TCW

INSIGHT

MONTHLY COMMENTARY

April High Yield Credit Update

BRIAN GELFAND | MAY 12, 2017

Brian G. Gelfand
Vice President
U.S. Fixed Income

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.

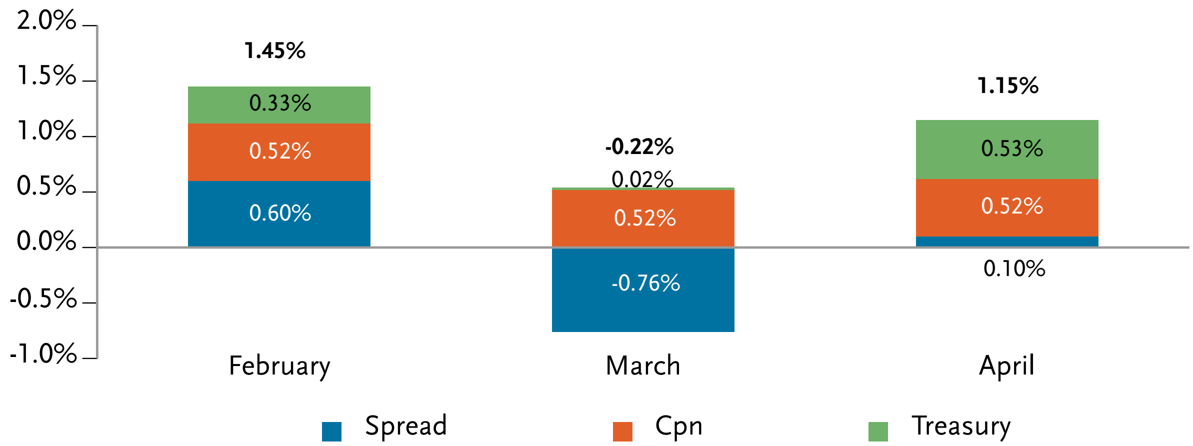
From the vantage point of a participant in markets outside of US credit (rates, commodities, stocks, derivatives, etc.), April was presumably a fairly eventful period. Underwhelming "hard" macroeconomic data (CPI and retail sales to name a few), rising geopolitical instability in both Syria and North Korea, an incredibly important election in France, tightening of credit availability in China, and an (un)surprising amount of wavering on the domestic policy front, all understandably fed into asset prices during the month. Indeed, reflation trades were being tested all around. The VIX trended higher, gold and Treasuries rallied, stocks tested critical support levels (the 50-day moving average on the S&P 500), base metals and oil breached major support levels (50-day and 100-day moving averages for copper and the psychologically important $50/bbl threshold for WTI). True, in many cases these trends reversed in late-April / early-May following a favorable outcome to the French election and a strong start to earnings season, but the volatility was real and meaningful nonetheless.

The same cannot be said for US credit, and specifically high yield. In general, prices of high yield bonds sustained a fairly unwavering grind higher throughout the month (idiosyncratic moves lower in a few stressed credits and some pressure in higher beta capital structures of structurally challenged sectors notwithstanding). In the middle of April, around the height of the geopolitical fervor, bonds were lower, but the drawdown was quick and shallow, and you had to look long and hard to find any meaningful sellers of risk. While high yield credit is not immune to the litany of risks highlighted above, in theory it may simply be the case that prices on bonds are adequately compensating investors for these risks. However, with the premium over treasuries received to take high yield risk (which compensates for prospective credit loss, price volatility and trading liquidity) implying well below historical average corporate defaults, suppressed market volatility and plenty of available liquidity, this does not remotely appear to be the case.

Market Performance

With interest rates as a tailwind and some incremental tightening in spread, high yield bond prices sustained a steady advance which translated into solid absolute returns for the asset class during the month. High yield bonds returned +1.15% in April, with an excess return of 62bps.

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



Source: Barclays

Despite the broader rally, there was less of the frenzied grab for risk we have seen for much of the past year. CCCs, select stressed and distressed situations (Valeant, iHeart), and some of the more challenged sectors (such as IPPs and Retailers) did feel some pressure. This, combined with support from interest rates and a firm bid from investors for safe credits to absorb excess cash, enabled higher quality risk to outperform for a second straight month, despite already tight spreads. BBs returned +1.35% for the month with spreads tightening -15bps vs. Single-Bs at +1.13% (-13bps) and CCCs at +0.66% (-1bp).

HY Performance	HY	Ba	B	Caa	Ca-D
April 2017 Total Return	1.15%	1.35%	1.13%	0.66%	0.98%
2017 Total Return	3.89%	3.44%	3.68%	5.35%	9.94%
April 2017 OAS Chg	-12bps	-15bps	-13bps	-1bps	
2017 Excess Return	2.79%	2.23%	2.61%	4.45%	

Source: Barclays

	Ba	B	Caa
HY OAS (3/31)	252	375	692
HY OAS (4/28)	237	362	691
Chg (bps)	(15)	(13)	(1)
Chg (%)	**6.0%**	**3.5%**	**0.1%**

Source: Barclays

At the sector level, oil-related risk underperformed as WTI dropped below the $50/bbl threshold after weekly crude and refined products inventory data revealed still stubbornly high levels of supply despite several months of production cuts from OPEC nations and steady end market demand. Higher beta energy stumbled as a result, whereas high quality peers (Concho, Parsley, Diamondback, Newfield, etc.) were notably resilient (and in some cases rallied as investors swapped into low beta names). IPP bonds also came under pressure following weak MISO capacity auction results which served to reinforce the long-term secular issues facing the sector. The fall-out in IPP stocks and a poorly received new issue from Talen further re-priced the sector lower. Pharma was the worst performing sector again in April with Valeant bonds moving lower on concerns regarding its ability to effect the requisite asset sales to deleverage its balance sheet (as I write today, however, Valeant bonds (and stock) have bounced sharply off the April lows after the company reported better-than-expected earnings and headlines emerged touting pending asset sales). On the other end of the spectrum, fundamentally defensive sectors such as Food & Beverage outperformed despite already tight spreads given the solid bid for low beta risk.

Best Sectors	April	YTD
Diversified Manufacturing	2.24%	5.40%
Food & Beverage	2.15%	4.32%
Finance Companies	1.84%	3.31%
Wirelines	1.78%	3.96%
Aerospace / Defense	1.74%	4.24%

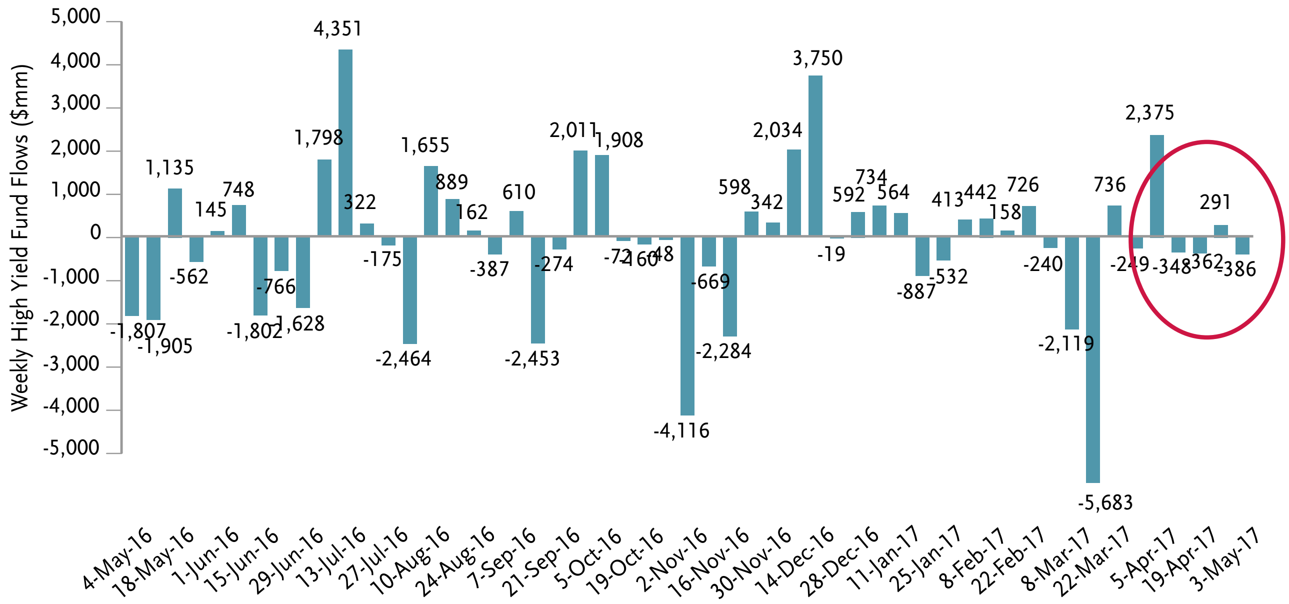
Worst Sectors	April	YTD
Pharmaceuticals	-1.53%	1.87%
Electric	-0.35%	4.01%
Oil Field Services	0.27%	5.12%
Independent	0.61%	1.44%
Financial Other	0.71%	2.85%

Source: Barclays

Market Technicals

The subdued volatility in the high yield marketplace is probably best exemplified by the near-zero net fund flows each week during the month (save for large net inflows in the first three days of the month). The fact is, absent a meaningful shock to sentiment (which was clearly unfettered despite the backdrop in April), and with many market participants out on vacation in the middle of the month, there wasn't much to necessitate large directional flows. On the whole, high yield funds took in ~$1bn net in April. Additional liquidity that when combined with cash on hand and a light new issue supply (discussed below) explains the steady grind higher in secondary bond prices.

Fund Flows Lacked Real Direction In April Following A Meaningful Spike In Outflows In March



Source: Lipper, JPMorgan

The primary calendar was supportive of market technicals in April given the dearth of new issue supply. A little over $16bn USD-denominated debt priced in April, a steep decline from the near record volumes that cleared in March. While the light calendar in April can be characterized as atypical (indeed, April new issue volumes have averaged >$30bn over the past several years as issuers rush to close deals before the Q1 earnings blackout period begins), the rationale is not unclear. Just as successful syndications in January and February coaxed issuers to the capital markets in March, the volatility created by the resulting glut of supply gave pause to issuer's capital markets plans in April. As a result, few deals jumped off the calendar before the quiet period around earnings commenced in the back half of the month. Deals that did clear the market, however, were met with solid demand, pricing on average 0.375% through initial price talk and still rallying an additional 1-2pts once trading in the secondary market commenced.

High Yield Net Supply ($mn)

Month	New Issue	Redemptions	Net Supply	Monthly Returns
4/30/16	31176.00	18,454	12,722	3.92%
5/31/16	28355.00	31,534	(3,179)	0.62%
6/30/16	22334.00	31,021	(8,687)	0.92%
7/31/16	13327.00	22,719	(9,392)	2.70%
8/31/16	16647.00	22,606	(5,959)	2.09%
9/30/16	25207.00	29,030	(3,823)	0.67%
10/31/16	13452.00	35,225	(21,773)	0.39%
11/30/16	15282.00	22,208	(6,926)	-0.47%
12/31/16	18581.00	26,359	(7,778)	1.85%
1/31/17	18803.00	20,783	(1,980)	1.45%
2/28/17	18916.00	26,891	(7,975)	1.45%
3/31/17	42629.00	32,555	10,074	-0.22%
4/30/17	16225.00	33,967	(17,742)	1.15%

Source: Barclays

Fundamental Trends

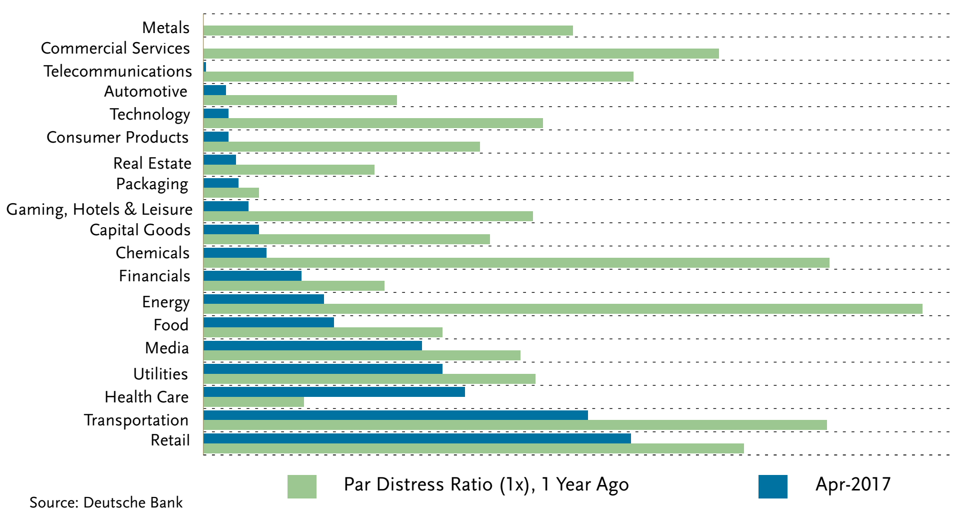
Three corporate defaults affecting $250mn in high yield bonds and $1.5bn in bank loans occurred in April; more than in each of the last two months (not that the bar was set particularly high). Of note, two of the defaults stemmed from the retail sector as rue21 missed an interest payment on its 9% unsecured bond maturing 2021 and Payless Shoesource filed for bankruptcy. These were the first retailer defaults of the year, emblematic of emerging stress in the sector resulting from a secular shift in consumer purchasing habits. However, though the issues facing traditional retailers (and adjacencies including rural malls) are well documented and have become exceedingly topical in financial circles as of late, credit distress within the sector is thus far situational rather than broad-based. Indeed, only 17% of high yield retail bonds trade wide of 1,000bps, a far cry away from the level of distress seen in commodity-linked sectors (Energy and Metals & Mining) a little over a year ago. While we believe fear and group-think will inevitably create opportunity in select areas of retail, as of now this has yet to be the case.

Retail Defaults Echo Emerging Stress In The Sector Resulting From Secular Disruptions...

Date	Company	Bonds ($mn)	Loans ($mn)	Total ($mn)	Industry
19-Jan	Avaya	2,683.2	3,233.9	5,917.2	Technology
4-Jan	Bonanza Creek	800.0	-	800.0	Energy
15-Apr	**rue21**	**250.0**	**521.0**	**771.0**	**Retail**
4-Apr	**Payless Shoesource**	**-**	**650.7**	**650.7**	**Retail**
1-Feb	Vanguard Natural Resources	508.6	-	508.6	Energy
3-Mar	Answers Corp	-	500.3	500.3	Technology
15-Mar	Gulfmark Offshore	429.6	-	429.6	Energy
18-Apr	**Panda Temple Power**	**-**	**377.1**	**377.1**	**Utility**
26-Jan	Goodman Networks	325.0	-	325.0	Telecommunications
30-Jan	Azure Midstream	-	298.2	298.2	Energy
	Total	**4,996.5**	**5,581.2**	**10,577.7**	

Source: J.P. Morgan

...However, Broad-Based Credit Stress Amongst Retailers Remains Nascent



Source: Deutsche Bank