TCW

INSIGHT

MONTHLY COMMENTARY

May High Yield Credit Update

BRIAN GELFAND | JUNE 14, 2017

An *economic* tug of war over was waged in the high yield bond market in May. On one side, the *micro*-, championed by solid Q1 earnings, supply/demand asymmetry (undersupplied, overbought) and few corporate defaults. On the other, the *macro*-, pressured by underwhelming hard data (inflation, growth, auto sales and residual values, and brick-and-mortar retail sales to name a few), commodity deflation, rising geopolitical tensions, and increasingly apparent fiscal/political paralysis. Objectively the *micro*- triumphed over the *macro*- this month, as risk premiums declined (and relative spreads compressed), re-pricing to levels which woefully fail to adequately compensate lenders for taking leveraged risk this late in a credit cycle. This would not be the first time high yield investors failed to appropriately discount the macro. One need not look further than early 2015, when investors looked past deteriorating global economic data for over six months before sharply re-pricing spreads to mirror the fundamental reality. The economic data was prescient, leading an earnings recession that incited a feedback loop of negative fund flows, rising corporate defaults and higher risk premiums. Today, the stage looks (un)surprisingly familiar.

In 2015, Risk Premiums Adjusted ~Six Months After the Citi Economic Surprise Index Signaled Deteriorating Fundamentals

Source: Bloomberg

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.

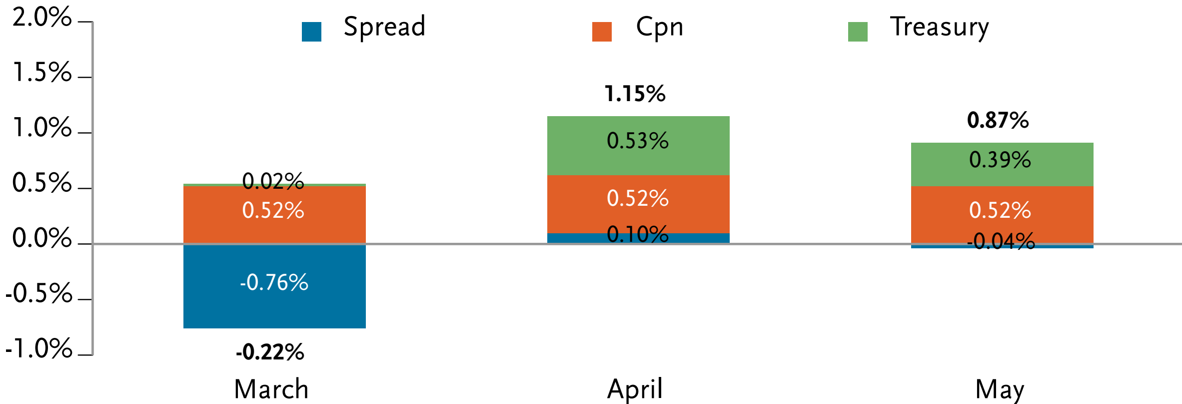
And While History May Not Repeat...

Source: Bloomberg

MARKET PERFORMANCE

High yield bonds outperformed small cap equity comps (R2K -2.2%) and commodities (namely, WTI -$2) to return +0.87% in May, carried by the 50bps of recurring coupon and the rally in Treasuries (following some intra-month volatility). Soft macroeconomic data and incremental uncertainty in the political/geopolitical spheres re-racked 5-30yr Treasury yields lower. This is noteworthy, considering one of the more definitive consensus forecasts at the start of the year was for higher interest rates, and we are now nearly half way through 2017 with the 10yr ~23bps lower (textbook).

Interest Rates Have Supported Rising High Yield Bond Prices for the Past Two Months



Source: Barclays

CCCs outperformed in May, returning +1.63% vs. +0.70% for Bs and +0.83% for BBs (which benefited from greater interest rate duration). A result that is fairly consistent with what one would expect given low volatility and favorable market technicals during the month. BB-rated bonds entered May at an average price of $104.35 and an average OAS of 237bps, leaving this higher quality/lower credit risk cohort pressing up against a valuation wall, with arguably little room for further spread tightening or meaningful price appreciation (given the negative convexity of callable bonds). In contrast, despite poor absolute valuations, the higher nominal yields and lower dollar prices of higher risk credits mathematically allow for greater incremental spread compression and price appreciation.

HY Performance	HY	Ba	B	Caa	Ca-D
May 2017 Total Return	0.87%	0.83%	0.70%	1.64%	-1.23%
2017 Total Return	4.79%	4.30%	4.41%	7.08%	8.58%
May 2017 OAS Chg	-8bps	-1bps	-10bps	-29bps	
2017 Excess Return	3.29%	2.65%	2.97%	5.88%	

Source: Barclays

Turning to sector performance, a few themes stand out. First, Pharmaceuticals, the worst performing sector in April, outperformed meaningfully in May, up +6.3%. Better-than-expected earnings results from several constituents (amplified by some short covering) drove the solid total return for the month. Valeant Pharmaceuticals, the sector's largest constituent, led the charge with its longer-dated unsecured bonds up +6-8pts over the course of the month. Next, Healthcare posted solid returns with hospital bonds (notably Community Health) benefiting from an earnings rally and largely ignoring the headline risks surrounding healthcare reform (investors generally understand the AHCA to be DOA in the Senate). Wireless credits also performed well with large capital structures re-pricing higher amid heighted M&A rhetoric. Underperforming this month were Industrial Other, Energy-related sectors and Transportation Services. The Industrial Other sector was impacted by a single issuer, Noble Group, which saw its bonds trade from 95 cents to 40 cents virtually overnight after the commodity trading business disclosed significant losses from a coal trading strategy gone awry. Within Transportation Services, Hertz, and to a lesser extent Avis Budget Group, weighed on sector performance following poor earnings results that confirmed fears of declining residual values and emerging competition from ride-sharing services. Away from these idiosyncratic situations, Energy-related risk, specifically higher beta credits (those with significant negative operating leverage to sub-$50 oil), underperformed in May given lower/volatile oil prices as fears of U.S. shale production growth overshadowed the extension of OPEC production cuts.

Best Sectors	May	YTD
Pharmaceuticals	6.30%	8.28%
Banking	1.91%	6.36%
Healthcare	1.87%	7.32%
Wireless	1.74%	6.26%
Paper	1.71%	6.16%

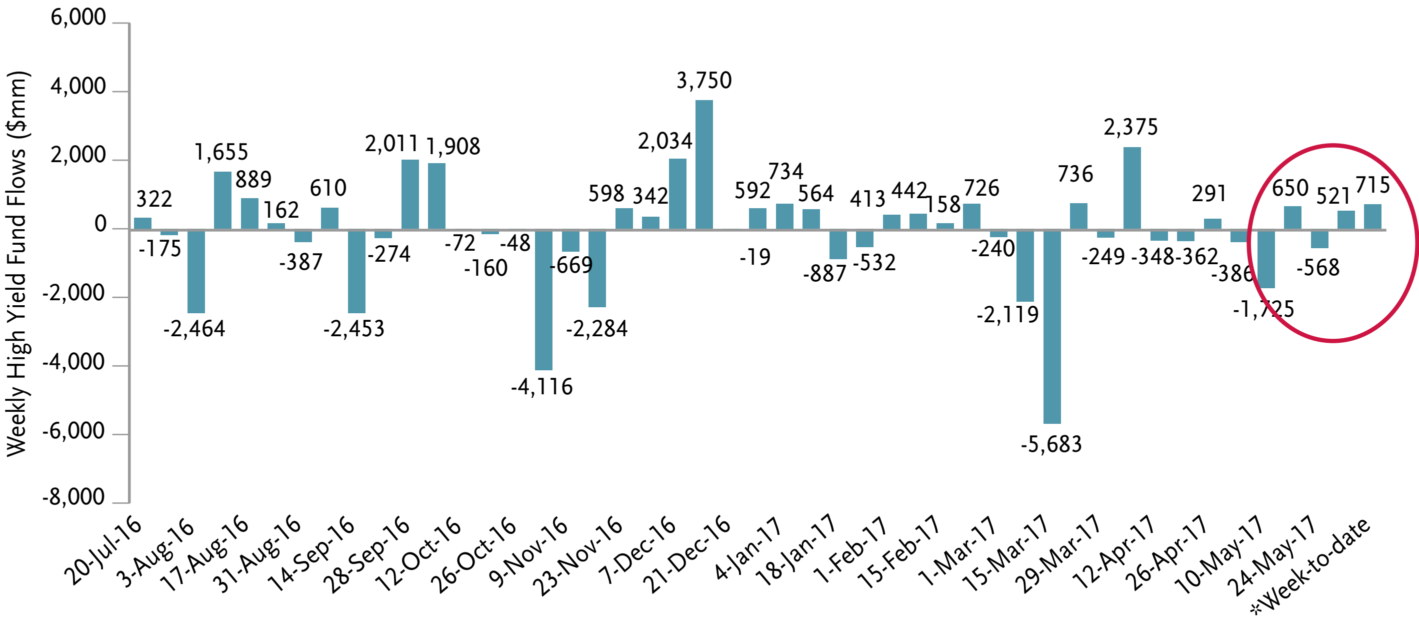
Worst Sectors	May	YTD
Industrial Other	-3.18%	2.19%
Oil Field Services	-0.84%	4.23%
Consumer Products	-0.33%	2.88%
Transportation Services	-0.26%	5.15%
Independent	0.71%	1.52%

Source: Barclays

MARKET TECHNICALS

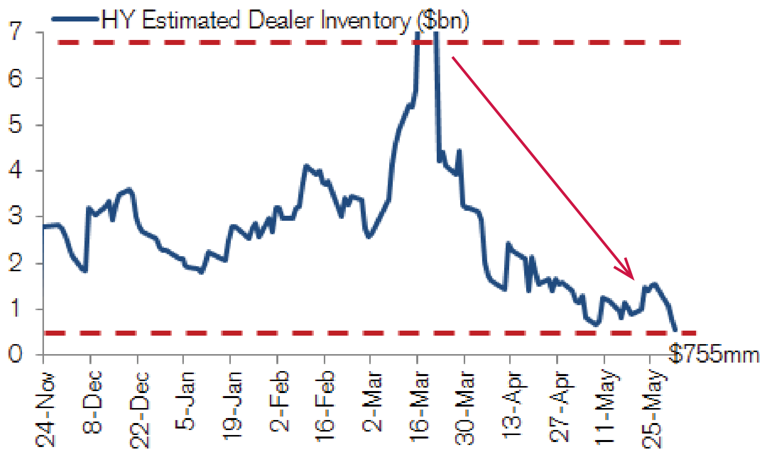
The technical backdrop ultimately proved supportive in May, aiding the steady move higher in prices. Fund flows were net negative for the month (-$1.9bn per Lipper), though this had a negligible impact on market liquidity. In fact, the narrative of too much cash chasing too few bonds remained in full force, and it is likely the case that much of the net outflows attributable to ETFs simply reflected a rotation on the part of actively managed funds out of HYG and into newly issued cash bonds (i.e. liquidity did not actually leave the marketplace). Compounding the narrative, dealer inventories held near multi-year lows forcing investors to bid up in order to source paper.

Modest Net Outflow Did Little To Drain Excess Liquidity From the Marketplace



Source: Lipper, JPMorgan

Dealer Inventories Are Well Off the Mid-March Highs and Are Now Exacerbating the Technicals



Source: Credit Suisse

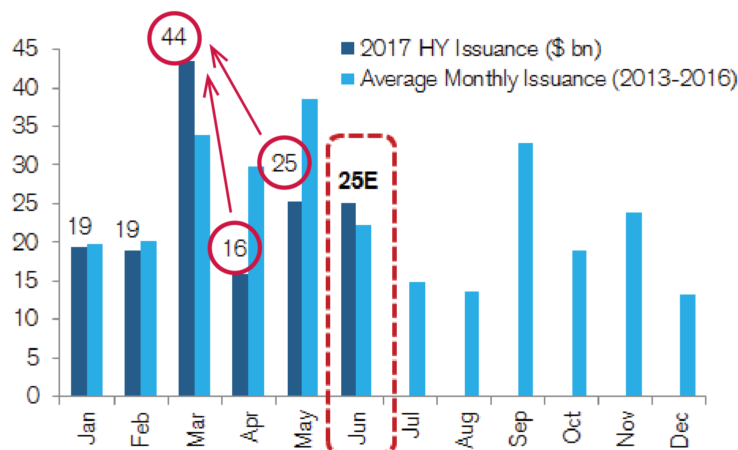
New issue volumes underwhelmed for a second straight month, with only $26bn in USD-denominated bonds clearing the primary market. That is up from the $16bn that priced in April, but below the $35-40bn volumes typically realized during the month of May. Historically, May's primary calendar is full with benchmark refinancings from seasoned issuers looking to satisfy their capital markets needs before the summer lull. This year, however, many of these deals were pulled forward into March, cannibalizing May (and April) supply. The result, a new issue pipeline spotted with smaller deals unable to satiate demand for bonds.

High Yield Net Supply ($mn)

Month	New Issue	Redemptions	Net Supply	Monthly Returns
4/30/16	31,176.00	18,454	12,722	3.92%
5/31/16	28,355.00	31,534	(3,179)	0.62%
6/30/16	22,334.00	31,021	(8,687)	0.92%
7/31/16	13,327.00	22,719	(9,392)	2.70%
8/31/16	16,647.00	22,606	(5,959)	2.09%
9/30/16	25,207.00	29,030	(3,823)	0.67%
10/31/16	13,452.00	35,225	(21,773)	0.39%
11/30/16	15,282.00	22,208	(6,926)	-0.47%
12/31/16	18,581.00	26,359	(7,778)	1.85%
1/31/17	18,803.00	20,783	(1,980)	1.45%
2/28/17	18,916.00	26,891	(7,975)	1.45%
3/31/17	42,629.00	32,555	10,074	-0.22%
4/30/17	16,225.00	33,967	(17,742)	1.15%
5/31/17	26,426.00	28,265	(1,839)	0.87%

Source: Barclays

Seasonally High New Issue Volumes in May Were Pulled Forward Into March

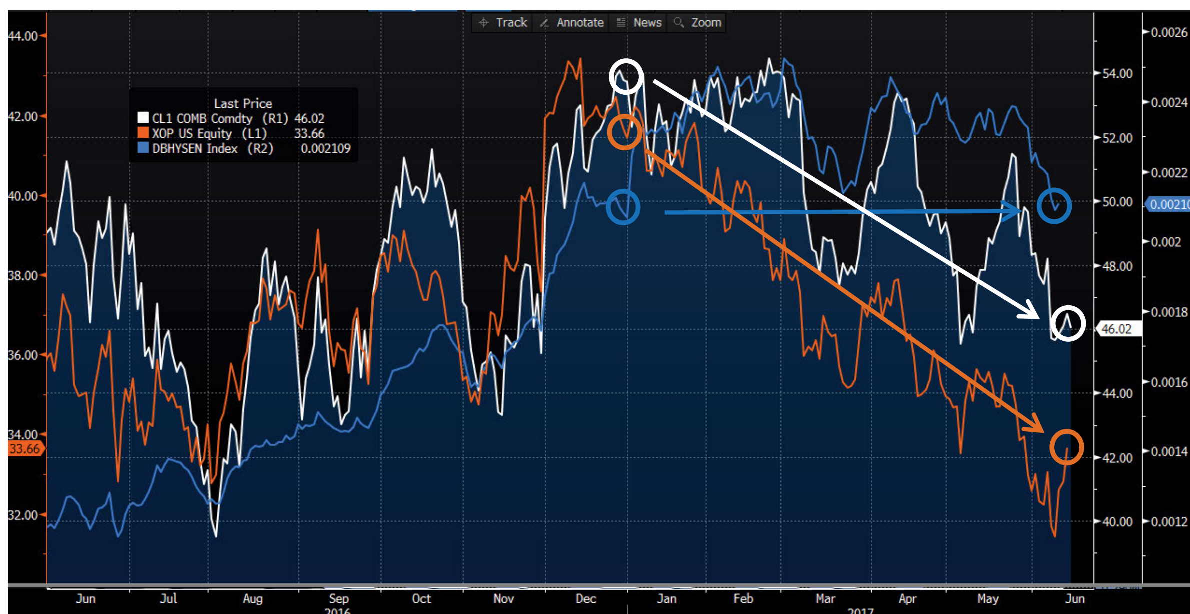


Source: Credit Suisse

FUNDAMENTAL TRENDS

Corporate default volumes increased month-over-month, though remained low relative to volumes realized a little over a year ago. Five issuers (bond and loan) defaulted on $2.7bn of debt in May ($2.9bn including distressed exchanges), three of which related to the oil and gas industry. While the distressed/value investor lens has refocused its gaze away from commodity-levered credits towards emerging opportunities in Retail and Transportation Services, these energy-linked defaults are a sobering reminder of the vulnerability of these capital structures to low commodity prices, particularly in light of the fact that domestic oil prices have been in a downward trend since February and have now settled below $50/bbl testing mid-$40/bbl support levels.

Risk Premiums for High Yield Energy Bonds Have Remained Stable YTD Despite Deteriorating Fundamentals. YTD HY Energy Spreads Are Flat While WTI Is Down -$8 and Energy Stocks Are Down -19%



Source: Bloomberg

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865 South Figueroa Street | Los Angeles, California 90017 | 213 244 0000 | @TCWGroup