TCW

INSIGHT

MONTHLY COMMENTARY

February High Yield Credit Update

BRIAN GELFAND | MARCH 14, 2017

It would appear February was the calm before the storm, as thus far in March we have seen ~0.75pts shaved off the Barclays HY Index (though benchmark bonds are down on average ~2.5pts), HYG is down -2.3% from the late-Feb highs, completely erasing year-to-date gains, and market average yield-to-worst and OAS are +50bps and +30bps off the lows, respectively. Ok, "storm" may be a stretch this early into a sell-off, particularly considering we have seen a few episodes of volatility in the past twelve months that were ultimately short-lived (specifically around Brexit and the U.S. election). Indeed, absent a true risk-off, one characterized by a meaningful exodus from the asset class on fears of real credit loss (a la 2015/2016), these bouts of volatility have proven and will continue to prove difficult to sustain. More on March in next month's commentary.

In contrast, February lapped the mid-Feb 2016 wides in HY spreads by setting new tights (at least since mid-2014), a rather apropos anniversary present given the current state of the market. Per Goldman Sachs, HY spreads, +363bps for the Barclays U.S. HY Index as of Feb. 28, are in the first percentile post-crisis and the 16th percentile over the last three decades! Now, admittedly credit spreads can extend their rally further (why can't the title of the next Goldman piece be "High Yield Spreads Hit Multi-Decade Tights"?); however, the upside/downside for spreads is undeniably asymmetric. Concerning in absolute terms when considering the pendulum-like nature of credit spreads, but even more discomforting when juxtaposed against the numerous risks (China/EM, corporate balance sheets, European banks, market liquidity, etc.) and general uncertainty (particularly around government policy) this late in the credit cycle. Risk and uncertainty for which we feel inadequately compensated to underwrite in many situations/capital structures we are looking at today. As such, we remain defensively positioned in our portfolios, placing a premium on liquidity and low beta at the exact time when the market is reaching for the exact opposite.

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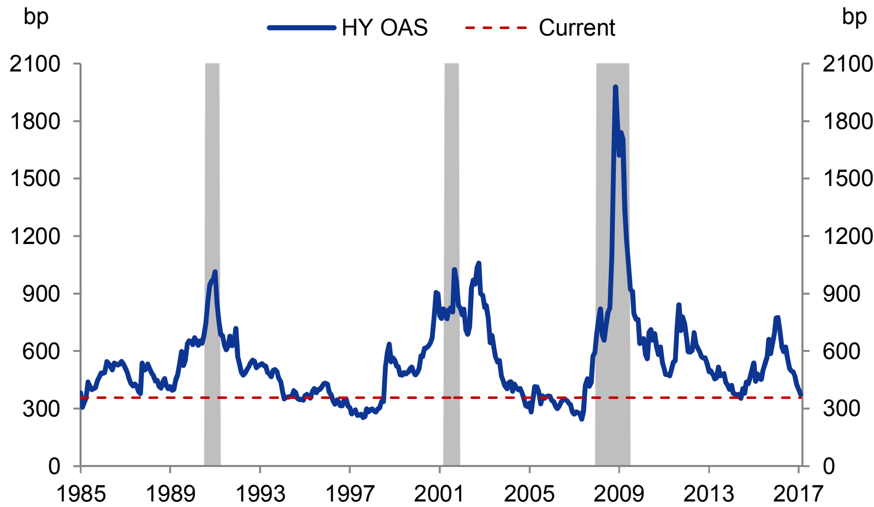
Mr. Gelfand is a Vice President in the U.S. Fixed Income group, where he trades high yield securities. Mr. Gelfand joined TCW in 2014 as a Credit Analyst responsible for research in the telecom, technology, and media sectors. Prior to joining TCW, he interned at PIMCO in the Portfolio Management Group 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.

HY Spreads Currently Stand In The 16th Percentile Since 1985 (1st Percentile This Cycle)

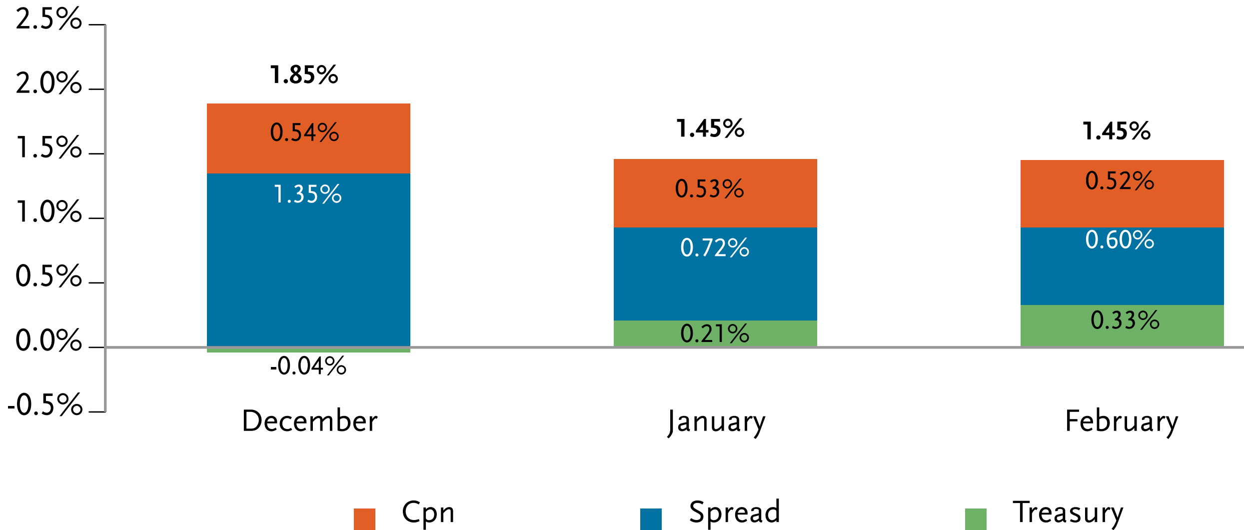


Source: Goldman Sachs

Market Performance

High yield bonds benefited from a broader risk rally in February returning +1.45% (versus +3.97% for the S&P 500). Counter intuitively, Treasuries actually served as a tailwind during the month with 5yr and 10yr yields down -3bps and -9bps, respectively (though interest rates have since sharply adjusted higher, arguably a delayed response to the more hawkish (less dovish) tone out of the Fed throughout the month in commentary pertaining to a March rate hike).

Firing on All Cylinders In February, Spread, Rates And Coupon Each Added to Returns During the Month



Source: Barclays

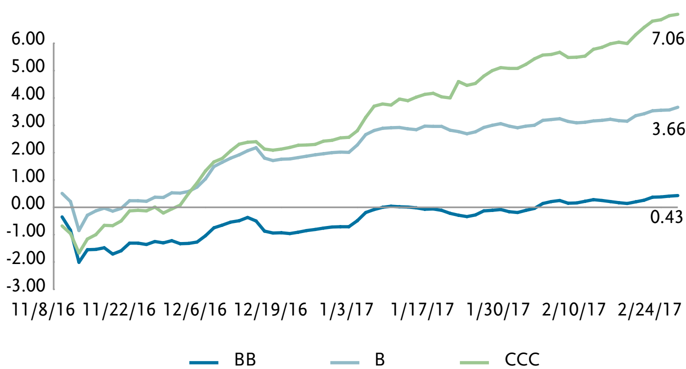
February realized another positive monthly total return (the 12th of the last 13 in fact) and was another month where greater risk generated higher returns. Indeed, looking across ratings buckets, CCC-rated debt earned a total return of +2.74%, over 2x that of single-B rated bonds and nearly 3x that of BBs. Distressed securities led the charge generating +4.22% for the month. As a result, spreads across the market compressed further, reducing the prospective incremental premium earned for taking incremental risk. Looking at our post-election market tracker, the outperformance of CCCs over the past few months is quite apparent. The market unambiguously views the White House/Republican policy agenda of deregulation, tax reform and fiscal expansion as positive, a conclusion we do not dispute, however, the market also has unambiguously failed to discount any disruption to or deviation from that agenda (outcomes we do not underwrite to be low probabilities). With CCC prices now up +7pts and spreads near -300bps tighter since the election, the consequence to a disappointment to market expectations has grown considerably.

HY Performance	HY	Ba	B	Caa	Ca-D
February 2017 Total Return	1.45%	1.09%	1.28%	2.74%	4.22%
2017 Total Return	2.93%	2.20%	2.69%	5.30%	9.11%
February 2017 OAS Chg	-25bps	-13bps	-18bps	-67bps	
2017 Excess Return	2.39%	1.61%	2.17%	4.87%	

Source: Barclays

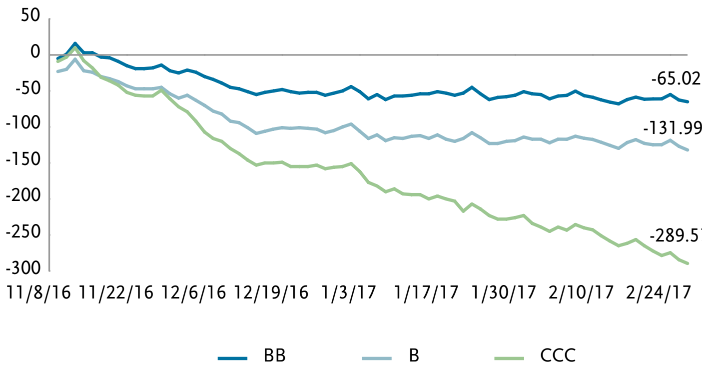
BBs are Now Positive, but CCC Outperformance Since the Election Accelerated in February

Rolling Change In Price Since Nov. 8 ($USD)



Source: Barclays

Rolling Change In OAS Since Nov. 8 (Bps)



Source: Barclays

The bifurcation in sector performance is not all that surprising when considering the mean reverting nature of markets. To put it simply, February saw previously oversold sectors outperform and previously overbought sectors give back prior gains and underperform. Independent E&Ps, the top performing credits in 2016, were atop the list of worst performing sectors in February, and in-fact generated a negative total return in an otherwise positive returning month. Declining natural gas prices amid changing forecasts for weather conditions weighed on gas-levered E&Ps, though the weakness permeated much of the sector. The underperformance has accelerated in March with declining oil prices now taking the reins from gas as the principal fundamental driver. On the other end of the spectrum, Pharma was the big outperformer during the month, taking a reprieve from several months of downward pressure on the sector's largest capital structures. Healthcare in general outperformed as investors began pricing in a less contentious and disruptive repeal/replace of the ACA (the evidence for which is still weak in our opinion). Finally, Cable & Satellite got a boost from Intelsat, the sector's bellwether distressed situation, which saw a significant re-pricing of its capital structure intra-month on news that Softbank is considering recapitalizing the business in conjunction with a merger with its OneWeb satellite platform.

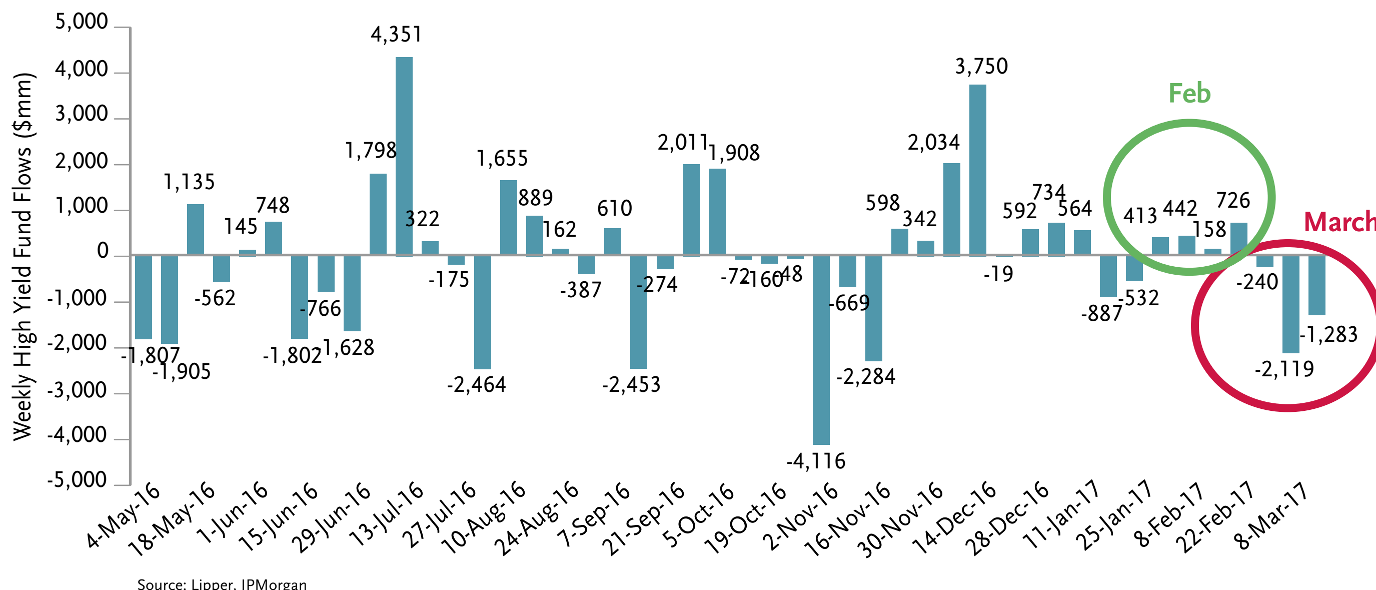
Best Sectors	February	YTD
Pharmaceuticals	5.27%	6.60%
Transportation Services	2.96%	4.15%
Healthcare	2.66%	4.61%
Cable Satellite	2.66%	4.02%
Industrial Other	2.31%	4.78%

Worst Sectors	February	YTD
Independent	-0.59%	1.29%
Supermarkets	0.30%	1.73%
Consumer Products	0.56%	1.73%
Midstream	0.61%	2.89%
Retailers	0.67%	-0.27%

Source: Barclays

Market Technicals

Not much changed in February as it relates to the technical underpinnings of the marketplace. High yield fund flows (active and passive funds) were net positive during the month, with +$1.5bn of liquidity injected into the marketplace. We have now experienced three months of consecutive inflows, which includes December's $7.8bn net inflow, one of the largest monthly inflows on record. Bubbling beneath the surface, however, is an investor that may be near fully invested and overweight risk, leaving little room to absorb any disruption to the status quo (whether exogenous fundamental shock or, as we have seen thus far in March, a heavy new issue calendar).



Source: Lipper, JPMorgan

New issues were in focus in January given the resurgence of bubble-era deal characteristics (aggressively capitalized LBOs, loose covenant protections, and almost comically flawed terms and structures). In February, the profile of deals was less offensive, though the pricing of risk was as frothy as ever, with issuers clearing bonds at yields seemingly at odds with their own credit curves. It was another ~$19bn month, effectively three months in a row of steady USD-denominated volume, with the majority of deals being refinancings (67%) including both bond-for-bond and bond-for-loan take-outs. Issuers were taking advantage of an extremely accommodative market ahead of anticipated rising interest rates to term out higher coupon and floating rate paper...good for issuers, although adding incremental credit duration at historically tight spreads should give investors pause.

High Yield Net Supply ($mn)

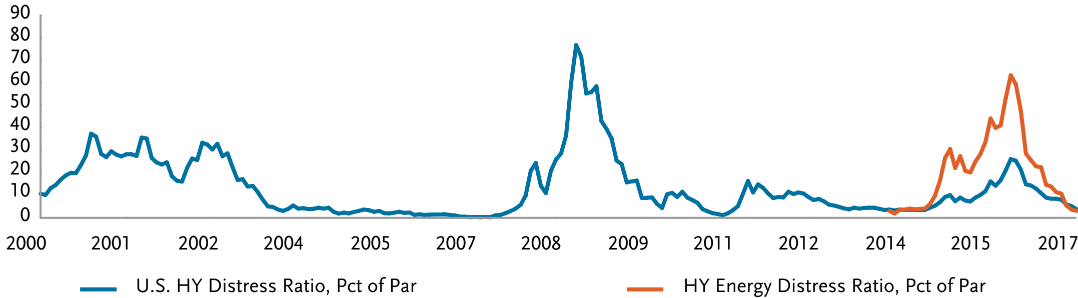
Month	New Issue	Redemptions	Net Supply	Monthly Returns
1/31/16	5,923	12,449	(6,526)	-1.61%
2/29/16	7,557	15,556	(7,999)	0.57%
3/31/16	18,226	12,920	5,306	4.44%
4/30/16	31,176	18,454	12,722	3.92%
5/31/16	28,355	31,534	(3,179)	0.62%
6/30/16	22,334	31,021	(8,687)	0.92%
7/31/16	13,327	22,719	(9,392)	2.70%
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%
1/31/17	18,803	20,783	(1,980)	1.45%
1/31/17	18,916	26,891	(7,975)	1.45%

Source: Barclays

Fundamental Trends

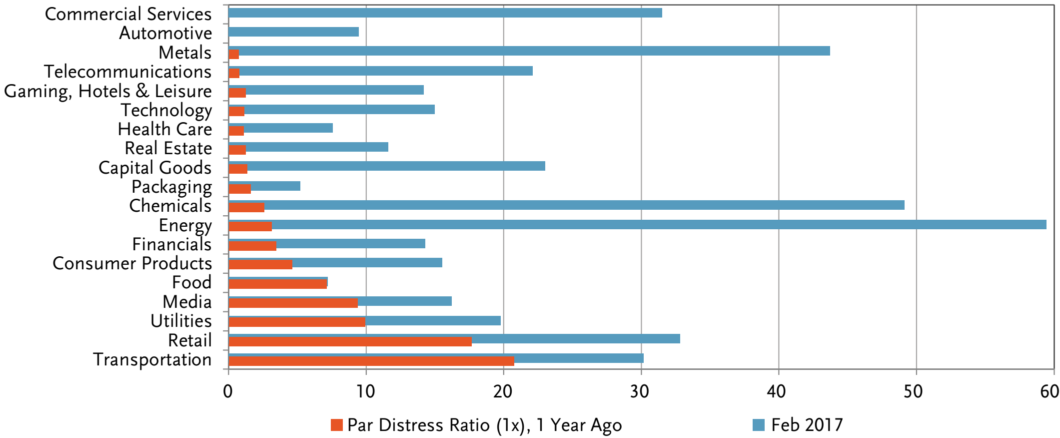
There is very little to discuss as it relates to high yield bond defaults this month, with only a single issuer defaulting on a little over $500mn of high yield debt. Vanguard Natural Resources is a marginal natural gas 'fracker' that filed for Chapter 11 in bankruptcy court in February. The muted default volumes this month, combined with the sizeable volumes of February 2016 now rolling out of the LTM data set, has taken the LTM default rate down 0.16 percentage points month-over-month to 3.9% per Deutsche Bank Credit Strategy. Also informative is the trailing three-month annualized default rate, a barometer of recent momentum, which stands at 3.3%, serving as an anchor for strategists (and the market's) benign forward default outlook. As a corollary to the market's rosy implied default expectations, the current distressed ratio (the percent of high yield bonds with spreads greater than 1,000bps) now stands at a mere 3.9%, on par with levels reached during the 2014 post-crisis tights. Retail, trucking and merchant power related risk currently account for the few pockets of distress, whereas the commodity complex has near fully remediated from the wides a year ago.

The Percentage of HY Bonds With Spreads >1,000bps Continues to Decline



Source: Deutsche Bank

Pockets Of Stress Are Fairly Broad And More Idiosyncratic In Nature Vs. The Commodity-Linked Distress Theme In Early 2016



Source: Deutsche Bank

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