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INSIGHT

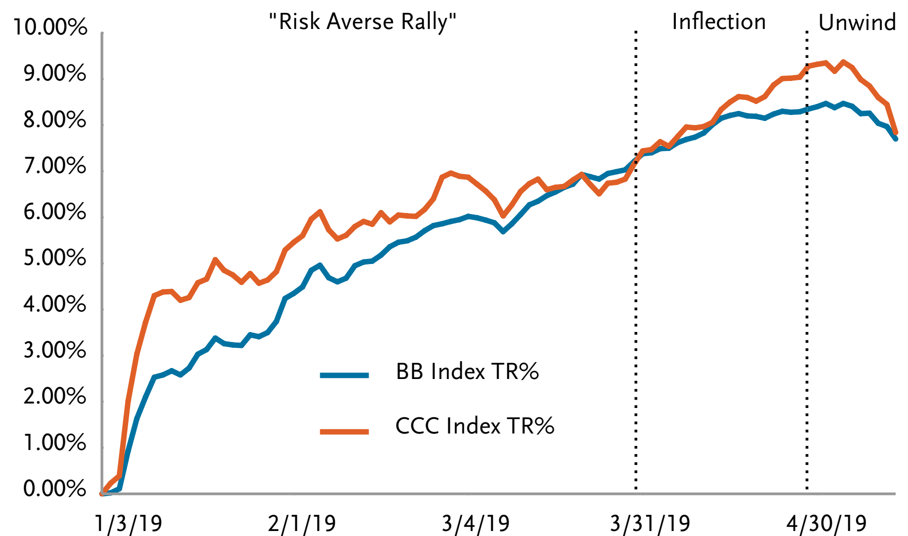
MONTHLY COMMENTARY

April High Yield Credit Update

BRIAN GELFAND | 17 MAY 2019

The *risk averse rally* we had come to know through the first quarter of 2019, inflected in April as sentiment around an impending trade deal between the United States and China and growing comfort around ongoing central bank support ignited risk-seeking behavior and shifted investor demand down in credit quality. While BB-rated bonds had outperformed higher risk CCC-rated debt through March, a rarity in an environment where returns are in excess of 7% in just a three-month period, CCCs recaptured the lead in April, outperforming BBs by +92 basis point (bps). Now, fast-forward two weeks and this renewed complacency and increase in risk tolerance has proved short-lived as the collapse in trade negotiations and a lackluster earnings season incited an acute unwind of the April rally (in equities and high yield bonds).

CCCs Staged an Outsized Rally in April, Though the Gains were Pared in May



	Total Return %		
Date	BB	CCC	Delta
3/29/2019	7.21%	7.15%	-0.06%
4/30/2019	8.40%	9.32%	0.92% ↑
5/13/2019	7.70%	7.84%	0.14% ↓

Source: Bloomberg

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Mr. Gelfand is a Credit Trader in the Fixed Income group, focused on trading high yield securities. He joined TCW in 2014 as a Credit Analyst responsible for research across the telecom, technology and media sectors. Previously, while working towards his MBA, Mr. Gelfand completed internships in the Portfolio Management group at Pacific Investment Management Company LLC (PIMCO) and as a Research Analyst with Kayne Anderson Capital. He began his career as a Client Management/ Business Development Associate with Canyon Capital Advisors where he helped manage the firm's institutional and high net worth client relationships. Mr. Gelfand holds a BA from the University of Pennsylvania and an MBA from the UCLA Anderson School of Management.

April High Yield Credit Update

While April was generally characterized by dampened volatility, valuation compression (in many cases re-testing the October 3rd tights) and investor exuberance, May has shown early signs of a pivot back toward uncertainty and fear. As volatility spikes and spreads decompress, opportunities have started to emerge for disciplined value investors to add investments back at improved valuations.

Market Performance

High yield bonds earned investors impressive returns of +1.42% in April, advancing gains for the year to +8.78%. The more typical risk-on trade that ensued during the month, and which resulted in 33bps of incremental spread compression for the Bloomberg/Barclays U.S. High Yield Index, served as the principal driver of performance as interest rates exerted far less influence on bond prices in April than they did in March. Indeed, excess returns (performance in excess of that attributable to a shift in the Treasury curve) were +1.37% for the month.

As discussed above, higher beta, CCC-rated bonds outperformed in April as risk tolerance improved for what can be classified as the (ostensive) "haves" of this highly leveraged cohort. This contrasts with the "have-nots," referring to the growing list of fundamentally broken capital structures which are no longer receiving any support from investors (Weatherford, EP Energy and Bristow to name just a few, more below). BB-rated bonds still generated attractive absolute returns of +1.11% for the month, a notable achievement, as these credits have become increasingly negatively convex with valuations converging on cyclical tight.

HY Performance	HY	Ba	B	Caa	Ca-D
April 2019 Total Return	1.42%	1.11%	1.56%	2.03%	3.02%
2019 Total Return	8.78%	8.40%	8.88%	9.32%	21.05%
April 2019 OAS Chg	-33bps	-17bps	-30bps	-88bps	
2019 Excess Return	7.20%	6.75%	7.33%	7.83%	

Source: Bloomberg, Barclays

Thematically consistent with the general rotation out the risk spectrum, sectors which began the month trading at the highest average yield and widest average spread outperformed those that were already trading at tight relative valuations. Indeed, the benchmark credits within the Managed Care (Health Insurance) and Electric sectors trade at some of the tightest spreads in the marketplace (+/-200bps over Treasuries) and therefore have very little room to rally, while bonds in the Retail, Oil Field Services and Transportation Services sectors constitute much of the higher risk, higher (nominal) yielding opportunities in the marketplace currently.

Best Sectors	April	2019
Supermarkets	3.40%	12.78%
Retailers	3.26%	11.95%
Oil Field Services	2.77%	14.18%
Transportation Services	2.48%	9.57%
Automotive	2.31%	7.94%

Worst Sectors	April	2019
Aerospace / Defense	0.35%	7.61%
Health Insurance	0.41%	6.83%
Other Financials	0.47%	5.62%
Chemicals	0.59%	6.80%
Electric	0.67%	8.54%

Source: Bloomberg, Barclays

Market Technicals

Market technicals have yet to waver this year, particularly on the demand side as the high yield marketplace has been the beneficiary of an uninterrupted stream of capital inflows. Just under $15bn has rotated out of equities and leveraged loans and into high yield (and investment grade) bonds through April. As such, cash reserves are argued to be inflated, feeding the narrative for a sustained rally as that dry-powder is put to work. Interestingly, this conventional wisdom, which by the way was the prevailing thinking in September of last year, has been tested in the first two weeks of May as fundamental headwinds (both macro and micro) re-priced risk assets lower in short order. So much for those supportive technicals.

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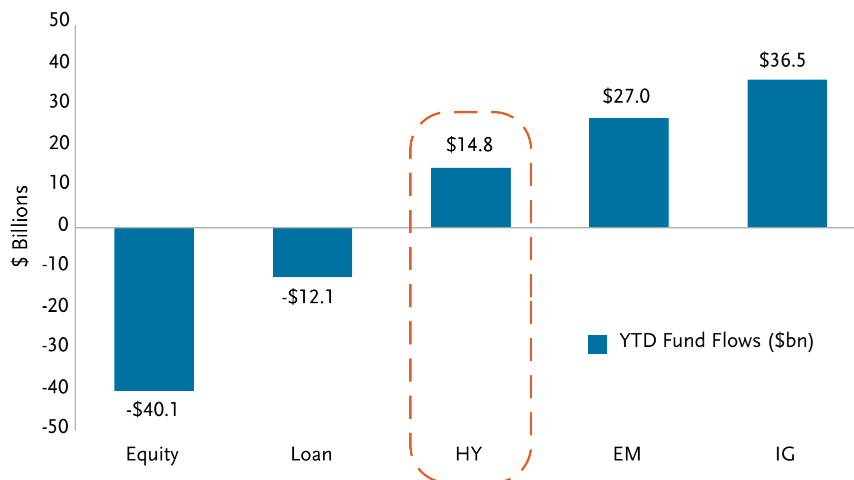
Fund Flows Have Been Supportive for Bond Prices, Though as May is Proving Thus Far, Market Technicals are an Unstable Underpinning



Source: Credit Suisse

Deal flow in April was on the lighter side relative to the momentum in February and March but not inconsistent with a capital markets environment that is open for business. Over $17bn in USD-denominated high yield debt was syndicated in April. Deals that came to market, cleared at incrementally lower yields amid robust investor demand. Moreover, amid the fervor, investors accommodated aggressive maneuvers by financial sponsors, who were obliged to capitalize on renewed investor complacency to "take chips off the table." Take Staples for example – the sponsor here effected a dividend recap pulling $1bn out of the enterprise just over a year after it acquired the business. Investors permitted the leveraging transaction which has left the balance sheet, in our opinion, in a precarious state for a few hundred basis points of incremental coupon. More dividend recaps have since followed, both in the bond and loan market, seemingly consistent with the unicorn IPO scramble in the equity markets (principals are looking to strike while the iron is hot, and are in a hurry to do so).

Month	New Issue	Redemptions	Net Supply	Monthly Returns
4/30/18	17,359	17,603	(244)	0.65%
5/31/18	15,201	20,654	(5,453)	-0.03%
6/30/18	14,993	13,118	1,875	0.40%
7/31/18	7,755	8,440	(685)	1.09%
8/31/18	16,740	13,488	3,252	0.74%
9/30/18	18,257	10,638	7,619	0.56%
10/31/18	12,229	15,561	(3,332)	-1.60%
11/30/18	6,021	14,501	(8,480)	-0.86%
12/31/18		13,095	(13,095)	-2.14%
1/31/19	16,573	4,392	12,181	4.52%
2/28/19	20,688	11,810	8,878	1.66%
3/31/19	21,720	19,817	1,903	0.94%
4/30/19	17,646	19,890	(2,244)	1.42%

Source: Barclays

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Fundamental Trends

Corporate default activity has increased of late, though off an extremely suppressed base. While an incremental six borrowers (two in the bond market, four in the loan market) defaulted on their obligations in April, this should not be construed as elevated volume as the trailing default rate (at approximately 1.2% per Credit Suisse) continues to sit at cyclical lows. More interesting, however, and we have touched on this in recent memos and have continued to monitor, is the growing cohort of Energy credits that have come under severe financial duress despite the accommodative market backdrop. The list spans smaller capital structures including Jones Energy, Alta Mesa, American Energy-Permian Basin, Halcon Resources and PHI, Inc. to larger operators such as Sanchez Energy, Bristow, EP Energy and Weatherford International (the latter two being bellwether credits in the sector). In a few cases, the unsecured debt of these capital structures is trading at just cents on the dollar, implying little-to-no recovery for bondholders. The debate is whether these continue to represent isolated fractures or rather, portend broader distress. For the moment, it would appear credit selection is of the upmost importance as the cost of fundamental missteps has become rather severe. ■

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