TCW

INSIGHT

MONTHLY COMMENTARY

June High Yield Credit Update

BRIAN GELFAND | JULY 14, 2016

Brexit...what Brexit? While not the sentiment we share, and not to make light of an event which we believe signifies real fundamental risk to global economic, financial and political systems, it is hard to construe the response in the high yield marketplace any other way. High yield investors were offside given the outcome of the vote; however, the initial unwind was quite orderly and the dip shallow (high yield bonds were down a meager 1-3pts the day after the vote. This compares favorably to far more violent price action seen in global stock, rates and currency markets). Outflows did materialize, though were modest, short-lived and easily absorbed with cash on hand rather than inciting much in the way of forced selling. After the dust had settled, the rally in Treasuries, combined with an emerging appetite from foreign capital for U.S. credit risk, brought high yield benchmark prices near or above pre-Brexit levels by month-end (a trend which has accelerated significantly month-to-date in July).

The Impact of Brexit On Prices for HY Bonds was Virtually Erased By Month-End

	6/17/16 The Week Before	6/23/16 Thursday Night	6/24/16 Friday Morning	6/30/16 Month End	Chg since Thursday Close
HY26	102.01	103.32	101.77	103.40	+0.08
HYG	83.13	84.64	82.90	84.70	+0.06
S '23	77.00	82.50	80.50	82.75	+0.25
DISH '26	101.25	102.75	101.25	103.50	+0.75
FCX '23	82.00	87.50	86.50	87.75	+0.25
HCA '26	103.00	103.75	102.50	104.25	+0.50
FDC '24	99.25	100.00	99.00	100.50	+0.50
S&P 500	2,071	2,113	2,040	2,103	-0.47%
UST 10yr	1.61%	1.74%	1.54%	1.42%	-32bps

Source: Bloomberg

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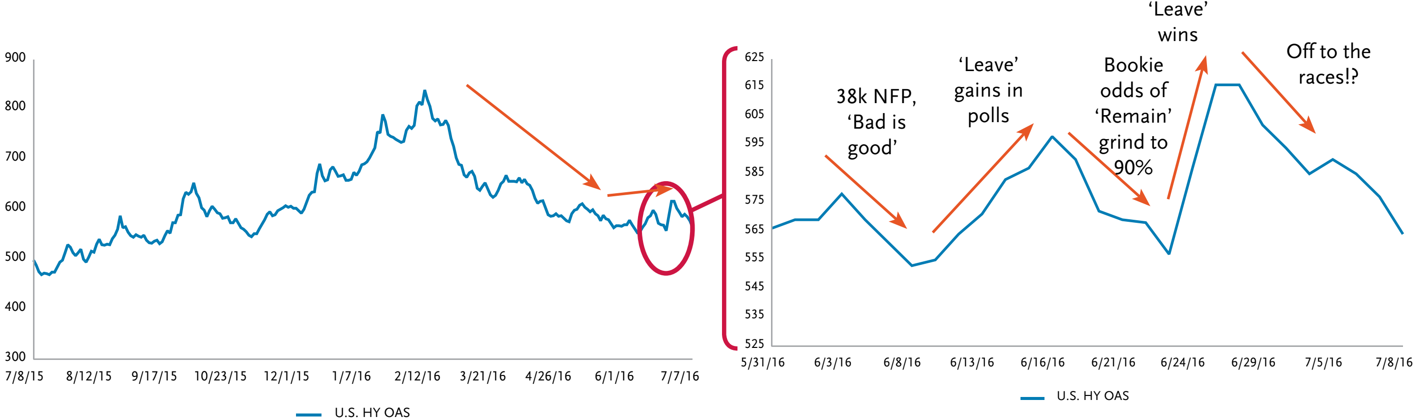
Mr. Gelfand is a Vice President in the U.S. Fixed Income group, where he trades high yield securities. Mr. Gelfand joined TCW in 2014 as a Credit Analyst responsible for research in the telecom, technology, and media sectors. Prior to joining TCW, he interned at PIMCO in the Portfolio Management Group 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.

The momentum in the marketplace following Brexit has prompted some proponents to frame U.S. high yield as a "sweet-spot" among the opportunity set of global credit, given its limited direct exposure to UK/EU fundamentals and relatively attractive nominal yields in an increasingly 'yield-less' world. While the thesis appears to hold water for now, we expect it to come under significant pressure as the transmission of risk through 2nd, 3rd and higher order channels becomes increasingly apparent. As such, although the technicals reign supreme, we do not see fundamental support to chase the rally in a post-Brexit world.

Market Performance

Volatility returned to the high yield marketplace in June, temporarily (as it were) bucking the virtual one-way trade that took hold beginning back in mid-February. The uncertainty created by the then-pending referendum heightened investor paranoia as the market digested a daily barrage of polling updates, gyrating commodity prices (WTI repeatedly bounced between ~$50/bbl and $46/bbl several times during the month), and (un)ambiguous economic data with associated central bank rhetoric. The surprise outcome of the vote did little to pave a clear path forward. In fact, the political and fundamental outlook is incrementally blurred by the result. That being said, after an orderly and short decline in high yield prices in the immediate aftermath of the Brexit announcement, it was off to the races as both U.S. risk and risk-free assets became the de facto destination of capital flows clamoring for relatively "insulated" and positive yielding paper.

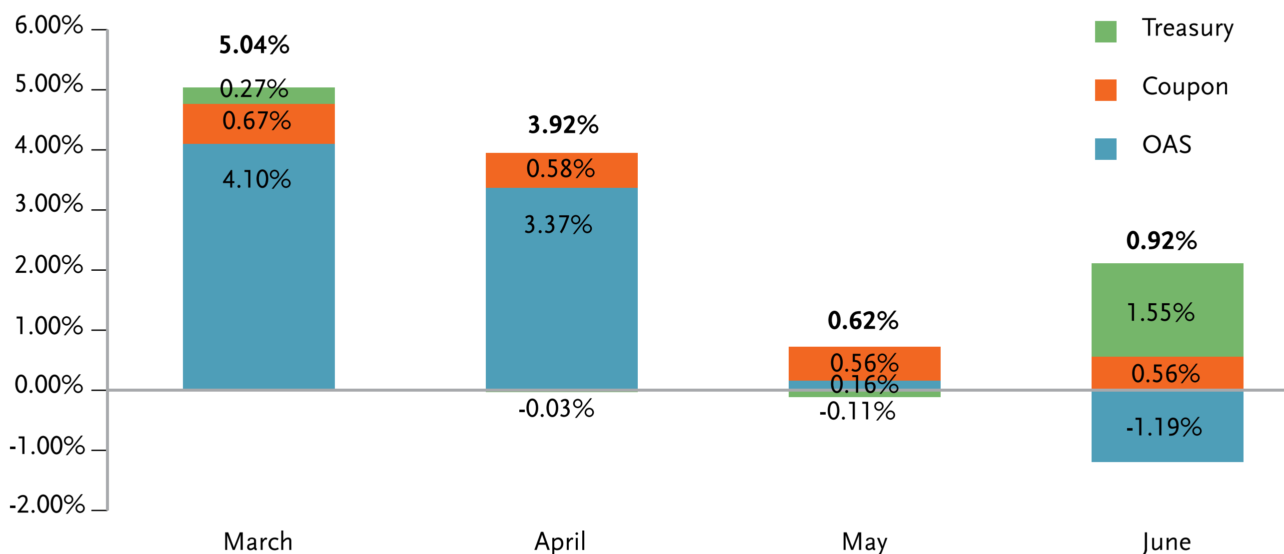
Volatility Emerged In the Lead Up and Immediate Aftermath of the UK Referendum



Source: Barclays

We highlighted the evolution of performance attribution last month and it is worth noting again here. Following a relentless rally from the mid-February wides, much of the momentum in spread compression has been exhausted and we saw that play out in May, with total return for the month carried essentially by carry. In June, spreads became a drag on performance with the sell-off in the immediate aftermath of the Brexit results driving risk premiums higher across the quality spectrum. Indeed, spread widening cost the U.S. HY index -119bps of performance for the month (all of which realized between June 24 and month-end), pressuring both coupon and, more importantly, treasuries to shoulder total return. Treasuries were up to the task, however, with interest rate duration contributing +155bps to performance resulting in a respectable return for the month of +92bps.

A Decline In Treasury Yields Drove Positive HY Performance In June as Spreads Widened M/M



Source: Barclays

On an absolute basis, spreads of CCC-rated bonds widened more than those of BB- and B-rated credits during the month; however, on a relative basis, and from a total return perspective, CCCs won the day. CCCs earned +1.50% in June, while distressed securities realized an impressive +6.43% (the latter resulting primarily from idiosyncratic drivers versus market beta). This compares to BB and Single-B performance of +0.70% and +0.81%, respectively. While the move in Treasuries was less of a tailwind for CCCs versus BBs/Bs given lower interest rate duration, the move in spreads was similarly less of a headwind given the lower spread duration of CCCs – with the relative carry accounting for the difference.

CCC + Distressed Outperformed as A Result of Lower Duration, Higher Carry and Idiosyncratic Catalysts

HY Performance	HY	Ba	B	Caa	Ca-D
June 2016 Total Return	0.92%	0.70%	0.81%	1.50%	6.43%
2016 Total Return	9.06%	7.60%	7.41%	16.03%	39.44%
June 2016 OAS Chg	+28bps	+31bps	+29bps	+51bps	
2016 Excess Return	+503bps	+323bps	+350bps	+1,269bps	

Source: Barclays

The composition of sector performance did not deviate too far from what we have come to expect in recent months. Metals & Mining remained a top performer and Energy credits across the value chain of E&P, Services and Midstream had a strong showing in June. Although commodity prices, particularly WTI, were volatile during the month, the high nominal IRRs on offer in these sectors relative to the rest of the market remain a siren's song to weary investors looking for yield. Moreover, price action within these sectors during the month was favorably impacted by idiosyncratic self-help/balance sheet repair initiatives, including terming out maturities, equity-for-debt exchanges and asset sales. Renewed capital markets accessibility for these companies has been critical in order to effect these strategies, and as such, we remain wary of adding commodity-linked credit risk around these events given the low risk-adjusted returns on offer and the dependence of these capital structures on a sustained risk-on trade which we believe to be near or past its expiration. Sectors that underperformed during the month included Pharmaceuticals, largely attributable to price volatility in Valeant bonds, and Banking, the constituents of which include subordinated indebtedness of European financial institutions and the bonds of a cyclically sensitive domestic auto lender, which were acutely impacted by the outcome of the Brexit vote and the subsequent collapse in interest rates.

E&P and Metals & Mining Outperformed Again In June

Best Sectors	June	2016 YTD
Oil Field Services	7.02%	18.53%
Metals & Mining	3.80%	29.70%
Independent	2.84%	25.70%
Midstream	1.34%	18.15%
Wireless	1.31%	8.41%

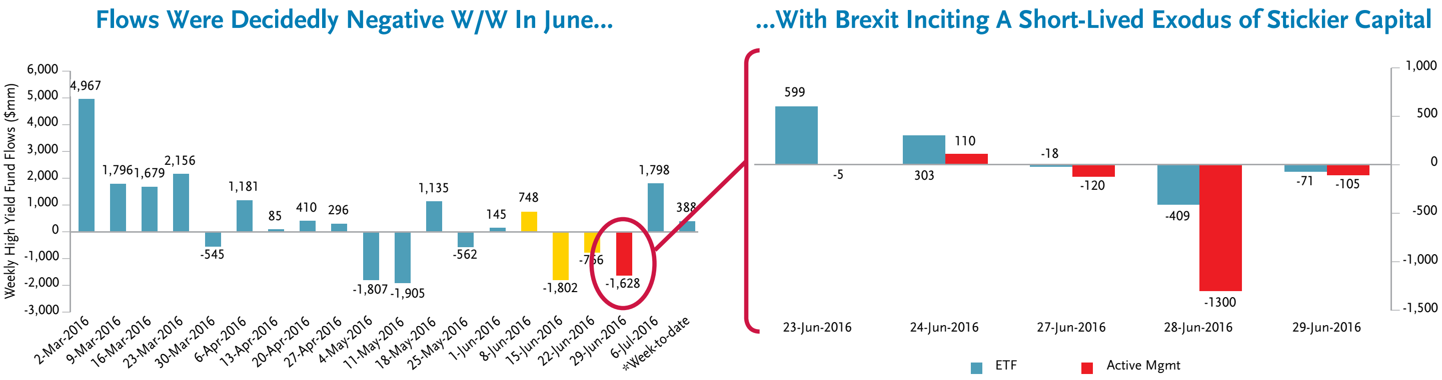
Worst Sectors	June	2016 YTD
Pharmaceuticals	-1.53%	-3.16%
Banking	-0.72%	0.74%
Leisure	-0.40%	1.78%
Cable / Satellite	-0.39%	2.72%
Media Entertainment	-0.24%	5.87%

Source: Barclays

Market Technicals

Fund flows were net negative for the month of June, with high yield ETFs and open-ended funds reporting a -$3.4bn outflow, extending the -$2.4bn outflow seen in May, and further reversing March and April's cumulative +$10.7bn inflow. Despite these outflows, in addition to those experienced during the exodus from the sector in the beginning of the year, high yield funds have still taken in $3.6bn net year-to-date. The first few weeks of the month saw much of the same in terms of flow attribution with ETFs as the marginal seller (through its arbitrage mechanism) of high yield risk. However, with real money investors (mutual funds) having stable flows, relatively high cash balances (anecdotally, funds are running with 4-6% cash versus traditional levels of 1-3%), and keen to quickly bid on any sliver of relative value in this exceedingly stretched market, the dips have been shallow and short-lived. Interestingly, a shift in the flow mix did begin to emerge in the days following the Brexit vote. Mutual funds started to see client redemptions, with the Tuesday following Brexit having a near record $1.3bn pulled from actively managed funds. As we have discussed, the

stability of this investor base has lent material downside support to bond prices during recent periods of volatility/ETF selling. Should funds begin to see clients head for the exits en masse (or should fund managers at least perceive the risk of client redemptions to have increased), reminiscent of January/early-February, what was once a supportive technical could quickly turn into a material headwind – an opportunity on which we will look to capitalize. As it turned out, Tuesday's print was an outlier (for now), with actively managed fund flows quickly stabilizing and then reversing as the search for positive nominal yields with minimal first order UK/EU exposure funneled investors into U.S. corporate credit.



Source: Lipper, JPMorgan

Primary market activity was a tale of two halves in June. The first two weeks carried the momentum of the prior two months, with deal volume averaging ~$8bn/week, comparable to the run-rate experienced in April and May. As we moved into the week preceding the UK referendum, issuers were reticent to jump off the calendar ahead of the vote as they i) recognized a premium would be demanded to clear any deal given the uncertainty in the marketplace, and ii) saw the poles pointing to a 'stay' victory and felt confident that simply waiting a week would result in more favorable terms/pricing. That confidence was quickly shattered, however, when the 'leave' camp won the day, causing issuers to remain on the sidelines as the secondary market managed through the volatility. With volumes tapering off in the back-half of the month, the high yield market priced $22.3bn in debt, off the highs for the year seen in April and May of $31.2bn and $28.4bn, respectively. June levels were still well ahead of the depressed level of activity witnessed in the beginning of the year. As sentiment in the marketplace has decidedly turned exuberant in the post-Brexit world, we would expect June's pent-up new issue backlog to be released in July.

High Yield Net Supply ($mn)

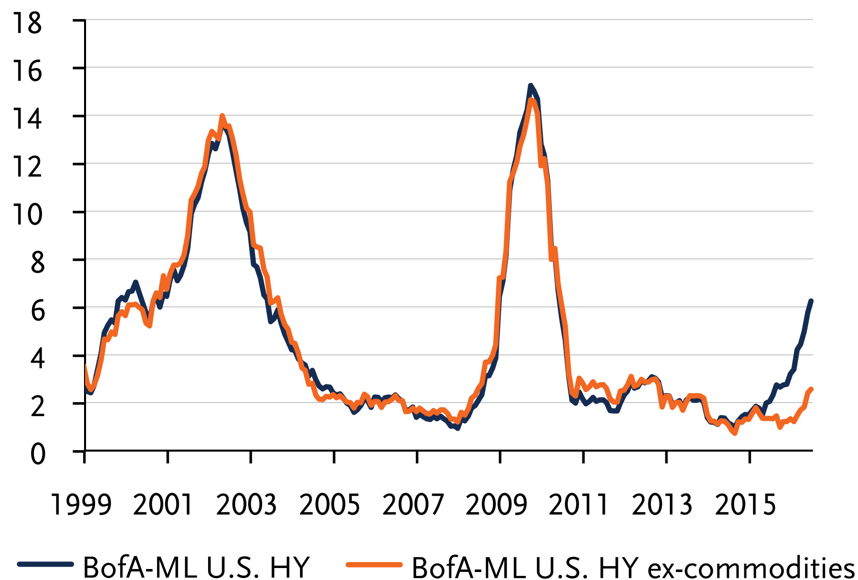
Month	New Issue	Redemptions	Net Supply	Monthly Returns
12/31/15	3,077	28,406	(25,329)	-2.52%
1/31/16	5,923	12,449	(6,526)	-1.61%
2/29/16	7,557	15,556	(7,999)	0.57%
3/31/16	18,226	12,920	5,306	4.44%
4/30/16	31,176	18,454	12,722	3.92%
5/31/16	28,355	31,534	(3,179)	0.62%
6/30/16	22,334	31,021	(8,687)	0.92%

Source: Barclay's

Fundamental Trends

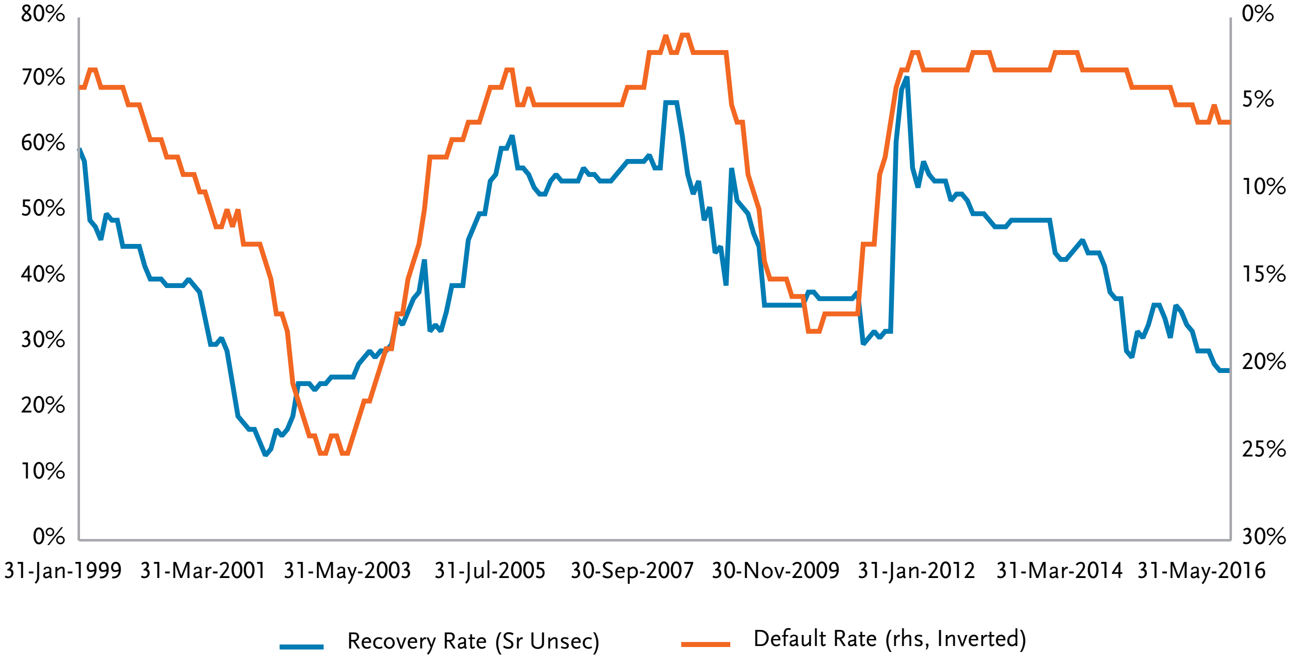
There wasn't much of a default tale to tell in the month of June as only two companies (both Energy-related) defaulted on $1.4bn of debt, a year-to-date low. With capital markets open and risk premiums well off the mid-February wides, issuers that not too long ago were facing imminent (and in many cases, needed) restructurings are finding opportunities to improve liquidity and kick the proverbial can down the road outside of bankruptcy. As noted above, debt-for-equity swaps and refinancings with longer-dated secured or senior guaranteed indebtedness (either through public tender or privately conducted secondary market repurchases) were principal amongst the strategies employed during the month, notably among stressed/distressed debtors in the commodity-linked sectors of Energy and Metals & Mining. Should market conditions remain accommodative in the coming months, we would expect this moderation in default activity to continue, though this is not our base case. Year-to-date, 37 companies have defaulted (incl. 20 Energy companies and four Metals & Mining companies), or ~$44bn of debt, which is now >15% higher than full-year 2015 volumes. The TTM default rate continued to climb in June to 6.3% (though it was 2.8% ex-Commodities).

Trailing 12-Month HY Default Rate Continued to Climb In June to 6.3%



Source: Bank of America Merrill Lynch

The path of recovery rates on defaulted debt remains an outlier when considering the current level of default activity as well as the absolute level and current trajectory of high yield spreads. Specifically, recovery rates on unsecured bonds in the low-to-mid 20s is more consistent with levels realized during the trough of the credit cycle, and traditionally a signal of depressed fundamentals, over-leveraged capital structures and weak contractual governances. We recognize a skew in the data over the past year and a half exists as defaults have been largely confined to struggling Energy and Metals credits operating in a challenging commodity price environment; however, we think it important to consider: i) that the downward trend in the data began before the decline in commodity prices, ii) the current recovery rate ex-Commodities is still depressed in the low-to-mid 30s, and iii) while prior cycles have each had their sector(s), which experienced the downturn most acutely, fundamental stress rarely occurs in a vacuum.



Source: Moody's Investor Services, Barclays Research

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