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INSIGHT

MONTHLY COMMENTARY

March High Yield Credit Update

SIMON PARK | APRIL 5, 2016

FOMO in the Eye of the Storm

In the age of social media, a new term describing an emerging mental health syndrome has been added to the lexicon of the English language, and to the pages of the Oxford English Dictionary in 2013. That term is FOMO (Fear of Missing Out).

FOMO
noun

> Anxiety that an exciting or interesting event may currently be happening elsewhere, often aroused by posts seen on a social media website.

Everyone knows the effect that Facebook can have on a person's insecurities, where all the people on Facebook seem to always be having the most amazing, fantastic experiences in the most exotic places. You are constantly updated on what others are doing, and everyone's lives are apparently spectacular. That produces inner feelings of inadequacy, the sense that you've been left out, that you're missing out somehow on the great lives that everyone else are leading. Psychologists say this Fear of Missing Out can be destructive in teens and adults alike by creating sadness and anxiety, creating unrealistic expectations about the future, and disconnecting people from the ability to make choices in their lives for fear of missing out on something better.

Now apply that to an industry full of intelligent, overachieving and competitive people, give them constantly updated indicators of how much fun everyone else is having, and we have the financial markets. FOMO for market participants is a fact of life. It's a constant internal battle to wage. In theory, investments are made on expectations of future returns. Investment professionals are paid to objectively assess the investing environment, do their analysis, and if the expected risk-adjusted rate of return meets objectives, make the investment. If the return on offer is poor, decline. Maintain discipline. Easier said than done.

Simon Y. Park
Managing Director
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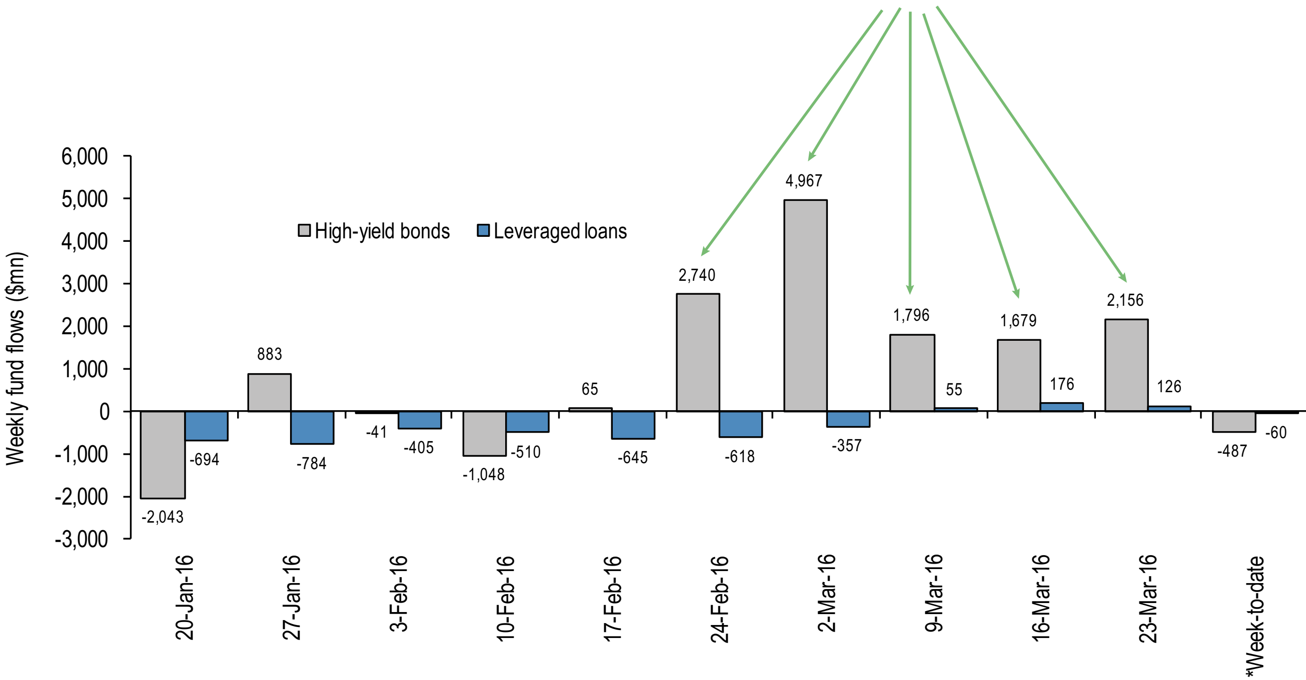
Mr. Park is a Managing Director in the U.S. Fixed Income group, where he trades high yield and cross over securities and CDS. Prior to joining TCW in 2015, Mr. Park was a portfolio manager and the fund risk manager for the hedge fund JAE Credit Management, focusing on U.S. corporate securities and derivatives 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.

Like a high school senior that sees all his friends on Facebook having the time of their lives on spring break in Cancun while he's on a family camping vacation, the anxiety to belong and fear of missing out can be excruciating for investors to not participate in a bear market rally. And the thinking then becomes, since everyone else is attending the party, maybe things aren't as bad as they may seem.

	HY
HY Returns 12 month 2/11	-10.90%
HY Returns 6 month 2/11	-10.00%
HY Returns YTD 2/11	-5.16%
HY Returns 2/12-3/21	+9.56%

A near 10% return over 5 weeks is definitely a party investors have been unable to risk passing on, and massive flows have contributed to the fear driven buying.

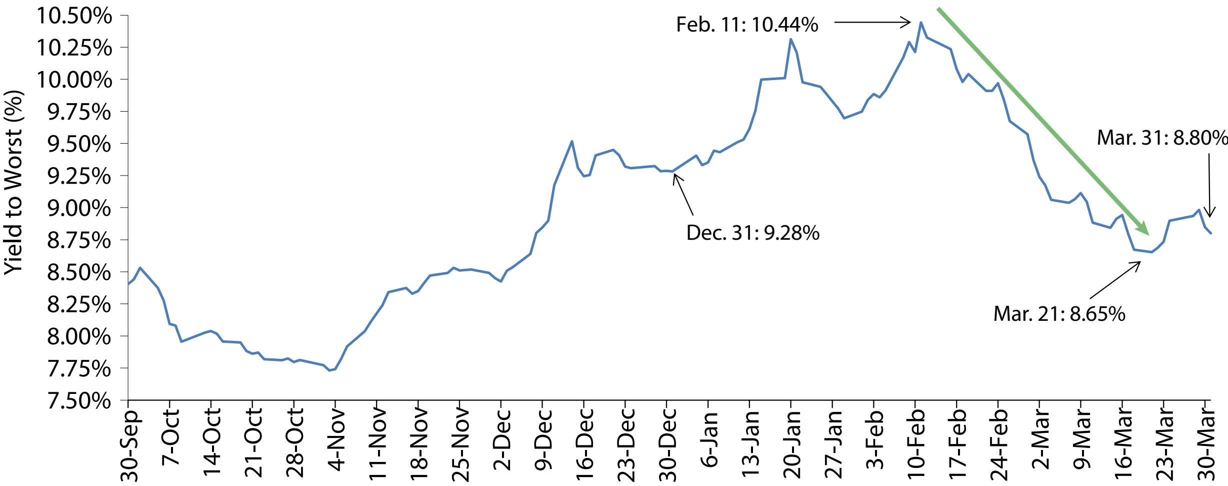
Flows Have Their Best 5 Week Stretch Ever at $13.3B



Source: JP Morgan

Creating a one way market during that 5 week rally, making it nearly impossible for underinvested and formerly defensive positioned investment managers to keep up.

High Yield Bond Yields Nearly Uninterrupted Rally 2/12-3/21



Source: JP Morgan

But what does that tell us about whether this is a party worth attending?

To go back to a storm analogy used in a previous note, often time the most dangerous time of a tropical storm is when someone believes the storm has passed, and undoes all their preparation for the storm by leaving protected areas too soon.

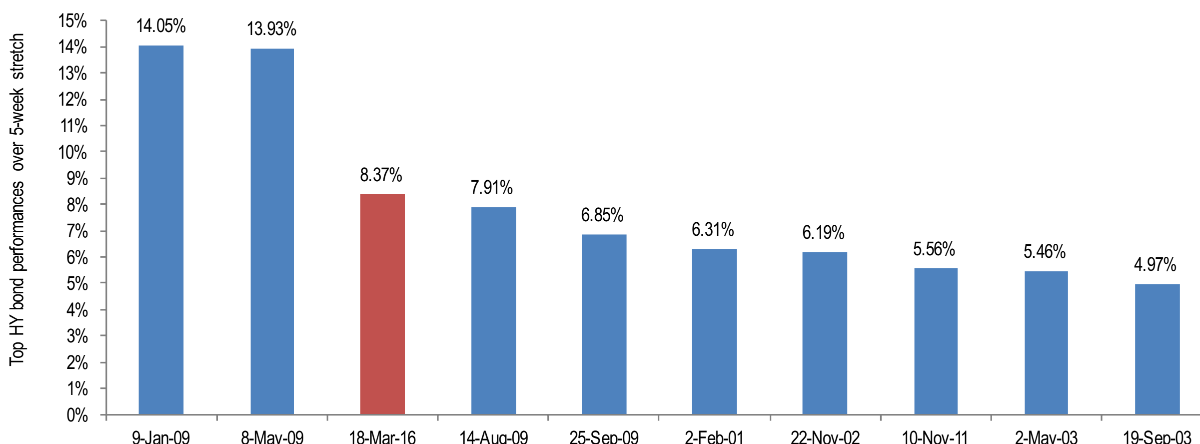
“A common mistake, especially in areas where hurricanes are uncommon, is for residents to exit their homes to inspect the damage while the calm eye passes over, only to be caught off guard by the violent winds in the opposite eyewall.” – National Weather Service

We believe that the calm that has descended upon the markets is a brief respite in a more violent end to the current credit cycle. While building some tactical beta longs made sense in January and through February in extremely oversold market conditions, we believe from these levels that more attractive opportunities will resurface again. We believe we are in the eye of the storm, and the calm in the markets will prove temporary. Instead of enjoying the clear skies and sand that we expect to be fleeting, we take the calm now to reinforce our defenses, and we seek to stay in protected areas until we see more concrete signs that the storm is passing.

Market Performance

Positive momentum continued in March, as a combination of improving energy prices, forcefully dovish central bank rhetoric, and an influx of cash proved to be enough to bring investors into the market in a flow driven rally. The overall market extended the gains from their February 11 lows, with a snapback that historically has only occurred when coming out of a recession, nothing quite like it having been experienced mid-cycle. Looking at similar 5 week periods, the closest one to the 8.37% rally in the 5 week period ending March 18 was 5.56% in November 2011. The only real comparable 5 week snapbacks were clustered during the start of the recovery in 2009.

Top 5 Week Stretches of Performance in High Yield



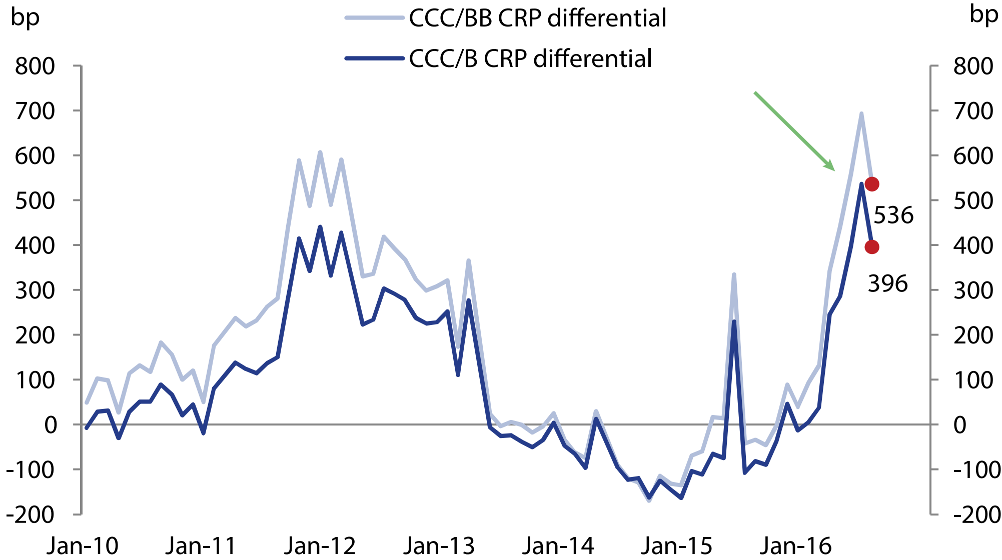
Source: JP Morgan

Spreads decreased 70bps on the month and are now 183bps tighter from the lows seen on Feb 11.

	HY	Ba	B	Caa	Ca-D
March 2016 Total Return	+4.44%	+3.45%	+3.60%	+9.27%	28.84%
2016 Total Return	+3.35%	+3.86%	+2.46%	+3.76%	4.68%
March 2016 OAS Change	-70bps	-50bps	-78bps	-171bps	
2016 Excess Return	+426bps	+327bps	+341bps	+908bps	

As would be expected at this heightened stage of the rally, we have seen risk compression accelerate, with CCCs up a handsome 9.27% on the month with BBs and Bs up a more pedestrian mid 3%, with the distressed universe of Ca-D issues up an eye-popping 28.84%.

Spreads Have Compressed in the Relationships of CCC/BB and CCC/B



Source: BAML, Moody's, Goldman Sachs Global Investment Research

Performance continued to be driven by global commodity linked industries, with energy related issues taking firm command of the top ranks. And with the turning upside down of the performance tables, safe-haven industries that had led performance the previous 12 months became the underperformers, with largely domestic non-cyclical industries like Food & Beverage still positive, but unable to keep up with their formerly beaten down brethren.

Best Sectors	March	Previous 12 Months
E&P	+22.41%	-50.40%
Oil Field Services	+18.25%	-34.06%
Metals & Mining	+8.97%	-23.49%
Midstream	+7.57%	-11.02%
Industrial Other	+7.52%	-8.92%

Worst Sectors	March	Previous 12 Months
Food & Beverage	+1.14%	+4.61%
Cable & Satellite	+1.45%	-3.36%
Banking	+1.64%	-1.45%
Wireless	+1.66%	-4.23%
Restaurants	+1.87%	+5.54%

Market Technicals

The new issue market re-opened for business, with positive performance allowing for issuers to be confident in prospects of getting a fair shake from investors in the primary market. New issuance came in at a respectable $18.2B this month, not a blow-out, but its best month since the last time markets were open in November after similarly posting positive returns in October. The highlight was a difficult deal from Western Digital to finance its acquisition of Sandisk, which contributed $5.2B of debt to the new issue tally, the largest new issue since Frontier's $6.6B issue in September of last year. Tough industry conditions forced pricing to widen out 125bps from initial price talk, and speaks to the still difficult conditions for lower quality issuers, despite the BB ratings. Issuance generally continues to be skewed to higher quality, with issuance this month composed of 60% BB, 37% B, and only 3% CCC.

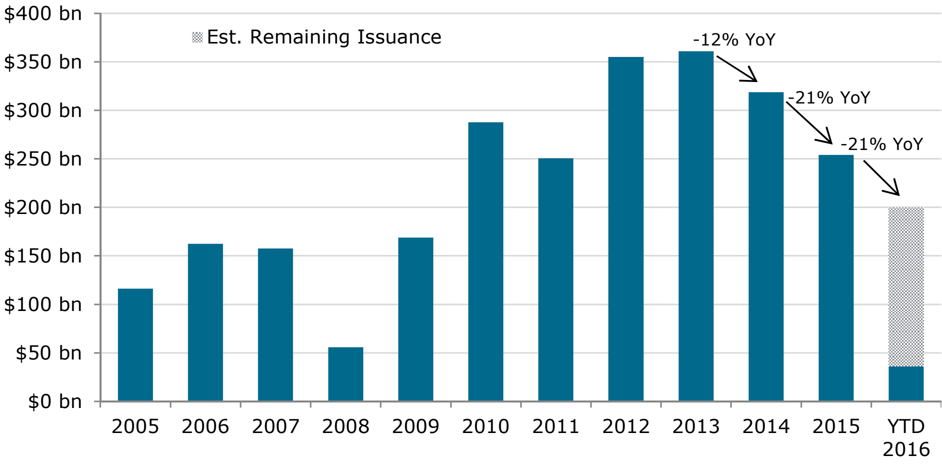
High Yield Net Supply (US$mm)

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: Barclay's

And despite a persistently growing overall total size of the high yield market, we're on pace for a third straight year of decreasing issuance, a clear signal that capital markets continue to get tighter for issuers.

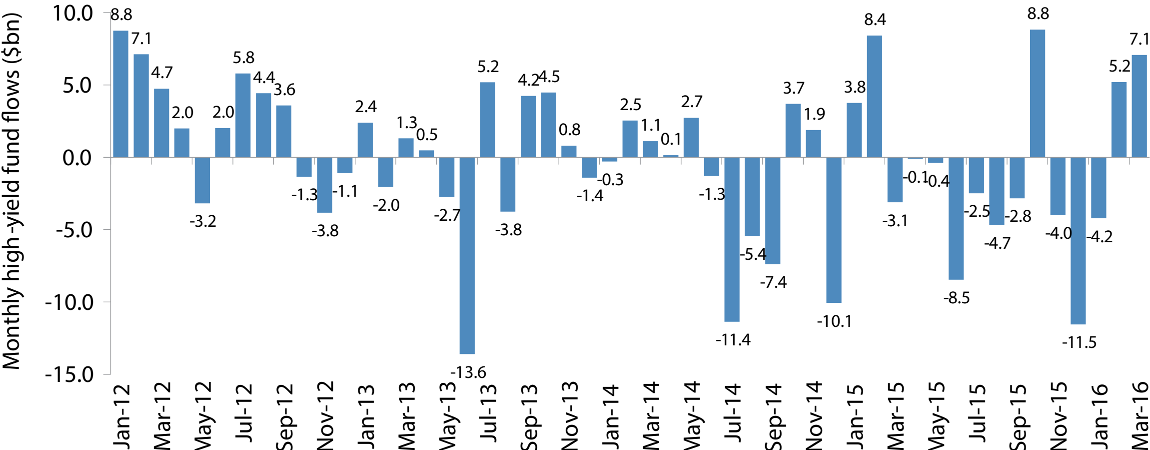
HY New Issue Off to a Slow Start



Source: Wells Fargo Securities

On the demand side, high yield mutual funds saw a second consecutive month of inflows, with the two month tally now totaling $13.3B, after three months of outflows totaling -$19.8B, and outflows for 10 of the previous 11 months totaling -$33B. On the year, funds have now seen a cumulative $8B in inflows, similar to the $9.1B positive inflow at this time last year, which interestingly largely marked the best point of performance for the year in 2015.

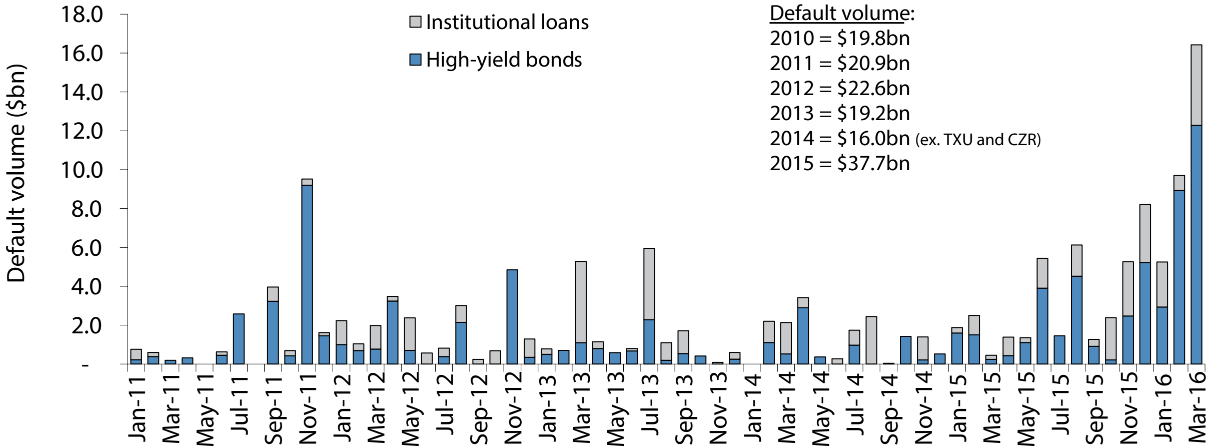
High Yield Funds Report Sixth Highest Monthly Inflow on Record



Source: Lipper FMI

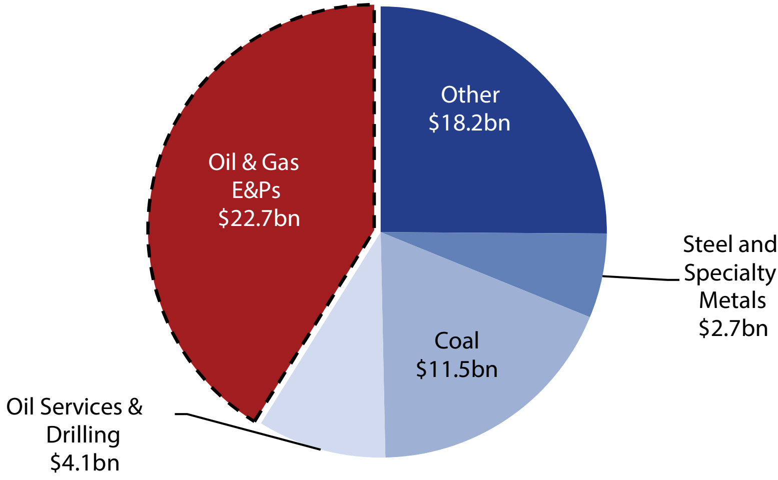
Fundamental Trends

Default activity continued to surge in March, with seven companies defaulting on $16.4B in debt, of which $12.3B was in high yield bonds, making last month the busiest month of defaults outside of April 2014's TXU driven total ($39.5B) and December 2014 Caesar's drive total($18.3B).



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.

Defaults continued to be largely composed of issuers in the Energy and Metals/Mining sectors, pushing up overall default rates up to 3.40%, but so far a much more benign 1.50% excluding commodity sectors. While a good sign so far, it also implies the market has yet to see the finale for the ending of the current cycle.



Source: Moody's, Goldman Sachs Global Investment Research

Summary

Markets extended their bounce in March, with a nearly non-stop rally from oversold conditions in February. We believe it was just that, an oversold rally within the context of a bear market. Given the length and scope of the rally, we believe we have been afforded the opportunity in the calmness of the eye of the storm to further prepare for worse weather ahead.

The Fear of Missing Out is something not only applicable to teenagers on Facebook. We deal with it as human beings in life and investors in the market constantly. We believe an objective weighing of risk and reward at all points in the cycle optimizes returns over the length of the entire cycle, rather than chasing whatever is the popular thing others are doing. ■

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