TCW

INSIGHT

MONTHLY COMMENTARY

July High Yield Credit Update

BRIAN GELFAND | AUGUST 12, 2016

July marked a brave new world in financial markets as the month saw both all-time highs in stocks and record lows in risk-free yields (indeed, the S&P 500 and 10yr U.S. Treasuries hit all-time highs/lows on the same day!). Spreads on high yield and investment grade corporate bonds gapped tighter as well, with all of this taking place as companies reported negative year-over-year earnings growth for the fifth consecutive quarter (a trend never seen absent a recession). The cognitive dissonance of a parallel rally in risk and rates juxtaposed with souring fundamentals is, by definition, rather discomforting. However, so is the case when a dearth of reasonable (or for that matter, positive) yields abroad significantly inflates demand for a limited supply of comparably attractive U.S. assets.

The technicals created by this global hunt for relative value were quite powerful in the marketplace for high yield debt in the first two weeks of the month, as the market forces of supply and demand were perfectly skewed to squeeze prices to new highs. Frantic buyers who 'needed to put cash to work' faced reluctant sellers who 'faced reinvestment concerns,' with the asymmetry compounded by a notably light new issue calendar. One need not look further than the price action in high quality benchmark issues and energy bonds to see the effects of this technical imbalance. Prices for higher quality bonds set new high water marks as foreign investors clamored to buy paper, and spreads for energy-linked credits completely decoupled from their historically tight (and fundamentally rational) relationship to oil prices as an underweight and underperforming investor base reached for yield (and prospective returns).

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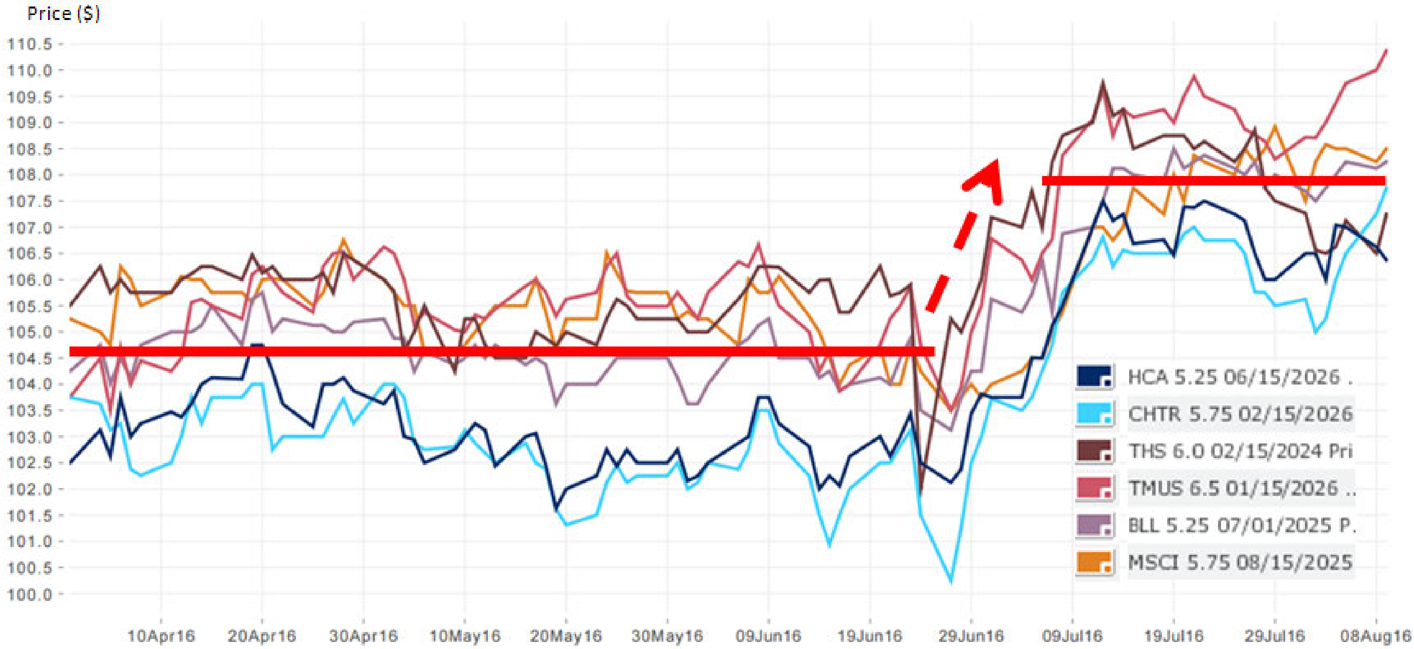
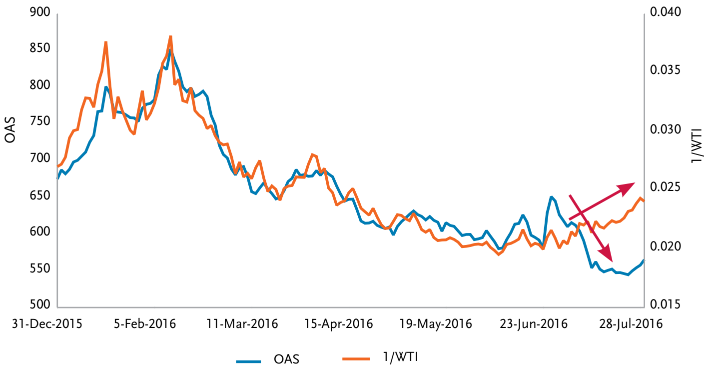
Mr. Gelfand is a Vice President in the U.S. Fixed Income group, where he trades high yield securities. Mr. Gelfand joined TCW in 2014 as a Credit Analyst responsible for research in the telecom, technology, and media sectors. Prior to joining TCW, he interned at PIMCO in the Portfolio Management Group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

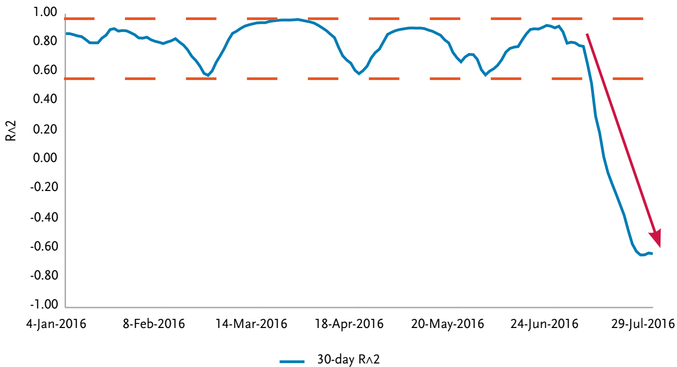
High Quality Benchmark Issues Felt the Squeeze of Too Much Cash Chasing Too Few Bonds



Source: Barclays

Energy Bond Prices Decoupled from Oil Prices as Technicals Trumped Fundamentals





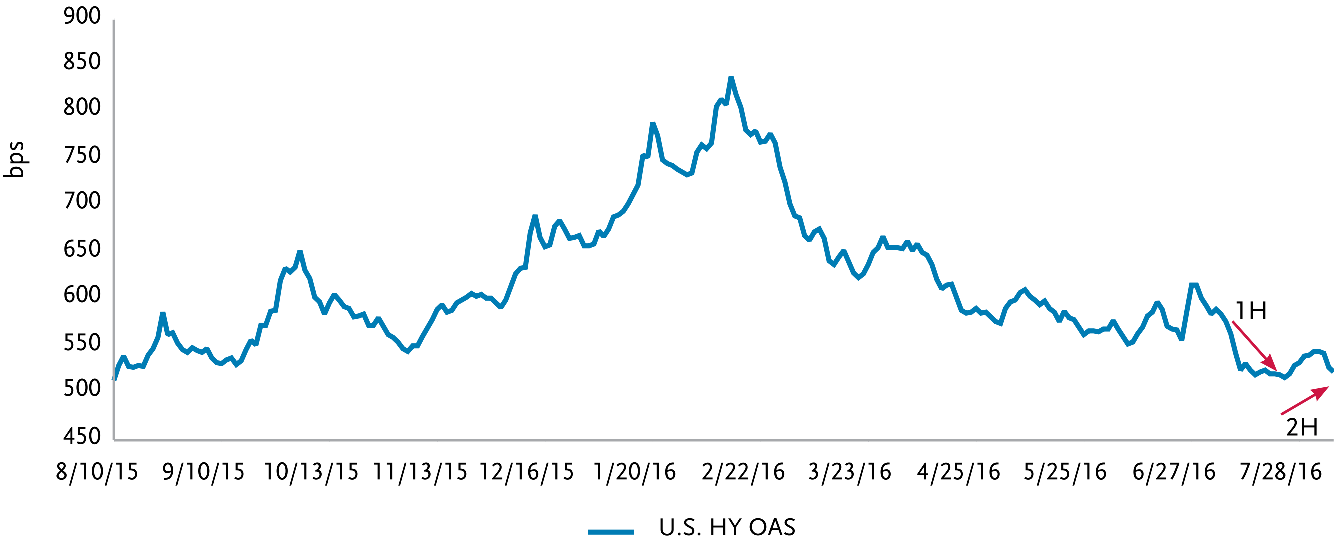
Source: Bloomberg

While discomforting, we have seen this movie before...the proverbial pendulum swings far to one side before the physical forces of mean reversion pull it back to (through) center. Low risk premiums would have you believe the fundamentals don't matter and the technicals have room to run. We believe in mean reversion.

Market Performance

High yield bonds posted solid total and excess returns in July as security prices followed a step function higher in the first two weeks of the month. As discussed above, a simple market framework of supply/demand explains it all – a flood of capital from yield-hungry foreign (and domestic) investors created an aggressive bid for bonds in a marketplace void of offers from reluctant sellers and repressed issuance. The result, a technically-driven squeeze with one-off trades setting new highs in entire capital structures. While the rally was felt broadly across sectors and credit quality, the result of a meaningful and indiscriminate bid from index replicating ETFs, we note that fundamentally defensive, high credit quality BBs were particularly in high demand (as these bonds are argued to intersect the 'sweet-spot' for ex-CCC/ex-Energy foreign mandates). Indeed, BBs outperformed on a beta-adjusted basis with -44bps of spread tightening or an 11% change in spread versus the -60bps (10%) and -62bps (6%) for Bs and CCCs. Bond prices retreated from the remarkable highs to more "reasonable" levels in the back half of the month as supply from new issuance emerged and investors finally took note that WTI was sub-$45/bbl ($41.60/bbl by month end) and re-priced energy risk down accordingly.

HY Spreads Staged A Remarkable, Technical Sponsored Rally in the First Half of July...



Source: Barclays

...With BBs Outperforming On A Beta-Adjusted Basis

	Ba	B	Caa
HY OAS (6/30)	394	576	1,119
HY OAS (7/31)	350	516	1,057
Chg (bps)	(44)	(60)	(62)
Chg (%)	**11.2%**	**10.4%**	**5.5%**

Source: Barclays

In absolute terms, higher beta CCC and distressed securities outperformed yet again in July (though as noted above, on a risk-adjusted basis, higher quality outperformed). Unlike in June, when a rally in rates counterbalanced a widening in credit spreads, total return in July was driven almost entirely by spread compression. Comparable duration Treasuries were nearly unchanged on the month.

CCC + Distressed Outperformed On A Nominal Basis as Investors Are Forced Out the Quality Spectrum

HY Performance	HY	Ba	B	Caa	Ca-D
July 2016 Total Return	2.70%	2.49%	2.80%	2.94%	5.65%
2016 Total Return	12.01%	10.27%	10.41%	19.44%	47.32%
July 2016 OAS Chg	-54bps	-44bps	-60bps	-62bps	
2016 Excess Return	+260bps	+235bps	+271bps	+291bps	

Source: Barclays

A rising tide lifts all boats…nearly all sectors realized positive returns in July as market technicals generally overwhelmed idiosyncratic drivers. The sole outliers were E&P bonds (with Oil Field Services near negative territory as well) that eventually buckled under the weight of a -14% decline in WTI, despite virtually ignoring the move during the first half of the month. Looking at the right tail of the distribution, Wireless led the way in July with the two large and liquid capital structures of Sprint and T-Mobile benefiting from the favorable beta trade in addition to reporting better than expected Q2'16 operating results. Metals & Mining credits also outperformed as prices for iron ore and other commodity metals were up on the month.

Energy-Linked Credits Underperformed the Market, Though Outperformed the Move in WTI/Nat Gas

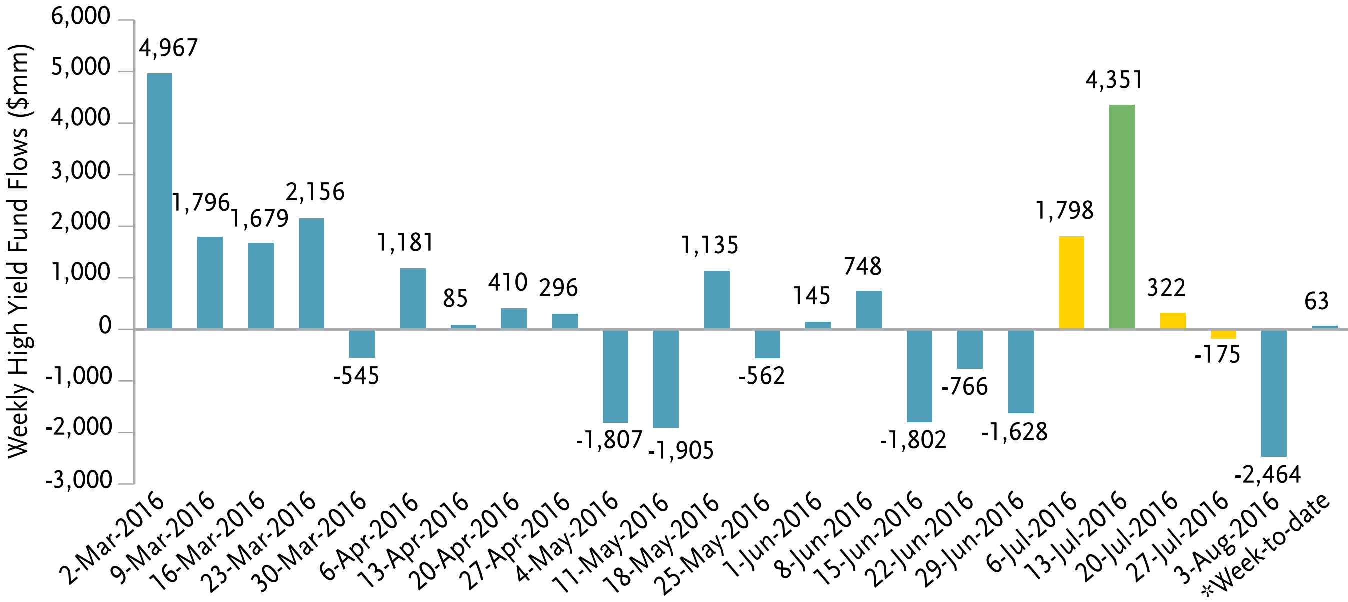
Best Sectors	July	2016 YTD
Wireless	4.16%	12.92%
Metals & Mining	4.04%	34.95%
Industrial Other	3.97%	16.59%
Media Entertainment	3.79%	9.89%
Wirelines	3.76%	12.32%

Worst Sectors	July	2016 YTD
Independent	-0.64%	24.90%
Oil Field Services	0.48%	19.10%
Financial Other	1.24%	3.06%
Supermarkets	1.70%	6.18%
Healthcare	1.84%	7.58%

Source: Barclays

Market Technicals

July saw the flood-gates open with liquidity pouring into the marketplace as high yield bonds (among other U.S.-based assets) gained favor with global investors in the wake of Brexit. Fund flows were net positive with high yield ETFs and open-ended funds reporting net inflows of +$5.8 billion. This follows two consecutive months of net outflows in May and June. The magnitude of the flows, particularly in the second week of the month, brought to light a limitation in the methodology for tracking fund flow data. Specifically, a $1 inflow into an actively managed mutual fund that is subsequently invested by the manager in the HYG ETF effectively gets counted as $2 of inflows. While it is clear this double-counting distortion exists, it should not distract from the reality that capital flows into the HY sector in July were robust (whether through ETFs, actively managed funds, or foreign accounts investing directly in high yield bonds), and had a pronounced effect on price action in the marketplace. Although the technicals remain decidedly one-sided today, we remain mindful of the fact that fund flows cut both ways. Should late-cycle investor behavior begin to emerge as we expect it will, prices of risk assets such as high yield bonds are susceptible to material downside volatility as investors clamor for the exits.



Source: Lipper, JPMorgan

The opposing side of the technical coin (i.e. new issue supply) helped fuel the surge in bond prices as well. If we back up to the last two weeks of June, primary issuance effectively ground to a halt as businesses were understandably reticent to bring a deal in the weeks before and after the UK referendum. Moving into July, although downside volatility quickly subsided and robust flows brought fresh capital, starved to find a home, into the marketplace, second quarter earnings season got underway and the concurrent corporate blackout periods curtailed issuance yet again. That is not to say issuers were completely sidelined, though the $13 billion of USD-denominated bonds priced during the month was the lowest level of activity since February. Deals that did come to market, however, were largely met with

insatiable demand, a trend that has continued thus far in August. There was a case during the month, however, of a highly levered, cyclical issuer with challenged secular prospects and a weak competitive moat that was unable to garner sufficient investor interest in its bond offering, despite having increased the prospective coupon of the deal several times during the marketing process. While the case study does suggest that at least some semblance of discipline remains in the marketplace today (we were worried), it should also serve as a sobering reminder of the dependence of marginal issuers on access to the capital markets and the risks facing their capital structures and operations should access be denied.

High Yield Net Supply ($mn)

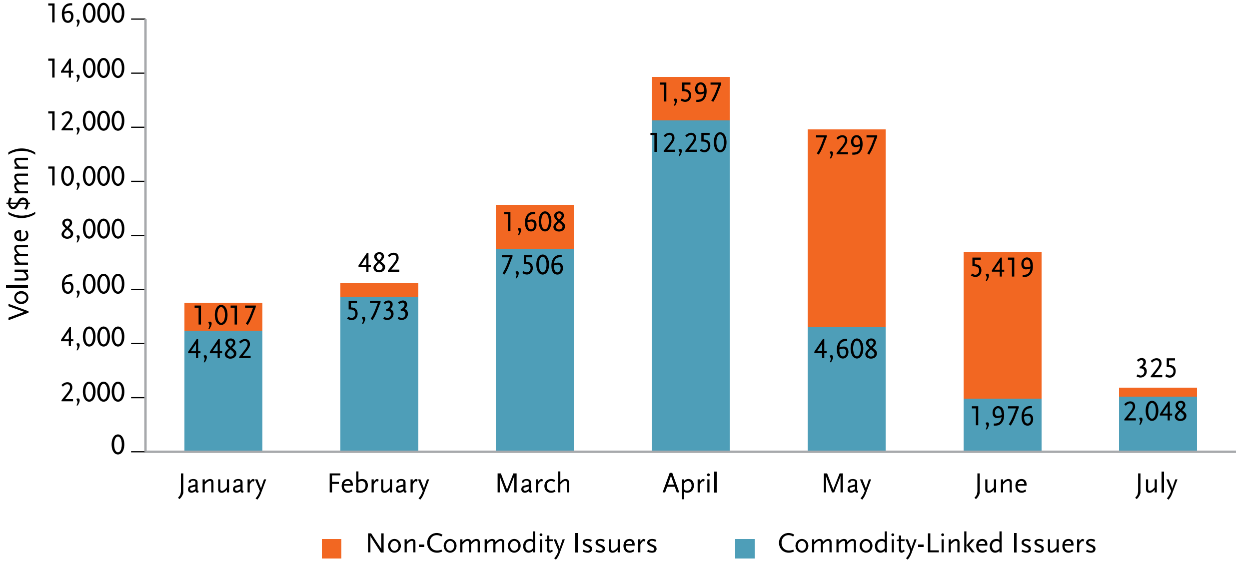
Month	New Issue	Redemptions	Net Supply	Monthly Returns
12/31/15	3,077	28,406	(25,329)	-2.52%
1/31/16	5,923	12,449	(6,526)	-1.61%
2/29/16	7,557	15,556	(7,999)	0.57%
3/31/16	18,226	12,920	5,306	4.44%
4/30/16	31,176	18,454	12,722	3.92%
5/31/16	28,355	31,534	(3,179)	0.62%
6/30/16	22,334	31,021	(8,687)	0.92%
7/31/16	13,327	22,719	(9,392)	2.70%

Source: Barclays

Fundamental Trends

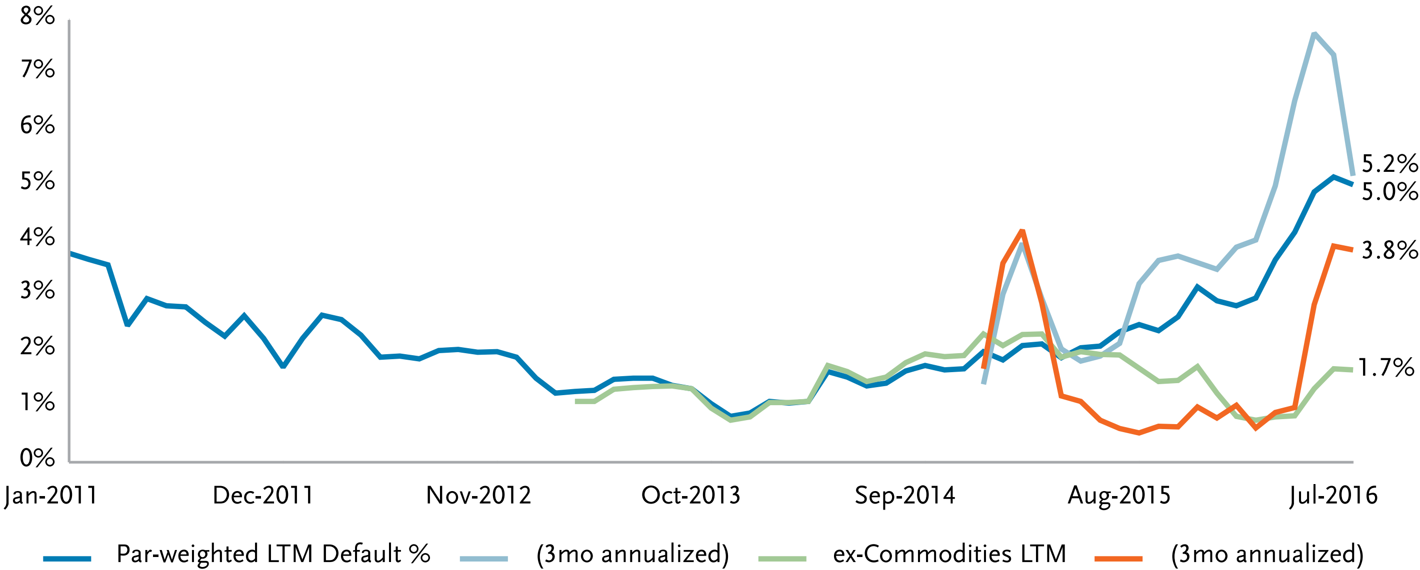
Default activity (including distressed exchanges) was quite muted in July with six issuers defaulting on $2.4 billion of high yield bonds, a run-rate more consistent with the moderate levels seen in 2015 (~$4 billion/month) versus the first half of 2016 (~$9 billion/month). The drop-off in activity primarily stems from the near total absence of non-commodity defaults during the month. Only one non-commodity related issuer defaulted in July, which follows notably higher volumes in May and June. This makes intuitive sense as accommodative capital markets afford marginal issuers opportunities to sustain their balance sheets and stay a default. As for commodity-linked Energy and Metals & Mining defaults, activity was consistent with what we have seen over the past month and a half, which has been far less aggressive relative to volumes in February, March and April. That being said, commodity-linked credits continue to account for more than 70% of high yield default volume year-to-date, which currently totals ~$56 billion, or 10% above full-year 2015 volumes. The trailing twelve-month par-weighted default rate through July is 5.0%. Embedded in this figure is a 20.0% default rate for commodity-linked issuers that is skewing a 1.7% default rate for the rest of the index. Looking at the annualized default rate of the past three months, arguably a more timely barometer of the recent momentum in default activity, the non-commodity default rate is actually trending closer to 4%, while the commodity-linked defaults have come off considerably as April's peak volume falls away.

Non-Commodity Issuer Defaults Declined In July, While Commodity-Linked Default Volumes Were Flat M/M



Source: Deutsche Bank

Non-Commodity Defaults Have Increased In Recent Months, While Commodity-Linked Volumes Have Declined



Source: Deutsche Bank

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