TCW

INSIGHT

MONTHLY COMMENTARY

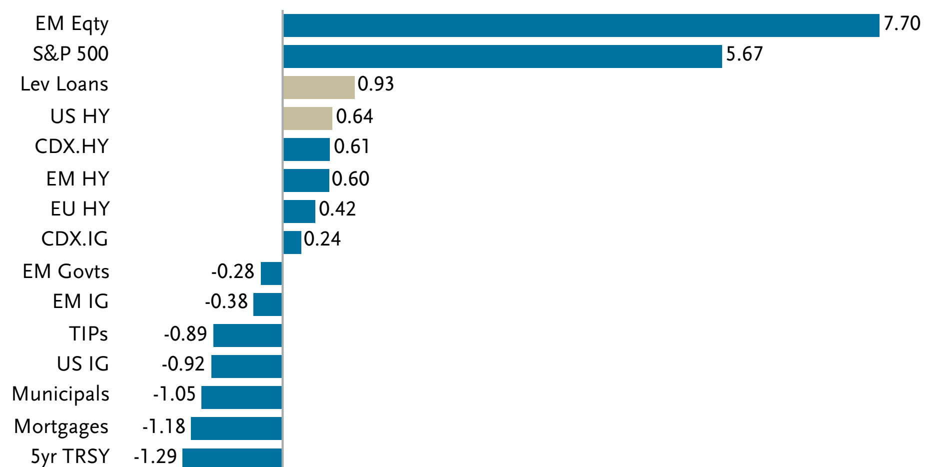
January High Yield Credit Update

BRIAN GELFAND | FEBRUARY 14, 2018

Though the remarkable start to 2018 seems like a distant memory (ironically just two weeks into February) given the recent route of global markets, let's recap. January was a great month for risk assets, while less than stellar for safer alternatives. U.S. stocks returned an impressive +5.7%, bested only by emerging market equities, earning near 8%. Enthusiasm over tax reform and its impact on corporate earnings boosted the former, while mounting calls for synchronous global growth (and a weaker dollar) juiced the latter. Though high yield bonds failed to keep pace, the result of already-rich absolute valuations and headwinds from rising Treasury yields, the +0.60% market return and +1.96% return for higher beta (CCC rated) bonds were respectable nonetheless.

Importantly, average spreads of high yield debt tightened -32bps through January 26th (effectively absorbing the ~30bps rise in 5yr Treasury yields), setting fresh tights for this cycle (311bps vs. the 323bps set in June 2014). In our view, this left valuations of high yield bonds 32bps less compelling than the already uninspiring risk/reward on offer to start the year. With spreads setting post-crisis tights entering the tenth year of this cycle combined with a deafening calm in the marketplace for the better part of January, investor optimism and complacency seemingly had reached a peak, and our call for caution and defensive positioning felt ever appropriate...

Risk Assets Posted Solid Returns to Open 2018
Led by a "Melt-Up" in Global Equities



Source: BofA Merrill Lynch Global Research

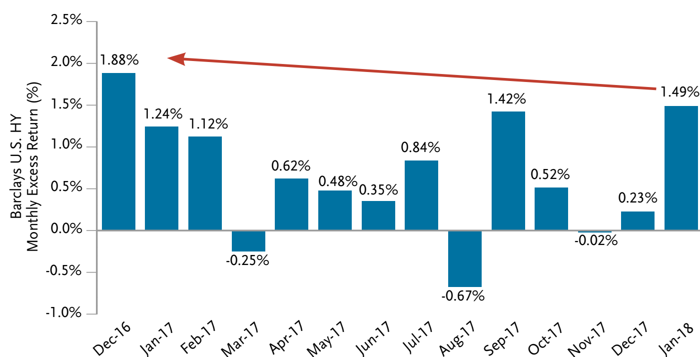
Brian G. Gelfand
Vice President
Fixed Income

Mr. Gelfand is a Credit Trader in the Fixed Income group, focused on trading high yield securities. He joined TCW in 2014 as a Credit Analyst responsible for research across the telecom, technology and media sectors. Previously, while working towards his MBA, Mr. Gelfand completed internships in the Portfolio Management group at Pacific Investment Management Company LLC (PIMCO) and as a Research Analyst with Kayne Anderson Capital. He began his career as a Client Management/Business Development Associate with Canyon Capital Advisors where he helped manage the firm's institutional and high net worth client relationships. Mr. Gelfand holds a BA from the University of Pennsylvania and an MBA from the UCLA Anderson School of Management.

Market Performance

As discussed on the previous page, the exuberance in global risk asset markets carried high yield bonds to a respectable +0.60% total return in January. More impressive, however, were excess returns (total return less the drag from equal duration Treasuries) of +1.49%, the best performance since December 2016.

High Yield Bonds Generated Solid Excess Returns for the Month



Source: Barclays

Exuberance over the current state of underlying business and global macro fundamentals, combined with a growing concern over the path of interest rates, encouraged a still very sanguine investor base to rotate out of lower yielding, higher quality bonds into higher nominal yielding, lower quality credits. The technicals created by this momentum, in addition to the higher empirical interest rate duration of BB rated bonds vs. CCCs, led CCC rated risk to outperform in a fairly meaningful way. Indeed, CCCs earned a total return of near 2% while BBs effectively broke even as more modest spread compression and coupon earned just enough to combat headwinds from the ~30bps rise in Treasury yields.

HY Performance	HY	Ba	B	Caa	Ca-D
January 2018 Total Return	0.60%	0.04%	0.71%	1.96%	1.29%
2018 Total Return	0.60%	0.04%	0.71%	1.96%	1.29%
January 2018 OAS Chg	-24bps	-21bps	-27bps	-35bps	
2018 Excess Return	1.49%	1.08%	1.53%	2.65%	

Source: Barclays

While the rotation into more levered capital structures (CCCs) was a clear signal of the risk-on psychology, sector selection offered further affirmation. Last year's trash (at least the second half of last year) was January's treasure as structurally challenged battleground sectors and credits generated stellar gains. Drillers (service providers to the onshore and offshore oil and gas E&P industry), were the best performing credits as the rising tide of higher oil and gas prices lifted all boats. With spot WTI and Brent prices rallying to $65/bbl and $70/bbl, respectively, a largely under-exposed investor base scrambled to add sector beta. Away from Energy, Wirelines were (briefly) back en vogue, specifically industry bellwether Frontier Communications, which saw its bonds rally across the term structure +5-12pts on the back of news the company was seeking an amendment to its credit agreement, which would permit it to issue additional liens on its assets (thereby increasing its optionality to stay an inevitable restructuring for a couple more years). Finally, hospital bonds (notably the unsecured debt of highly levered operators Tenet Healthcare and Community Health Systems) were big outperformers this month as beaten-down investor expectations for utilization trends inflected positive (influenced by an aggressive flu season) and company specific catalysts skewed favorably – Tenet indicated it would pursue strategic options to deleverage its balance sheet, while Community suggested it was close to an agreement with bank lenders that would enable the company to address its near-term maturities. Underperforming on the month were generally high quality sectors (cable, packaging, etc.), which were caught at the epicenter of technical (risk rotation, negative fund flows), macro (rising interest rates) and idiosyncratic (in the case of cable, Altice's international credit silos suffered after the company moved to spin-off its more stable U.S. business lines) pressures.

Best Sectors	January (%)	Worst Sectors	January (%)
Oil Field Services	3.45	Cable Satellite	-0.70
Wirelines	1.81	Wireless	-0.51
Retailers	1.79	Restaurants	-0.45
Supermarkets	1.65	Banking	-0.35
Healthcare	1.59	Packaging	-0.35

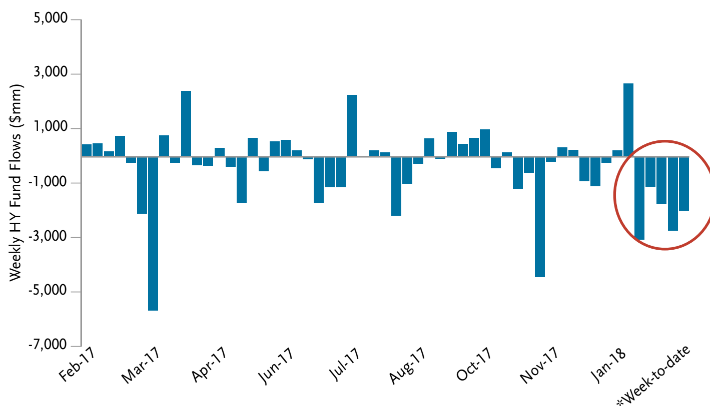
Source: Barclays
Green Text= Best Performing; Red Text= Worst Performing

Market Technicals

Fund flows were mixed week-over-week in January, as net inflows during the first two weeks, concurrent with the global risk-on trade, inflected sharply negative in the back half of the month (and this negative momentum has carried aggressively into February). High yield funds, both ETFs and mutual funds, realized net outflows of -$2.4bn to start the year, coming on the tails of -$18bn net outflows in 2017. While the spike in volatility

in stocks and Treasuries has accelerated the exodus from high yield thus far in February, the impetus for the outflows in January is clear – interest rates. To be sure, both equity and loan funds saw positive inflows in January, signaling the rotation out of high yield stemmed from fears of rising inflation and interest rates rather than concerns over corporate fundamentals.

Fund Flows Quickly Inflected Negative as Concerns Over Rising Rates Weighed on Sentiment



Source: Lipper, JP Morgan

The primary market was slow to start, but volumes ramped exponentially as the month progressed. USD-denominated issuance totaled $24bn in January, the most active start to a year since 2013. Two themes dominated the calendar this month. First, high quality issuers clamored to opportunistically raise capital at historically low (sub-5%) all-in costs given expectations of rising interest rates (indeed, as we write today, only a select few 8-10yr high yield bonds still yield less than 5%). Second, the industry composition skewed heavily towards commodity-levered issuers (near 50% of issuance), particularly land and offshore drillers, that were gifted a window to access capital (from a risk-seeking investor base) amidst the rising commodity tape.

Month	New Issue	Redemptions	Net Supply	Monthly Returns (%)
Dec-16	18,581	26,359	(7,778)	1.85
Jan-17	19,028	20,783	(1,755)	1.45
Feb-17	20,075	26,891	(6,816)	1.45
Mar-17	42,879	32,555	10,324	-0.22
Apr-17	16,275	33,967	(17,692)	1.15
May-17	25,797	28,265	(2,468)	0.87
Jun-17	19,764	37,114	(17,350)	0.14
Jul-17	11,006	28,127	(17,121)	1.11
Aug-17	17,723	19,252	(1,529)	-0.04
Sep-17	37,394	22,548	14,846	0.90
Oct-17	23,321	32,135	(8,814)	0.42
Nov-17	27,003	15,210	11,793	-0.25
Dec-17	17,622	24,511	(6,889)	0.30
Jan-18	24,141	31,692	(7,551)	0.60

Source: Barclays
Green Text = Best Performing; Red Text = Worst Performing

Fundamental Trends

January high yield default activity was benign with only one issuer, Exco Resources, defaulting on a little over $200mn of high yield bonds. This brought the trailing 12-month par-weighted default rate (per JPM) to 0.99%, back to the mid-2014 lows of this cycle. With very little stress (or distress) priced into capital structures today – average CCC rated debt yielding just +634bps over Treasuries and less than 6% of bonds with risk premiums in excess of 1,000bps – the impetus for rising default activity, at least for the time being (as this can correct swiftly), is low. ■

Bloomberg Index Services Limited. BLOOMBERG® is a trademark and service mark of Bloomberg Finance L.P. and its affiliates (collectively "Bloomberg"). BARCLAYS® is a trademark and service mark of Barclays Bank Plc (collectively with its affiliates, "Barclays"), used under license. Bloomberg or Bloomberg's licensors, including Barclays, own all proprietary rights in the Bloomberg Barclays Indices. Neither Bloomberg nor Barclays approves or endorses this material, or guarantees the accuracy or completeness of any information herein, or makes any warranty, express or implied, as to the results to be obtained therefrom and, to the maximum extent allowed by law, neither shall have any liability or responsibility for injury or damages arising in connection therewith.

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. TCW, its officers, directors, employees or clients may have positions in securities or investments mentioned in this publication, which positions may change at any time, without notice. While the information and statistical data contained herein are based on sources believed to be reliable, we do not represent that it is accurate and should not be relied on as such or be the basis for an investment decision. 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. TCW assumes no duty to update any forward-looking statements or opinions in this document. Any opinions expressed herein are current only as of the time made and are subject to change without notice. Past performance is no guarantee of future results. © 2018 TCW