TCW

INSIGHT

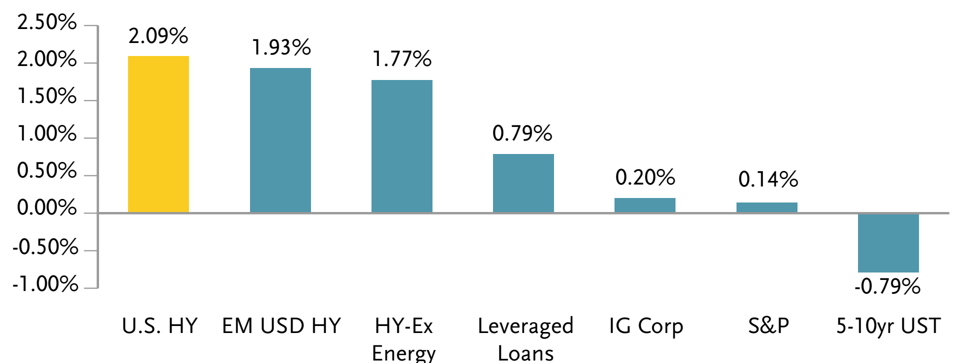
MONTHLY COMMENTARY

August High Yield Credit Update

BRIAN GELFAND | SEPTEMBER 15, 2016

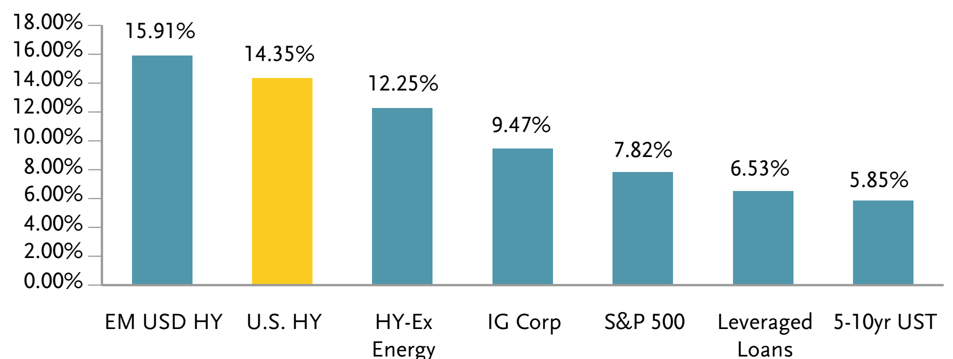
I will refrain from altering the title of this monthly commentary for consistency sake, though needless to say, with the prospective IRRs on offer in the *Junk* or *Sub-Investment Grade* market today, the term *High Yield* just doesn't seem all that appropriate. But I digress, as the fact remains on a trailing basis, returns for the asset class have been nothing short of stellar: +14.4% YTD and +2.1% in August. Comparatively, there is no equal when considering performance across major asset classes on a year-to-date basis, save for EM credit, and in the month of August specifically, HY stood atop the podium.

HY Returns Topped All Major Asset Classes in August...



Source: Barclays, Credit Suisse

...With Market Leading YTD Performance



Source: Barclays, Credit Suisse

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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.

August High Yield Credit Update

The marketplace for high yield bonds continues to benefit from overwhelming demand for paper as an increasingly global investor base crowds into one of the few remaining trades which seem to offer relatively high *returns*...excuse me, *yields*. The natural conclusion of this imbalance between the demand for and supply of bonds, has been higher market clearing prices (and inversely, lower risk premiums). In July, this demand targeted higher quality credits, pushing bond prices to new highs. In August, with yields on higher quality bonds now significantly reduced, this demand rotated out the risk spectrum. The effect was to advance, across quality buckets, the spread compression that has taken place for much the year.

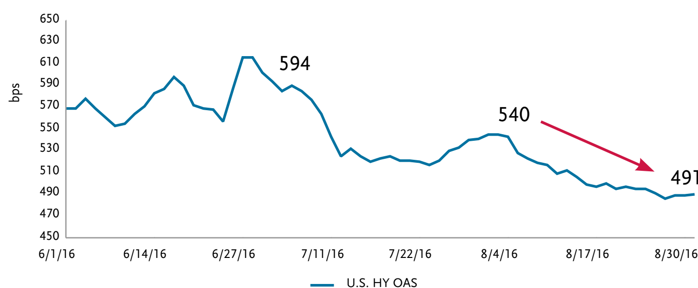
Now, there is nothing inherently wrong with this dynamic, as there are many conditions that fundamentally warrant rising demand and declining spreads. However, these conditions do not appear to be in place today. Whether you consider the micro, with now five (and potentially six) consecutive quarters of negative earnings growth, deteriorating credit metrics, and structurally vulnerable market liquidity, or the macro, with sluggish GDP growth, deflationary pressures, and increasing political/populist uncertainty, risk is fundamentally on the rise, not the decline. Instead, market levels are increasingly reliant on the 'hope trade' that prevailing technicals will continue to maintain the status quo and preserve prospective total return.

Favorable technicals absent substantiating fundamentals is a formula which we believe to be unsustainable in a mean reverting world. As such, we continue to maintain a defensive posture in our portfolios, focused on underwriting fundamental risk in preparation to deploy capital when the technicals turn.

Market Performance

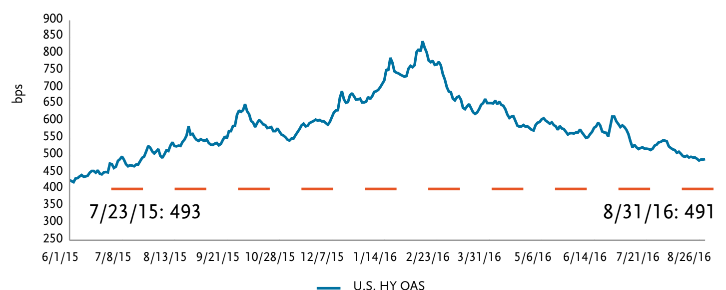
August saw high yield spreads grind steadily tighter for the better part of the month, with only a modest pullback in the last few days interrupting an otherwise one-way trade. Spreads have been on an incredible run since touching local wides in mid-February, closing out August at 2016 lows and in-line with levels last seen in July 2015. The +2.09% total return for the asset class marked the seventh straight month of positive performance, bringing YTD total return to +14.35%! *Complacency* would be the best word to describe investor sentiment during the month. Complacency regarding lower-for-longer interest rates and the efficacy of a central bank put. Complacency regarding dormant market volatility. Complacency regarding favorable technicals continuing to trump weakening fundamentals in the marginal pricing of risk. And that complacency, compounded by rising crude prices during most of the month, drove higher risk credits (i.e. CCCs and distressed) and higher beta sectors (i.e. commodity-linked E&P, Chemicals, Pharma, etc.) to outperform on an absolute and beta-adjusted basis as investors reached for yield. Indeed, CCC spreads tightened -108bps for a 10.2% change on the month, over double that of B-rated credit spreads (-47bps, 8.1%) and near quadruple that of BB-rated credit spreads (-27bps, 7.7%).

August Saw HY Spreads Grind Steadily Tighter...



Source: Barclays

...Bringing Levels Full Circle Over the Last 13 Months



CCCs Outperformed on an Absolute and Beta-Adjusted Basis

	Ba	B	Caa
HY OAS (7/31)	350	516	1,057
HY OAS (8/31)	323	474	949
Chg (bps)	(27)	(42)	(108)
Chg (%)	**7.7%**	**8.1%**	**10.2%**

Source: Barclays

As noted, higher beta CCC-rated bonds (and distressed securities) lead the charge in August, with Energy-related credits, specifically E&P, posting the strongest gains. While a broad-based reach for yield definitely favored lower quality credits and drove the relative spread compression discussed above, the back up in Treasury yields compounded the relative total return across quality buckets as BBs have greater interest rate duration than do CCCs.

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

HY Performance	HY	Ba	B	Caa	Ca-D
August 2016 Total Return	2.09%	1.48%	2.28%	3.29%	5.88%
2016 Total Return	14.35%	11.90%	12.92%	23.37%	55.98%
August 2016 OAS Chg	-49bps	-27bps	-42bps	-108bps	
2016 Excess Return	10.68%	8.62%	9.37%	20.39%	

Source: Barclays

There was no red ink spilled across high yield sector returns for the month. Sure, there was wide dispersion in performance across industries as fundamental drivers diverged (and starting yields left some sectors poised for further tightening while others had little room to run); however, with every sector in the black, the technicals were ultimately able to buoy all boats yet again. Independent E&P led the charge supported by rising crude prices in the middle of the month, in addition to positive idiosyncratic catalysts for benchmark issuers such as Chesapeake, which tendered for existing near-dated bonds with a new 1.5 lien term loan. Specialty Pharma also had a solid month on the back of a rally in the Valeant capital structure following the installment of a new CFO (vote of confidence) and continued rhetoric from management that leverage reducing asset sales are in the company's future. Chemicals also posted healthy returns in August as Chemours and Tronox bonds rallied after the companies demonstrated sustained increases in TiO_2 pricing during the second quarter. Underperforming on the month, though still generating positive returns, was Healthcare, notably rural for-profit hospitals that posted a series of underwhelming Q2 earnings results.

Best Sectors	August	2016 YTD
Independent	6.10%	32.52%
Pharmaceuticals	3.87%	4.19%
Financial Other	3.85%	7.03%
Wireless	3.19%	16.52%
Oil Field Services	3.09%	22.78%

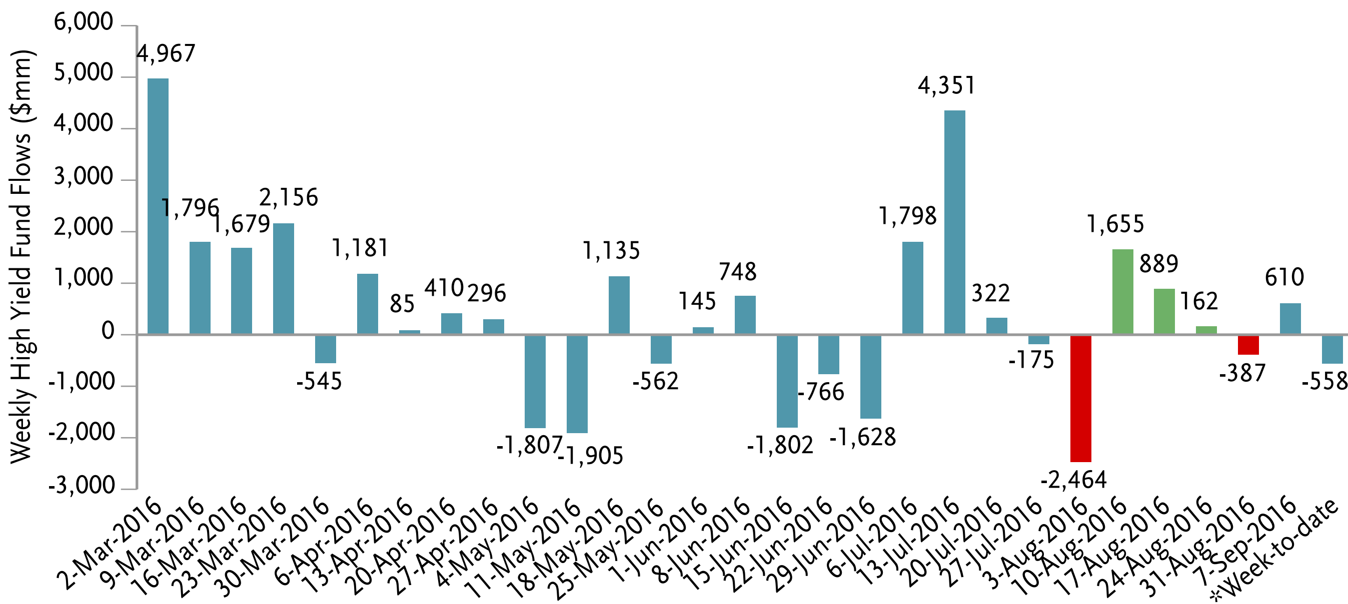
Worst Sectors	August	2016 YTD
Healthcare	0.35%	7.95%
Construction Machinery	0.67%	9.41%
Consumer Cyclical Services	0.68%	10.10%
Electric	0.78%	14.21%
Industrial Other	0.84%	17.57%

Source: Barclays

Market Technicals

It's all about the technicals! Demand-side technicals, to be exact, remained the central tenant of high yield bond performance in August. As discussed above, prices for high yield debt have been very well bid in recent months as ~$9.6 billion of net inflows into actively managed funds and ETFs thus far in 2016 (in addition to demand from crossover buyers and foreign accounts) have resulted in an influx of excess cash in the marketplace searching for a home. That demand pushed bond prices to new highs in July and subsequently drove spreads incrementally tighter in August. Interestingly, net fund flows were seemingly soft in August, as a large outflow in the first week of the month was nearly balanced by steady inflows in the subsequent weeks. Hardly a great technical story, however, there are a few things to consider here: 1) the overwhelming majority of the $2.5 billion outflow in the first week was from ETFs while actively managed funds had relatively balanced flows (as such, it is likely a portion of these flows were simply caused by a rotation on the part of active fund managers out of ETFs and into cash bonds versus cash actually leaving the marketplace), and 2) though flows were not robust during the month, with so much liquidity in the marketplace, anything apart from a sustained pace of meaningful outflows week-over-week is supportive for market demand. Now, although it is true a material exodus from the marketplace has been fleeting for many months now despite fundamental weakness, if Q4 of 2015 is any indication, investor sentiment and capital flows can turn on a dime, and we believe bond prices today are incredibly vulnerable to a change in the technicals...what the technicals giveth, they can taketh away.

Although Net Flows Were Balanced During the Month, the Cumulative Level of Excess Cash in the Marketplace Remains Highly Accommodative for Bond Prices



Source: Lipper, JPMorgan

Primary market activity during the month was rather robust from a seasonal perspective, with volumes eclipsing those seen during August 2015 and 2014, though understandably modest in absolute terms. Pent-up activity from a notably light, $13 billion USD-denominated July new issue calendar, was unleashed during the first two and a half weeks of August. As a result, approximately $17 billion of USD-denominated high yield bonds were priced during the traditionally sleepy summer month. As has been the case in recent months, new deals have been easily absorbed by investor demand with order books building up to multiples of deal size and the ultimate clearing price of the bonds coming at or through the tight end of the levels originally conceived by the underwriter. The menu of credits represented on the calendar was diverse and included a healthy representation of commodity-related issuers, which have enjoyed renewed access to the capital markets in recent months. Notably absent from the primary market, however, were CCC-rated issuers, which is traditionally a signal for elevated volatility and rising corporate defaults ahead, though risk premiums in the primary and secondary market appear to be ignoring this fact (among many other weakening fundamental indicators).

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%
8/31/16	16,647	22,606	(5,959)	2.09%

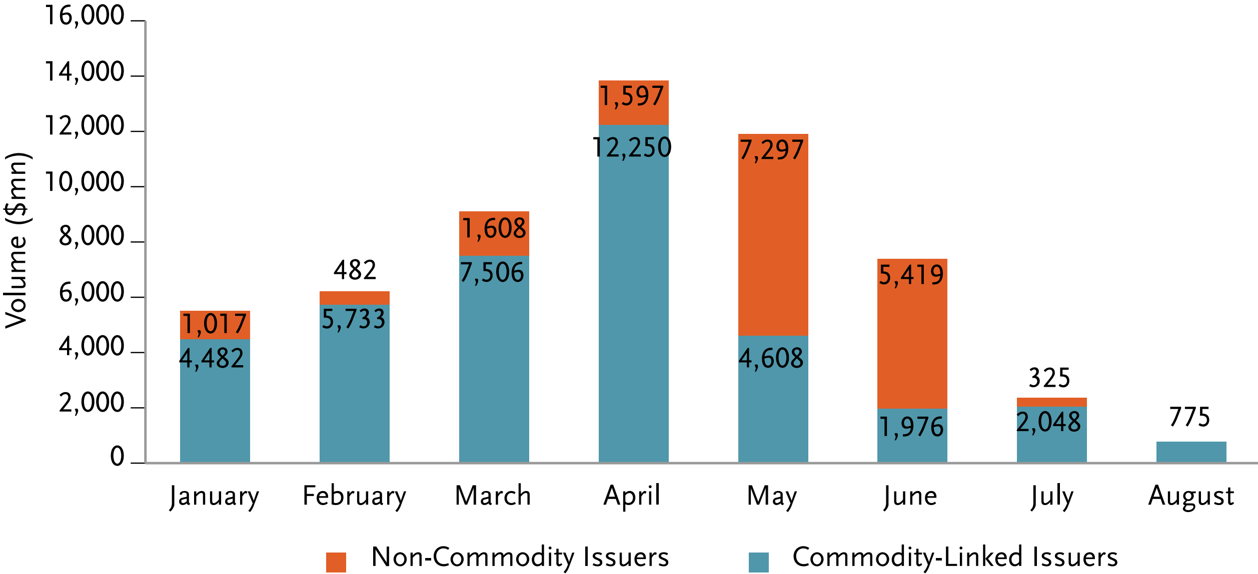
Source: Barclays

Fundamental Trends

Few high yield corporate bond defaults took place during the month of August...one actually, extending the trend of muted default activity we saw in July. At just $775 million of defaulted bonds ($940 million including loans), August leveraged finance default volume was the lowest monthly total in almost a year and a half. The modest activity experienced over the past two months, contrasts sharply with the heavy volumes seen during the first six months of the year (volumes that propelled YTD 2016 to rank as having the fifth highest annual default total on record). Highly leveraged borrowers' ability to service and repay their indebtedness is largely dependent on recurring access to capital (this is especially true for marginal issuers, though we note that even the most creditworthy, BB-rated leveraged borrowers generally rely on the ability to roll their debts in order to sustain their balance sheets). Therefore, it is no coincidence that against the backdrop of extremely accommodative debt and equity markets over the past two months, we have seen very little in the way of default activity. Companies are afforded a 'stay' by the marketplace, though in many cases this is simply a delay of the inevitable. No matter how accommodative the capital markets may be, however, there are certain capital structures that just no longer work, and not surprisingly, the single default during the month was a missed interest payment by Basic Energy Services, an oilfield services business. Commodity-linked sectors, namely Energy and Metals & Mining, have accounted for over 70% of the ~$57 billion in 2016 default volume.

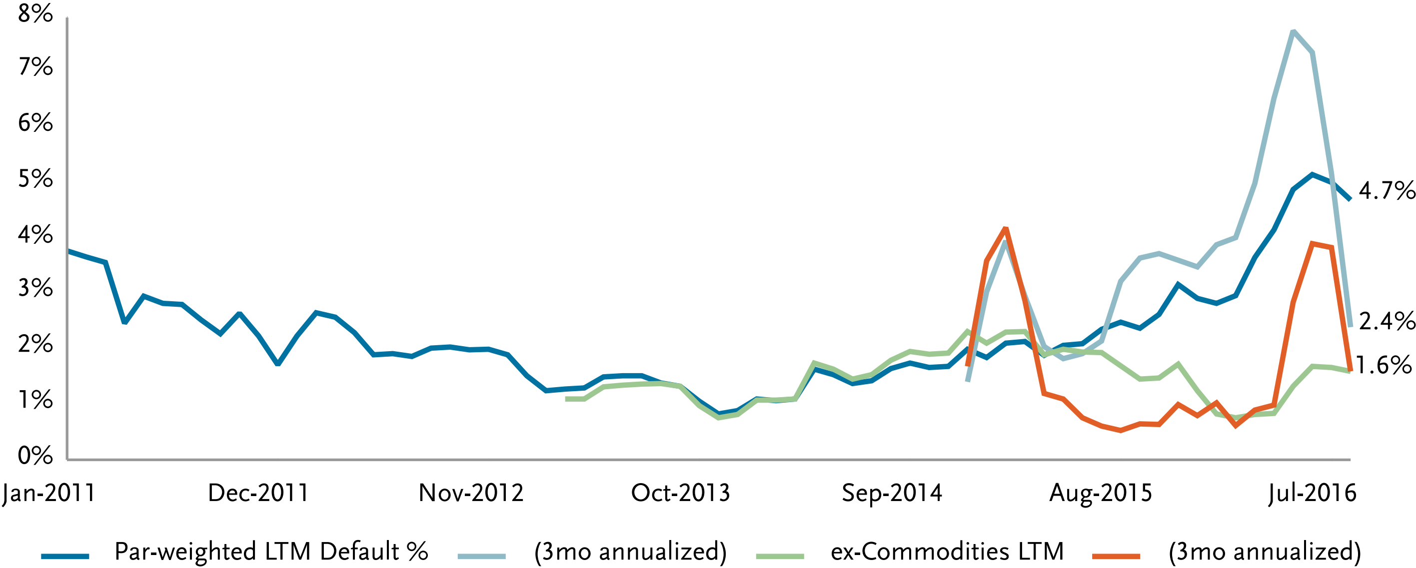
The trailing 12-month par-weighted default rate through August is 4.7%. While certainly the LTM metric is the most widely used benchmark in the marketplace, we think it prudent to also consider a more timely barometer to understand the momentum in recent default activity, specifically the trailing three-month default rate annualized. This statistic currently stands at 2.4%, down from 5.2% last month. Although we have seen a pullback in default volumes in recent months, we expect to see this data revert higher in the coming quarters as the cycle matures.

Default Activity was Virtually Non-Existent in August as Accommodative Markets Gave Marginal Borrowers A "Stay"



Source: Deutsche Bank

Recent Default Momentum Has Turned Sharply Lower in August



Source: Deutsche Bank

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