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INSIGHT

MONTHLY COMMENTARY

May High Yield Credit Update

BRIAN GELFAND | 18 JUNE 2019

The market giveth and then it taketh away. That sentiment worked from multiple perspectives this past month, whether from the vantage of the issuer – incrementally accommodative capital markets quickly began to shutter, particularly for marginal credits – or the investor – mark-to-market gains in April were effectively unwound in May. Growing trade tensions with China and Mexico, deteriorating fundamentals for global commodity prices (notably oil), as well as geopolitical unease between the US and Iran may have been the catalysts for the risk-off trade mid-month, though more interestingly (importantly), they exposed an already fragile fundamental foundation:

1. **Decline in investor risk tolerance –** we have observed several indicators of elevated risk aversion this year despite the headline data suggesting a high-returning, risk-on backdrop for high yield credit. This vulnerability was exposed in May with CCCs underperforming BBs in a material way as investors were no longer willing to lend support to a growing list of marginal capital structures.
2. **Very poor market liquidity –** this slices both ways as we currently are observing amid the rebound in June, though in May, bid-ask spreads widened meaningfully as momentum built to the downside led by outflows from ETFs. These spikes in volatility expose the tenuous liquidity position in which credit markets find themselves. In December, the excuse for the 'gappy' price action was lower market participation due to the holiday season and year-end (dis) incentives. In May, several trading days felt very similar to those in December with average spreads of high yield bonds widening +75 basis point (bps) in a hurry. What's the excuse this time?

These current features of the marketplace represent a vulnerability as well as present an opportunity. A vulnerability when investor behavior becomes complacent and credit risk is mispriced with spreads near cyclical tights. Though this can quickly give way to opportunity as order swings to disorder and credit risk re-prices swiftly and meaningfully.

Market Performance

The risk-off trade in May resulted in the first negative total return month for high yield bonds this year. The -1.19% drawdown (partially) unwound the near 9% gains through April, one of the strongest starts to a year for the high yield market in its history. The deep bid for Treasuries helped soften the blow as interest rates sank ~35bps along the term structure. Indeed, excess returns (performance in excess of that attributable to the move in interest rates) were -2.50% for the month.

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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.

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We observed beta decompression during the month as is typical with risk-off trends. A flight to quality was exhibited inter-asset class (stocks and HY bonds into Treasuries) as well as intra-asset class (CCCs and cyclical risk into BBs and non-cyclical risk). Moreover, already tentative investor risk tolerance (an underappreciated feature of the current market environment) gave way to broader capitulation across a number of challenged capital structures (more on these idiosyncratic meltdowns below). In terms of performance, BB-rated bonds earned a total return of -0.69% while CCCs lost -2.73%. On a year-to-date basis, BBs are now outperforming higher risk CCCs by 1.31%.

HY Performance	HY	Ba	B	Caa	Ca-D
May 2019 Total Return	-1.19%	-0.69%	-1.18%	-2.73%	-4.30%
2019 Total Return	7.49%	7.65%	7.59%	6.34%	15.85%
May 2019 OAS Chg	75bps	68bps	83bps	112bps	
2019 Excess Return	4.58%	4.54%	4.83%	3.61%	

Source: Bloomberg, Barclays

Few sectors were left unscathed this month save for those with large constituents that realized discrete right-tail event catalysts, namely Sprint. The positive performance for the Wireless sector was propelled by the rally in Sprint bonds after FCC Chairman Pai announced plans to approve the Sprint/T-Mobile merger subject to certain agreeable concessions. While the ultimate path forward remains uncertain – the market awaits DoJ approval and resolution to a pending lawsuit filed by a consortium of State Attorneys General – the bonds rallied meaningfully (+3-9 pts along the curve) following the FCC news as the market-implied odds of deal approval reset higher. Outside of Sprint, most outsized price movers this month were to the downside, with several capital structures experiencing drawdowns of -10 to -20pts! Several of these meltdowns occurred in the Energy sector (Halcon Resources, Weatherford International, Comstock Resources), which has seen a fair number of credits completely lose sponsorship this year due to a combination of declining commodity prices and growing aversion toward the sector. However, the stress has begun to filter through to other corners of the market with significant drawdowns observed in May in Pharmaceuticals (Mallinckrodt), Metals and Mining (U.S. Steel, AK Steel, First Quantum), Automotive (Adient), Retail (JC Penney) and Technology (Exela) sectors, to name a few.

Halcon Resources (HKUS) – Just One Example of Total Loss of Investor Sponsorship

Source: Bloomberg

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Best Sectors	May	2019
P&C	1.27%	10.89%
Wireless	1.13%	8.76%
Railroads	0.34%	8.14%
Airlines	0.20%	4.90%
Office REITs	0.15%	5.28%

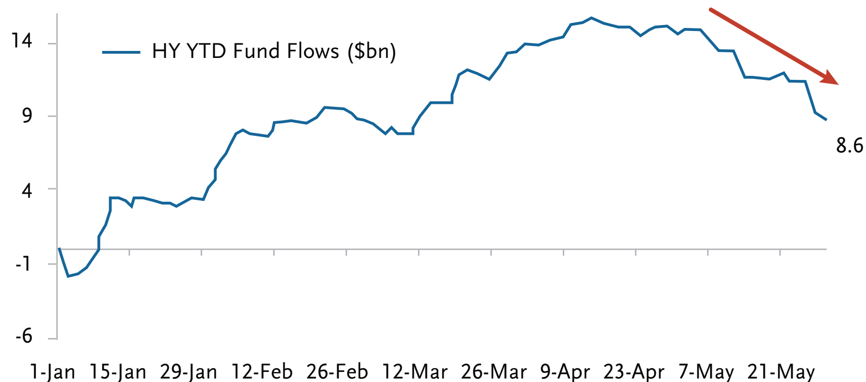
Worst Sectors	May	2019
Oil Field Services	-8.57%	4.40%
Independent	-3.99%	4.05%
Pharmaceuticals	-2.80%	7.53%
Automotive	-2.29%	5.47%
Metals and Mining	-2.23%	6.01%

Source: Bloomberg, Barclays

Market Technicals

The positive momentum in high yield market technicals (particularly demand side technicals, i.e. fund flows) inflected in May. High yield funds, specifically ETFs, which had accumulated just under $15bn of inbound capital this year through April, faced approximately $6bn in redemptions this month. Daily fund flows became increasingly volatile towards the end of the month in particular, with HY ETFs experiencing $1bn+ intra-day outflows in late-May/early-June.

The Steady Stream of Capital Into The High Yield Market This Year Reversed in May



Source: Credit Suisse, EPFR

Issuers identified a window early in the month to capitalize on accommodative market conditions following the April rally, accessing the market for needed (and opportunistic) capital. Over $23bn in USD-denominated high yield bonds were syndicated into the marketplace in May, with a significant percent of the volume clearing before the inflection in market conditions – nice timing. Indeed, issuers, particularly marginal credits, have become very quick to exploit any opportunity to raise needed financing, so as not to risk the capital markets shuttering on them as was the case in Q4'18. Issuance took a pause in late-May / early-June, however, as marginal credits were sidelined by the sudden shift in risk tolerance. Moreover, higher quality, opportunistic issuers elected to wait out the storm in hopes for a better day. Incidentally, calmer seas re-emerged in mid-June, at least for high quality borrowers, and these credits immediately launched their latent deals.

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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%
5/31/19	23,490	9,001	14,489	-1.19%

Source: Barclays

Fundamental Trends

We welcome our readers to view our recent memo posted to the TCW website, Beneath the Aggregates: Growing List of "Idiosyncratic" Collapses. Here, we expand on our observation that despite the relative calm signaled by market aggregates (i.e. trailing default rates, credit spreads, distress ratios, total return), a growing (and underappreciated) universe of capital structures have seen the price of their bonds drop precipitously this past year: -10, -20, and upwards of -50 to -80pts. These incidences are seemingly increasing in size of capital structure and sector reach. While idiosyncratic in their drivers, common among them is evidence of waning investor risk tolerance, which has the potential to reset prices (transmit) more broadly. In May, four such high yield borrowers defaulted on their obligations, including Weatherford International, Bristow, Cloud Peak Energy and Sungard Availability. Weatherford, in particular, is of note, representing a large capital structure (and sector) that has been propped up by risk-seeking investor behavior since 2016 only to now (since October 2018) see that support pulled completely.

Works Until it Doesn't – WFT 9.875s Traded Near Par in October 2018, Now at 50c

Source: Bloomberg

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