TCW

INSIGHT

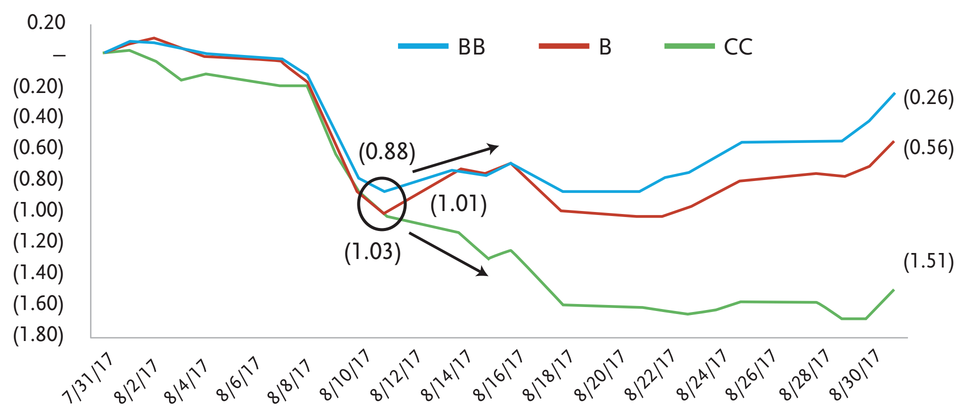
MONTHLY COMMENTARY

August High Yield Credit Update

BRIAN GELFAND | SEPTEMBER 14, 2017

A recap of the high yield bond market in August truly has two distinct chapters, aligning with the stark contrast in market activity (or lack thereof) between the first and second half of the month. The first chapter saw a bout of downside volatility creep back into the marketplace, a little "fire and fury" if you will, as spreads gapped +36bps wider over the course of a couple days. With Kim Jong Un rattling his saber abroad and political/policy stagnation taking hold at home, the ingredients for a traditional risk-off cocktail began to coalesce. However, the sell-off that ensued proved very technical in nature (indigestion from an accelerated new issue calendar compounded by broad based ETF selling). Indeed, price declines were initially pretty even across sectors and ratings categories, indicative of an indiscriminate re-pricing rather than a more discerning risk-off/flight-to-quality trade. As the tape quieted in the second chapter of the month, however, fundamentals began to peer through, driving name, sector and quality specific price action. Evidence of decompression across fundamental lines started to emerge, reinforcing our position that security selection (discerning between the winners and losers) with a focus on relative downside risk will be key to outperforming at this point in the credit cycle.

Indiscrimate Selling Initially was Followed by More Discerning Price Action Later in The Month



Source: Bloomberg

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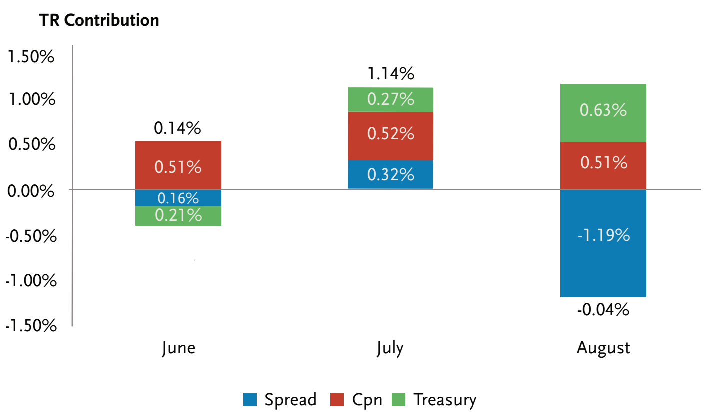
Mr. Gelfand is a Vice President in the U.S. Fixed Income group, where he trades high yield securities. Mr. Gelfand joined TCW in 2014 as a Credit Analyst responsible for research in the telecom, technology, and media sectors. Prior to joining TCW, he interned at PIMCO in the Portfolio Management Group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

MARKET PERFORMANCE

Carry and duration offset much of the negative impact from spread widening during the month, though fell a bit short as total return in August ultimately finished in the red. High yield bonds returned -0.04% in August, with spreads +26bps wider by month end (+36bps in the first two weeks offset by a -10bps grind tighter for the duration of the month).

Across ratings buckets, higher quality bonds were the only cohort to generate a positive total return this month. Greater interest rate sensitivity and a grab for safer, cash-surrogate risk towards the end of the month lifted BB bond prices off the lows set in early August, while CCC rated risk continued to languish following the initial sell-off.

Credit Spread Widening Weighed on HY Bond Performance in August



Source: Barclays

HY Performance	HY	Ba	B	Caa	Ca-D
August 2017 Total Return	-0.04%	0.27%	-0.13%	-0.72%	-0.48%
2017 Total Return	6.05%	6.14%	5.24%	7.53%	11.59%
August 2017 OAS Chg	26bps	15bps	23bps	50bps	
2017 Excess Return	3.86%	3.69%	3.14%	5.76%	

Source: Barclays

As alluded above, several issuer and sector specific events during the month began to drive meaningful bifurcation in performance across credits. The Fresh Market and other levered supermarket bonds continued to trade lower in August after initial fears of the Amazon effect on industry economics (competition, deflation, margin erosion, etc.) were at least partially confirmed.Price cuts announced at Whole Foods ranged across numerous items with initial spot checks identifying price cuts consistently in the 40-50% range. Windstream bonds (and stock) also sold off meaningfully during the month, with the other ILECs gapping lower in concert (Frontier, CenturyLink), after the company announced a surprise end to its dividend. The declines signaled concern over the company's medium-term liquidity position and reignited fears regarding the secular challenges facing the sector. Oil-levered credits underperformed as weak commodity prices, both spot and futures, compounded already wavering sentiment following generally underwhelming second quarter results. Notably, higher beta energy credits (Servicers and E&Ps with subpar acreage/basin exposure and high costs of extraction) continue to meaningfully underperform higher quality comps as investors temper expectations for a sustained recovery in oil prices. On the other end of the distribution, Transportation Services, specifically Hertz, Avis and auto dealers, received a jolt as investors priced in the prospective benefits from Harvey and Irma to used car sales, dealer inventories and residual values. IPPs also outperformed following Energy Capital Partners announced acquisition of Calpine, sparking renewed focus on near-term credit enhancing M&A optionality in the merchant power space.

Best Sectors	August	YTD
Transportation	1.96%	9.56%
Electric	0.91%	7.88%
Banking	0.72%	9.88%
Construction Machinery	0.68%	7.50%
Automotive	0.59%	5.91%

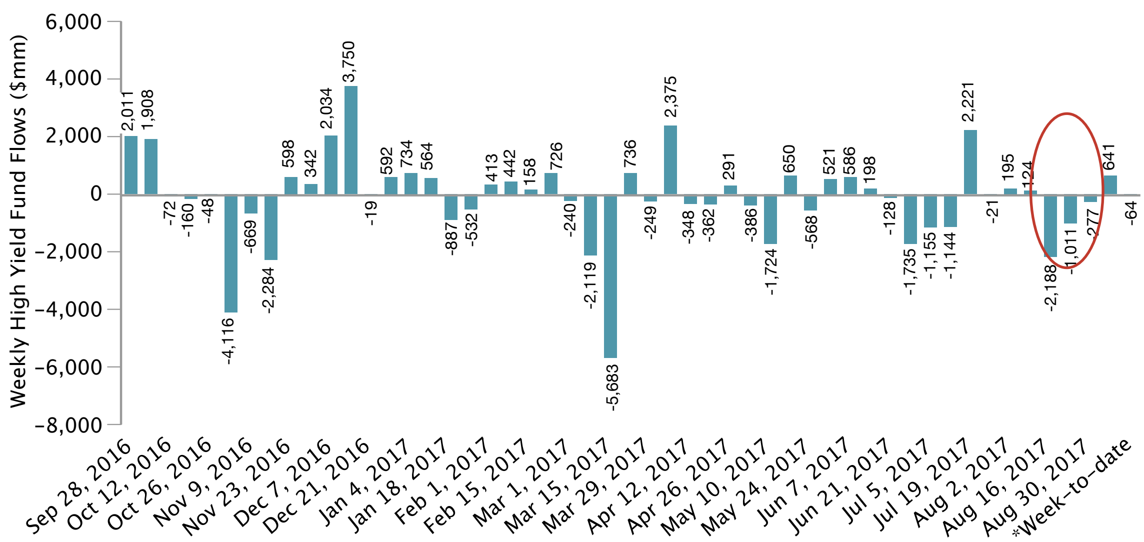
Worst Sectors	August	YTD
Supermarkets	-1.75%	-0.96%
Wirelines	-1.70%	2.81%
Independent	-1.50%	-0.58%
Leisure	-1.19%	4.93%
Oil Filed Services	-1.05%	1.13%

Source: Barclays

MARKET TECHNICALS

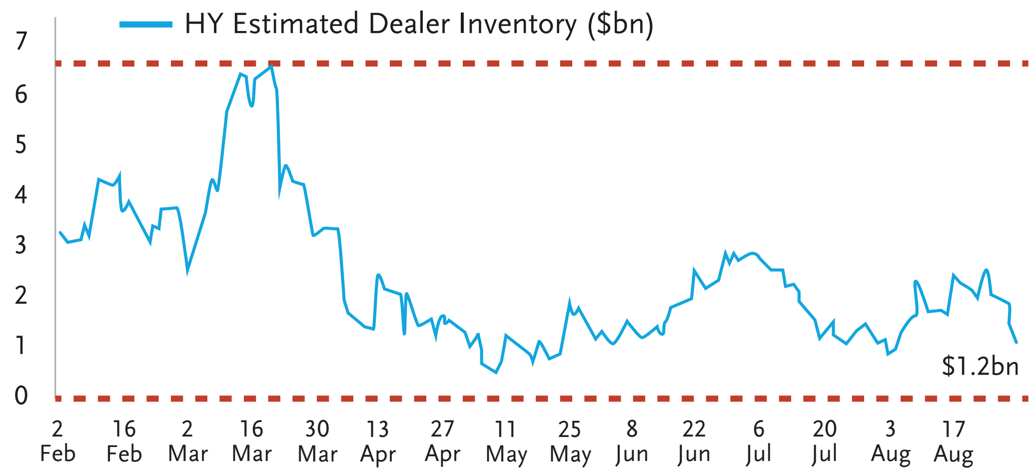
High yield funds, particularly ETFs, saw fairly meaningful net outflows, totaling -$3.3bn, during the month. The selling pressure was most pronounced in the second week of the month as geopolitical tensions weighed on retail risk appetite and the heavy new issue calendar (discussed below) likely incentivized institutional portfolio managers, who utilize HYG for cash management purposes, to reduce holdings of the ETF. Outflows did subside as the month progressed and rhetoric out of North Korea and the White House calmed, easing technical pressures and supporting the late month grind higher in higher quality credits. Dealer inventories painted a similar picture throughout the month: They rose amid the outflows and secondary selling against the heavy new issue calendar. Then they sharply contracted back toward the lows of the year as investors put cash back to work in a sparsely populated marketplace.

A Stretch of ETF Outflow Mid-Month Indiscriminately Pressured Market Prices



Source: Lipper, JP Morgan

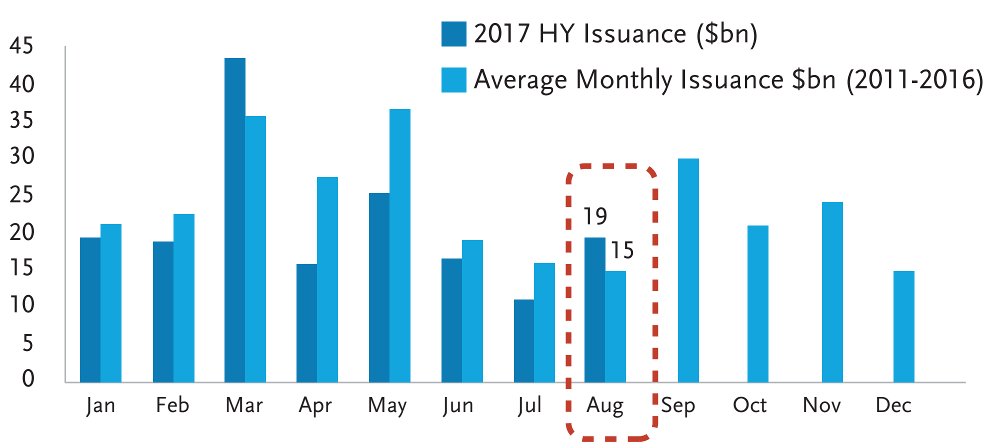
Dealer Inventories Remain Near YTD Lows Ahead of Historical Active September Trading/Issuance



Source: Barclays

In contrast to light new-issue activity in July, the primary market was open for business during the first half of August (before shuttering in the final two weeks of the month). Approximately $19bn in USD-denominated debt cleared the high yield market before August 18th, keeping pace with the near-record-setting March calendar. Commodity sensitive cyclical and structurally challenged credits crowded the calendar with deals being funded at still fairly reasonable costs of capital. The standout deal of the month was undoubtedly the Tesla senior notes which priced at par to yield 5.3%; an interesting benchmark bond to track going forward. Taking stock of new issue performance mid-month, results were mixed with several deals trading below issue price as heavy issuance in a short window weighed on the market.

August Saw Above Average Issuance Crowded into the First Two Weeks of the Month



Source: Credit Suisse

High Yield Net Supply ($M)

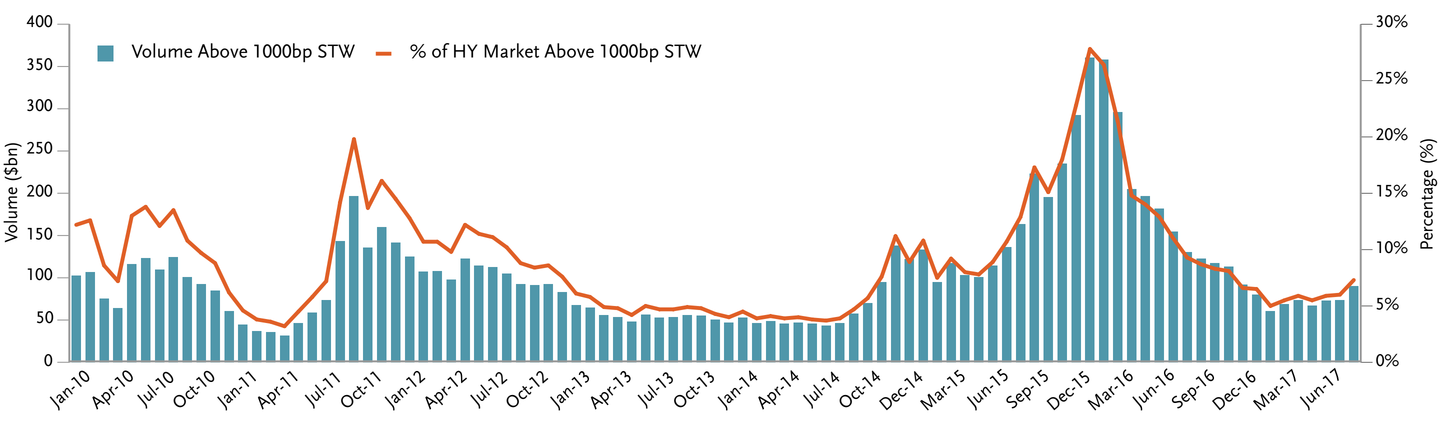
Month	New Issue	Redemptions	Net Supply	Monthly Returns
08/31/16	16,647	22,606	(5,959)	2.09%
09/30/16	25,207	29,030	(3,823)	0.67%
10/31/16	13,452	35,225	(21,773)	0.39%
11/30/16	15,282	22,208	(6,926)	-0.47%
12/31/16	18,581	26,359	(7,778)	1.85%
1/31/17	18,803	20,783	(1,980)	1.45%
2/28/17	18,916	26,891	(7,975)	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	19,721	37,114	(17,393)	0.14%
7/31/17	11,006	28,127	(17,121)	1.11%
8/31/17	19,473	19,252	221	-0.04%

Source: Barclays

FUNDAMENTAL TRENDS

August witnessed zero high yield borrowers default on their obligations, following similarly de minimis default activity in July (recall, loan-only borrower True Religion and distressed retailer J Crew filed Chapter 11 and effected a distressed exchange, respectively). While defaults were nonexistent in August, the level of stress in the marketplace (defined as the par value of bonds trading >1,000bps) did notch higher during the month. Indeed, with CCCs underperforming, particularly in the Energy patch, and secularly pressured credits re-pricing sharply lower (Wirelines, Retail / Supermarkets), the level of stress and the level of dispersion in high yield credit is quietly increasing.

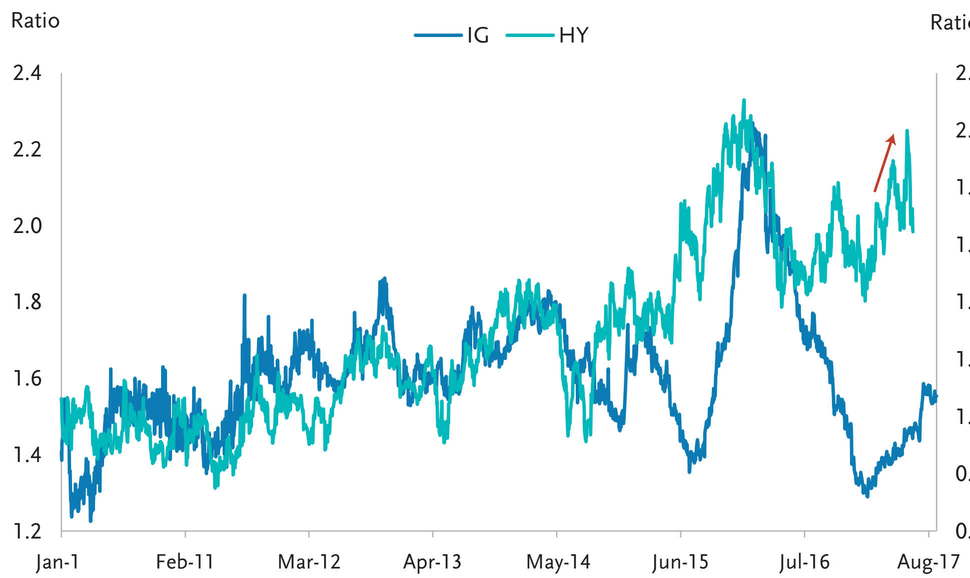
The HY Distressed Ratio Increased +130 bps in August to 7.3%



Source: JP Morgan

....And Bond Level Dispersion Is Rising As Well

Ratios of the inter-declie range, differential between the 90th and 10th percetiles, to the median spread across the bond constituents of iBoxx IG and HY indicies.



Source: iBoxx, Goldman Sachs Global Investment Research