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INSIGHT

MONTHLY COMMENTARY

February High Yield Credit Update

SIMON PARK | MARCH 7, 2016

Reflection Effect and Bear Market Rallies

Bear market rallies are counter-trend rallies that occur within the context of a negative primary trend. They tend to be short, usually on the order of several days, weeks, or less frequently, months. They also tend to be extremely violent, much more so than the grinding rallies that occur within a primary bullish trend. Obviously, it is difficult to identify a bear market rally until after the fact, but it is important to understand why they occur, and what causes them in order to attempt to identify them, and then act accordingly.

They usually occur after extended periods of negative returns. October of 2015, in hindsight, was clearly a counter-trend rally.

Month	Monthly Returns
6/30/2015	-1.49%
7/31/2015	-0.58%
8/31/2015	-1.74%
9/30/2015	-2.45%
10/31/2015	2.75%
11/30/2015	-2.22%
12/31/2015	-2.52%
1/31/2016	-1.61%
2/1-2/11/16	-3.55%
2/12-3/4/16	6.68%

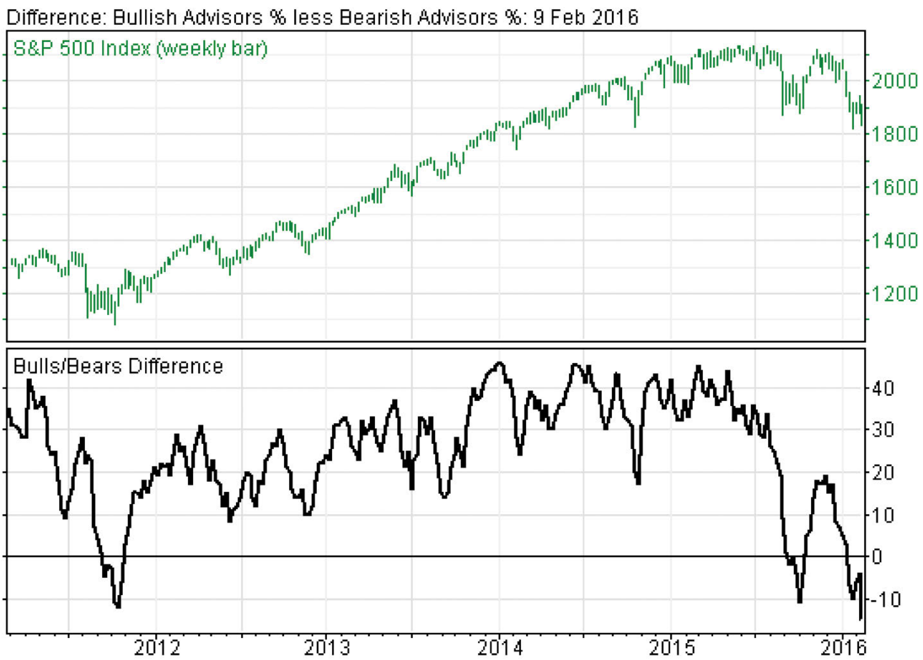
Source: Barclays

Simon Y. Park
Managing Director
U.S. Fixed Income

Mr. Park is a Managing Director in the U.S. Fixed Income group, where he trades high yield and cross over securities and CDS. Prior to joining TCW in 2015, Mr. Park was a portfolio manager and the fund risk manager for the hedge fund JAE Credit Management, focusing on U.S. corporate securities and derivatives Previously, Mr. Park was a Managing Director and portfolio manager in relative value corporate credit for the internal investment unit at UBS and its externally run hedge fund, Dillon Read Capital Management. Mr. Park started his career at Goldman Sachs and was a Managing Director focused on crossover credit on its corporate bond trading desk. Mr. Park earned his BA in Economics from Harvard College.

They usually occur after sentiment has gotten to a low enough level in the short-term that selling has gotten exhausted. Before the recent bounce, a useful sentiment indicator from Investor's Intelligence showed bears outnumbering bulls in early February, a relatively rare occurrence, and often a short-term buy signal. The degree of relative pessimism was at an extreme, with the bull/bear spread at -11.9, slightly greater than last summer, and similar to the low reading in the fall of 2011, but not quite to the despondent -20s seen in 2008-2009.

Bullish Sentiment Drops to 6-Year Lows



Source: Investor's Intelligence

The rallies also tend to be short and sharp, as we saw in October and have seen the last few weeks, and tend to be most violent in the most oversold and hated industries. As can be seen below, the volatility of returns in the first half of February and second half of February could have been nearly entire years, in and of, themselves. They certainly felt that way!

	HY	Ba	B	Caa
Return 2/1-2/11	-3.55%	-2.95%	-3.55%	-5.36%
Return 2/12-2/29	+4.12%	+4.26%	+4.02%	+4.11%

Source: Barclays

And leading the way higher in the rally were in fact the sectors most despised by investors; the energy and basic materials complexes, where the biggest shorts and underweights lie. This recipe for combustion often leads to a case of forced, rather than desired, risk addition as may be the case currently.

	2/1/-2/11	2/12-3/4	Subgroup	LTM 2/11	2/12-3/4
Basics	-2.07%	11.76%	Metals & Mining	-28.11%	15.91%
Capital Goods	-2.67%	6.02%			
Communications	-3.23%	5.81%			
Consumer Cyclical	-1.92%	4.31%			
Consumer Non-Cyclical	-1.86%	3.41%			
Energy	-11.64%	16.78%	Exploration & Production	-54.86%	22.55%
Technology	-2.73%	5.13%			
Transportation	-2.83%	4.58%			
Utility	-2.99%	5.97%			
Financials	-3.87%	5.03%			

Source: Barclays

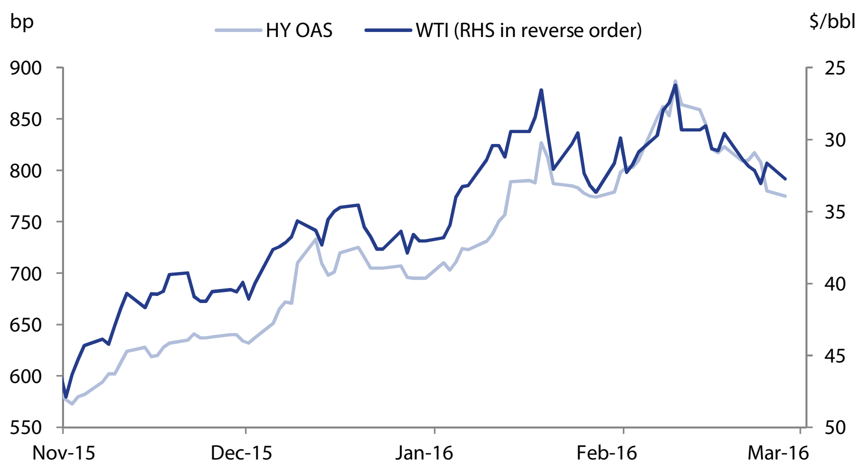
One interesting way to explain bear market rallies comes from applying the work of psychologist and Nobel Prize winning behavioral economist Daniel Kahneman. In his Prospect Theory, he explains the way we humans are wired psychologically through the Reflection Effect in making decisions. Basically, counter-intuitively, we are wired to be risk-averse when the outcomes of a decision are positive, but risk-seeking when the potential outcomes are negative.

He shows this through a simple game, where players may be given a choice of a) an assured $50, or b) 50% chance of $100. In this game between positive outcomes, the expected value of the two outcomes is the same, yet the great majority choose to pocket the guaranteed $50, the more conservative choice, avoiding the risk of the game. This may explain the nature of rallies in bull markets, where profit taking causes a slow grind higher as investors with profits sell to lock in their profits.

On the other hand, in a game where the choice is of a) an assured loss of $50, or b) 50% chance of a loss of $100, more players choose to roll the dice and try to break even, a riskier play, and the exact opposite (reflection) behavior shown in the first game where the outcomes were positive. And according to psychological studies, this behavior gets exaggerated under stress (at least for men), as decision making focuses more on the positive outcomes, and less on the consequences of negative outcomes. It is natural human instinct to avoid loss, rather than minimize loss. This may explain the nature of bear market rallies, as investors increase their risk tolerance when faced with losses in order to get back to even.

Market Performance

February opened the month with an acceleration of the sell-off in risk assets, as oil prices continued to plumb new lows, trading down as much as 22% MTD at the lows to $26.21. With stability in prices coming from the rolling of the front contract in unison with chatter amongst some large producers of a production freeze, the sell-off halted mid-month to start a furious rally. On top of that, a successful defense of the yuan by the Chinese central bank and stability in global banking share prices added fuel to the fire. High Yield bond prices advanced in 9 of the last 11 trading sessions in February to put the month back into positive territory, at +0.57%, cutting YTD losses that were at one point as high as -5.16% to -1.04%. As High Yield continues to track the price of oil closely, we continue to think the market will remain volatile as energy markets continue to search for balance and equilibrium.



Source: BAML, Haver Analytics, Goldman Sachs Global Investment Research

Interestingly, the month continued to see continued overall decompression, with the BB cohort leading returns for the month at +1.31%, and CCCs continuing to lose ground at -1.29%. As value gets drained from BBs, we will most likely need to see the rally broaden out to the lower parts of the markets for the rally to have legs.

	HY	Ba	B	Caa
February 2016 Total Return	+0.57%	+1.31%	+0.47%	-1.29%
2016 Total Return	-1.04%	+0.40%	-1.10%	-5.05%
February 2016 OAS Change	-8bps	-17bps	-25bps	-2bps
2016 Excess Return	-343bps	-217bps	-343bps	-702bps

Source: Barclays

Performance was led by some of the more globally cyclical industries, such as Metals & Mining and Chemicals, particularly during the rally in the second half of the month. E&P made a furious comeback, being down as much as -18.88% MTD at the lows on February 11, but still managed to finish in the red, while cutting losses to -8.38%. Momentum remained strong for those sectors with large shorts/underweights though to end the month, as investors got caught with high cash levels and underweight to the most volatile sectors, forcing the chase for performance to become more urgent the farther it went. At the same time, consistent safehaven domestic sectors continued to maintain the pace, with Gaming and Food/Beverage posting strong monthly returns.

Best Sectors	Feb	Last 12 Months
Metals & Mining	+6.95%	-23.49%
Gaming	+2.98%	+2.57%
Wireless	+2.70%	-4.23%
Chemicals	+2.59%	-6.53%
Food & Beverage	+2.56%	+4.61%

Worst Sectors	Feb	Last 12 Months
E&P	-8.38%	-50.40%
Oil Field Services	-3.27%	-34.06%
Banking	-1.95%	-1.45%
Paper	-1.78%	-14.29%
Pharmaceuticals	-1.41%	-3.77%

Source: Barclays

Market Technicals

The new issue market continued to be shut down amidst the volatility, with only $7B issued during the month, posting its fourth month out of the last five in single digits. Like the secondary market, divergence has become pronounced, with high quality defensive issues such as Treehouse Foods, Pinnacle Foods, and health insurer Centene receiving an overwhelmingly positive response from the market looking to put money to work in safe positions that allow you to sleep at night. On the other hand, LBO financing for Solera was the poster child for the difficulty of cuspier names that actually need financing, having delayed their deal multiple times, having to agree to stricter covenants, dropping their euro tranche, and pricing 150bps wide to initial talk at a 5 point discount.

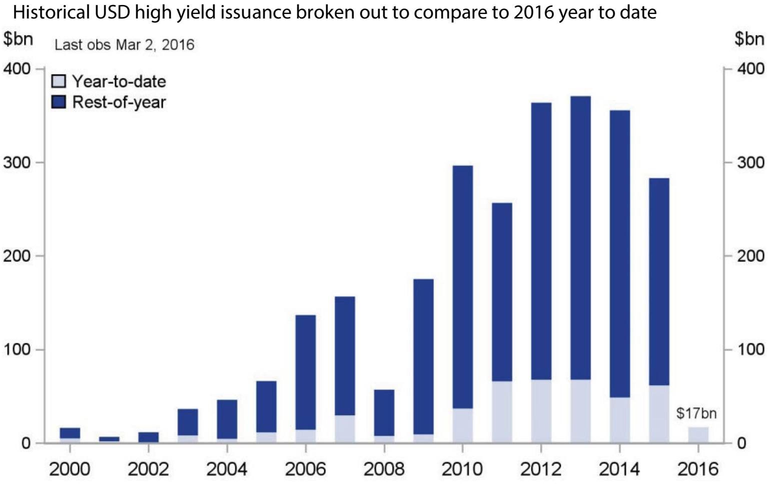
High Yield Net Supply (US$mm)

Monthly	New Issue	Redemptions	Net Supply	Monthly Returns
2/28/2015	30888	15562	15326	2.41%
3/31/2015	36631	25154	11477	-0.55%
4/30/2015	34331	33253	1078	1.21%
5/31/2015	33551	29863	3688	0.30%
6/30/2015	20781	21828	-1047	-1.49%
7/31/2015	12120	26654	-14534	-0.58%
8/31/2015	10141	21507	-11366	-1.74%
9/30/2015	19171	12492	6679	-2.45%
10/31/2015	9106	14504	-5398	2.75%
11/30/2015	23014	20435	2579	-2.22%
12/31/2015	3077	28406	-25329	-2.52%
1/31/2016	5923	12449	-6526	-1.61%
2/29/2016	7557	15556	-7999	0.57%

Source: Barclays

Given the lack of issuance, and high cash levels at funds, we would expect further stability to result in a robust period of issuance in the next few months, with continued murmurs of frequent issuers ready to hit a strong tape with hope for low new issue concessions.

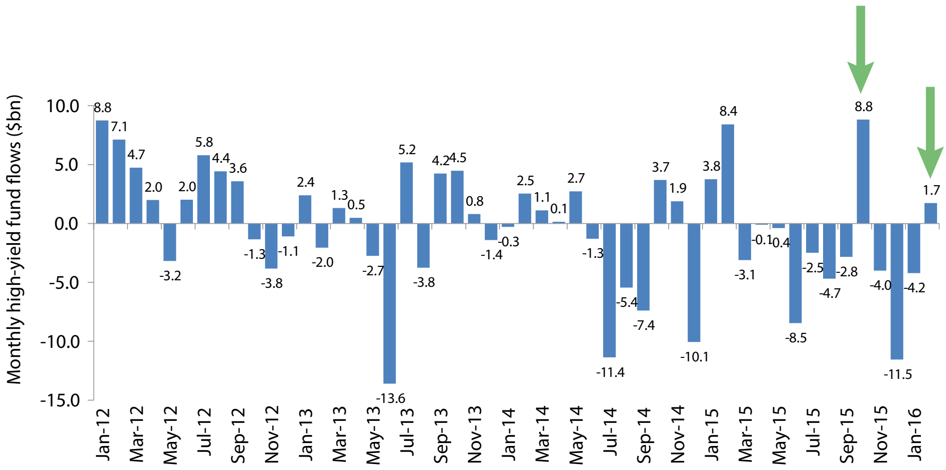
YTD Issuance Lowest Since Credit Crisis



Source: Dealogic, Goldman Sachs Global Investment Research

On the demand side, with the positive price action in the second half of the month, high yield funds managed to report a positive month of inflows, totalling $1.7B, only the second month of inflows in the last 12 months. So far this year, mutual funds have reported a $2.5B outflow in total, with some extremely volatile ETF flow data amounting to very little overall effect in the end, totaling -$40mm YTD.

High Yield Funds Report Only 2nd Month of Inflows in Last 12

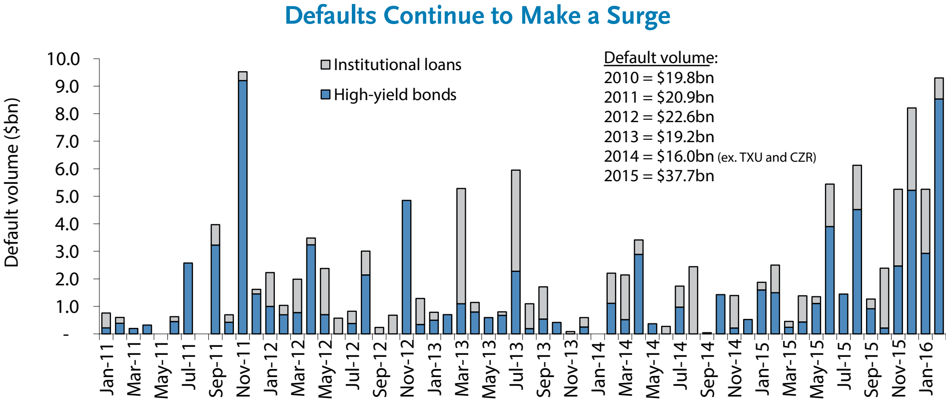


Source: Lipper FMI

Fundamental Trends

Default activity picked up in the month, with eight companies defaulting on high-yield bonds in the month for a total of $8.5B, the highest since August 2009, and marking a high and increasing data point in this down leg of the credit cycle. So far this year, 13 companies have defaulted on $14.6B in bonds and loans, compared to just five defaults totaling $4.4B in debt in the first two months of last year.

Defaults Continue to Make a Surge

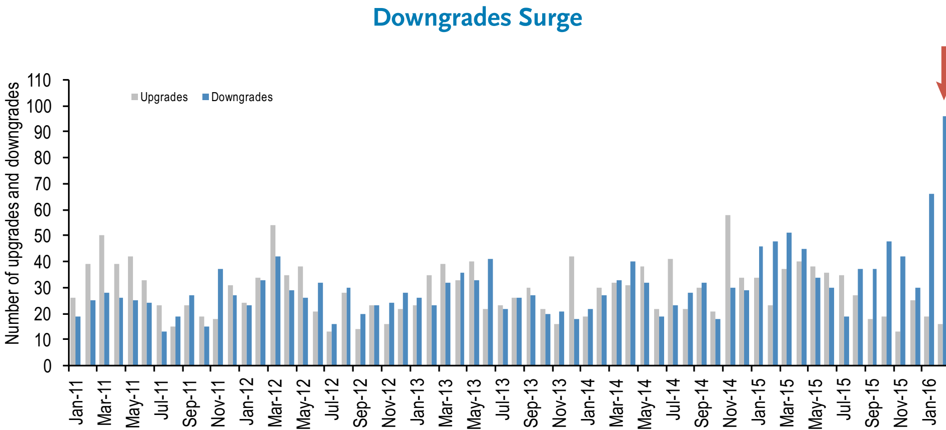


Source: JP Morgan

Note: Excludes the record setting defaults of Energy Futures' $36bn default in April 2014 and Caesar's $18bn default in December 2014.

In addition, agencies have started the year with their hatchets in hand, with Moody's particularly aggressive on their view on energy, positioning ratings for a more secular reset in fundamentals, as opposed to S&P and Fitch that are maintaining some cyclical attribution to oil price forecasts. Nevertheless, the change in direction and tone of credit quality as viewed from the agencies is clear, with downgrades of 94 HY companies versus 19 upgrades, a nearly 5-1 ratio. By volume it has been worse, a ratio exceeding 12-1.

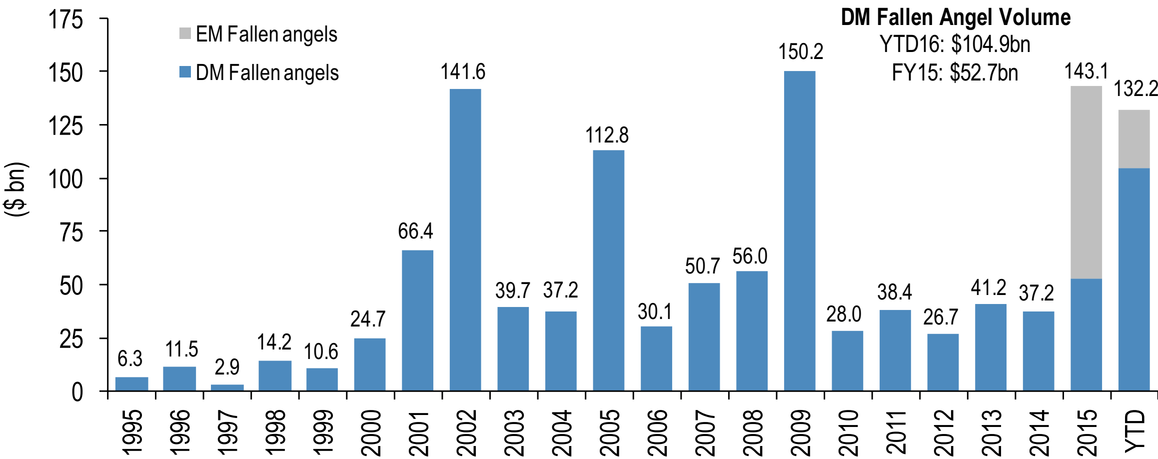
Downgrades Surge



Source: JP Morgan

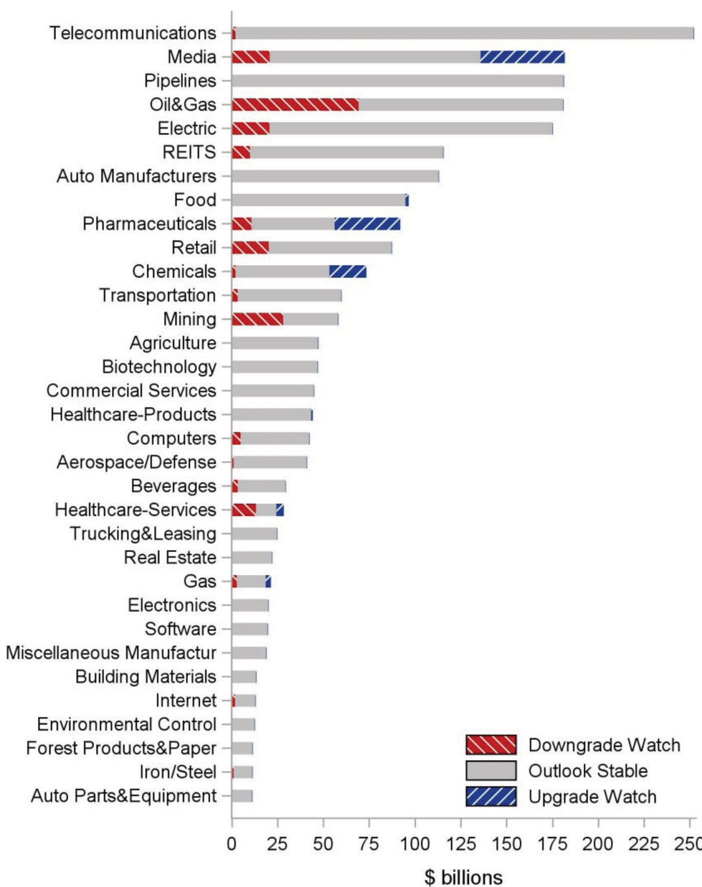
And while syndicate desks have not been making a lot of new HY bonds, agencies have offered their assistance, with Developed Market downgrades from IG to HY from at least one agency already doubling the entire volume of last year, and it's only been two months, a pace of YOY increase even Stephen Curry would have a hard time keeping up with.

More Bonds Get the HY Badge of Honor



Source: JP Morgan

Another $228B of BBB-Rated Bonds Remain on Negative Outlook/Downgrade Watch



Source: Bloomberg, Goldman Sachs Global Investment Research.

Summary

Markets in February started the month poorly, although there was a strong rebound into month-end, similar to January. The market presented the opportunity to add risk at more attractive levels early in the month, but the window was small. The subsequent rally has now brought more money chasing performance in the space, removing some of that value. But bear market rallies tend to be short, indiscriminate, and violent. We think that after a remarkable 6%+ rally in the broad high yield market in the last three weeks, it is now prudent to start using the strength to rotate into higher quality holdings that we believe will have the credit strength to make it through to the other side of the credit cycle.

It is difficult in the midst of a rally to recognize it as a bear market rally. We are wired to hope and believe, with positive feedback reinforcing that belief. Yet it is important to think objectively about the expected value of outcomes when making investment decisions. We continue to believe that better opportunities to invest in riskier assets lie ahead as the current credit cycle comes to its end. ■

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