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INSIGHT

MONTHLY COMMENTARY

March High Yield Credit Update

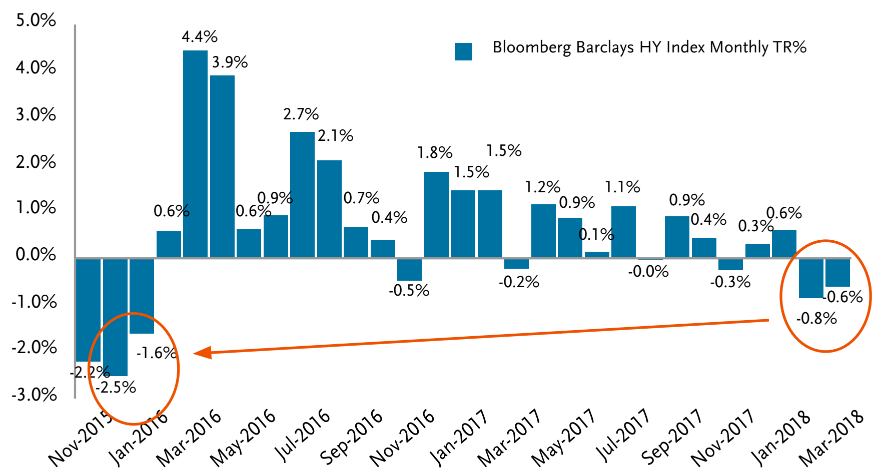
BRIAN GELFAND | APRIL 15, 2018

High yield bonds traded with a heavy tone in March, though the price action wasn't nearly as bad as the macro picture would have suggested. Down days proved orderly, typically buttressed by declining interest rates, dealer liquidity (low inventories) and stable two-way flow, while up days were tempered by heavy new issue supply, negative fund flows and valuations already near cycle extremes. Sure, bonds traded down more days than they traded up, but the tight trading ranges for bond prices ($0.98) and credit spreads (17bps) suggest high yield investors have thus far handicapped the noise of escalating trade tensions, White House turmoil, geopolitical instability and FAANG volatility as simply that...noise. In contrast, stocks and Treasuries are reacting to these existential risks more acutely with 20-30% spikes in equity volatility, 600-700pt intra-day moves in the Dow and 8-10 basis point gaps in the 10yr beginning to feel less the exception than the norm. Our asset class is traditionally the canary in the coalmine for shifts in risk regimes, but with credit spreads near cyclical tights and investor indifference to gyrations in those "other" markets, high yield continues to give the all clear signal (whether right or wrong).

Market Performance

Following an -0.85% loss in February, high yield bonds generated a modestly negative return of -0.6% in March to mark the first consecutive negative monthly returns for the asset class in over two years. Though the bull flattener in the term structure served as a tailwind for credit, the steady +18bps move wider in credit spreads outweighed this support from rates (and carry). Indeed, the excess return for the month was -1.14%.

The Asset Class Has Not Experienced Consecutive Monthly Losses Since 4Q15



Source: Bloomberg Barclays

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Mr. Gelfand is a Vice President in the 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.

In contrast to February, when heightened inflation and interest rate concerns weighed on BB-rated bonds more than higher beta (wider spread) credits, March attribution reflected that of a more traditional, though mild, risk-off move. CCCs underperformed BBs by -0.3% as the credit spread basis between the ratings cohorts decompressed by 22bps. While BBs recouped some of their first quarter underperformance in March, CCCs remain the better investment thus far this year at +0.3% total return in Q1 vs. -1.6% for BBs.

HY Performance	HY	Ba	B	Caa	Ca-D
March 2018 Total Return	-0.60%	-0.54%	-0.54%	-0.84%	-2.64%
2018 Total Return	-0.86%	-1.60%	-0.55%	0.30%	2.22%
March 2018 OAS Chg	18bps	26bps	34bps	48bps	
2018 Excess Return	-0.17%	-0.76%	0.06%	0.78%	

Source: Bloomberg Barclays

Though existential risks were less of a concern for investors this month, attention was paid to idiosyncratic risks, with sector, company and even CUSIP-specific events driving elevated dispersion. Within Wireless (an underperformer on the month), for example, price action within the Sprint complex was distinguished at the CUSIP level as prices of the two Sprint Capital bonds (as opposed to the benchmark Sprint Corporation bonds) remediated materially from local highs. The thesis that led these specific CUSIPs to outperform the rest of the capital structure in recent months lost sponsorship in the face of mounting evidence to the contrary. In Pharmaceuticals, a sector which outperformed in March, downward pressure on Mallinckrodt and Endo following commentary out of the Oval Office about opioid-related legislation was offset by a renewed bid for Valeant bonds. Most notable, however, was the Energy sector, with commodity-price-sensitive Oil Field Services and Independent E&P underperforming despite the impressive grind higher in crude. This decoupling of the historically strong correlation between spot oil and HY Energy bond prices (effectively since the spot WTI price rallied from ~$55/bbl to the mid-$60/bbl) has begun to garner much attention with bonds only now starting to play catch-up.

Best Sectors	March	2018
Financial Other	0.44%	1.03%
Diversified Manufacturing	0.20%	0.24%
Transportation Services	-0.03%	0.10%
Pharmaceuticals	-0.05%	-1.26%
Paper	-0.06%	-0.29%

Worst Sectors	March	2018
Oil Field Services	-1.68%	-2.33%
Supermarkets	-1.32%	-2.27%
Independent	-1.29%	-2.75%
Banking	-1.08%	0.03%
Wireless	-1.01%	-1.92%

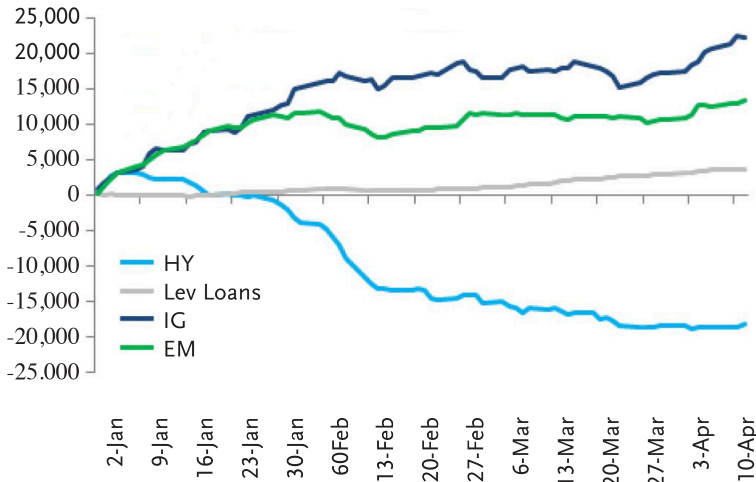
Source: Bloomberg Barclays

Market Technicals

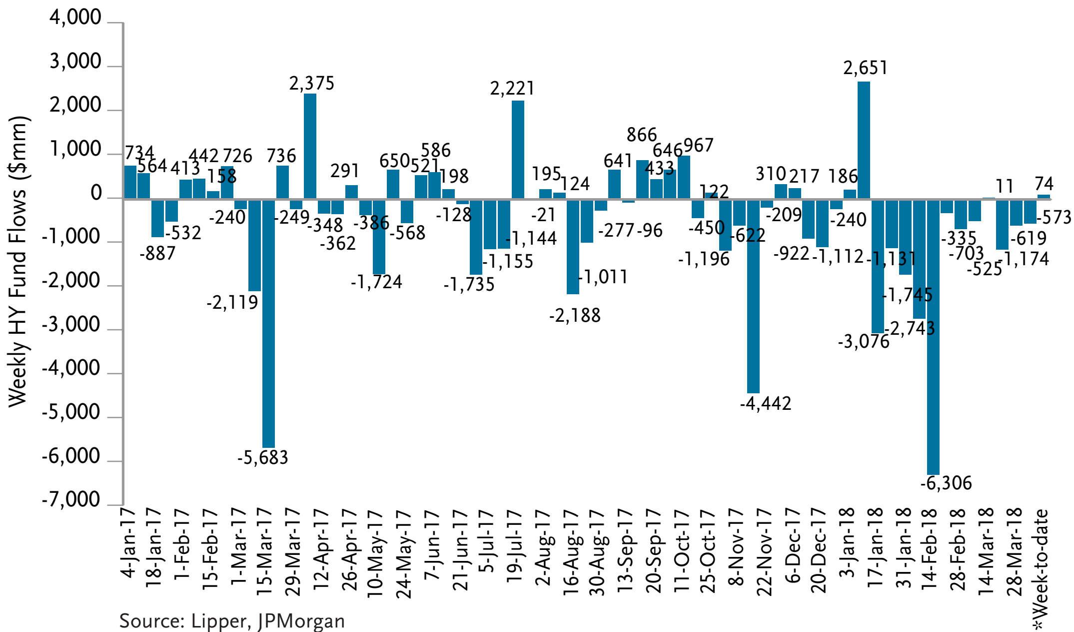
Outflows from the asset class persisted in March, representing the sixth consecutive month of capital flight which, as seen below, stands in stark contrast to inflows into each of the other principal fixed income markets. High yield ETFs and mutual funds reported a net outflow of -$2.3bn in March (moderating from the large -$12.4bn exodus in February), as the high yield market continues to find itself at the nexus of today's dominant investor concerns – rising interest rates, renewed volatility and elevated asset values. Importantly, the capital flows, while decidedly one directional, remain very orderly and have yet to incite any meaningful dislocation in the marketplace.

HY Remains at the Nexus of Investor Concerns Leading to Further, Though Moderating, Capital Flight

YTD Retail Fund Flows ($mm)



Source: Credit Suisse, EPFR



Source: Lipper, JPMorgan

In classic March fashion, the new issue flood gates opened amid volatile market conditions following a drought of deal activity in February. Though ebbing with the week-by-week tone of the market, primary volumes tallied a not insignificant $27bn. That was a far cry away from the glut of supply which roiled the market one year prior, but was still enough to create bouts of indigestion. The menu of deals which cleared the market ran the full gamut from benchmark issues from Valeant and Teva, to fresh battleground bonds in Frontier and J.C. Penny second liens, to a hodgepodge of less creditworthy borrowers thankful the capital markets remain open to them (even if at double-digit rates – take what you can get). The overarching theme of accommodative market conditions supported by an as of yet unfettered investor risk appetite remains firmly in-tact.

High Yield Net Supply ($MM)

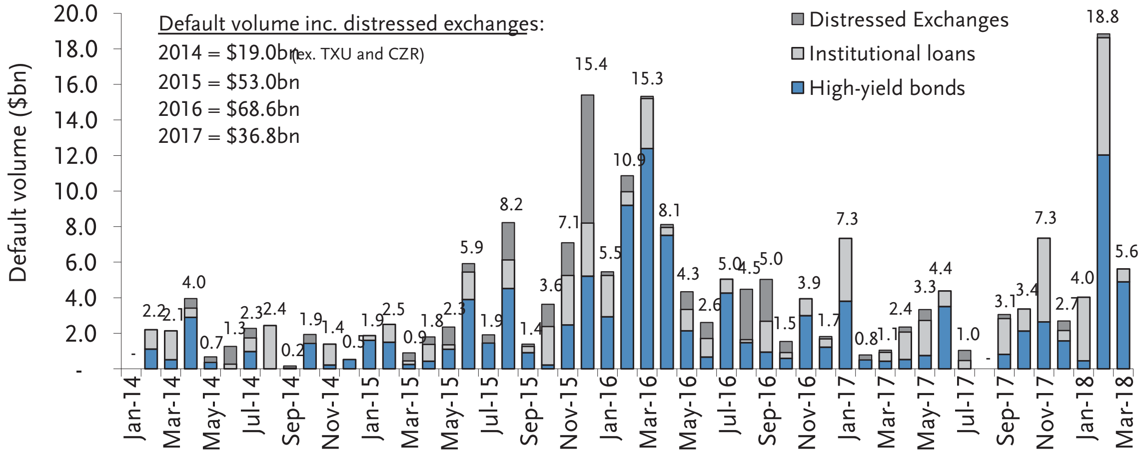
Month	New Issue	Redemptions	Net Supply	Monthly Returns
12/31/16	18,581	26,359	(7,778)	1.85%
1/31/17	19,028	20,783	(1,755)	1.45%
2/28/17	20,075	26,891	(6,816)	1.45%
3/31/17	42,879	32,555	10,324	-0.22%
4/30/17	16,275	33,967	(17,692)	1.15%
5/31/17	25,797	28,265	(2,468)	0.87%
6/30/17	19,764	37,114	(17,350)	0.14%
7/31/17	11,006	28,127	(17,121)	1.11%
8/31/17	17,723	19,252	(1,529)	-0.04%
9/30/17	37,394	22,548	14,846	0.90%
10/31/17	23,321	32,135	(8,814)	0.42%
11/30/17	27,003	15,210	11,793	-0.25%
12/31/17	17,622	24,511	(6,889)	0.30%
1/31/18	24,141	31,692	(7,551)	0.60%
2/28/18	12,238	23,591	(11,353)	-0.85%
3/31/18	26,509	22,949	3,560	-0.60%

Source: Barclays

Fundamental Trends

The "catching the falling knife" exercise in Retail / Supermarkets drew further blood from investors as the sector was plagued by a series of negative events throughout the month – the Toys"R"Us liquidation, Claire's Stores bankruptcy, Bi-Lo (Winn Dixie) bankruptcy and Mattel ratings downgrade to name a few. With respect to corporate defaults, Claire's and Bi-Lo filed for Chapter 11 bankruptcy protection after entering into RSA agreements with creditors. They were joined by FirstEnergy Solutions, the merchant power arm of utility FirstEnergy, which filed for bankruptcy after lengthy negotiations with its creditors and lobbying efforts with state and federal agencies for subsidy support fell short. Nine West Holdings, the struggling women's apparel manufacturer, and Remington Outdoor, the firearm and ammunition manufacturer, filed for bankruptcy protection as well. All told, borrowers defaulted on a total of $6bn of debt in March, down from $19bn in February ($16bn of which was iHeartMedia).

Bankruptcy Activity Picked Up in March Led by Borrowers in the Retail / Supermarket / Apparel Sectors



Source: JPMorgan

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