TCW

INSIGHT

MONTHLY COMMENTARY

January High Yield Credit Update

BRIAN GELFAND | FEBRUARY 13, 2017

The new year brought all participants back into the pool, with both frequent and infrequent issuers testing new price levels and new boundaries in regards to deal structure and covenant language. Taking a step back, the primary market, or the market for new issue bonds, is generally a good gauge to calibrate the state of the high yield marketplace as a whole – which credits have access and which do not, which terms are acceptable and which are not, which covenants are agreeable and which are not. And with syndications generally ranging from $250 million to several billion, at what price is the market willing to clear large blocks of said credits, terms and covenants. Succinctly, the primary market resets the limits of the marketplace.

Now, coming back to my comments on January, new issues during the month (and continuing into the first week of February) were particularly noteworthy, with each successive deal confirming our view of the sheer excess in the marketplace today. First was the return of highly levered, CCC-rated issuers (largely sponsor-led deals). Barred access for much of 2016 (and 2H'15), these risk profiles were over-represented in January, accounting for 18% of the calendar versus only 6% in 2016 and 14% of the entire high yield market. Moreover, the levels at which these deals cleared set new "high water marks," with mid-6% coupons as the rule, not the exception. Next were the deal structures, and for those active in the market back in 2006, the parallels should be apparent. Several deals had aggressive terms, but the most glaring was a new issue initially contemplated with a 5-year term, only one year of call protection, issued by a holding company with no guarantee or security from the operating assets, and a coupon where the borrower was obligated to pay cash interest on the first coupon date, but then had the option to toggle to a payment-in-kind coupon thereafter (a "PIK toggle", or a negatively amortizing bond). This was a sponsor-led deal with the proceeds going to pay the private equity firm a sizeable dividend only months after acquiring the asset. The bond cleared with a low-double digit yield and only modest adjustments to the above terms. Finally, we turn to covenants. Covenants

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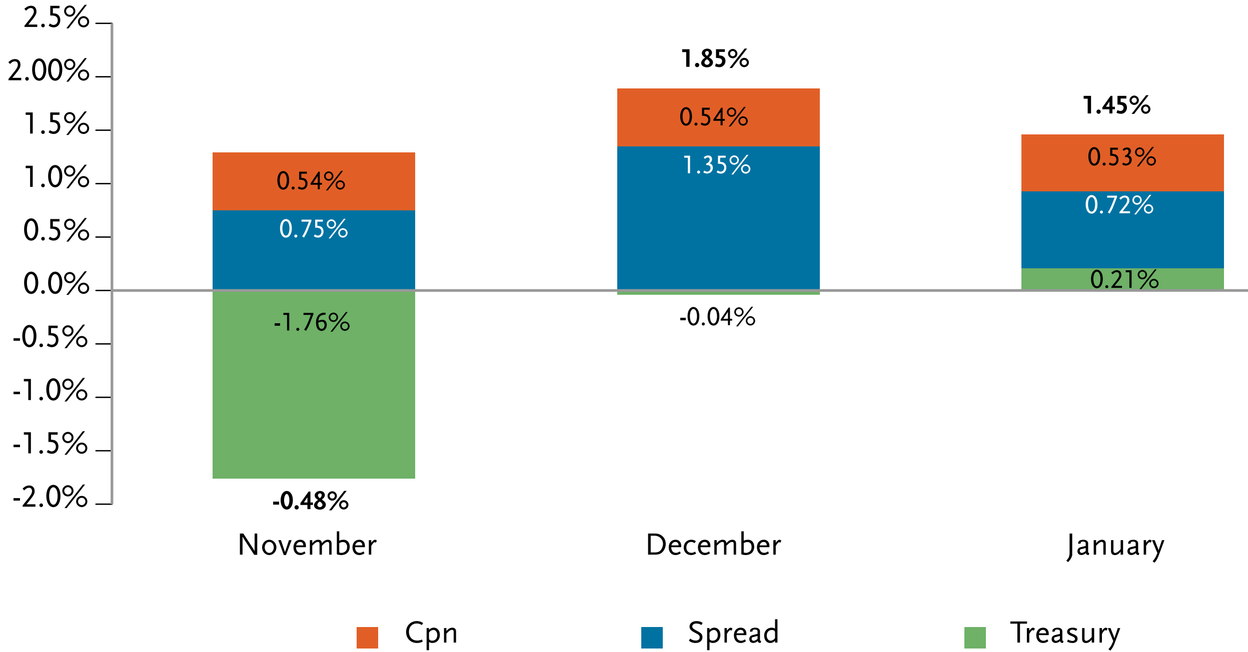
serve as protections for creditors, governing what a borrow can and cannot do and affording creditors leverage to enforce compliance with these rules. In January, attempts were being made by issuers to introduce a “no premium upon default” clause in bond indentures which would have the effect of significantly limiting the recourse creditors have to enforce compliance with the agreed upon covenants – a veritable death blow to covenants as warned by industry watchdog Covenant Review. The market decidedly rejected this clause, however, and it looks as if the risk has subsided for now; though I think the mere attempt by issuers to introduce such language is telling of at least their perception of the frothiness of the market in recent months.

Again, the primary market is a barometer for the state of the marketplace generally, and the signal we are receiving from the new issue calendar is that of complacency…even exuberance. As fundamentals, particularly in relation to price (spread), are at odds with this signal in our view, we recommend extreme caution when investing today.

Market Performance

The secondary market for high yield bonds was well bid in January as both risk sentiment and rates (on the margin) supported higher prices. High yield bonds kicked off the year generating a total return of +1.45%. Rates were cooperative during the month in that 5yr and 10yr Treasuries were fairly range bound, creating little distraction from a reflation thesis which continues to drive risk premiums lower. Indeed, option-adjusted spreads on high yield bonds tightened -21bps in January, with the OAS of the Barclays U.S. High Yield Index moving below +400bps (the first time since the 2014 lows of this credit cycle).

Tightening Spreads Continue to Be The Driving Force Behind High Yield Bond Performance In January



Source: Barclays

Average Option-Adjusted Spreads are Now <400bps, A Range Consistent With The Tights of this Credit Cycle

Source: Barclays

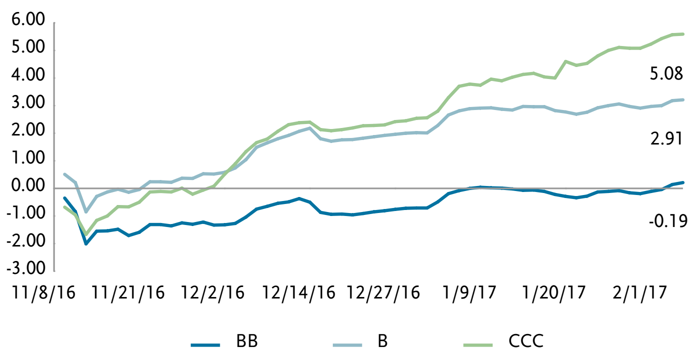
As is generally the case in a bond rally characterized by spread compression, lower quality/high risk credits outperformed (i.e. CCC and longer duration risk led the charge). Specifically, CCC-rated bonds saw credit spreads tighten -70bps and generated a total return of +2.5%. This compares to BB-rated bonds which earned a total return of +1.1% with only -8bps of spread tightening. As can clearly be seen below in charts tracking the cumulative change in price and spread across ratings buckets since the election, the outperformance of CCCs accelerated in January compared to the prior two months. With the most fundamentally defensive capital structures offering little room for further upside (particularly given the negative convexity of callable bonds trading at a premium to par), investors are capitulating to the momentum and bidding up prices of fundamentally weaker credits in search of relatively higher yields and prospectively higher returns – a strategy we believe offers poor risk/reward in this environment at these prices…to say it nicely.

HY Performance	HY	Ba	B	Caa	Ca-D
January 2017 Total Return	1.45%	1.10%	1.39%	2.50%	4.70%
2017 Total Return	1.45%	1.10%	1.39%	2.50%	4.70%
January 2017 OAS Chg	-21bps	-8bps	-19bps	-70bps	
2017 Excess Return	1.24%	0.88%	1.18%	2.30%	

Source: Barclays

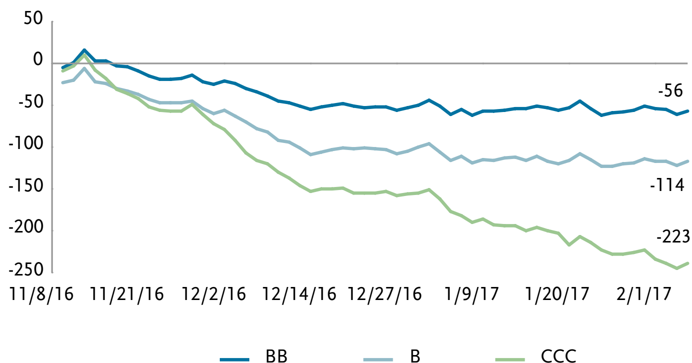
CCC Outperformance Since The Election Accelerated in January

Rolling Change in Price Since November 8 ($USD)



Source: Barclays

Rolling Change in OAS Since November 8 (Bps)



Source: Barclays

Turning to sector performance, department store and specialty retail woes have been the topic du jour in the marketplace over the past several weeks as lackluster fourth quarter earnings reports have brought the secular headwinds facing traditional retail into focus. Interestingly, while the structural challenges facing leveraged department stores and select retails brands (incl. Toys R Us, J Crew, Neiman Marcus, etc.) have been well understood by investors for some time, this past quarter saw signs of weakness begin to permeate those corners of retail which were traditionally viewed as immune for one reason or another, including premium brands (L Brands, Levi's), innerwear (HanesBrands), and pet specialty (PetCo, PetSmart). Whether simply noise or indications of further weakness to come, time will tell, but at least this past month saw the market decidedly shun the retail sector in what was otherwise a risk on environment. The other sector that posted a negative total return for the month was finance companies. This, however, was singularly the result of the largest sector constituent, Navient, the student loan servicer, selling off amid headlines that regulators are scrutinizing certain of the company's business practices. All other industries generated positive returns for the month, where higher risk generally implied higher returns.

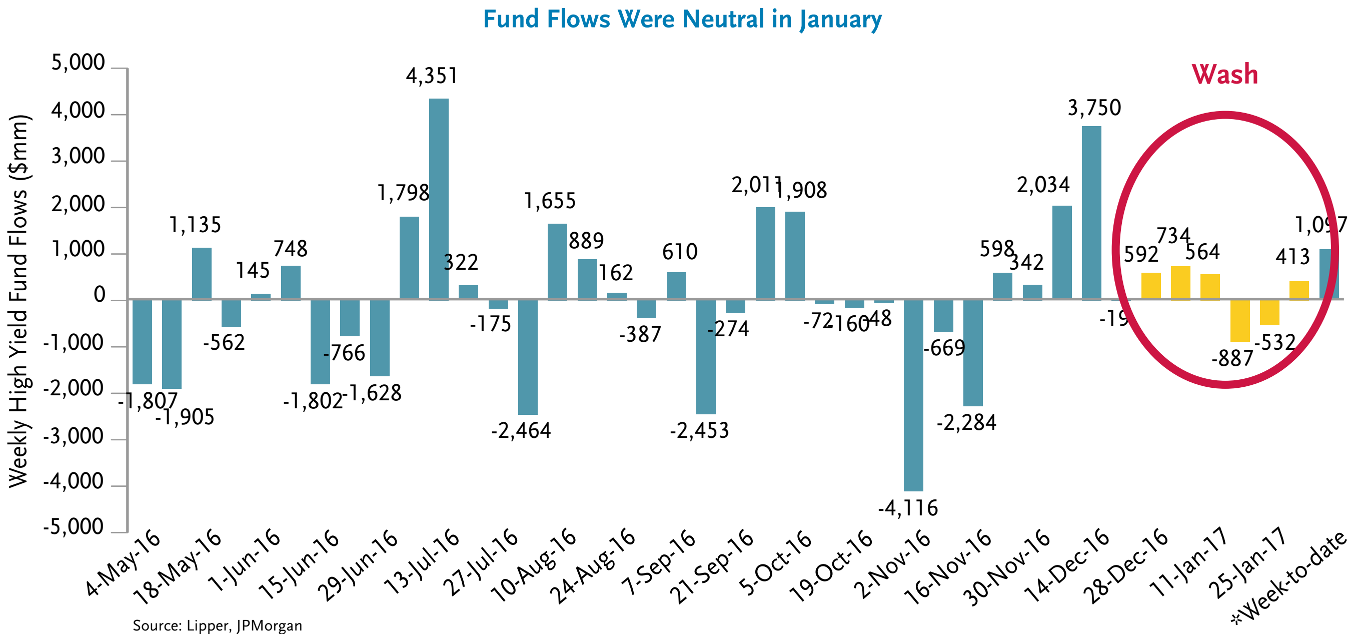
Best Sectors	January
Oil Field Services	4.04%
Electric	2.90%
Industrial Other	2.42%
Midstream	2.28%
Chemicals	2.23%

Worst Sectors	January
Retailers	-0.94%
Finance Companies	-0.19%
Technology	0.63%
Aerospace/Defense	0.95%
Restaurants	1.04%

Source: Barclays

Market Technicals

Net fund flows were effectively a wash in January, at least according to the Lipper data. Although no hard data exists to support the following claim, we would note the net outflows for the month were almost exclusively from high yield ETFs, which given the coincident activity in the primary market, may suggest the "outflows" in-fact reflected a rotation on the part of money managers out of beta products and into newly issued cash bonds (i.e. capital didn't really leave the marketplace, but was just recycled). Regardless, the narrative of asymmetric demand/supply has yet to see any meaningful disruption. After $9.2 billion net inflows in 2016, with $7.4 billion net inflows in December alone, the marketplace remains awash in cash desperate to find a home.



Not to rehash the comments earlier, but the primary market was in focus this month, not as a result of record volumes, though ~$19 billion to start the year is of course respectable, but due to the sheer excess of aggressive leverage, terms and structures on offer. Some deals/structures were rejected by the marketplace, notably the egregious "no premium upon default" covenant, though these were the clear exception as the majority of deals cleared at prices attractive enough to bring issuers to market.

High Yield Net Supply ($mn)

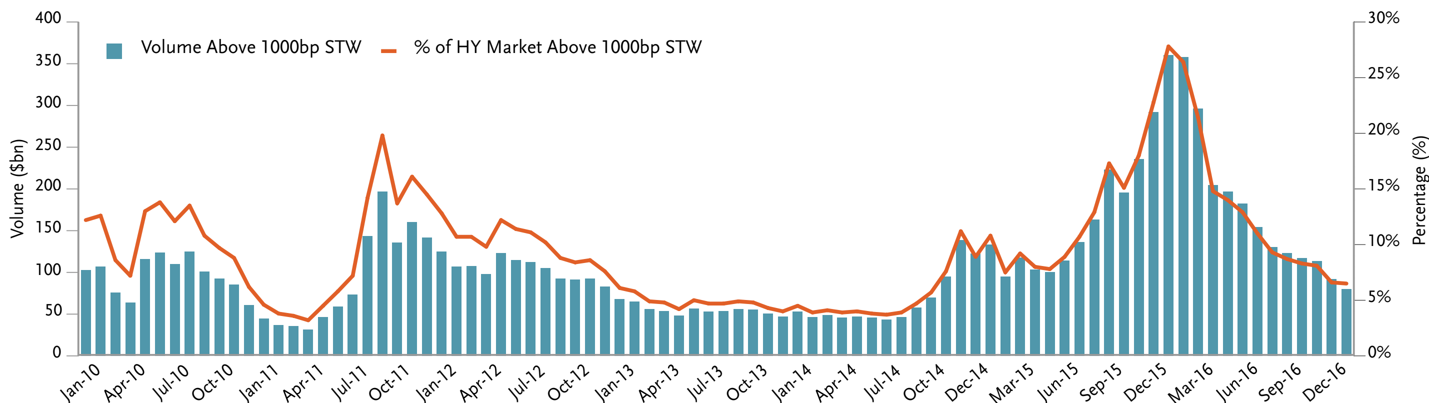
Month	New Issue	Redemptions	Net Supply	Monthly Returns
1/31/2016	5,923	12,449	(6,526)	-1.61%
2/29/2016	7,557	15,556	(7,999)	0.57%
3/31/2016	18,226	12,920	5,306	4.44%
4/30/2016	31,176	18,454	12,722	3.92%
5/31/2016	28,355	31,534	(3,179)	0.62%
6/30/2016	22,334	31,021	(8,687)	0.92%
7/31/2016	13,327	22,719	(9,392)	2.70%
8/31/2016	16,647	22,606	(5,959)	2.09%
9/30/2016	25,207	29,030	(3,823)	0.67%
10/31/2016	13,452	35,225	(21,773)	0.39%
11/30/2016	15,282	22,208	(6,926)	-0.47%
12/31/2016	18,581	26,359	(7,778)	1.85%
1/31/2017	18,803	20,783	(1,980)	1.45%

Source: Barclays

Fundamental Trends

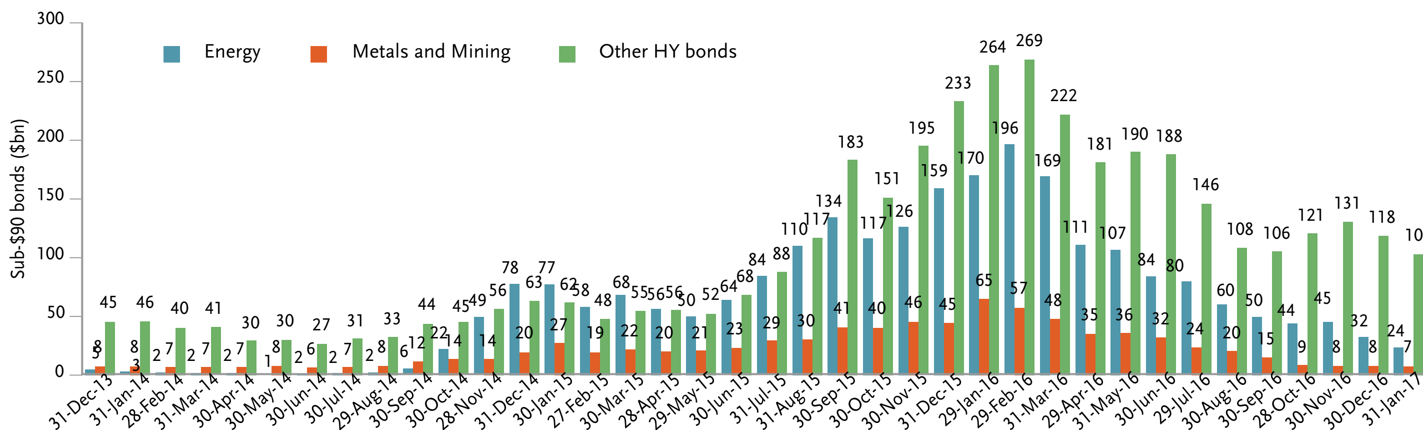
And then there were two…well three really. With Avaya filing for Chapter 11 in Bankruptcy Court in January, iHeartMedia (fka Clear Channel Communications) and Intelsat remain the last men standing amongst the high-profile pre-crisis vintage LBOs (Univision should be counted as well, though in contrast with embattled iHeart and Intelsat, which are engaged in creative/aggressive liability management strategies to stay bankruptcy, Univision bonds are currently not priced for distress). In addition to Avaya, only a couple debtors defaulted on their obligations in January, consistent with recent trends. A total of four companies defaulted on $7.3 billion of debt ($3.8 billion high yield bonds, $3.5 billion leveraged loans). The trailing 12-month default rate at the end of January stood at 4.1% (the trailing three-month annualized default rate, a better indicator of current momentum, stood at 3.5%). The marketplace is quite forgiving amid elevated demand for high yield bonds and loans. As a result, default activity remains low, contributing to the positive reinforcement of low risk premiums. Indeed, the percent of high yield bonds with spreads greater than 1,000bps (a common barometer for market distress), now stands at ~6%, with retail, not commodity-sensitive risk, the key contributor.

The High Yield Distressed Ratio has Declined Meaningfully Over The Last Twelve Months…



Source: JPMorgan

...With Commodity-Sensitive Credits No Longer The Epicenter Of Market Distress



Source: JPMorgan

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