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INSIGHT

MONTHLY COMMENTARY

May High Yield Credit Update

BRIAN GELFAND | JUNE 13, 2016

Black Ice

In a recent commentary, we discussed the idea of FOMO (Fear of Missing Out) and the influence this behavioral tendency was having in the marketplace for leveraged credit. Now, with the relentless rally in high yield spreads extending through May and into early June, which we note has occurred largely absent a remediation in the litany of fundamental and structural risks which called for higher risk premiums in the first place, additional cognitive biases are seemingly exerting meaningful pressure, most notably Recency and Social Proof. Consider this analogy:

> *You're driving down a busy highway on a cold evening following a storm. You are generally conscious of the heightened risks on the road, but a smooth ride thus far gives you little reason to change your driving habits or reduce your speed. You then drive over a patch of black ice, temporarily lose control, though ultimately correct and avoid an accident. In the immediate aftermath, your driving habits change. You become more defensive, reduce your speed and remain vigilant for other patches of black ice. The recency of the event has increased your perception of its likelihood to happen again. As time passes without a second encounter, however, you become more complacent, begin to increase your speed, and ultimately revert back to your prior driving habits. You now perceive the likelihood of an accident to have declined. Moreover, you observe other drivers speeding down the road, thereby reinforcing, or proving your behavior to be "correct."*
>
> *But have the conditions on the road actually changed? Has the probability of driving over another patch of black ice somehow declined? And what about other 'potholes' that exist, but up until this point been less apparent?*

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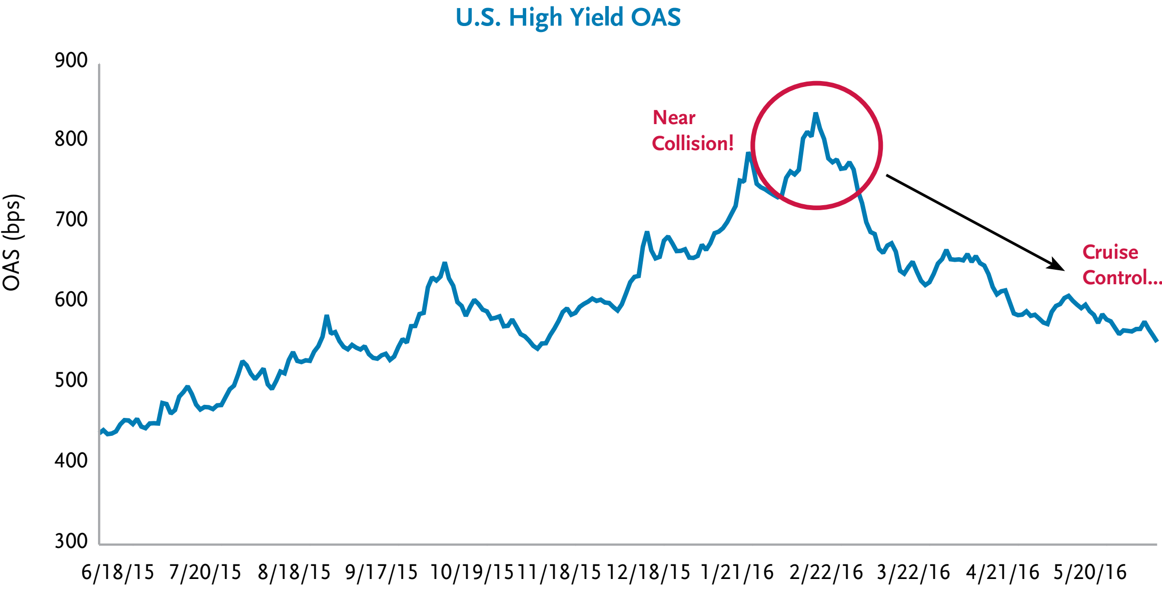
Investor behavior in recent weeks would suggest that we have entered the phase of this mini-cycle where recency has waned and the positive reinforcing system of social proof has taken hold. An air of exuberance has crept into the marketplace, and while many argue it to be reluctant, the result is still a significant reduction in underwriting discipline. One need not look further than the new issue calendar in April and May, which saw the return of the first Independent E&P issuance in nine months, in addition to a series of previously scorned Metals & Mining credits that brought deals which garnered overwhelming investor demand.



Source: Barclays

In contrast with other actors in the high yield marketplace today, we remain acutely aware of the prevailing conditions on the road, maintaining discipline and driving defensively to prepare for both the risk and opportunity that lie ahead.

Market Performance

The high yield market generated negative returns during the first week and a half of trading as the confluence of macro (soft U.S./China economic data, USD volatility, commodity weakness) and micro (lackluster corporate earnings) drivers incited heavy ETF selling and a broader re-rating of risk premiums. The retrenchment, however, proved to be short-lived, as cash rich investors quickly emerged to buy the dip, and a rebound in commodity prices, notably WTI (which briefly flirted with the psychologically important $50/bbl level towards the end of the month), drove a bid for higher yielding commodity-linked credits.

Spreads Did an About-Face in March, Generally Correlated with the Path of Oil

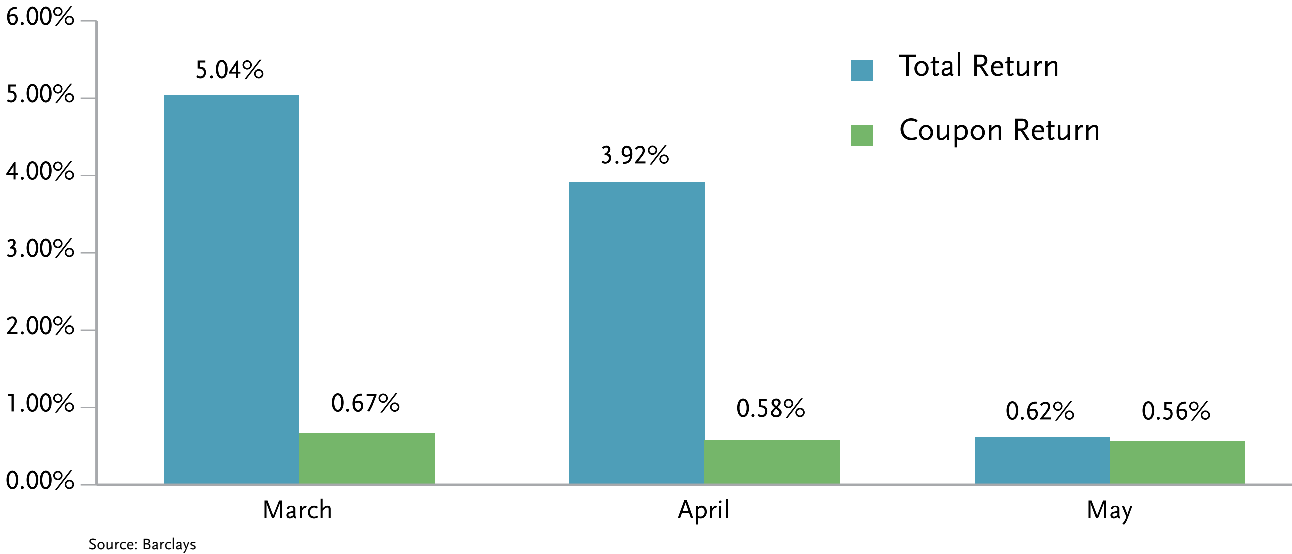
Source: Bloomberg

Dissecting the attribution of performance for the month, however, we note that in contrast with March and April, total return in May was principally driven by carry (not surprising given the extent of spread compression which took place since the mid-February wides). Indeed, save for the CCC part of the credit spectrum, which tightened -63bps in a performance chasing reach for yield, high quality credits and the HY market overall experienced only modest spread compression (Single-B spreads actually widened +7bps). The result of this delta in spread performance, combined with the structurally higher yields of lower quality/higher risk bonds, drove CCC outperformance for the month.

CCC + Distressed Outperformed and the HY Market Extended Its Route to an Impressive 8.20% YTD TR

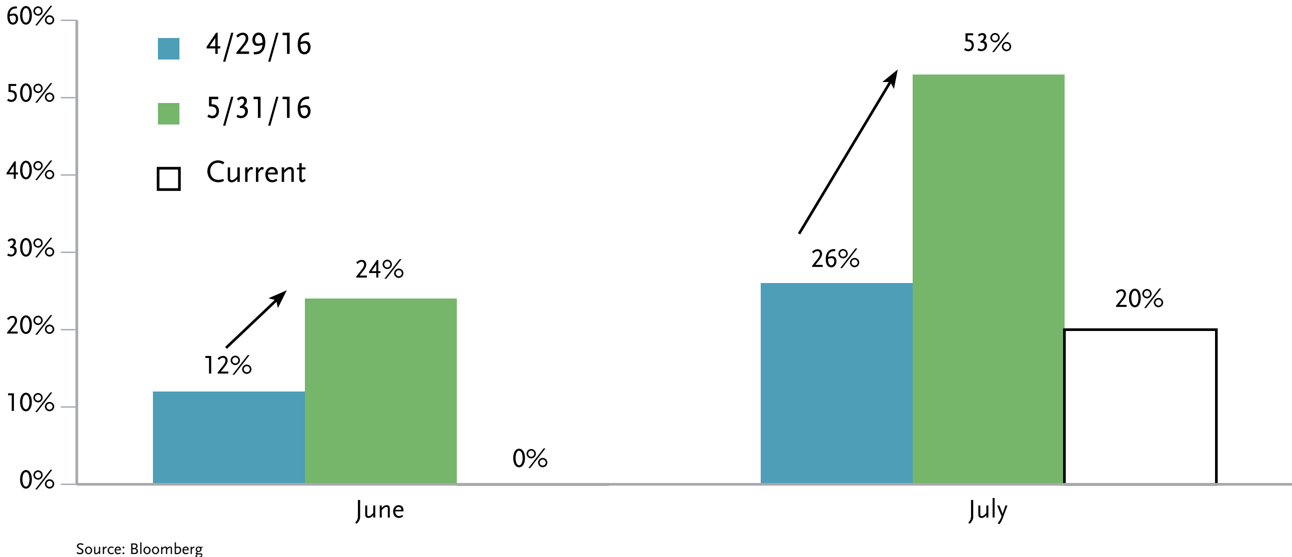
HY Performance	HY	Ba	B	Caa	Ca-D
May 2016 Total Return	0.62%	0.32%	0.20%	2.23%	6.22%
2016 Total Return	8.20%	6.99%	6.63%	14.32%	31.01%
May 2016 OAS Chg	-11bps	-8bps	7bps	-63bps	
2016 Excess Return	+562bps	+435bps	+428bps	+1229bps	

Source: Barclays



Source: Barclays

Moreover, following the release of the Fed minutes in the middle of the month, the market implied probability of a summer rate hike reset higher, disproportionately restrained lower yielding credits given their lack of meaningful spread to absorb rising rates.



Source: Bloomberg

Not all sectors generated positive returns in May, bucking the rising tide theme pervasive in both March and April. With this relentless beta trade showing some signs of maturing in May, fundamentals began to peer through with sector and company-specific results steering relative performance. Of note, Oil Field Services credits retraced some of their gains as selling pressures emerged around the bankruptcy filings of certain companies. Retailers were another underperformer driven by a barrage of underwhelming department store first quarter earnings results. Finally, Pharma experienced some volatility as the Valeant saga continued and Endo International announced disappointing guidance with its Q1 earnings release. On the other end of the spectrum, Energy remained well bid, with a total return of +3.3% in May, bringing cumulative performance since the mid-February lows for the sector to +46%! Continued remediation in oil (and gas) prices, driven in part by supply outages in Nigeria, Canada, and Libya, was enough of a catalyst to coax a bid out of a yield starved and hopeful investor base. While we do not contest the recent rally in commodities has incrementally improved the fundamental prospects for these businesses, we highlight the margin of safety within these capital structures remains razor thin across the sector. We firmly believe the IRRs on offer today do not adequately compensate investors for the downside risk to these credits.

Best Sectors	May	Previous 12 Months
E&P	3.93%	22.22%
Midstream	2.00%	16.59%
Industrial Other	1.83%	11.49%
Chemicals	1.73%	11.64%
Media Entertainment	1.70%	6.12%

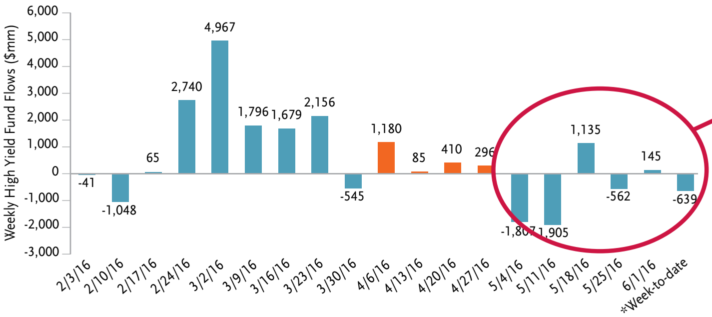
Worst Sectors	May	Previous 12 Months
Oil Field Services	-2.59%	10.75%
Retailers	-1.55%	7.11%
Pharmaceuticals	-1.11%	-1.65%
Financial Other	-1.02%	1.94%
Supermarkets	-0.77%	4.59%

Source: Barclays

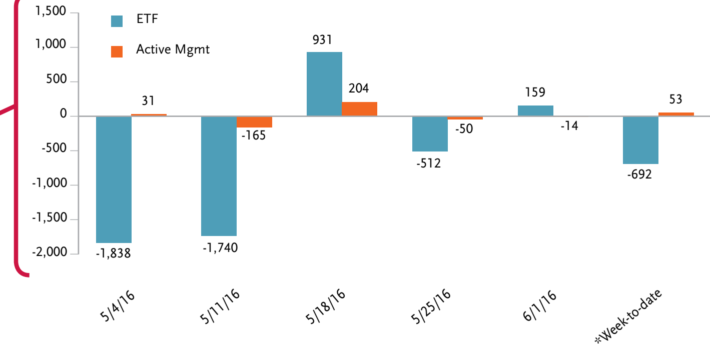
Market Technicals

We began to see some volatility in fund flows in May, following three consecutive months of near uninterrupted inflows into HY ETFs and actively managed funds. Notably, the outflows were attributable almost exclusively to ETFs as selling pressures extended from both retail investors shedding risk on negative headlines and institutional investors swapping out of HYG to make room in their portfolios for the month's heavy new issue calendar. High yield funds reported a -$2.4bn outflow in May, which followed a respectable +$1.7bn inflow in April and a near record-setting +$9.0bn inflow in March. Year-to-date, high yield funds have taken in $9.6bn.

HY Funds Faced Net Outflows in May...



...With the Volatility Concentrated in ETFs



Source: Lipper, JPMorgan

The primary market was open for business in May and issuers of all flavors were obliged to capitalize on the window investors afforded them to meet their financing needs. New issue volumes of $28.4bn kept pace with April's run-rate (as compared to the severely depressed volumes to start the year), with activity in early June maintaining similar momentum. There was no shortage of diversity in the make-up of the calendar with credits spanning the gamut of quality, tenor, and industry up for sale. Despite this, however, good (even decent) deals were hard to come by. Cleaner BB-rated deals remained a staple, though investors could be certain that no discounts would be on offer for high quality paper as demand overwhelmed supply. Unable to source high quality at reasonable yields, investors clamored out the risk spectrum driving prices through what we believe to be fundamentally justifiable levels. May also saw incremental commodity-sensitive issuers, emboldened by the success of their peers in the prior month, return to the primary market to unbelievable fanfare. This irrational exuberance could be a signal this mini-cycle is nearing a correction.

High Yield Net Supply ($mm)

Monthly	New Issue	Redemptions	Net Supply	Monthly Returns
12/31/2015	3,077	28,406	(25,329)	-2.52%
1/31/2016	5,923	12,449	(6,526)	-1.61%
2/29/2016	7,557	15,556	(7,999)	0.57%
3/31/2016	18,226	12,920	5,306	4.44%
4/30/2016	31,176	18,454	12,722	3.92%
5/31/2016	28,355	31,534	(3,179)	0.62%

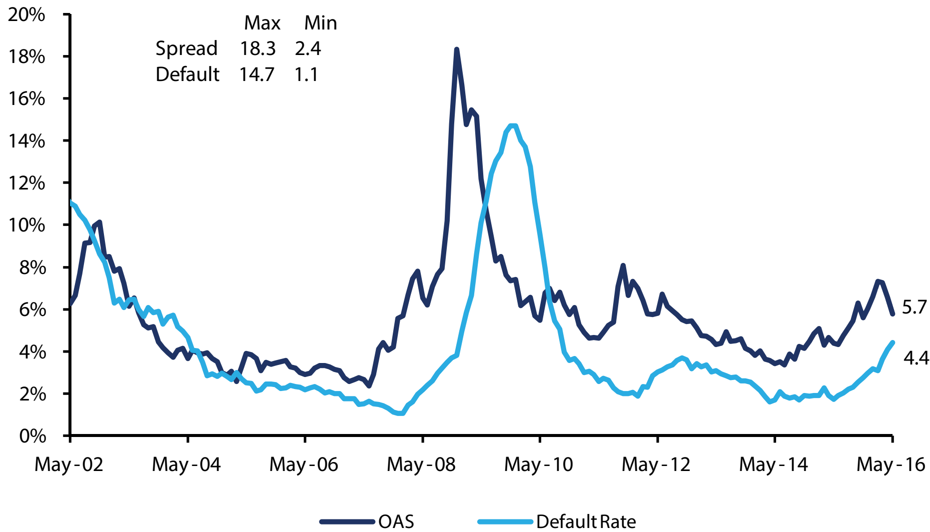
Source: Barclay's

Fundamental Trends

Defaults continue to become more commonplace than a year ago, though volumes in May were tempered relative to the activity seen in each of the first four months of the year, as the rally in commodities and renewed risk appetite in debt and equity markets extended a temporary lifeline to financially stressed businesses. A total of five companies defaulted on contractual obligations during the month, representing $3.5bn of debt ($2.3bn of high yield debt). Year-to-date, 35 companies have defaulted with notional volume of $41.9bn. This now eclipses the full-year 2015 total

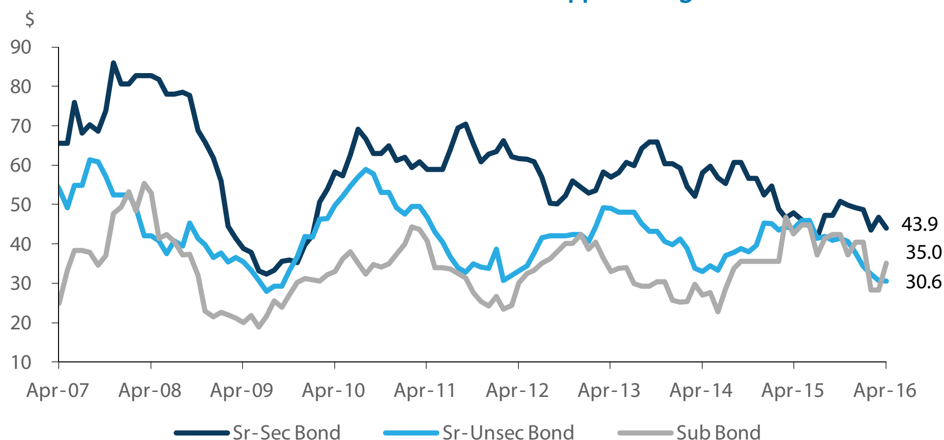
of $37.7bn and represents the sixth highest annual total since the late-90s. As has been the theme all year, default activity has been principally driven by companies in the commodity-linked sectors of Energy (66% of YTD volume) and Metals & Mining (18%). A broader transmission of financial distress which we have seen repeatedly occur through prior default cycles has yet to materialize in a meaningful way thus far; however, we do believe the non-commodity leveraged finance universe is more susceptible to contagion than current spreads and credit strategist default forecasts would imply.

Trailing 12-Month HY Default Rate Continued to Climb in May to 4.4%



Source: Moody's Investor Services, Barclays Research

In last month's commentary, we highlighted the notable decline in estimated recovery rates of defaulted bonds to cyclical lows. The trend (as seen in the chart below), which extended through May, has sparked debate amongst market strategists as to its drivers – whether structural, cyclical, skewed, or anomalous? We do recognize the presence of a skew in the headline figure today; indeed, with ~85% of current defaults extending from Energy, and Metal & Mining sectors, which have seen both meaningful earnings declines and multiple compression on the back of depressed commodity prices, recoveries are unambiguously being pulled lower. However, to suggest the recent data to be anomalous and/or transitory, ignores what we believe are clear structural tenants (namely lofty balance sheet leverage and weak covenant protections) which should continue to depress recoveries as we move through the late stages of this credit cycle.



Source: Moody's Investor Services, Barclays Research

Note: Measured by global bond prices taken one month after default. Source: Moody's Investor Service

Low Recoveries on Commodity-Linked Credits Have Depressed Aggregate Recovery Rates

Annual HY Bond Recovery Rates

Sector	2015	LTM
Total	25.19	24.27
Ex- Energy	32.06	30.62
Ex-Metals/Mining	27.09	25.00
Ex- Energy & Metals	46.09	40.01

Source: JP Morgan

Summary

High yield credit continued to have a firm bid in May, though as this mini-cycle matures within the context of what we believe is the beginning of a multi-year deleveraging, adhering to our disciplined approach to credit underwriting becomes increasing paramount. We won't be taking our eyes off the road. ■

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