TCW

INSIGHT

MONTHLY COMMENTARY

July High Yield Credit Update

BRIAN GELFAND | AUGUST 16, 2018

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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.

Amid a good month for risk assets broadly, high yield bonds stood among the ranks. Stocks rallied globally (S&P 500 +3.72%, Nikkei +1.12%, FTSE +1.52%), domestic and European credit gained (U.S. IG credit +0.72%, U.S. leveraged loans +0.74%, Pan-Euro HY +1.31%), even EM credit, the epicenter of quantitative tightening induced volatility/fundamental stress experienced a relief rally (EM HY +2.16%) – though as we write in early August amid the escalating Turkish economic crisis, the reprieve appears to have been short lived. As for U.S. high yield, July's total return of +1.09% was the top tick thus far in 2018. Investor attention was cannibalized by the *micro* for much of July with a deluge of information to absorb as earnings season commenced in the back half of the month and corporate activity/M&A accelerated. Earnings skewed positive in fiscal Q2, and results from high yield issuers in July followed suit. With respect to the *macro*, tremors from central bank tightening temporarily stilled, at least on the surface, and investors faded the tariff volleys between the U.S., EU and China, focusing instead on what management teams are seeing/had to say on the matter (our market has yet to be unnerved by the *macro*). Add to the mix supportive market technicals – issuance during the month was historically low (just $7.5bn in high yield bonds were syndicated) and capital on balance flowed into the marketplace for the first time this year – and the underpinnings for the risk rally become apparent.

Market Performance

Investors ignored trade tensions and embraced better-than-expected earnings from late-July releases to generate +1.09% and +1.28% in total and excess returns, respectively, for high yield credit. The option-adjusted spread of the Bloomberg/Barclays U.S. HY Index tightened -27bps to +336bps, extending this year's range-bound trend, though ending the month near the tights of the range (and near the tights of this cycle). All sectors and credit rating cohorts rose with the tides. More on this below.

While CCCs outperformed for yet another month, BB-rated bonds kept pace despite modest interest rate headwinds. Still, the basis in year-to-date performance between CCC and BB-rated debt remains wide at over 500bps! Absolute returns for the CCC cohort have been strong in a neighborhood of lackluster asset performance globally year-to-date. That being said, in a recent memo, Morgan Stanley noted the breadth of contributors to these gains is narrow, evidenced by several high beta credits which we have observed sell-off meaningfully this year. This, in addition to the performance dispersion among capital structures in higher credit quality cohorts, has created opportunities for credit pickers to identify the winners (value) while side-stepping the losers (value traps).

HY Performance	HY	Ba	B	Caa	Ca-D
July 2018 Total Return	1.09%	1.13%	0.97%	1.23%	2.93%
2018 Total Return	1.25%	-0.66%	1.84%	4.44%	25.14%
July 2018 OAS Chg	-27bps	-27bps	-22bps	-44bps	
2018 Excess Return	2.07%	0.38%	2.54%	4.93%	

Source: Bloomberg, Barclays

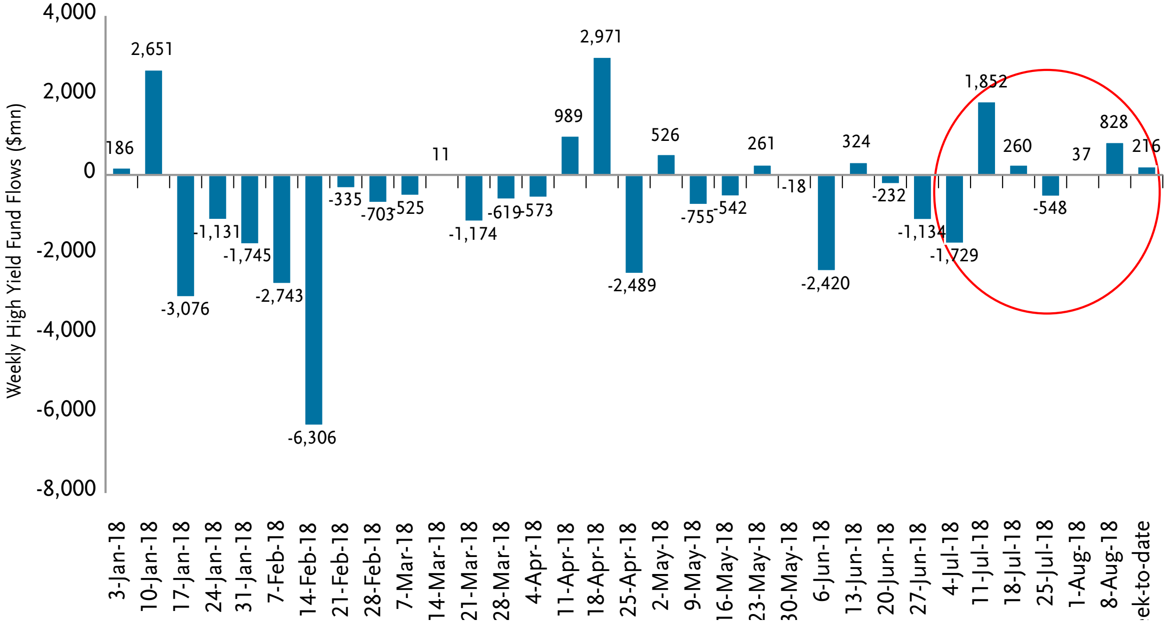
All sectors generated positive returns last month as the risk rally left no soldier behind. Micro fundamentals distinguished credit and sector level performance from the pack, specifically corporate M&A and earnings. Supermarkets led the move higher with many of the sector bellwethers contributing to the advance. The Fresh Market bonds were up +7pts from distressed levels during the month as investors looked favorably on the company's decision to shutter 15 unprofitable stores and improve run-rate cash flow generation. Albertson's reported better-than-expected earnings and affirmed full-year guidance creating support for the bond complex. Finally, it was announced that Supervalu will be acquired by food distributor United Natural Foods for $2.9bn. Bonds traded higher following the announcement. The Wireless sector also outperformed, underpinned by general strength in the large capital structures of Sprint and T-Mobile as well as outsized gains in idiosyncratic situations including Wind Tre (bonds traded up +13pts after it was announced that Hong Kong-based CK Hutchison would acquire the 50% stake in the Italian mobile operator it did not already own) and Numericable-SFR, the French telecom unit of conglomerate Altice (bonds rallied following comments from management that consolidation in the French telecom market was inevitable). Lagging on the month, though still in positive territory, were Homebuilders, a sector which has underperformed year-to-date. Rate concerns, cost inflation and emerging signs of an aging housing cycle, in addition to generally rich bond valuations (average spreads of Home Construction bonds were the tightest of any sector entering the year), have pressured performance.

Best Sectors	July	YTD 2018
Supermarkets	2.56%	5.65%
Wireless	2.19%	2.06%
Pharmaceuticals	2.03%	5.98%
Metals & Mining	1.56%	0.56%
Cable / Satellite	1.56%	1.83%

Worst Sectors	July	YTD 2018
Home Construction	0.22%	-2.04%
Retailers	0.29%	2.61%
Diversified Manufacturing	0.38%	0.16%
Paper	0.41%	0.17%
Consumer Products	0.42%	-0.24%

Source: Bloomberg, Barclays

Deviating From Trend, High Yield Funds Experienced Capital Inflows In July



Source: Lipper, JPMorgan

Breaking from trend, July fund flows were stable in what has otherwise been a year of protracted capital flight from the high yield asset class. The year-to-date cumulative net outflow from high yield funds (mutual funds and ETFs) is in excess of -$24bn; however, this month funds received net inflows for only the second time in almost a year with +$527mn entering our marketplace. As highlighted previously, it is the lack of price volatility in the face of capital flight (save for February) that remains somewhat perplexing. Though with stable fund flows this past month, coupled with uncommonly low issuance (a feature thus far in 2018), the technical backdrop was situated to support a rally in asset prices.

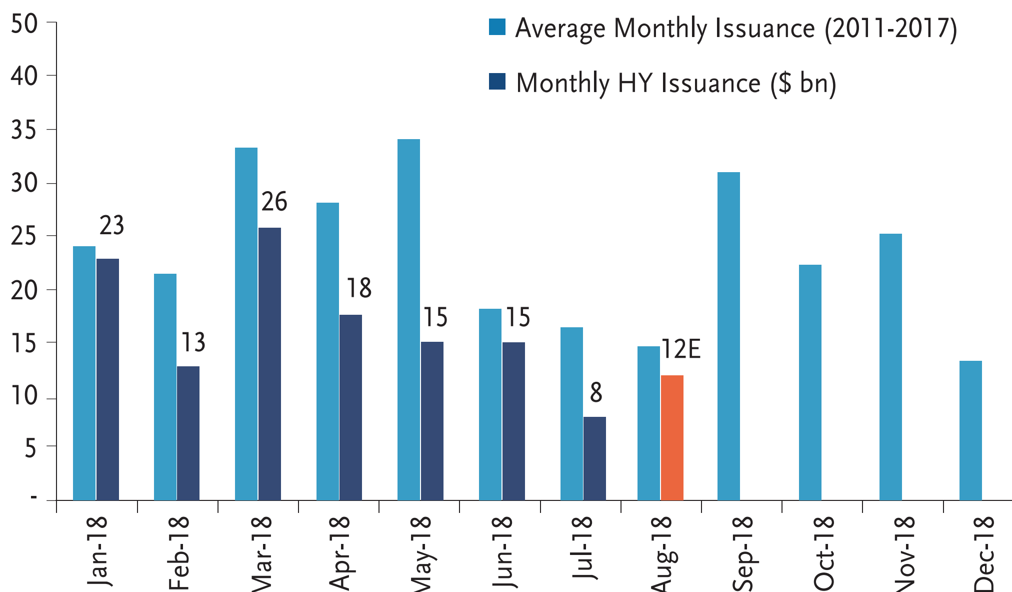
Investors who were left wanting, following the underwhelming new issue activity in June, were surely disappointed in July as volumes were half that of the prior month and down -32% year over year. Just $7.5bn of USD-denominated debt was syndicated to the market in July, one of the lowest tallies of this cycle. Deals that were brought to market were financings for smaller enterprises, namely syndications of $300-500mn deals, which tend to garner sponsorship from concentrated holder bases, and typically realize lower levels of liquidity subsequent to pricing. Though opportunities to uncover value do present themselves among this cohort of issuers, this past month yielded few investments which we believed offered adequate compensation for their risks.

High Yield Net Supply ($MM)

Month	New Issue	Redemptions	Net Supply	Monthly Returns
6/30/17	19,764	37,114	(17,350)	0.14%
7/31/17	11,006	28,127	(17,121)	1.11%
8/31/17	17,723	19,252	(1,529)	-0.04%
9/30/17	37,394	22,548	14,846	0.90%
10/31/17	23,321	32,135	(8,814)	0.42%
11/30/17	27,003	15,210	11,793	-0.25%
12/31/17	17,622	24,511	(6,889)	0.30%
1/31/18	24,141	31,692	(7,551)	0.60%
2/28/18	12,238	23,591	(11,353)	-0.85%
3/31/18	26,509	22,949	3,560	-0.60%
4/30/18	17,360	30,052	(12,692)	0.65%
5/31/18	15,202	31,611	(16,409)	-0.03%
6/30/18	14,994	18,107	(3,113)	0.40%
7/31/18	7,454	16,205	(8,751)	1.09%

Source: Barclays

Primary Supply Has Trended Below Historical Averages Each Month This Year

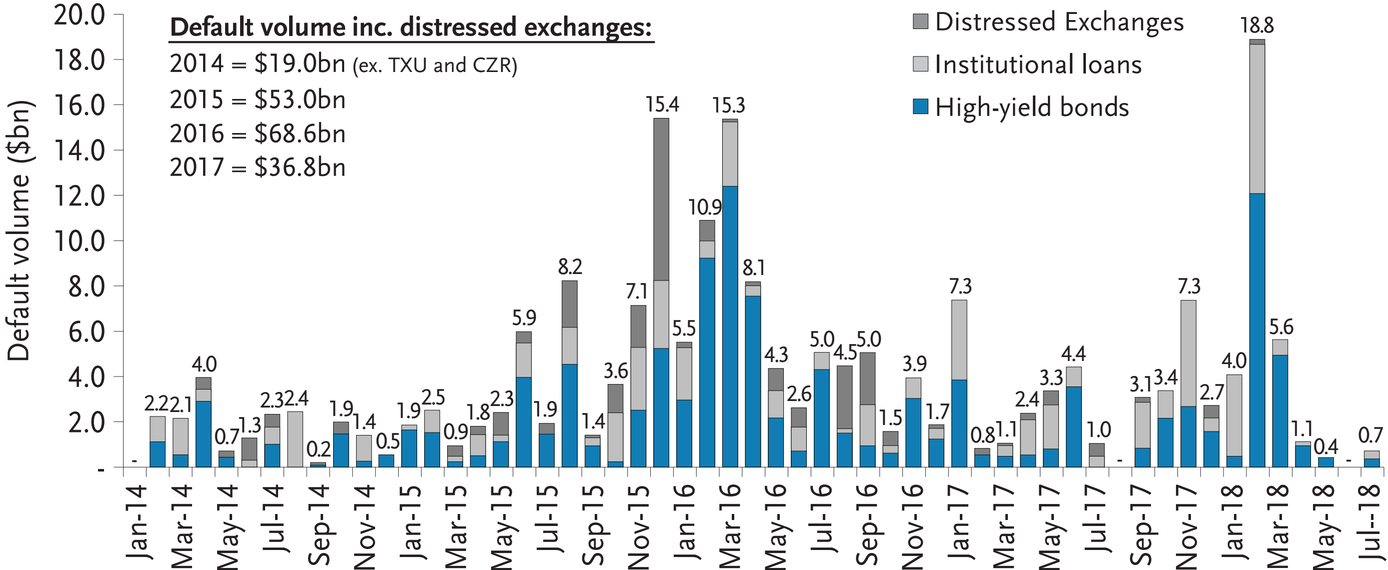


Source: Credit Suisse

Fundamental Trends

The benign default environment carried through July, with only a single high yield corporate default during the month. Westmoreland Coal missed interest payments due July 1 on $350mn in senior secured notes and $320mn in term loans as it negotiated a plan of reorganization with lenders ahead of its December loan maturity. This follows zero defaults in June, one default in May and two defaults in April. Such light volumes have pushed the trailing twelve-month default rate to a meager ~2% (1.3% ex. IHRT) per JPM. While the trailing data embeds little information about future trends, we note that expectations for forward defaults remain anchored to this low, 2% level of activity, in large part due to the supportive market conditions. Considering how quickly sentiment and risk pricing in leverage finance can change course, we put little stock in these forecasts. After all, trailing defaults, market conditions and forward expectations were all optimistic in early 2011 and 2015, were they not? ■

Low Corporate Default Activity Is Indicative of Where We Are, but Tells Us Little About Where We Are Going



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

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