INSIGHT

TCW

MONTHLY COMMENTARY

July High Yield Credit Update

BRIAN GELFAND | AUGUST 14, 2017

The third quarter kicked off with a broad-based melt-up in high yield bond prices consistent with risk assets broadly. While the "melt-up" characterization is fair when considering the -12bps of spread compression and +$0.60 of price appreciation in the Barclays High Yield Index, the truth is the month was not that linear. In fact, sitting here in early August and feeling the uneasiness that is currently permeating investor psychology, one can't help but draw parallels to market conditions in early July. Stock prices were fading, oil was inflecting downward after an almost two week rally, outflows were ramping (though not yet disruptive), interest rates were rising and geopolitical and policy risks were starting to build. Ultimately, the dip in bond prices proved shallow and short-lived, as fundamental signals stabilized (oil rebounded nicely, earnings were decent) and highly supportive technicals took hold. While the verdict is still out on August, the ease at which the market can be jarred from its state of complacency is telling about investor conviction at current valuations.

HYG Traded Heavy in the First Week of July Before Grinding to All-Time Highs by Month End

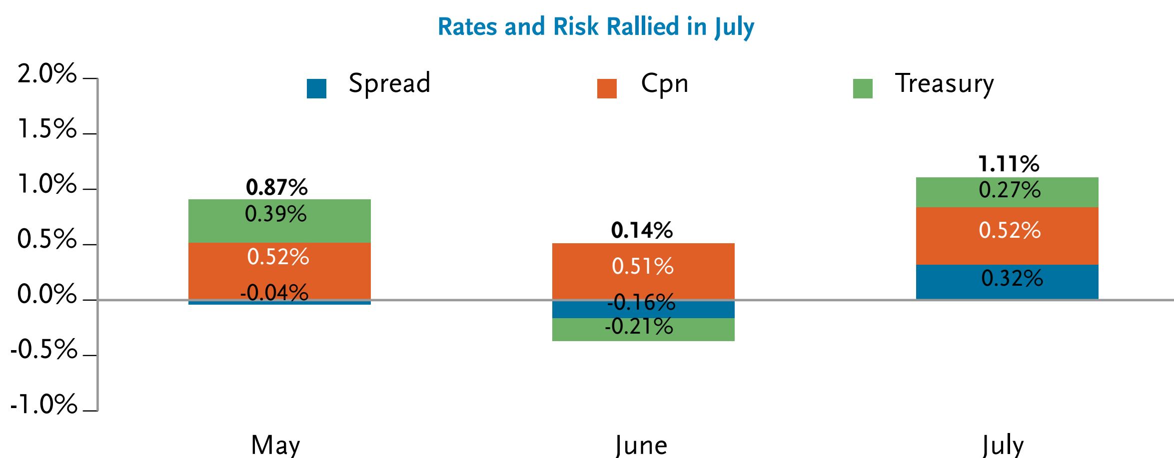
Source: Bloomberg

Brian G. Gelfand
Vice President
U.S. Fixed Income

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.

MARKET PERFORMANCE

High yield bonds generated solid returns in July, shaking off a rather weak start to the month as rising commodity prices (specifically spot WTI) and excess cash (see discussion on technicals below) lifted bond prices across the risk spectrum. Indeed, the rebound in oil off local lows settled investor nerves and encouraged incremental risk taking, while cash build from balanced fund flows, seasonally low issuance, and cash inflows from coupon payments, tenders and calls drove demand for low beta, "cash substitute" paper. In aggregate, high yield bonds generated a total return of +1.1% for the month, or a >14% annualized return (now that would be a good year!).



Source: Barclays

Consistent with a risk-on market psychology, CCCs took back the reins in July, outperforming fundamentally higher credit quality bonds. While high beta did lead the rally, returns across the ratings cohorts were robust. Notably, despite entering the month with spreads at post-crisis tights, BBs still managed to earn a +1% total return!

CCCs Led, Though Higher Quality Credits Outperformed Their Beta

HY Performance	HY	Ba	B	Caa	Ca-D
July 2017 Total Return	1.11%	1.01%	1.04%	1.61%	0.59%
2017 Total Return	6.09%	5.85%	5.37%	8.31%	12.13%
July 2017 OAS Chg	-9bps	-7bps	-10bps	-19bps	
2017 Excess Return	4.54%	4.16%	3.86%	7.01%	

Source: Barclays

Both exogenous and idiosyncratic drivers reinforced the "rising tide" momentum during the month that benefited all sectors, except Supermarkets. Amazon's encroachment on the grocery industry, through the planned acquisition of Whole Foods, has put the market on edge as investors struggle to handicap risk under the new business reality. Set against this uneasy backdrop, Albertsons bonds re-priced meaningfully after the company's private equity sponsor concurrently shelved plans for an anticipated IPO (a creditor-friendly liquidity event) and announced it would take a large cash dividend out of the business (a bad signal for creditors). At the other end of the spectrum, commodity-levered credits outperformed, principally in the Energy patch. Weekly inventory data turned bullish for most of the month, driving oil prices higher. As a result, Oil Field Services and high beta E&P bonds retraced some of the June selloff while higher quality E&Ps and Midstream credits traded above pre-selloff levels. Adding fuel to the flames, Halcon announced the sale of its Bakken acreage at a valuation well above what had been expected by the market. Halcon unsecured bonds rallied +12pts on the news, with other Single-B Bakken-levered credits trading higher in concert (on short covering!).

Best Sectors	July	YTD
Independent	2.32%	0.94%
Metals and Mining	2.29%	7.08%
Oil Field Services	2.11%	2.20%
Food and Beverage	1.82%	6.31%
Pharmaceuticals	1.81%	11.18%

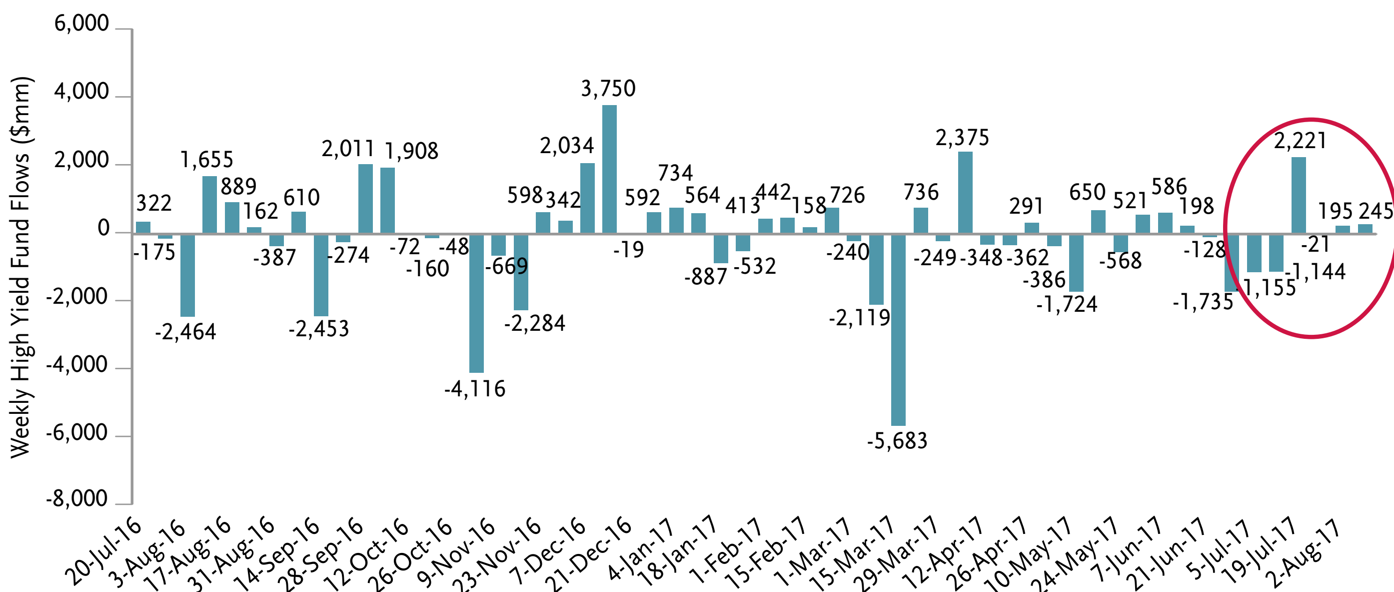
Worst Sectors	July	YTD
Supermarkets	-1.54%	0.80%
Wireless	0.24%	6.73%
Consumer Products	0.35%	3.98%
Financial Other	0.39%	4.82%
Leisure	0.40%	6.12%

Source: Barclays

MARKET TECHNICALS

Market techncials were exceedingly accommodative during the month as demand, simply put, decidedly overwhelmed supply (both secondary and primary, more on the new issue calendar below). Outflows in the beginning of the month quickly subsided and did little to incite much in the way of forced selling as low primary issuance and cashflows from coupons and principal paydowns offset the flow drag. A large $2bn+ inflow into HY ETFs in the middle of the month put upward pressure on bond prices. The ensuing OWICs from authorized participants became the marginal price setter in the marketplace as these accounts (ETF arbitragers) indiscriminately bought paper to satiate demand.

HY Funds Had Net Inflows of +$478mn in July that Drove a Steady Grind Higher in Bond Prices



Source: Lipper, J.P. Morgan

The new issue calendar, or lack thereof, was even more culpable for the squeeze higher in secondary bond prices than the demand-side technicals. New issue volumes were very light in July (even seasonally adjusted) with the primary market only clearing $11bn in USD-denominated bonds (the first deal didn't price until two weeks into the month). Without any large benchmark deals in the market, small, infrequent issuers found themselves cast into the spotlight, with deals garnering seemingly insatiable interest from investors looking to diversify in a marketplace otherwise void of opportunity. Asymmetric supply / demand for these new issues was apparent in early trading with freshly minted bonds trading up +2-3pts even after pricing through the tight end of our assessment of fair value as investors clamored to add size.

Regardless of Valuation, Overwhelming Demand Seemed to Carry New Issues in Early Trading

Issuer	Bond	Rating	Issue Price	Next 2-day Bid/Offer
McLaren	MCLAUT 5.75 22	B2/BB-	100	102.5 / 103
Hovnanian	HOV 10.5 24	Caa2/CCC+	100	103.5 / 104
Lithia Motors	LAD 5.25 25	Ba2/BB	100	102 / 102.25
NGPL Pipeco	NGPLCO 4.375 22	Ba1/BB+	100	102.875 / 103.125

Source: Bloomberg, TCW

High Yield Net Supply ($mn)

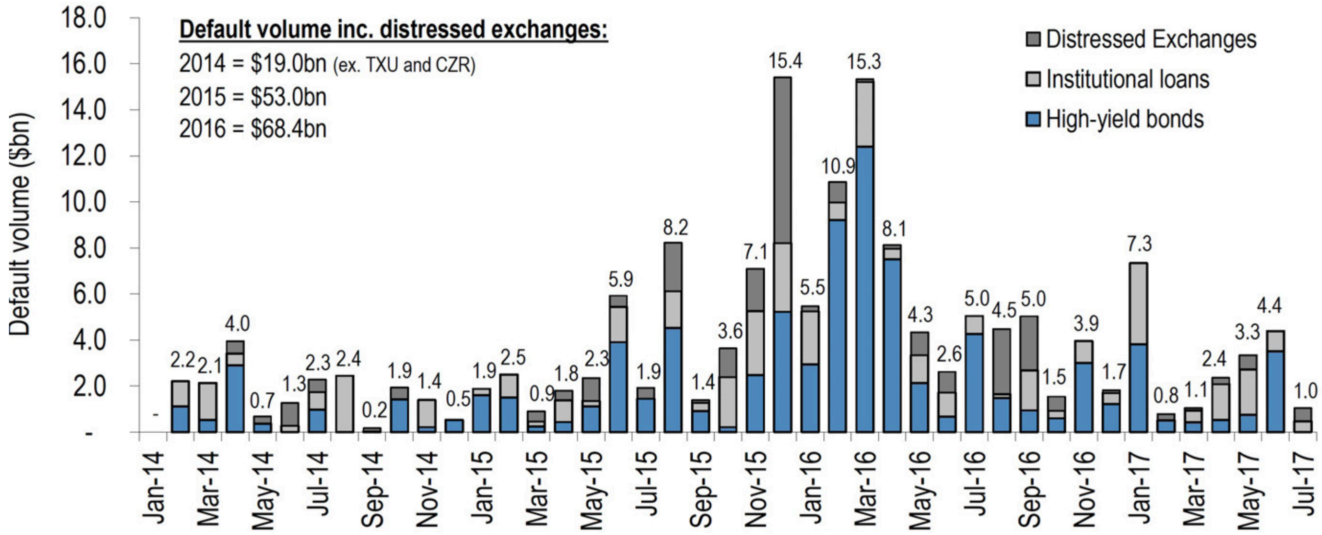
Month	New Issue	Redemptions	Net Supply	Monthly Returns
6/30/16	22,334	31,021	(8,687)	0.92%
7/31/16	13,327	22,719	(9,392)	2.70%
8/31/16	16,647	22,606	(5,959)	2.09%
9/30/16	25,207	29,030	(3,823)	0.67%
10/31/16	13,452	35,225	(21,773)	0.39%
11/30/16	15,282	22,208	(6,926)	-0.47%
12/31/16	18,581	26,359	(7,778)	1.85%
1/31/17	18,803	20,783	(1,980)	1.45%
2/28/17	18,916	26,891	(7,975)	1.45%
3/31/17	42,629	32,555	10,074	-0.22%
4/30/17	16,225	33,967	(17,742)	1.15%
5/31/17	26,426	28,265	(1,839)	0.87%
6/30/17	19,271	37,114	(17393)	0.14%
7/31/17	11,006	28,127	(17,121)	1.11%

Source: Barclays

FUNDAMENTAL TRENDS

Symbolic of the general calm in the marketplace in July was the total absence of high yield issuer defaults during the month. Indeed, only a single loan-only issuer filed for Chapter 11, and one high yield issuer effected a distressed exchange (though this did trigger a technical default per ratings agency standards). The companies were both apparel / retail brands, True Religion Apparel and J Crew, respectively. As a result, trailing default rates have declined significantly from the early-2016 peak, reinforcing investor forecasts for benign default volumes over the near-to-medium term. We believe market prices imply sub-2% forward defaults, in-line with the low end of strategist projections, though at apparent odds with what has historically transpired at the end of a credit cycle. ■

LTM HY Default Rates Per JPM Fell to a Meager 1.3% in July (Including Distressed Exchanges)



Notes: Excludes the record setting defaults of Energy Futures' $36bn default in April 2014 and Caesar's $18bn default in December 2014.
Source: J.P. Morgan

BLOOMBERG is a trademark and service mark of Bloomberg Finance L.P. BARCLAYS is a trademark and service mark of Barclays Bank Plc, used under license. Bloomberg Finance L.P. and its affiliates (collectively, "Bloomberg") or Bloomberg's licensors own all proprietary rights in the BLOOMBERG BARCLAYS INDICES. Neither Bloomberg nor Barclays Bank Plc or Barclays Capital Inc. or their affiliates (collectively "Barclays") guarantee the timeliness, accuracy or completeness of any data or information relating to BLOOMBERG BARCLAYS INDICES or make any warranty, express or implied, as to the BLOOMBERG BARCLAYS INDICES or any data or values relating thereto or results to be obtained therefrom, and expressly disclaims all warranties of merchantability and fitness for a particular purpose with respect thereto. It is not possible to invest directly in an index. Back-tested performance is not actual performance. Past performance is not an indication of future results. To the maximum extent allowed by law, Bloomberg and its licensors, and their respective employees, contractors, agents, suppliers and vendors shall have no liability or responsibility whatsoever for any injury or damages - whether direct, indirect, consequential, incidental, punitive or otherwise - arising in connection with BLOOMBERG BARCLAYS INDICES or any data or values relating thereto - whether arising from their negligence or otherwise. This document constitutes the provision of factual information, rather than financial product advice. Nothing in the BLOOMBERG BARCLAYS INDICES shall constitute or be construed as an offering of financial instruments or as investment advice or investment recommendations (i.e., recommendations as to whether or not to "buy," "sell," "hold" or enter into any other transaction involving a specific interest) by Bloomberg or its affiliates or licensors or a recommendation as to an investment or other strategy. Data and other information available via the BLOOMBERG BARCLAYS INDICES should not be considered as information sufficient upon which to base an investment decision. All information provided by the BLOOMBERG BARCLAYS INDICES is impersonal and not tailored to the needs of any specific person, entity or group of persons. Bloomberg and its affiliates express no opinion on the future or expected value of any security or other interest and do not explicitly or implicitly recommend or suggest an investment strategy of any kind. In addition, Barclays is not the issuer or producer of the BLOOMBERG BARCLAYS INDICES and has no responsibilities, obligations or duties to investors in these indices. While Bloomberg may for itself execute transactions with Barclays in or relating to the BLOOMBERG BARCLAYS INDICES, investors in the BLOOMBERG BARCLAYS INDICES do not enter into any relationship with Barclays and Barclays does not sponsor, endorse, sell or promote, and Barclays makes no representation regarding the advisability or use of, the BLOOMBERG BARCLAYS INDICES or any data included therein. Customers should consider obtaining independent advice before making any financial decisions. ©2016 Bloomberg Finance L.P. All rights reserved.

This material is for general information purposes only and does not constitute an offer to sell, or a solicitation of an offer to buy, any security. TCW, its officers, directors, employees or clients may have positions in securities or investments mentioned in this publication, which positions may change at any time, without notice. While the information and statistical data contained herein are based on sources believed to be reliable, we do not represent that it is accurate and should not be relied on as such or be the basis for an investment decision. The information contained herein may include preliminary information and/or "forward-looking statements." Due to numerous factors, actual events may differ substantially from those presented. TCW assumes no duty to update any forward-looking statements or opinions in this document. Any opinions expressed herein are current only as of the time made and are subject to change without notice. Past performance is no guarantee of future results. © 2017 TCW

865 South Figueroa Street | Los Angeles, California 90017 | 213 244 0000 | @TCWGroup