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INSIGHT

MONTHLY COMMENTARY

June High Yield Credit Update

BRIAN GELFAND | 19 JULY 2019

Here at the halfway mark in 2019, reflecting on the past six months feels appropriate. The 10%+ total return year-to-date has been impressive no doubt, though the evolution and composition of the performance is particularly interesting. The first six months can be parsed into four distinct phases:

Phase 1 (Q1'19) – characterized by a swift and broad-based reflation in credit off the December lows. Capital markets activity re-initiated. Performance across credit quality was uniform in that BB and CCC-rated bonds equally earned a 7%+ total return. The latter arguably underperformed its historical beta amid such a reflation with early evidence of certain breakable capital structures getting left behind (hence our "risk averse" rebound characterization).

Phase 2 (April) – observable beta compression. Now three months separated from the sell-off (and 7%+ in total return booked), risk-seeking behavior / complacency began to take hold (though felt tentative at best). This, combined with the tight relative (and absolute) spreads and negative convexity of high-quality bonds, led to a rotation down the risk spectrum. CCCs outperformed BBs by 81 bps during the month.

Phase 3 (May) – macro risks (or the appreciation thereof) flared back up (notably related to US/China trade, rising geopolitical tensions, and global growth). Softening micro fundamentals also peered through with numerous capital structures in the Energy sector completely collapsing (realized principal loss in many cases of -20 to -90pts). These discrete meltdowns grew in both frequency and sector reach. All of this combined to pressure an already tentative investor resolve, resulting in a quick unwind of April's risk rally.

Phase 4 (June to early-July) – a sharp recovery from the May sell-off, supported by calmed (for the time being) geopolitical / trade tensions, accommodative central bank rhetoric and capital inflows offset by evidence of further deterioration in micro fundamentals. The result: investor demand was acutely channeled to higher quality investments, leaving higher risk, CCC-rated debt behind.

The Evolution of This Year's 10%+ Total Return

	Phase 1	*Phase 2*	*Phase 3*	*Phase 4*	**YTD TR%**
	1/1-3/31	**4/1-4/30**	**5/1-5/31**	**6/1-7/12**	**(7/12)**
Index	7.26%	1.23%	-1.24%	2.49%	10.17%
BB	7.21%	0.95%	-0.75%	2.85%	10.72%
CCC	7.15%	1.76%	-2.76%	1.34%	7.76%
Delta	0.06%	-0.81%	2.01%	1.51%	2.96%

Source: Bloomberg, Barclays

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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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At this juncture, it would appear faith in central banking institutions to prolong the business cycle is the principal buttress for risk-asset prices. This is most evident in the pervasiveness of the "bad news is good news" investment thesis currently in both the stock and bond markets. But what influence do central bankers and their monetary arsenal truly have over the productivity of gas wells in the Haynesville Shale, or fee discounting in the real estate brokerage market, or legislation capping emergency healthcare fees? Ultimately, it is our view the idiosyncratic fundamentals will direct capital flows and the emerging bifurcation between the "haves" and "have nots" observed in the high yield market this year is evidence of these monetary policy limitations. Bad news is good news? Watch what you wish for.

Market Performance

High yield bonds staged a rebound in June following the drawdown in May, returning a robust +2.28% for the month. Credit risk premiums compressed -56 bps on average as macro tensions calmed, though signals from the Fed regarding prospective policy accommodation drove a rally in Treasuries that inflated bond prices further. Indeed, interest rate duration contributed 74 bps (or ~32%) to high yield returns in June.

As noted above, unique to the reflation in June (and in contrast with the rally in April), was the significant outperformance of BB-rated bonds relative to CCC-rated debt. BBs advanced +2.65% during the month, whereas CCCs returned just +1.06%. While interest rate sensitivity can explain part of the basis, the absence of risk-seeking behavior in the marketplace was (and still is) very apparent and played a role as well. Risk aversion was initially conditioned during the sell-off in the fourth quarter of last year and has been re-affirmed incrementally (via frequent idiosyncratic collapses) during the first six months of this year. The drawdown in May confirmed this already heightened unease. Simply put, investors have touched the hot stove too many times in recent memory, resulting in an unwillingness to extend credit to fundamentally riskier capital structures. Year-to-date, BBs have outperformed CCCs by approximately 300 basis points!

HY Performance	HY	Ba	B	Caa	Ca-D
June 2019 Total Return	2.28%	2.65%	2.30%	1.06%	-0.42%
2019 Total Return	9.94%	10.51%	10.06%	7.46%	15.36%
June 2019 OAS Chg	-56 bps	-59 bps	-55 bps	-14 bps	
2019 Excess Return	6.26%	6.59%	6.58%	4.01%	

Source: Bloomberg, Barclays

While a rising tide lifted most boats in June, beneath the surface we observed material sell-offs in several discrete capital structures, most notably in the Energy and Healthcare sectors. These idiosyncratic meltdowns advance a theme we have observed for much of this year. Intriguing are the diverse and seemingly unrelated drivers impacting the credits. Within Energy, Independent Exploration & Production companies with larger natural gas reserves (as opposed to oil reserves) have seen the prices of their bonds reset meaningfully lower in recent months (-7-30pts), with the downward momentum accelerating in June and July. Falling spot and forward natural gas prices among other factors have contributed to the re-rating of the cohort. Within Healthcare, business models which have historically arbitraged out-of-network emergency care, such as emergency room operators and medical helicopter operators, saw the value of their debt fall 10pts+ during the month as legislation addressing exorbitant patient billing advanced through House and Senate committees. Though the drivers are uncorrelated (commodity prices and healthcare legislation), common in each situation has been a swift removal of investor sponsorship.

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Best Sectors	June	2019
Banking	4.03%	12.75%
Automotive	3.26%	8.90%
Pharmaceuticals	3.20%	10.97%
Lodging	3.14%	11.24%
Metals and Mining	3.12%	9.31%

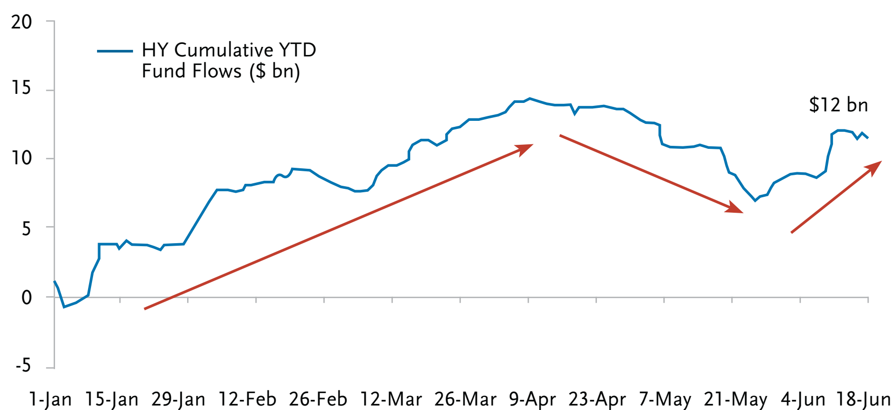
Worst Sectors	June	2019
Other Utility	0.00%	5.04%
Independent	0.55%	4.63%
Healthcare	1.14%	9.28%
Diversified Manufacturing	1.40%	9.37%

Source: Bloomberg, Barclays

Market Technicals

Though channeled acutely to the higher quality corners of the marketplace, demand in June was underpinned by robust capital inflows. Approximately $3.4 bn of liquidity entered the high yield market during the month, partially restocking the $6 bn outflow in May. Year-to-date, ETFs and mutual funds have been the beneficiaries of $12 bn of inbound capital. Anecdotally, as we sell down investments in credits which have advanced to seemingly unsustainable valuations, we are frequently provided the color that the buyer has capital that simply “must” be put to work.

Capital Returned to the High Yield Market in June, Supporting the Reflation in Bond Prices



Source: Credit Suisse, EPFR

New issue volumes remained healthy in June as capital markets cleared a diverse array of deals. Over $27 bn in USD-denominated high yield bonds were syndicated during the month. Still, the primary market exemplified the bifurcation between the “haves” and the “have-nots” observable in the secondary market (discussed above), as high quality issuers were met with significant demand for their deals, driving clearing levels in many cases inside of 5%, while riskier credits struggled to attract capital even with optically lofty double digit yields.

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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%
6/30/19	27,269	17,752	9,517	2.28%

Source: Barclays

Fundamental Trends

A single high yield issuer defaulted on its obligation in June, though this backward-looking indicator offers very little information about prospective trends. In a recent memo published in early-June, we identified 86 issuers that have seen the price of their bonds fall by more than 10pts since the October 2018 tights in credit spreads (and this in spite of the 10%+ total return recovery thus far in 2019). A little over a month later, that number has grown to 106. Credit stress has empirically proven to be a good indicator of future defaults and therefore we view the growing frequency and breadth of these idiosyncratic breakdowns as more informative about prospective activity than last month's single default.

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Number of Issuers with > -10pt Drawdown in Price Since October 3, 2018

	Issuer Count		
Sector	**5/27/19**	**7/12/19**	**Change**
Independent	23	27	+4
Oil Field Services	14	18	+4
Metals and Mining	7	7	
Retailers	4	3	-1
Automotive	4	3	-1
Food and Beverage	3	3	
Transportation Services	3	3	
Consumer Products	2	2	
Finance Companies	2	2	
Healthcare	2	5	+3
Home Construction	2	1	-1
Other Financial	2	2	
Paper	2	2	
Technology	2	4	+2
Midstream	2	3	+1
Pharmaceuticals	2	2	
Building Materials	1	1	
Chemicals	1	1	
Diversified Manufacturing	1	1	
Electric	1	1	
Other Industrial	1	4	+3
Tobacco	1	1	
Cable Satellite	1	1	
Retail REITs	1	1	
Wireline	1	3	+2
Wireless	1	1	
Supermarkets	0	1	+1
Construction Machinery	0	1	+1
Consumer Cyclical Services	0	2	+2
Total	**86**	**106**	**+20**

Source: Bloomberg

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