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INSIGHT

MONTHLY COMMENTARY

March High Yield Credit Update

BRIAN GELFAND | APRIL 12, 2017

In February's commentary, I alluded to the "storm" that began to stir in the early days of March. And while the clouds did take on an ominous hue, the prospective blizzard ultimately proved a light dusting. Still, after over a year of virtually clear skies, the formation of a cloud or two was indeed of note. While idiosyncratic catalysts are ever-present, it was really a trifecta (well, more like a Pick 4) of exogenous factors that weighed on an already unsteady investor resolve and drove volatile price action during the month:

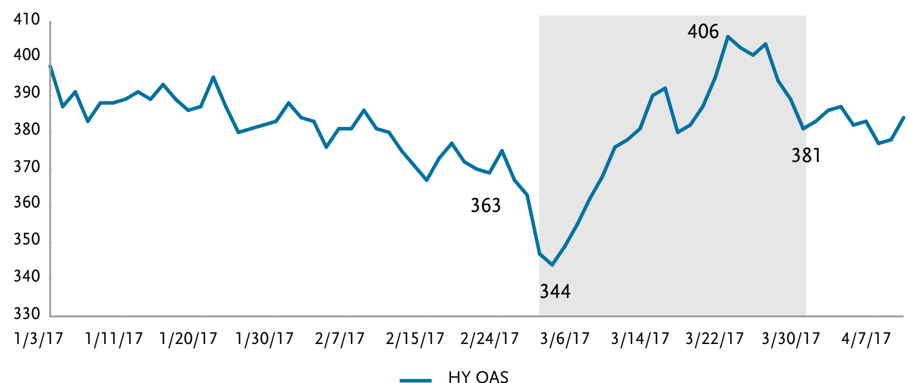
1) A severe technical imbalance resulting from a glut of new bond deals (over $17bn of new issue supply was unloaded on the market in the week ending March 10 alone),

2) A meaningful rise, and then subsequent fall, in interest rates surrounding the mid-month FOMC meeting,

3) Oil price volatility, with WTI holding below the psychologically discomforting $50/bbl threshold for most of the month, and of course

4) The complete collapse of the ACA repeal/replace process, and the read-through this has on the efficacy of the Trump/reflation thesis as a whole.

HY Spreads Set Fresh Lows Before Widening +62bps and Ultimately Settling +18bps M/M



Source: Barclays

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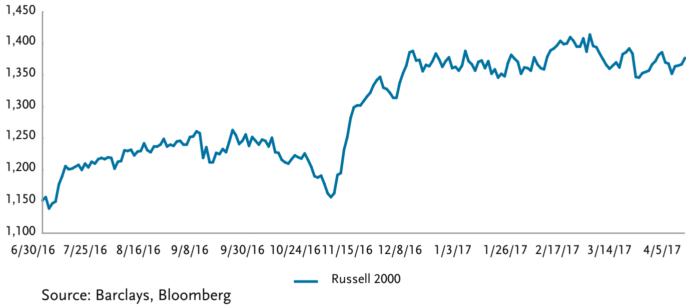
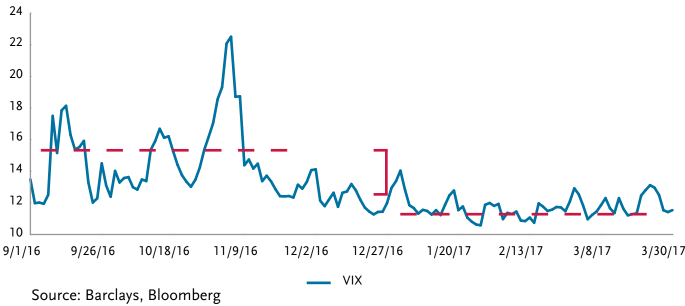
Mr. Gelfand is a Vice President in the U.S. Fixed Income group, where he trades high yield securities. Mr. Gelfand joined TCW in 2014 as a Credit Analyst responsible for research in the telecom, technology, and media sectors. Prior to joining TCW, he interned at PIMCO in the Portfolio Management Group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

The Trump pro-growth narrative was indeed tested this month, and while capital markets wavered on the margin, there is still no doubt the hope trade remains firmly reflected in asset prices. However, with markets now balancing on a two legged stool, the propensity to be thrown off balance has markedly increased.

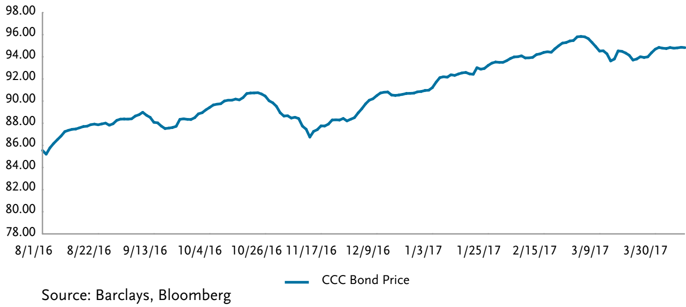
Even After the Failed ACA Repeal, a Significant Amount of Prospective Tax and Infrastructure Related Benefit Remains Priced Into Capital Markets



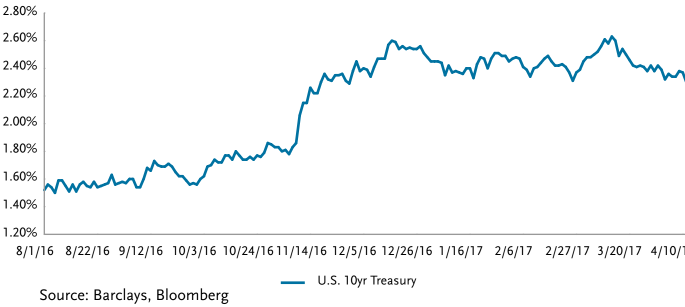
Source: Barclays, Bloomberg



Source: Barclays, Bloomberg



Source: Barclays, Bloomberg

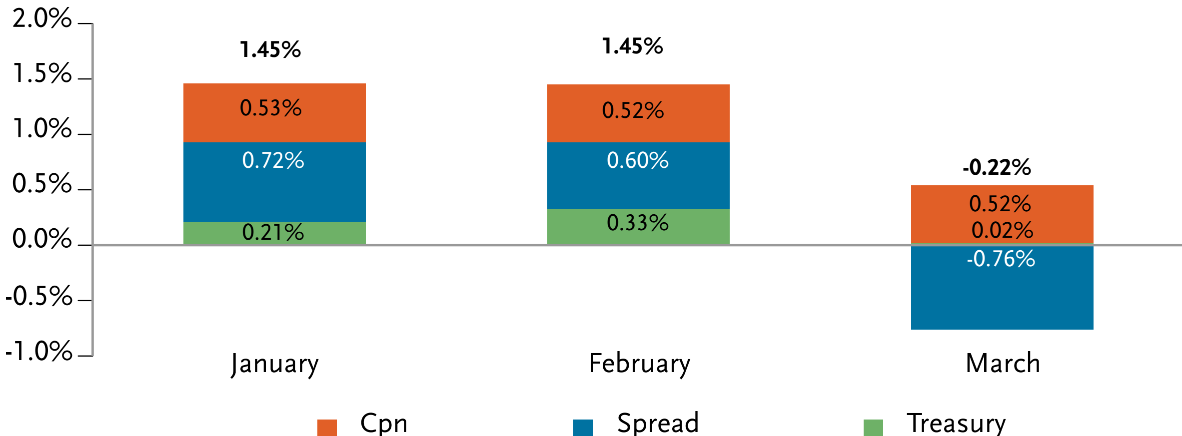


Source: Barclays, Bloomberg

Market Performance

March closed with high yield bonds returning -0.22%, the net result of a quasi-tail of two halves during the month. The sell-off in the first half of the month (with liquid benchmark bonds down in excess of -3pts at one point and Energy credits down -5pts on average) was partially retraced in the back half as the new issue pipeline moderated and Treasuries and oil rallied.

Coupon and Treasuries Only Partially Offset The Drag From Spread Widening In March



Source: Barclays

CCC-rated debt underperformed higher rated bonds for the first time in the last 12 months, generating a total return of -0.61% versus Single-Bs at -0.16% and BBs at -0.14%. The technical pressures from the new issue calendar seemingly impacted the different quality buckets equally (i.e. there wasn't material differentiation in the negative price response from BBs and CCCs to the calendar). However, as Treasuries rallied in the back half of the month, BBs and Single-Bs experienced a sharper bounce off the lows given higher interest rate duration. As such, while the underperformance of lower quality credits in a negative returning period is typical, the results were less a function of a true risk-off and more a function of technicals and duration.

HY Performance	HY	Ba	B	Caa	Ca-D
March 2017 Total Return	-0.22%	-0.14%	-0.16%	-0.61%	-0.22%
2017 Total Return	2.70%	2.06%	2.53%	4.66%	8.87%
March 2017 OAS Chg	20bps	3bps	29bps	23bps	
2017 Excess Return	2.14%	1.45%	1.98%	4.19%	

Source: Barclays

Drilling down to the sector level, prominent themes continued to drive relative performance. Underperforming this month were credits in the Pharmaceutical and Retail sectors, the latter also holding the title as the worst performing sector year to date. In Pharma, very weak earnings (and guidance) reported by Concordia reset consensus expectations for the future earnings power of the assets materially lower. Prices of the company's secured and unsecured bonds collapsed as a result, and now reflect a significant degree of principal impairment. Adding to the sector's woes, Valeant bonds came under pressure following reports that the company's champion shareholder, Pershing Square, was fully divesting its stake in the business. Turning to Retail, announced store closures and weak reported sales comps compounded what is already a negative opinion towards the industry. On the opposite end of the distribution, Electric/Utilities (which in the high yield market is dominated by independent power producers) outperformed as nat gas prices increased $0.42/mmbtu month-over-month to $3.19/mmbtu.

Best Sectors	March	YTD
Electric	0.70%	4.37%
Transportation Services	0.33%	4.49%
Technology	0.25%	2.28%
Paper	0.23%	2.85%
Home Construction	0.19%	3.10%

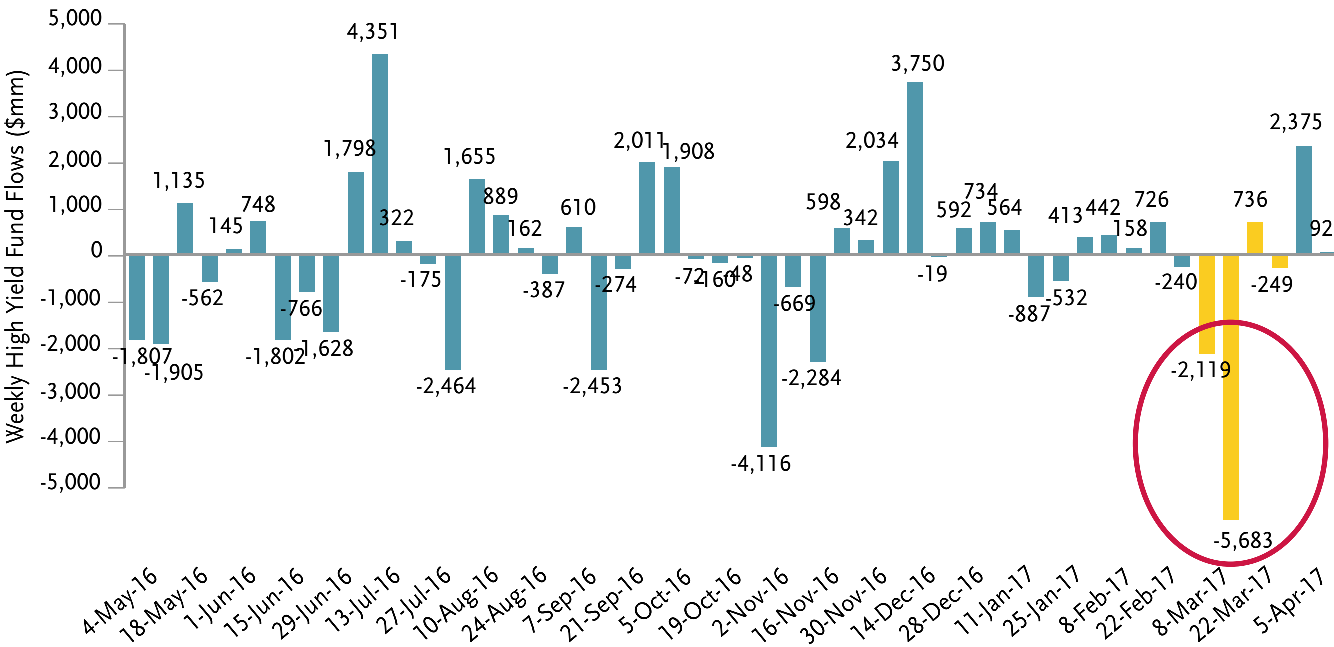
Worst Sectors	March	YTD
Pharmaceuticals	-2.95%	3.45%
Retailers	-1.00%	-1.27%
Financial Other	-0.85%	2.12%
Oil Field Services	-0.78%	4.83%
Wirelines	-0.73%	2.14%

Source: Barclays

Market Technicals

Market technicals were back in the spotlight in March, though serving as a headwind to prices, rather than the tailwind to which we have become oh too accustomed. High yield fund flows were net negative for the month, with net outflows of -$7.4bn. The first two weeks of the month alone had net outflows of -$7.8bn, wiping out ~82% of the net inflows for full-year 2016! Of particular note was the composition of the large -$5.7bn outflow during the second week of March. While the net outflows during the first week were largely confined to HY ETFs (which to our estimate was more a result of portfolio managers selling HYG holdings to free-up cash in order to invest in the full new issue calendar, rather than retail investors actually reducing high yield risk), the net outflows in the second week reflected broad-based redemptions from high yield mutual funds (i.e. investors reducing high yield beta and cash physically leaving the marketplace). As the redemptions ultimately proved short-lived (fund flows inflected positive after the second week), the follow-through forced selling in the cash market never quite materialized; however, the week-long exodus was a sobering reminder of how quickly investor resolve can wane.

Actively Managed High Yield Funds Experienced Large Redemptions In First Half of March



Source: Lipper, JPMorgan

While fund flows (i.e. demand) were indeed volatile, the dominant influence of the technical imbalance during the month was the supply side of the equation. $43bn of USD-denominated high yield bonds cleared the primary market in March, anchored by the $17.3bn week ending March 10th (the highest single week new issue volume ever). The specter of an imminent rise in interest rates brought droves of issuers into the market in order to accomplish their financing needs (refinancings, M&A, capital expenditures, dividends/share repurchases) at a prospectively favorable cost of capital. The result: supply overwhelmed demand creating an adverse feedback loop whereby higher primary yields pulled secondary yields higher, which in-turn pushed primary yields even higher…and so on and so forth. This created a welcomed buying opportunity, particularly in the primary market, where new deals came at attractive discounts to comparable risk (a stark contrast to the rich clearing levels we saw during the first two months of the year). Anecdotally, the pipeline of deals slated to launch in March was even larger than what actually cleared as the sharp re-pricing that took place following the first wave of deals kept several opportunistic issuers on the sidelines. As the month progressed, however, and new issue volumes moderated, the market's indigestion passed, and prices stabilized and began to remediate.

High Yield Net Supply ($mn)

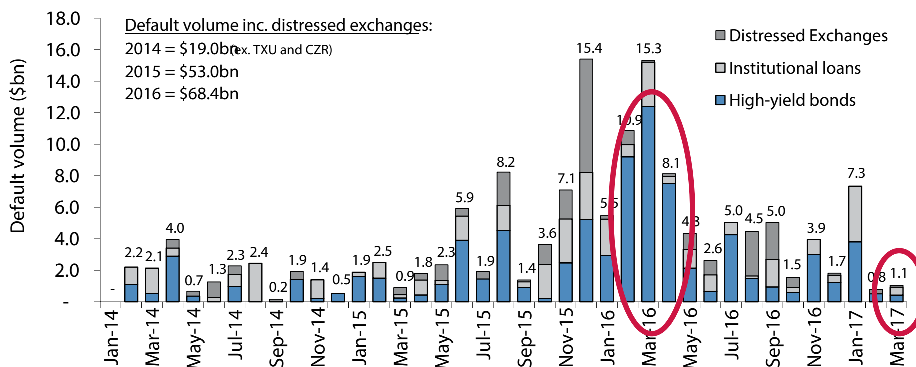
Month	New Issue	Redemptions	Net Supply	Monthly Returns
3/31/16	18,226	12,920	5,306	4.44%
4/30/16	31,176	18,454	12,722	3.92%
5/31/16	28,355	31,534	(3,179)	0.62%
6/30/16	22,334	31,021	(8,687)	0.92%
7/31/16	13,327	22,719	(9,392)	2.70%
8/31/16	16,647	22,606	(5,959)	2.09%
9/30/16	25,207	29,030	(3,823)	0.67%
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%
2/28/17	18,916	26,891	(7,975)	1.45%
3/31/17	42,629	32,555	10,074	-0.22%

Source: Barclays

Fundamental Trends

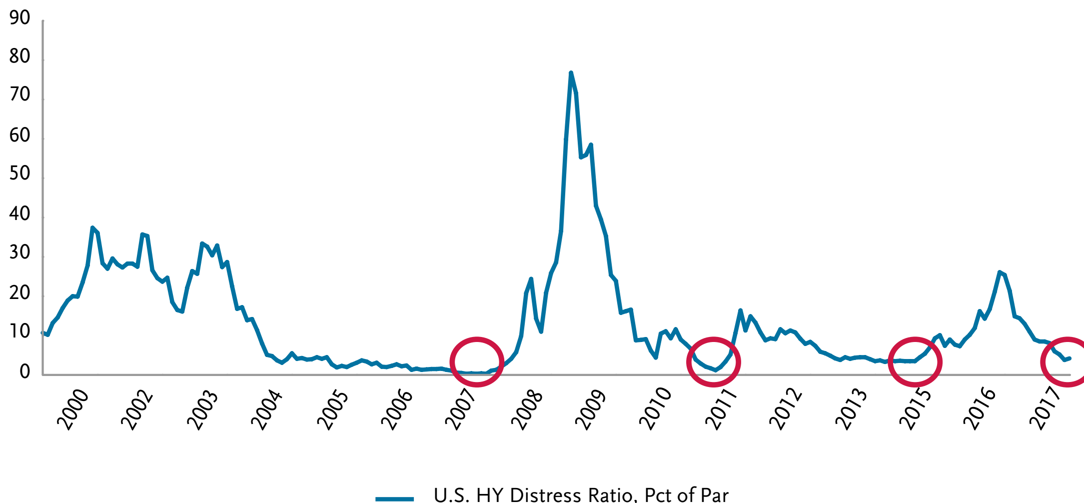
March saw very little in the way of default activity, consistent with the market's experience over much of the trailing 12 months. Indeed, as we have now fully lapped the peak default volumes of Q1'16, the rolling data looks very clean, save for the elevated volumes which carried over into April 2016 (and which are set to fall out of the data next month). As was the case in February, only one issuer defaulted, on $430mn of high yield bonds, in March. Gulfmark Offshore, which operates a fleet of support vessels for the offshore drilling industry, missed an interest payment on its 6.375% Senior Notes due 2022. The LTM default rate at the end of March gapped down 1.7 percentage points month-over-month to 1.9% per J.P. Morgan Credit Strategy. Additionally, the market distressed ratio, a gauge of investor complacency and implied forward default expectations, stood at a benign 4% at the end of the month.

The LTM Default Rate Collapsed In March as the Q1'16 Spike In Defaults Fell Out of The Trailing Data



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

Source: J.P. Morgan



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