historical sense, this alone does not preclude further tightening. The current risk/reward on offer in the marketplace leaves us uninspired when contextualized by the fundamentals – high corporate leverage, structural challenges facing an increasing number of industries, lackadaisical underwriting standards, macroeconomic uncertainty, and elusive market liquidity, to name a few. As a result, we enter 2018 steadfast in our conservative bias, with our core holdings concentrated in credits with durable balance sheets, non-cyclical business drivers and high free cash flow generation. In this way, we preserve ample capacity to add risk aggressively when valuations improve.

High Yield OAS is in the Bottom Quintile of Historical Levels, Though not Quite at the Tights of the Prior Cyclical Peaks...
(Barclays U.S. HY OAS)



Source: Bloomberg, TCW

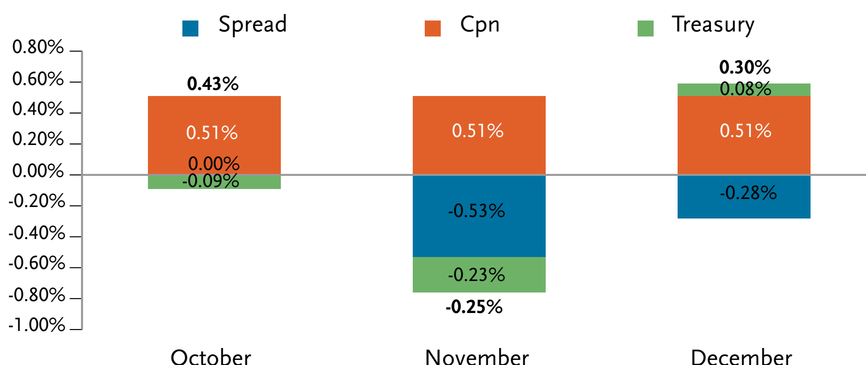
...However, Relative to Fundamentals, we are at 2007 Extremes
(HY OAS per Unit of Leverage)



Source: Credit Suisse, Morgan Stanley Research, Citigroup Index, Bloomberg

Market Performance

Despite a volatile fourth quarter the high yield market hobbled into year-end capping off a very respectable year, at least in terms of performance (see chart below). High yield bonds returned +0.3% for the month, as ~50bps in monthly coupon counterbalanced the headwinds from negative technicals (sizeable year-end primary volumes and retail outflows from ETFs) and large intra-month moves in interest rates



Source: Barclays

While we continued to see sector and credit specific catalysts drive relative performance in the marketplace (more details below), factors more systemic in nature, such as poor market technicals and interest rate volatility, exerted notable pressure this month. Indeed, high quality credits were the clear underperformers as greater empirical durations were amplified in this low absolute spread environment (BB-rated credits yielding ~200bps over Treasuries offer de minimis cushion to absorb volatility in interest rates). BBs returned just +10bps vs. higher beta Single-B and CCC cohorts at +34bps and +79bps, respectively. Moreover, large, liquid capital structures felt the pressure from ETF and portfolio manager selling to fund outflows and new issue bond purchases, respectively.

HY Performance	HY	Ba	B	Caa	Ca-D
December 2017 Total Return	0.30%	0.10%	0.34%	0.79%	1.03%
2017 Total Return	7.50%	7.32%	6.49%	10.38%	13.76%
December 2017 OAS Chg	-1bps	0bps	-5bps	-3bps	
2017 Excess Return	6.10%	5.75%	5.14%	9.28%	

Source: Barclays

At the sector level, supermarkets, pharmaceuticals, and energy-related credits outperformed in December, while retailers lagged. With respect to retailers, sector bellwether PetSmart was a focus capital structure for the market as prices of the unsecured debt declined ~16pts over the course of the month. The combination of uninspiring earnings (lower brick-and-mortar sales and profitability and continued uncertainty regarding Chewy.com's path to positive cash flow) and an elusive earnings call (management instilled little confidence in both operating and financial strategies) inflated the requisite risk premium to own PetSmart debt. Supermarkets on the other hand made a last-ditch effort to generate positive returns for the year, though fell just short of the black. Supermarkets returned +2.55% in December, led by The Fresh Market, which saw bonds squeeze higher after posting results that were not too out of sync with already low expectations. TFM bonds, however, remain priced for future fundamental stress as the levered grocer attempts an operational turnaround while facing a growing competitive threat from Amazon/Whole Foods. Also posting solid returns

in December were pharmaceutical credits with Valeant leading the charge higher. VRX unsecured bonds and stock were up +6pts and +24%, respectively, during the month as investors grew increasingly confident in the company's ability to grow and further deleverage its balance sheet over the coming years. The company issued new unsecured bonds in December, refinancing near-term maturities and more importantly proving to investors (both debt and equity) it can issue unsecured debt. Finally, the energy sector broadly outperformed with investors feeling more confident (for the moment) in adding commodity risk as crude prices set fresh local highs.

Best Sectors	December	2017
Supermarkets	2.55%	-0.07%
Pharmaceuticals	2.14%	14.33%
Oil Field Services	1.38%	8.11%
Independent	1.03%	6.39%
Transportation Services	0.99%	14.04%

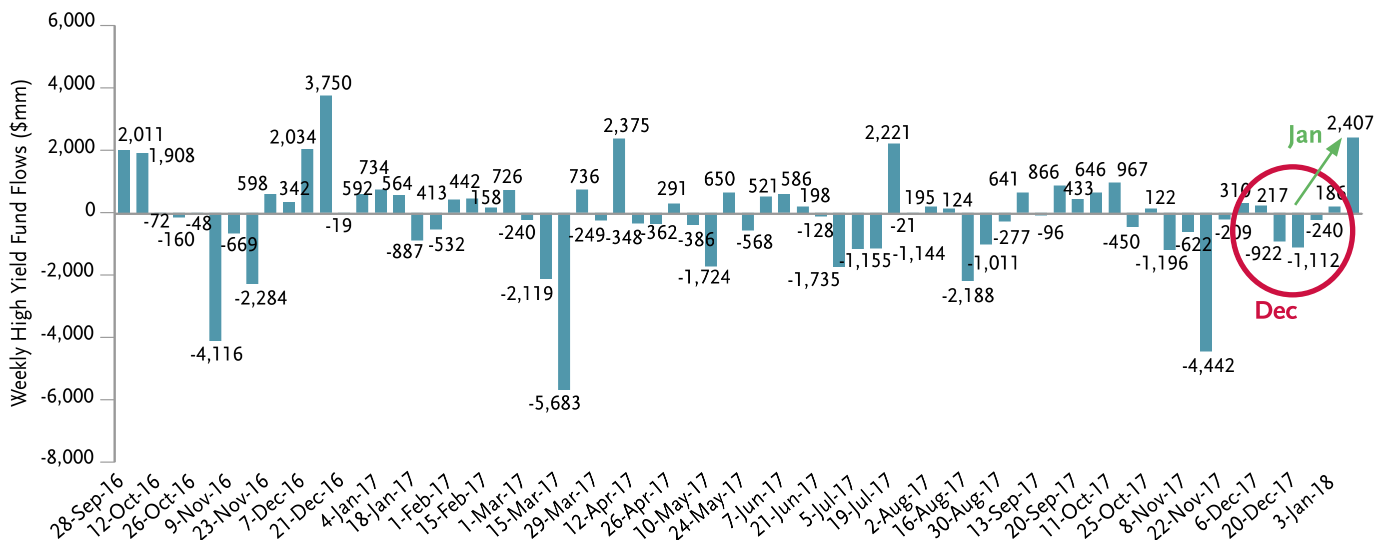
Worst Sectors	December	2017
Retailers	-0.56%	0.89%
Finance Companies	-0.53%	6.43%
Electric	-0.39%	11.82%
Cable Satellite	-0.24%	6.80%
Food & Beverage	-0.13%	7.11%

Source: Barclays

Market Technicals

Fund flows remained net negative during December, extending the weekly string of outflows experienced in November. High yield funds (ETFs and mutual funds) reported net outflows of -$2.1bn during the month, the majority of which was attributable to ETFs, which reflect both absolute selling of high yield exposure as well as institutional investors selling HYG holdings to fund new issue cash bond purchases. While this mix isn't perfectly clear, there is no ambiguity in the data for full-year 2017, which shows the high yield asset class lost ~$18bn in assets over the course of the year (a -$20bn net outflow from high yield mutual funds offset by a +$2bn net inflow into HY ETFs). In fact, the high yield market was one of the only major sectors that saw capital leave in 2017, with stock, bank loan and investment grade credit markets all experiencing large net inflows.

Fund Flows Were Net Negative in December, a Microcosm of the Large Exodus from the Asset Class in 2017



Source: Lipper, JPMorgan

New issue volumes were seasonally light given the marketplace was realistically open for just two of the four weeks during the month. That being said, the market was active during those two weeks as issuers sought to lock in attractive financing in 2017 rather than brave the unknowns (rates, spreads, fundamentals, technicals) of 2018. High profile deals during the month included Valeant, which issued 8-year unsecured bonds at 9.25%, proving to the capital markets it could raise unsecured financing (at a level), and Mattel, a fallen-angel which sought term financing in the high yield market to aid in its turnaround effort.

High Yield Net Supply ($MM)

Month	New Issue	Redemptions	Net Supply	Monthly Returns
12/31/16	18,581	26,359	(7,778)	1.85%
1/31/17	19,028	20,783	(1,755)	1.45%
2/28/17	20,075	26,891	(6,816)	1.45%
3/31/17	42,879	32,555	10,324	-0.22%
4/30/17	16,275	33,967	(17,692)	1.15%
5/31/17	25,797	28,265	(2,468)	0.87%
6/30/17	19,764	37,114	(17,350)	0.14%
7/31/17	11,006	28,127	(17,121)	1.11%
8/31/17	17,723	19,252	(1,529)	-0.04%
9/30/17	37,394	22,548	14,846	0.90%
10/31/17	23,321	32,135	(8,814)	0.42%
11/30/17	27,003	15,210	11,793	-0.25%
12/31/17	17,622	24,511	(6,889)	0.30%

Source: Barclays

Fundamental Trends

December capped off a mild-mannered year for default activity as generally accommodative capital markets buttressed less durable business models and capital structures. With $16.7bn notional high yield bond defaults in full-year 2017, volumes were the lowest since 2013, and stood in stark contrast with the commodity-led spike in bankruptcies and corporate restructurings in late-2015/early-2016. The trailing twelve-month default rate (including distressed exchanges) finished the year sub-2% (1.45% specifically per JPM). ■

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