TCW

INSIGHT

MONTHLY COMMENTARY

June High Yield Credit Update

BRIAN GELFAND | JULY 14, 2017

The first half of 2017 is in the books and a quick glance at the chart below of high yield bond spreads pretty much sums it up – an uninspiring grind tighter interrupted by a few ephemeral bouts of oil and interest rate induced volatility. As a result, high yield bonds returned a respectable +4.93% during 1H17 (i.e. coupon plus some modest spread tightening).

Poor Valuations Following the 2016 Rally Make it Difficult for Marginal Spread Tightening

Source: Barclays

Turning to June, high yield bond performance during the month can generally be bifurcated into two cohorts, *oil* and *not oil*. That is not to say idiosyncratic factors didn't drive name specific volatility. Indeed, names like Frontier, Hertz, PetSmart and certain leveraged grocers saw capital structures come under pressure while select distressed retail credits (J.Crew, Claire's) experienced a relief rally. However, as spot WTI fell below $45/bbl for the first time since November 2016, oil-linked credits re-priced lower while the rest of the market was largely left unscathed. Importantly, while market prices for energy risk did indeed decline with crude, trading volume at these lower levels was relatively light. The recent memory of selling energy bonds at the lows and missing the rebound, in addition to stable fund flows, persuaded investors to refrain from large scale selling...at least for the moment. A bias that was

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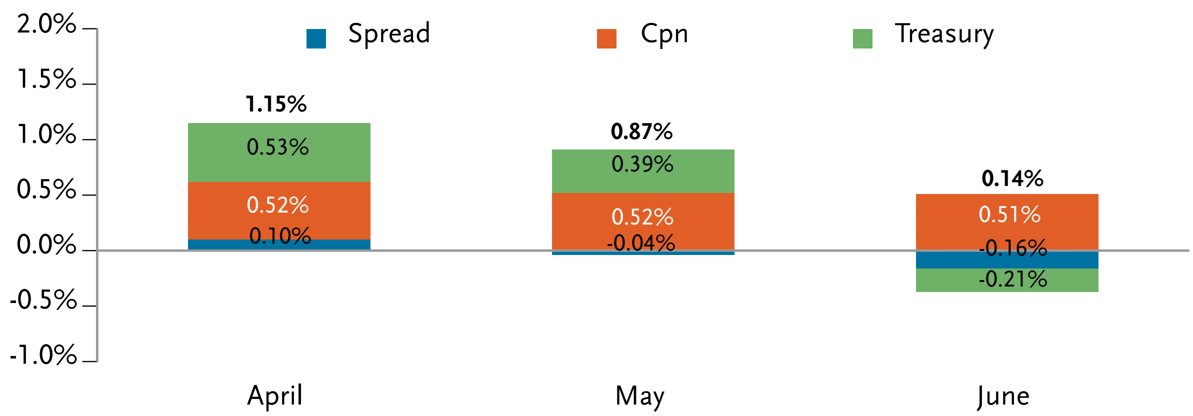
likely reinforced as spot WTI bounced off oversold levels towards the end of the month. As such, it would appear a sustained period of <$40/bbl oil will be necessary to truly knock energy-linked bonds off their perch.

MARKET PERFORMANCE

The one-two punch of oil and interest rates almost pushed high yield bond returns into the red in June; however, ~50bps of monthly coupon cushioned the body blow. As a result, high yield bonds returned +0.14% for the month, with an excess return of +0.35%.

Rates and Risk Sold Off in June as Coupon Carried Total Return



Source: Barclays

Higher quality, highly rated credits outperformed in June as BBs generated a +0.47% total return while Bs and CCCs posted -0.12% and -0.45% returns, respectively. A few considerations here:

1. Energy spreads decompressed – higher beta energy bonds (generally characterized by E&Ps with high financial leverage and legacy basin exposure requiring higher commodity prices to earn a profit, as well as Oil Field Services) sold off meaningfully in June relative to higher quality credits (i.e. well capitalized, Permian / Marcellus basin focused E&Ps plus Midstream), which remained fairly well bid. Indeed, the energy drag on performance was rather pronounced for B- and CCC-rated cohorts, whereas in the case of BBs the impact was fairly de minimis (see tables below).
2. Duration was well bid – BBs, with higher empirical duration, benefited from the rally in Treasuries during the first half of the month. Moreover, as Treasuries sold-off sharply during the last few days of the month, BBs proved resilient, preserving prior gains.

The result, spreads on BBs, particularly longer-duration 8-10yr bonds, went from tight to tighter (-12bps m/m). Also not to be overlooked, sharp re-pricings in the capital structures of specific distressed and special situation credits, including J.Crew, Claire's Stores and Cumulus Media to name a few, earned solid returns for the distressed cohort.

BB-Rated Bonds Outperformed in June...

HY Performance	HY	Ba	B	Caa	Ca-D
June 2017 Total Return	0.14%	0.47%	-0.12%	-0.45%	2.66%
2017 Total Return	4.93%	4.79%	4.28%	6.59%	11.47%
June 2017 OAS Chg	-2bps	-12bps	6bps	6bps	
2017 Excess Return	3.65%	3.38%	3.05%	5.55%	

Source: Barclays

...As Energy Bonds, Specifically High-Beta Energy Bonds, Dragged Down B/CCC Returns

Quality	30-Jun	2017
Impact of Energy		
High Yield x Energy	+0.50	+5.55
High Yield Ba x Energy	+0.59	+4.91
High Yield Ba x Energy	+0.18	+4.90
High Yield CCC x Energy	+0.74	+8.96

Source: Barclays

Much of the high yield market ex-Energy experienced a steady grind higher in price, with little differentiation in the returns among the top performing sectors. Of particular note, however, was the higher dispersion among the underperformers, dominated by oil-levered credits, grocers and weakness in select benchmark new issues. It is no surprise Oil Field Services, E&P, and to a far lesser extent, Midstream, were among the worst performing sectors for the month. In fact, the sell-off during the first three weeks of June completely erased the Energy sector's YTD gains, driving total return negative for a brief period before remediating back into positive territory by the end of the month. Away from Energy, Supermarket bonds (and stocks) were hit hard following Amazon's announced acquisition of Whole Foods. The weakness was compounded in the subsequent days with the (un)timely resignations of prominent industry executives (namely, the CEOs of The Fresh Market and Southern Grocers (formerly, Bi-Lo)). In addition, certain "hot" new issues from late-May traded down in June, namely PetSmart (secured and unsecured bonds) and Hertz (2nd lien), given poor valuations and weak technicals.

Best Sectors	June	YTD
Leisure	1.40%	5.77%
Banking	1.31%	7.76%
Finance Companies	1.18%	5.29%
Transportation Services	1.04%	6.25%
Home Construction	0.89%	6.52%

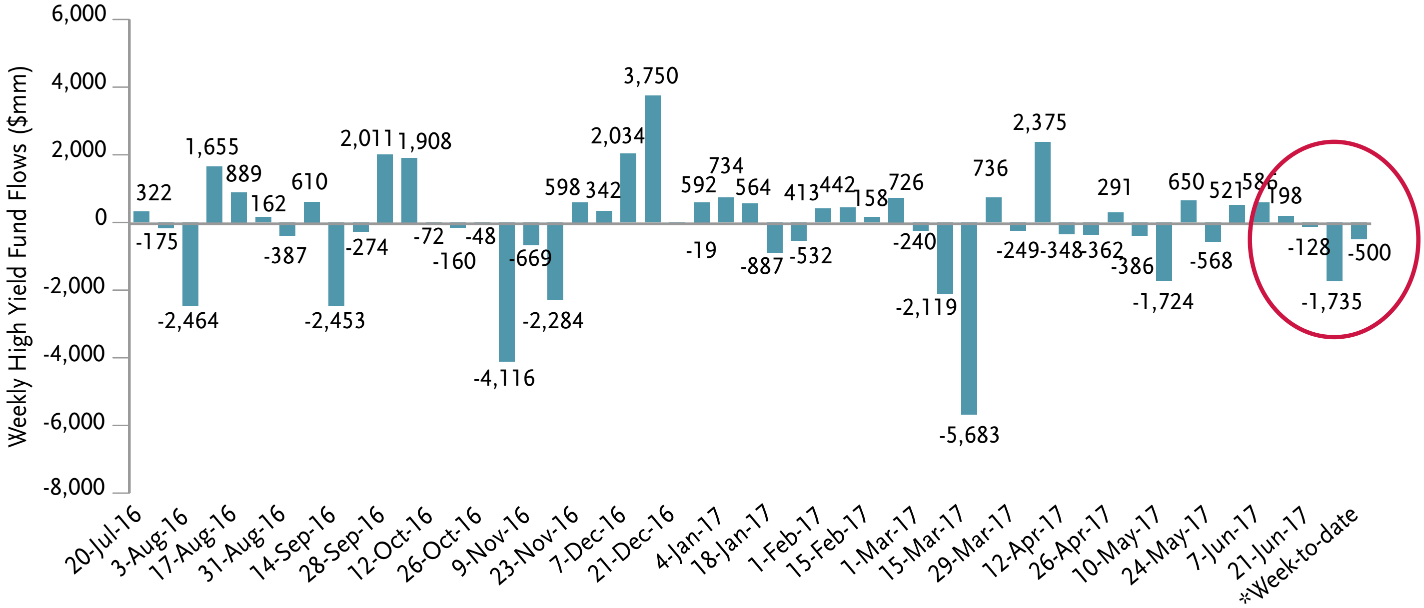
Worst Sectors	June	YTD
Oil Field Services	-3.97%	0.09%
Independent	-2.83%	-1.35%
Supermarkets	**-1.54%**	2.37%
Midstream	-0.29%	4.58%
Wirelines	-0.23%	4.08%

Source: Barclays

MARKET TECHNICALS

Although valuations are stretched today, no one is being forced to sell (a theme that continues to lend technical support to bond prices). A modest exodus did occur during the depths of the energy move intra-month as the sector-specific drawdown began to weigh on the psychology of the broader market. Net fund flows totaled -$1.1bn in June. However, outflows were largely confined to HYG and the selling pressure did little to re-price the market (ex. Energy) lower given a deep bid from fund managers with excess cash.

Contagion From the Energy Sell-off to Broader Market Sentiment was Limited



Source: Lipper, JPMorgan

New issue volumes were decent in June (seasonally consistent), mostly comprised of smaller deals from less frequent borrowers, as many of the benchmark issuers completed their financing needs earlier in the quarter. That being said, we did see a multi-billion dollar refinancing from Tenet Healthcare early in the month, and Charter Communications attempted to clear a new $1.5bn 10.5yr unsecured bond inside 5%, but failed to draw sufficient interest and later opted to finance in the IG market on a secured basis. $20bn in USD-denominated bonds cleared the primary market during the month. Issuers that did bring forth a deal were generally rewarded with favorable terms from investors, and higher yielding bonds with cleaner fundamental stories were met with solid demand, including Surgery Partners (high top-line growth supported by favorable outpatient trends) and Intelsat Jackson (sufficient asset coverage through position in capital structure).

High Yield Net Supply ($mn)

Month	New Issue	Redemptions	Net Supply	Monthly Returns
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%
6/30/17	19,271.00	37,114	(17393)	0.14%

Source: Barclays

FUNDAMENTAL TRENDS

Default volumes picked up in June, though remain mild by historical standards as still very accommodative capital markets afford even the most strained balance sheets a temporary stay of execution. At some point, however, certain capital structures simply no longer work. A total of six leveraged borrowers defaulted on their financial obligations during the month totaling $4.4bn (both bonds and loans). GenOn Energy, a wholesale power generation subsidiary of NRG Energy, filed for Chapter 11 to implement a restructuring plan the company had negotiated with its unsecured bondholders and NRG. The other prominent bankruptcy filing in June was that of children's retailer Gymboree. Declining sales from increased competition and an over-levered balance sheet forced the company to restructure its debt and reorganize around a smaller store base (the company will shutter over 25% of its footprint).

GenOn Energy and Gymboree Represent the Second and Third Largest Bankruptcies of 2017

Date	Company	Bonds ($mn)	Loans ($mn)	Total ($mn)	Industry
19-Jan	Avaya	2,683.2	3,233.9	5,917.2	Technology
14-Jun	**GenOn Energy**	**2,521.2**	**-**	**2,521.2**	**Utility**
11-Jun	**Gymboree**	**171.0**	**768.8**	**939.7**	**Retail**
4-Jan	Bonanza Creek	800.0	-	800.0	Energy
15-Apr	rue21	250.0	521.0	771.0	Retail
8-Mar	American Energy Marcellus	-	708.4	708.4	Energy
3-May	Ameriforge Group	-	662.1	662.1	Energy
4-Apr	Payless Shoesource	-	650.7	650.7	Retail
22-May	Mood Media Group	350.0	228.0	578.0	Diversified Media
1-Feb	Vanguard Natural Resources	508.6	-	508.6	Energy
	Total	**7,284.0**	**6,772.8**	**14,056.8**	
	Percent of all defaults	**77%**	**80%**	**78%**	

Source: J.P. Morgan

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