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INSIGHT

MONTHLY COMMENTARY

December High Yield Credit Update

BRIAN GELFAND | JANUARY 13, 2017

Well, that just happened! Feels like an appropriate adage to encapsulate the marketplace for high yield debt in 2016. The year opened with fear, driving risk premiums to within +75bps of their post-crisis wides, only to see the pendulum quickly swing to greed (optimism, complacency), collapsing spreads to within +75bps of their post-crisis tights by year-end. The result, high yield bonds reigned supreme, returning +17% for the year, outpacing all other sectors save for small-cap U.S. equities (the Russell 2000 returned +21% in 2016, though two-thirds of that performance was earned in the final two months of the year). On a risk-adjusted basis, however, high yield credit had no equal.

High Yield Credit Materially Outperformed Other Sections on an Absolute and Risk-Adjusted Basis

Note: Crude Oil (S&P GSCI) return represents S&P GSCI Crude Oil Index total return. Spt change equals 52% in 2016.
Source: Goldman Sachs

December was effectively a microcosm of 2016, as the characteristics driving total return for the month were near parallel to those affecting performance for the year, namely rising oil and gas prices, favorable technicals, and the hope that fundamentals would eventually catch-up to valuations. As we enter the new year, we reiterate our view the market appears to be pricing in a significant amount of certainty at a time we feel the near-term outlook is far from certain.

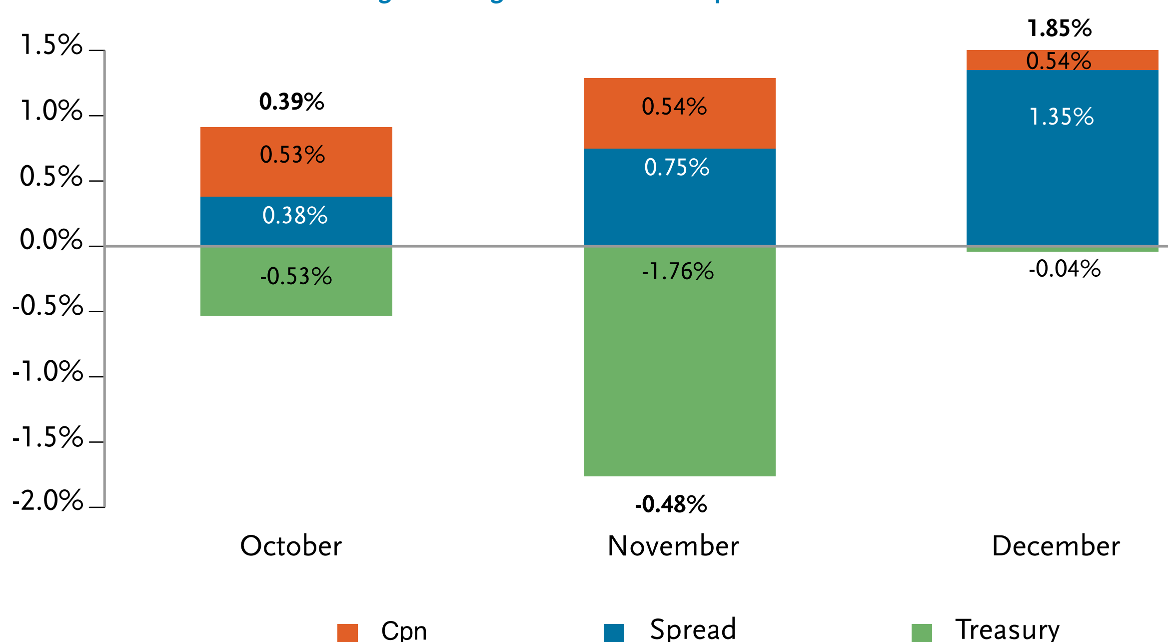
Brian G. Gelfand
Vice President
U.S. Fixed Income

Mr. Gelfand is a Vice President in the U.S. 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.

Market Performance

High yield bonds recovered handsomely in December, adding +1.85% to full year performance after generating a negative total return in November. General investor complacency amid a firming reflation thesis was exacerbated by the supportive technical asymmetry of positive fund flows, limited new issue supply and repressed trading liquidity, resulting in a broad based 'melting-up' of bond prices. Rising interest rates were also less of a headwind in December as 5yr and 10yr treasury yields ultimately increased a relatively modest +9bps and +6bps, respectively on the month (though there was considerable intra-month volatility).

Interest Rate Volatility Ultimately Proved Less of a Factor in Driving Total Return for December, Freeing Declining Risk Premia to Propel Price Gains



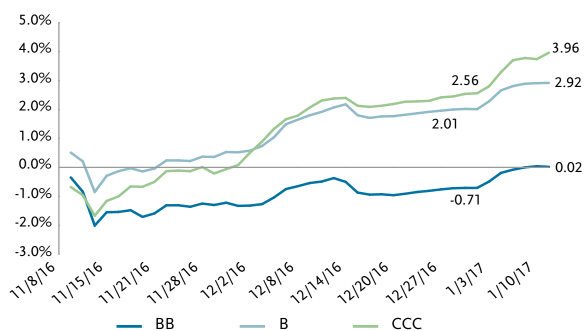
Source: Barclays

Spreads tightened across quality buckets, though the compression trade advanced in December with spreads on CCC-rated debt tightening over 4x those of BB-rated debt. The result, CCCs generated returns near 3x that of BBs during the month. BBs did, however, recover further from their post-election sell-off (the result of a high degree of interest rate sensitivity) with prices only down -0.7pts from November 8th levels by month-end. In-fact, as I write today, BBs have now fully recouped their initial losses. As noted in the chart below, the recovery in Single-B and CCC bond prices post-election was much faster, and prices advanced further in December and continue to rally in the new year.

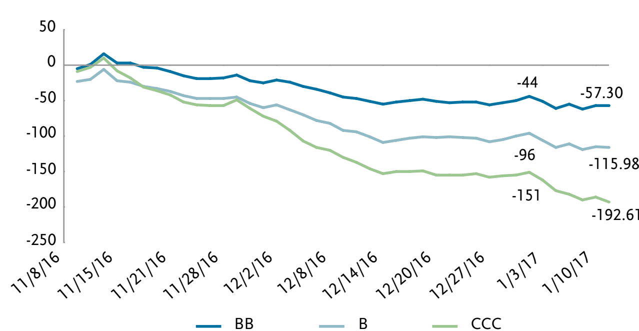
HY Performance	HY	Ba	B	Caa	Ca-D
December 2016 Total Return	1.85%	1.19%	1.97%	3.30%	5.19%
2016 Total Return	17.13%	12.78%	15.81%	31.46%	83.14%
December 2016 OAS Chg	-46bps	-22bps	-41bps	-92bps	
2016 Excess Return	15.73%	11.39%	14.40%	30.00%	

Source: Barclays

BBs Have Recovered Post-Election Losses, Though Lower Quality Credit Buckets Continue to Outperform



Source: Barclays



Source: Barclays

A rising tide carries all boats is the appropriate analogy for high yield sector performance in December as every industry generated positive returns during the month. That being said, pro-cyclical and commodity-linked credits expectedly outperformed given the risk-on environment. Specifically, energy risk (E&P and Oil Field Services credits) benefited from rising oil and natural gas prices, the former driven by early signs of compliance by members of OPEC with mandated production cuts, while the latter spiked on expectations of cold weather ahead. Additionally, the Healthcare sector, namely for-profit hospitals, rebounded off oversold levels as the marketplace re-assessed (whether correctly or incorrectly only time will tell) ACA reform risk. The worst performers on the month, though still in the black, included the usual suspects of Pharma and Retail, both sectors with secular headwinds that are at the forefront of investor sentiment. Underperformance by such sectors as Packaging stemmed less from adverse fundamental developments and more from the fact the tight spreads within which these defensive sectors trade leaves little room for further spread compression and greater vulnerability to interest rate volatility.

Best Sectors	December	2016
Oil Field Services	6.18%	37.01%
Independent E&P	3.54%	45.40%
Aerospace/Defense	2.89%	21.54%
Transportation Services	2.84%	9.16%
Healthcare	2.76%	7.24%

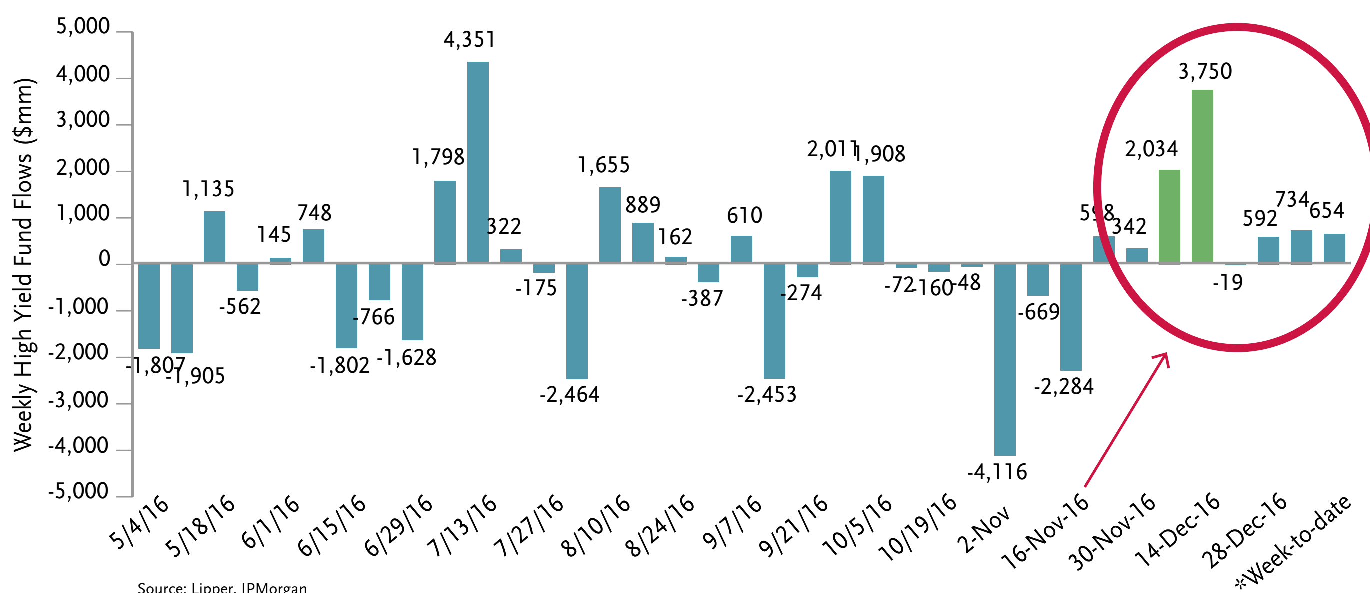
Worst Sectors	December	2016
Pharmaceuticals	0.62%	-4.17%
Packaging	0.75%	10.12%
Metals & Mining	0.75%	45.49%
Retailers	0.85%	12.30%
Home Construction	0.94%	8.59%

Source: Barclays

Market Technicals

Fund flows supported the melt-up theme experienced in the secondary marketplace during the month. A sizeable and steady inflow of capital into high yield accounts, fairly evenly split between actively managed funds and ETFs, compelled a bid for paper at the same time the primary marketplace was shutting down for the year (as discussed below). The result: an inflationary force exerted on prices of the existing stock of high yield bonds. Approximately $7.4bn of fresh capital, net, entered the high yield marketplace in December, $3.5bn into actively managed accounts and $3.9bn into ETFs, reversing much of the -$8.4bn in net outflows in October and November. Thus concluding the first year since 2012 where net fund flows were positive – 2016 (+$9.2bn), 2015 (-$16.6bn), 2014 (-$23.8bn), 2013 (-$4.7bn), 2012 (+$29bn).

Favorable Fund Flows in December Have Carried at a Steady Pace into the New Year



December concluded what were fairly light new issue volumes during the 4th quarter, even adjusting for seasonality (Q4'16 had the second lowest new issue volumes for a 4th quarter in the past five years, outpacing only Q4'15). There is little ambiguity, however, as to why:

- October – earnings blackouts plus the immediacy of the presidential election resulted in a dearth of new issue supply
- November – uncertainty pre-election and rising interest rates, utter shock, and some Thanksgiving turkey post-election sidelined prospective borrowers
- December – truncated period for market activity before entering the holiday season

That being said, the ~$18.6bn USD-denominated new issue calendar in December was rather full considering the marketplace was truly only open for business for about two weeks, likely reflecting substantial pent-up supply carrying over from October and November. Delving into the composition of the calendar, energy-linked issuers had notable representation, largely precipitated by a return of appetite for capital deployment (M&A, drilling programs), and acquiescent capital markets. Given the route the market took between the start and end of year (an unequivocal 180), it seems apropos that the final deals of the year were effectuated by the same class of issuers that were barred access in the beginning of the year. Total new issue supply for 2016 was $216bn, down -14.3% compared to 2015.

High Yield Net Supply ($mn)

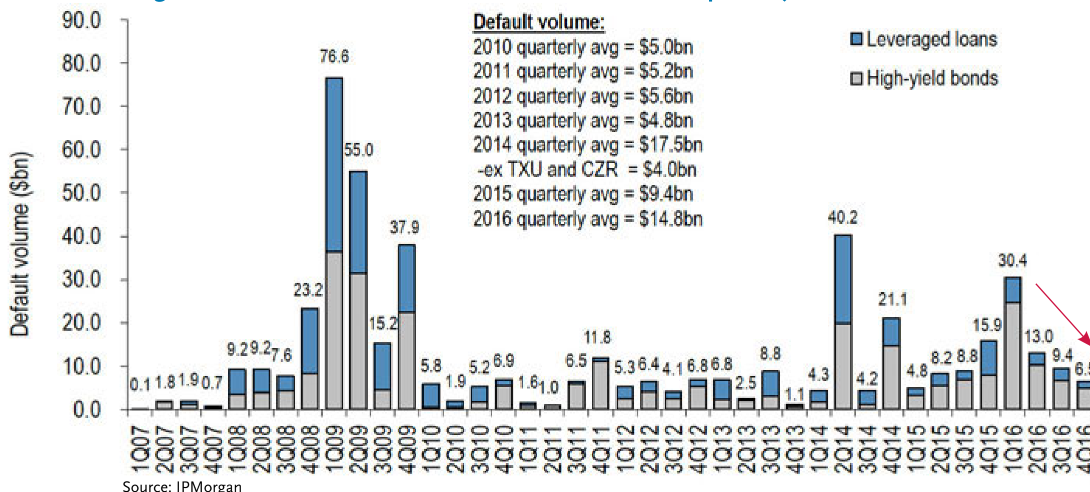
Month	New Issue	Redemptions	Net Supply	Monthly Returns
12/31/15	3,077	28,406	(25,329)	-2.52%
1/31/16	5,923	12,449	(6,526)	-1.61%
2/29/16	7,557	15,556	(7,999)	0.57%
3/31/16	18,226	12,920	5,306	4.44%
4/30/16	31,176	18,454	12,722	3.92%
5/31/16	28,355	31,534	(3,179)	0.62%
6/30/16	22,334	31,021	(8,687)	0.92%
7/31/16	13,327	22,719	(9,392)	2.70%
8/31/16	16,647	22,606	(5,959)	2.09%
9/30/16	25,207	29,030	(3,823)	0.67%
10/31/16	13,452	35,225	(21,773)	0.39%
11/30/16	15,282	22,208	(6,926)	-0.47%
12/31/16	18,581	26,359	(7,778)	1.85%

Source: Barclays

FUNDAMENTAL TRENDS

The benign default environment which had characterized the second half of 2016 extended through December to close a true year of two halves. Four companies defaulted on a total of $1.6bn of debt (bonds and loans) in December, a paltry amount when compared to the level of activity in the opening months of the year. The 'why' for the sharp inflection in default activity beginning in the second quarter is clear – the volume of corporate defaults is directly impacted by the accessibility of capital markets, which in-turn is directly impacted by investor tolerance for high yield credit risk. Risk appetites improved considerably as the year progressed and the impetus for corporate defaults declined. The annual default rate for 2016 was 4.5%, down from a peak trailing twelve-month default rate of 8% in April. Moreover, the recent pace of activity is much lower at ~2.6% when evaluated on a trailing three-month annualized basis. Consensus expectations are for an extrapolation of the current momentum with market strategists projecting 2017 high yield default rates between 2-3%. ■

High Yield Default Volumes Declined in Each Subsequent Quarter in 2016



Source: JPMorgan

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865 South Figueroa Street | Los Angeles, California 90017 | 213 244 0000 | @TCWGroup