TCW

INSIGHT

MONTHLY COMMENTARY

# September High Yield Credit Update

**SIMON PARK AND BRIAN GELFAND** | OCTOBER 13, 2016

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Mr. Park is a Managing Director in the U.S. Fixed Income group, where he trades high yield and cross over securities and CDS. Prior to joining TCW in 2015, Mr. Park was a portfolio manager and the fund risk manager for the hedge fund JAE Credit Management, focusing on U.S. corporate securities and derivatives Previously, Mr. Park was a Managing Director and portfolio manager in relative value corporate credit for the internal investment unit at UBS and its externally run hedge fund, Dillon Read Capital Management. Mr. Park started his career at Goldman Sachs and was a Managing Director focused on crossover credit on its corporate bond trading desk. Mr. Park earned his BA in Economics from Harvard College.

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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.

## Learned Helplessness and Passive Investing

A form of behavioral conditioning, learned helplessness begins when a person (or animal) is repeatedly subjected to an adverse stimulus it cannot escape. After sufficient repetition, the person (or animal) becomes conditioned to believe it fruitless to try to avoid the stimulus. A learned impression of utter helplessness sets in. Subsequent to which, even if the person (or animal) is presented with an opportunity to avoid such stimulus, this learned helplessness will prevent action, with the person (or animal) merely acquiescing to what it perceives as predetermined. (For those Game of Thrones enthusiasts out there, think Theon Greyjoy after Ramsay reduced him to Reek.)

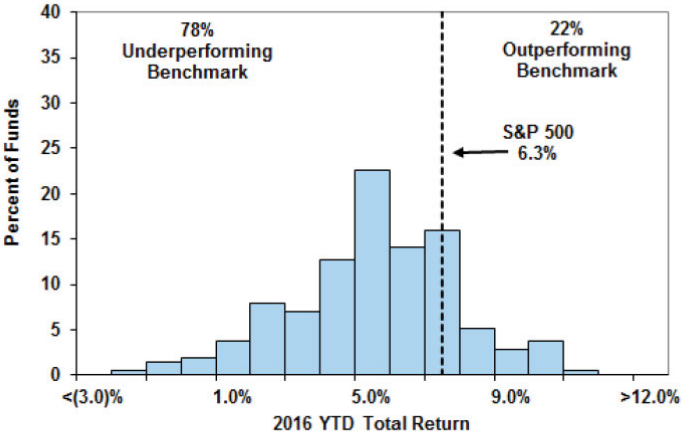
The condition of learned helplessness was discovered by psychologist Martin Seligman. In investigating this theory, Seligman ran an experiment using three groups of dogs. (As a dog lover, Simon would never be able to do this... He even tested a shock collar on himself before putting it on his dog, and then immediately decided to return it):

- Group 1 – the dogs were strapped in harnesses for a period of time and then released.
- Group 2 – the dogs were strapped in harnesses for a period of time, but were given electric shocks that could be avoided by pressing on a panel with their noses.
- Group 3 – the dogs were strapped in harnesses for a period of time, were given electric shocks, but were not given any ability to control the shocks. To this group, the shocks seemed random.

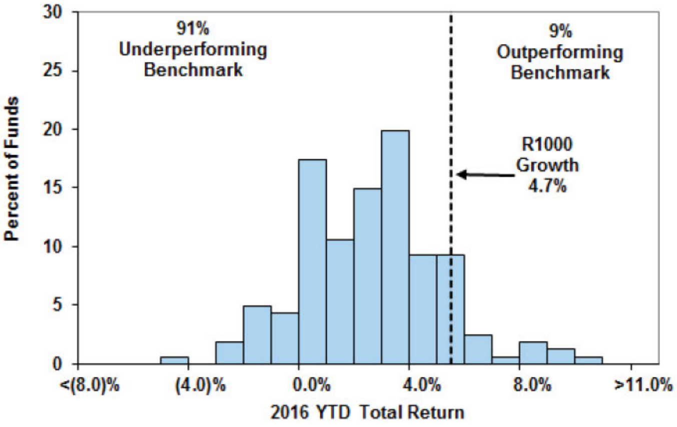
After this initial conditioning, the dogs were placed in a shuttle box comprised of two chambers separated by a low barrier, with the floor electrified on one side and not the other. The dogs merely had to climb over the barrier to the non-electrified chamber to avoid being shocked. The dogs in Groups 1 and 2 quickly learned that jumping the barrier avoided the shocks. (Simon is not 100% positive that his dog would have figured this out). The dogs in Group 3, however, because of their conditioning, made no attempt to escape. They had developed the expectation that nothing they could do would prevent being shocked.

When people become conditioned to feel they have no control over their environment, they may also begin to behave in a helpless manner. In investing, passive management or 'buying the market' can be equated as a form of investor acquiescence or helplessness. The debate over active vs. passive management often becomes most impassioned near market peaks. As the bull market matures and reaches its exuberant tail, the effects of market beta overwhelm, and the passive camp emerges as a siren luring wary investors with the assurance of no worse than market performance. This serves as an intriguing proposition, particularly in equities (a sector where the handover from active to passive management has been most acute), with only 22%, 9% and 17% of core, growth and value equity managers, respectively, beating their benchmark indices year-to-date.

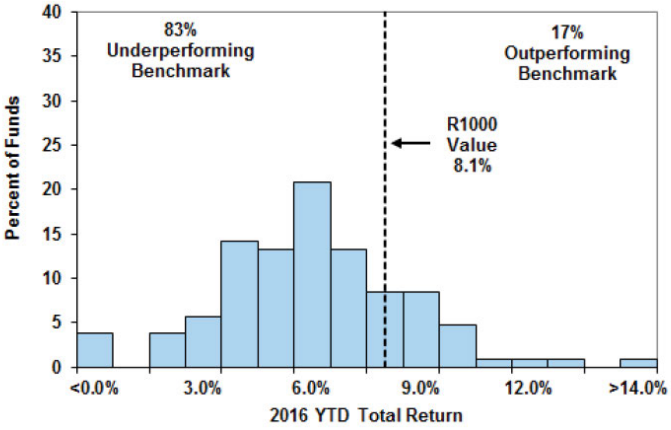
## Active Equity Strategies Have Lagged Their Respective Benchmarks in 2016



Source: FactSet, Goldman Sachs Investment Research



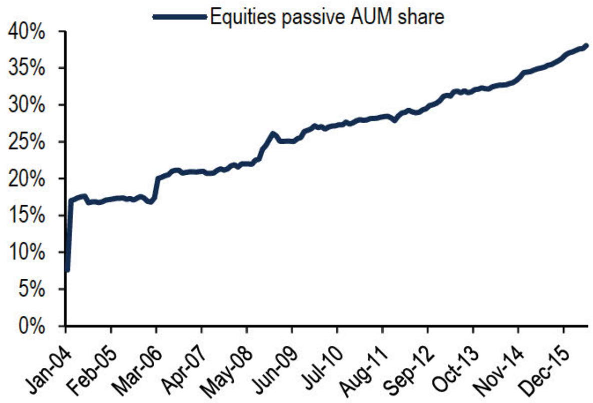
Source: FactSet, Goldman Sachs Investment Research



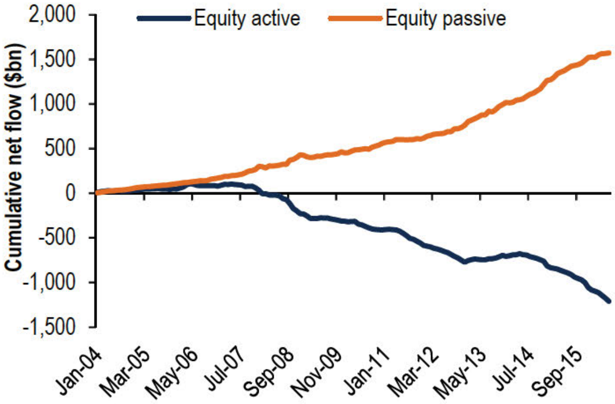
Source: FactSet, Goldman Sachs Investment Research

With few active equity strategies providing the elixir of outperformance, money has continued to rotate out of active funds and into passive vehicles, with 38% of equity AUM now in passive strategies.

## Equities



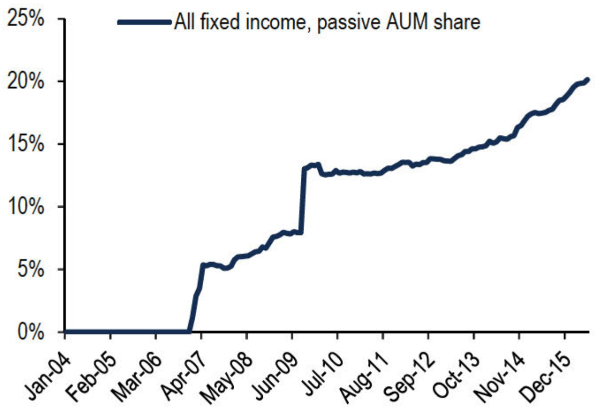
Source: BAML



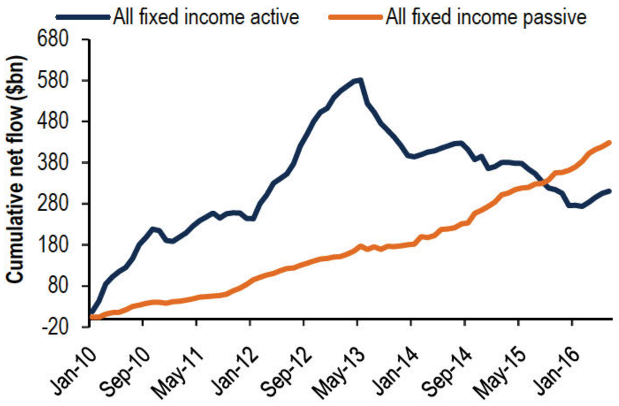
Source: BAML

And while active fixed income management has been more immune to such an exodus in the past, the rotation has accelerated amidst recent underperformance of active strategies and greater adoption of portfolio products (namely, ETFs).

## All Fixed Income

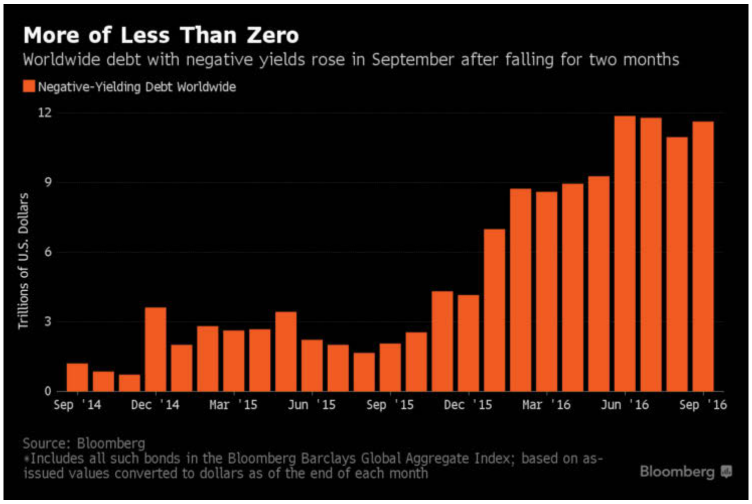


Source: BAML



Source: BAML

To be certain, a passive strategy will only do as well as the market, no better and no worse. Therefore, acquiescing today implies locking-in the prospective performance of the market. Well, with an increasing number of debt instruments in the global bond market carrying negative yields (compliments of global central bank policy), we think it reasonable to question the logic behind a strategy foregone to generate a negative rate of return (other than the prospect for a greater-fool outcome whereby the holder of a negative-yielding instrument is able to sell that asset (liability) at an even greater negative yield).


More of Less Than Zero

Worldwide debt with negative yields rose in September after falling for two months

Source: Bloomberg
*Includes all such bonds in the Bloomberg Barclays Global Aggregate Index; based on as-issued values converted to dollars as of the end of each month

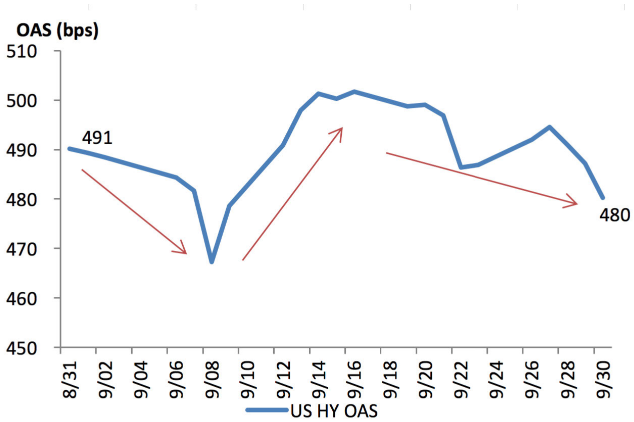
Moreover, the prevalence of negative yielding debt instruments begets lower yields on riskier instruments like investment grade and high yield credit. Therefore, today, a passive strategy in these riskier sectors effectively locks-in the prospective performance of a market where risk is dangerously mispriced (again, difficult to rationalize outside a greater fool theory). As such, with repressed yields for all fixed income products, and math on our side, we believe now is the time for active managers to lean against the tide of the helplessness that late-cycle dynamics (and global central banks) have conditioned investors to accept.

## Market Performance

If you were not paying attention to the markets during the month of September and were simply given the average OAS of the high yield market and the term structure of interest rates for August 31 and September 30, you would likely conclude it was a sleepy, coupon-clipping month. Indeed, with high yield spreads tightening just 11bps and 5yr, 7yr and 10yr treasury yields moving -5bps, -3bps and +1.5bps, respectively, high yield bond total return in September was largely attributable to carry (0.54% of the 0.67% total return was coupon). Intra-month, however, was characterized by elevated volatility in spreads and rates, with a high degree of correlation between the two (the cognitive dissonance of which we have covered in recent commentaries). Policy actions (and investor speculation thereof) from the Fed, ECB and BoJ (and you can now throw the BoE into the mix), and the resultant impact on sovereign curves, crowded the tape in September, influencing investor sentiment and price action. To be certain, there is a dearth of fundamental support for current high yield bond spreads (prospectively six quarters of negative earnings growth, deteriorating credit metrics, poor market liquidity), a thesis not only held by the bearish crowd, but increasingly acknowledged by many bulls. Rather the technicals, buttressed by artificially repressed sovereign rates, serve as the linchpin for the greater fool theory trade in effect today. As such, in a world where marketplace technicals and not credit fundamentals are setting the marginal clearing price for risk, this heightened attention (nearing paranoia status) to the principal drivers of said technicals, i.e. sovereign yields and central bank policies, makes perfect sense.

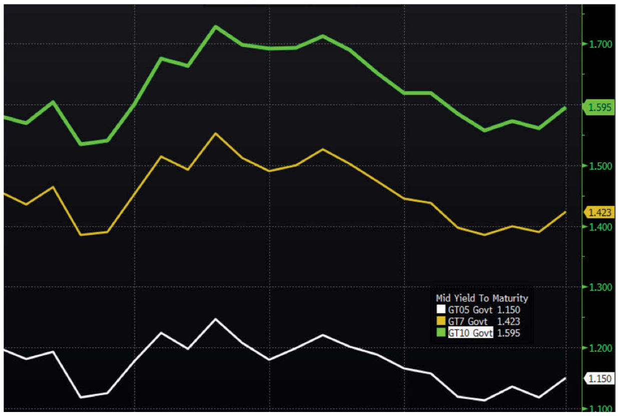
### High Yield Spreads and U.S. Interest Rates Took a Round Trip During September

U.S. HY Option-Adjusted Spread



Source: Bloomberg Barclays

5, 7, 10 Year U.S. Treasury Yields



Source: Bloomberg Barclays

Sharing the spotlight this month was crude, as the price of the nearest maturing WTI contract rallied in the final week of the month on headlines that OPEC oil ministers in Algiers reached an agreement in principal to target a production run-rate of 32.5-33mbd following their November 30th meeting. As this in theory represents a modest cut from the August and September near-peak production pace, commodity traders viewed the unexpected outcome as a bullish signal and re-priced crude accordingly. The news also compounded improving sentiment after weekly EPA stockpile data during the month showed consistent week-over-week declines in crude inventory. Energy-linked high yield debt rallied in-kind, and after the September rally, Energy is no longer the widest trading sector in the high yield marketplace. Although investor sentiment towards the commodity price deck is more favorable today, we note the margin for error is still razor thin as the physical market remains awash with supply and a rebalancing in the oil market is still not expected until 2H17 (assuming the status quo of falling supply and rising demand holds). Objectively, spreads of high yield energy bonds have already run ahead of the physical market, pricing in not only a straight-line return to equilibrium, but also a clearing price that permits generous free cash flow generation for the US independents. In other words, the high yield market has become uncomfortably comfortable with the recovery in the energy sector (as far as risk pricing in concerned).

Looking at returns across quality buckets, though muted in absolute terms, the compression trade remained unfettered in September, as spreads of CCC-rated bonds (and distressed securities) tightened by a greater degree than those of BB- and B-rated paper. Moreover, total return for distressed securities materially outperformed higher quality sectors during the month (as has been the case YTD).

| HY Performance | HY | Ba | B | Caa | Ca-D |
|---|---|---|---|---|---|
| September 2016 Total Return | 0.67% | 0.35% | 0.53% | 1.77% | 4.69% |
| 2016 Total Return | 15.11% | 12.29% | 13.28% | 25.55% | 63.29% |
| September 2016 OAS Chg | -11bps | -6bps | -7bps | -16bps | |
| 2016 Excess Return | 11.31% | 8.17% | 9.61% | 22.39% | |

Source: Barclays

The attribution of sector performance in September was not too dissimilar to what we have seen since the spring. E&P and Metals outperformed on the back of improved commodity prices and the overarching reach for nominal relative value. The wireless sector was supported by net positive price action in Sprint bonds as investors became increasingly constructive on the turnaround strategy of and future prospects for the carrier. Pharma has been a consistent underperformer in recent months as adverse regulatory scrutiny over high drug price increases continue to flank the sector. Concordia International was at the center of the sector's poor performance this month after a bill was introduced in the U.K. that would allow the Department of Health to regulate generic drug pricing (specifically targeting those drugs where the price increases have been deemed excessive). Other pharma capital structures traded down in-kind. The subordinated debt of European financial institutions also faced headwinds amidst negative headlines relating to Deutsche Bank. Finally, although not atop the list of underperforming sectors for the month, television broadcasting bonds re-priced lower as management teams suggested political advertising revenues will not meet prior lofty expectations given underspending from the Trump campaign.

| Best Sectors | September | 2016 YTD |
|---|---|---|
| Financial Other | 2.68% | 9.90% |
| Independent | 2.37% | 35.66% |
| Metals & Mining | 2.24% | 41.12% |
| Wireless | 1.29% | 18.02% |
| Midstream | 1.19% | 26.34% |

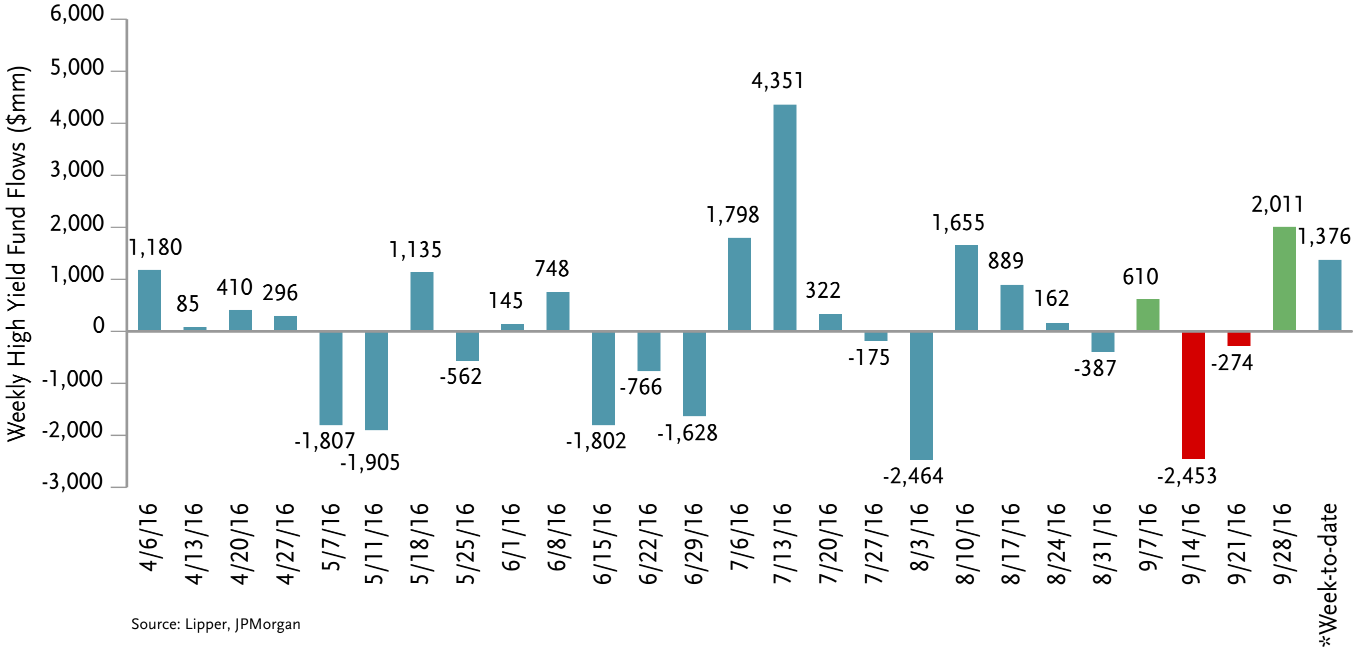
| Worst Sectors | September | 2016 YTD |
|---|---|---|
| Pharmaceuticals | -1.56% | 2.56% |
| Banking | -0.75% | 3.95% |
| Wirelines | -0.34% | 14.10% |
| Supermarkets | -0.29% | 8.65% |
| Aerospace / Defence | -0.19% | 17.58% |

Source: Barclays

## Market Technicals

High yield bond flows were actually net negative during the month, objectively a break from the current trend, though we wouldn't exactly call it an inflection point just yet. First, high yield funds reported a net outflow of just -$105mn, which compares to a net inflow of ~$1bn in August and >$5bn in July. More importantly, not to lose sight of the forest for the trees, as the high yield marketplace remains awash in liquidity with a reported inflow of +$9.6bn year-to-date. The technical thesis remains intact as the sufficient imbalance between the demand for high yield bonds and the supply of high yield bonds continues to hold (and will require a more meaningful reversal of fund flows to unwind – a la 4Q15 / 1Q16).

**Net Funds Flows Were Negative in September, Though Not Enough to Derail the Technical Narrative**



Source: Lipper, JPMorgan

The shadow calendar for high yield new issues was quite robust coming into the month given carryover from light summer volumes and an understandably deep bench of opportunistic issuers looking to raise capital at record low rates. Most dealers were calling for >$30mn USD denominated new issue volumes for the month, setting a high water mark for the year. The primary market kept pace during the first three weeks, with a diverse menu of issuers clearing deals at historically low yields ($7bn in week one, $8bn in week two, $7bn in week three). The pace slowed coming into the final week, however, as the back-up in rates and market volatility mid-month dissuaded some of the opportunistic supply from jumping off the bench. Only $2bn of USD denominated debt was issued during the final week of the month. As such, September ultimately priced a little over $25bn of USD denominated paper, very respectable, though shy of original expectations. Also weighing on the total was interest on the part of companies to finance part or all of their capital needs in Europe. The -50bp to -75bp discount between like-paper priced in USD vs. EUR was very enticing to companies, particularly those with natural currency hedges via business lines (and cash flows) in continental Europe.

### High Yield Net Supply ($mn)

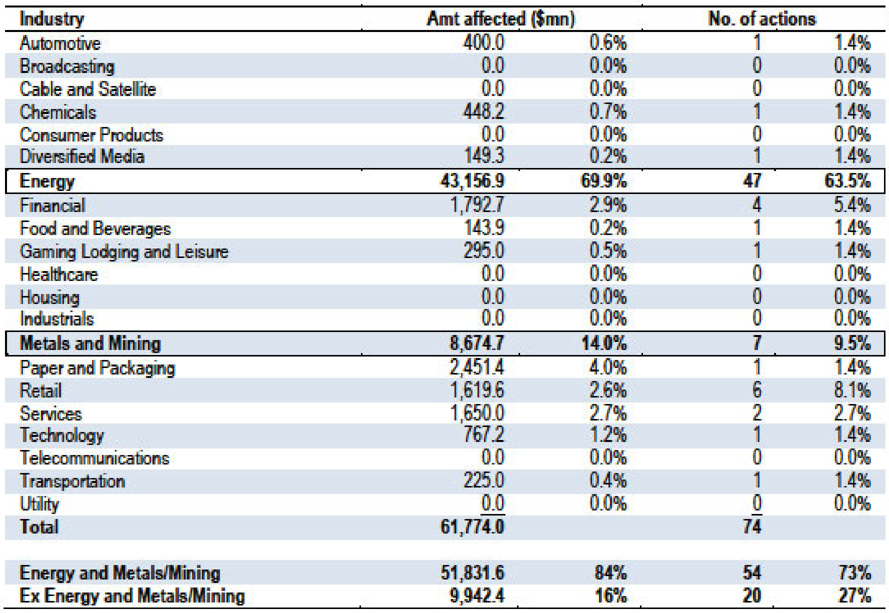
| Month | New Issue | Redemptions | Net Supply | Monthly Returns |
|---|---|---|---|---|
| 12/31/15 | 3,077 | 28,406 | (25,329) | -2.52% |
| 1/31/16 | 5,923 | 12,449 | (6,526) | -1.61% |
| 2/29/16 | 7,557 | 15,556 | (7,999) | 0.57% |
| 3/31/16 | 18,226 | 12,920 | 5,306 | 4.44% |
| 4/30/16 | 31,176 | 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% |
| 9/30/16 | 25,207 | 29,030 | (3,823) | 0.67% |

Source: Barclays

## Fundamental Trends

High yield corporate bond defaults remained dormant in September, continuing the paradigm that emerged this summer following elevated activity in the first half of the year. Last month's count of three high yield bond issuer defaults (note the original estimate of one default which we discussed in the last commentary has since been revised to three) affecting $1.6bn in high yield bonds, was followed by a current tally for September of two high yield bond issuer defaults impacting $945mn in notional debt. The two companies were an oilfield services provider and a miner, industries which have represented the lion's share of default volumes over the past nine months (see table below). Including institutional loans, default volume was $2.7bn for the month, less than 1/3rd the monthly average during the first five months of the year (~7 issuers and $8.5bn in par debt per month). Distressed exchanges were, however, prevalent in September. Approximately $2.2bn of par paper was party to distressed exchanges, which compares to $2.8bn in August and $3.3bn for the first seven months of the year. The decline in defaults and permissibility of distressed exchanges is characteristic of a marketplace that has re-opened to marginal issuers, a feature susceptible to quick reversion given the mature nature of the credit cycle.

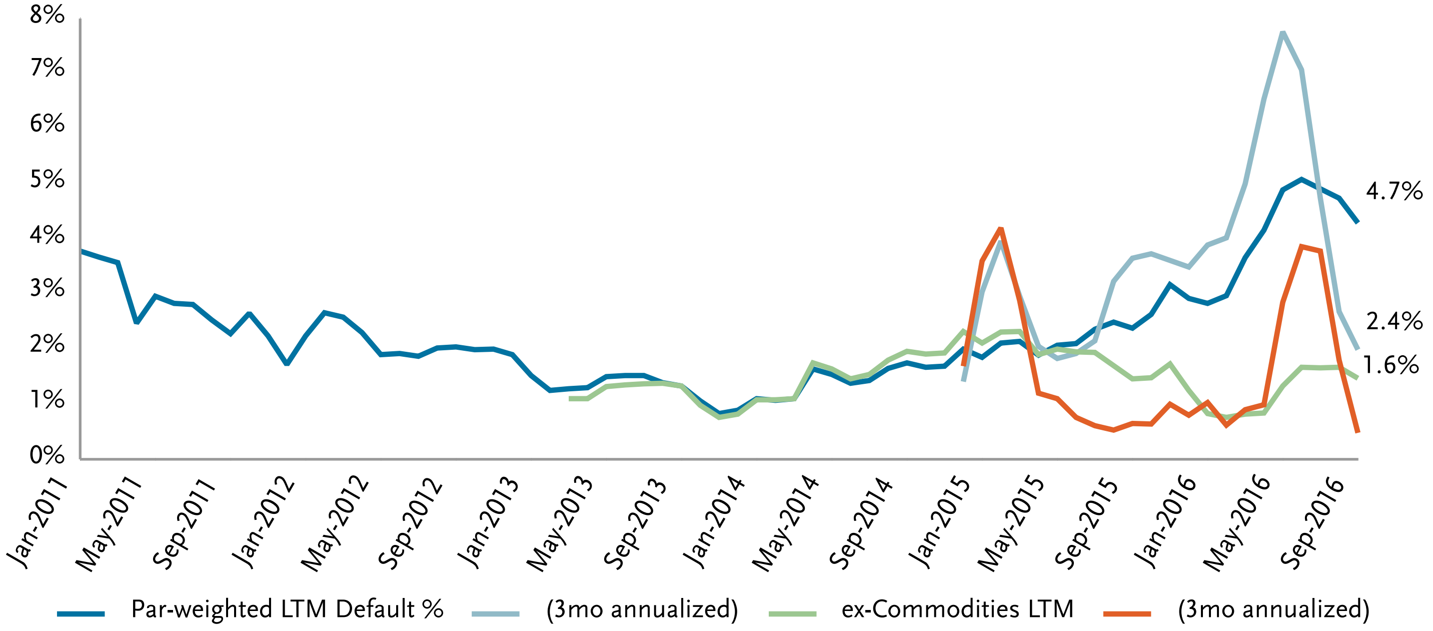
### Energy and Metals Issuers Continue to Represent the Majority of YTD Default Volumes, Though the Absolute Level of Activity has Greatly Diminished in Recent Months



| Industry | Amt affected ($mn) | | No. of actions | |
|---|---|---|---|---|
| Automotive | 400.0 | 0.6% | 1 | 1.4% |
| Broadcasting | 0.0 | 0.0% | 0 | 0.0% |
| Cable and Satellite | 0.0 | 0.0% | 0 | 0.0% |
| Chemicals | 448.2 | 0.7% | 1 | 1.4% |
| Consumer Products | 0.0 | 0.0% | 0 | 0.0% |
| Diversified Media | 149.3 | 0.2% | 1 | 1.4% |
| **Energy** | **43,156.9** | **69.9%** | **47** | **63.5%** |
| Financial | 1,792.7 | 2.9% | 4 | 5.4% |
| Food and Beverages | 143.9 | 0.2% | 1 | 1.4% |
| Gaming Lodging and Leisure | 295.0 | 0.5% | 1 | 1.4% |
| Healthcare | 0.0 | 0.0% | 0 | 0.0% |
| Housing | 0.0 | 0.0% | 0 | 0.0% |
| Industrials | 0.0 | 0.0% | 0 | 0.0% |
| **Metals and Mining** | **8,674.7** | **14.0%** | **7** | **9.5%** |
| Paper and Packaging | 2,451.4 | 4.0% | 1 | 1.4% |
| Retail | 1,619.6 | 2.6% | 6 | 8.1% |
| Services | 1,650.0 | 2.7% | 2 | 2.7% |
| Technology | 767.2 | 1.2% | 1 | 1.4% |
| Telecommunications | 0.0 | 0.0% | 0 | 0.0% |
| Transportation | 225.0 | 0.4% | 1 | 1.4% |
| Utility | 0.0 | 0.0% | 0 | 0.0% |
| **Total** | **61,774.0** | | **74** | |
| | | | | |
| **Energy and Metals/Mining** | **51,831.6** | **84%** | **54** | **73%** |
| **Ex Energy and Metals/Mining** | **9,942.4** | **16%** | **20** | **27%** |

The trailing 12-month par-weighted default rate through September declined -45bps to 4.3%. Assuming a continuation of the status quo, elevated volumes at the end of 2015 will begin to roll-off in the LTM data, putting downward pressure on the trailing default rate. This downward momentum is more fully appreciated when looking at the trailing three-month default rate annualized, which currently stands at 2.0% vs. a peak of 7.8% in May. When excluding the defaults of commodity-linked credits, the data obviously looks even more benign (though we tend to dismiss these more massaged figures as any series of data looks better when you remove the worse data points). ■

**Trailing Default Rates Continue to Decline**



Source: Deutsche Bank

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