TCW

INSIGHT

MONTHLY COMMENTARY

September High Yield Credit Update

BRIAN GELFAND | OCTOBER 16, 2017

Brian G. Gelfand
Vice President
Fixed Income

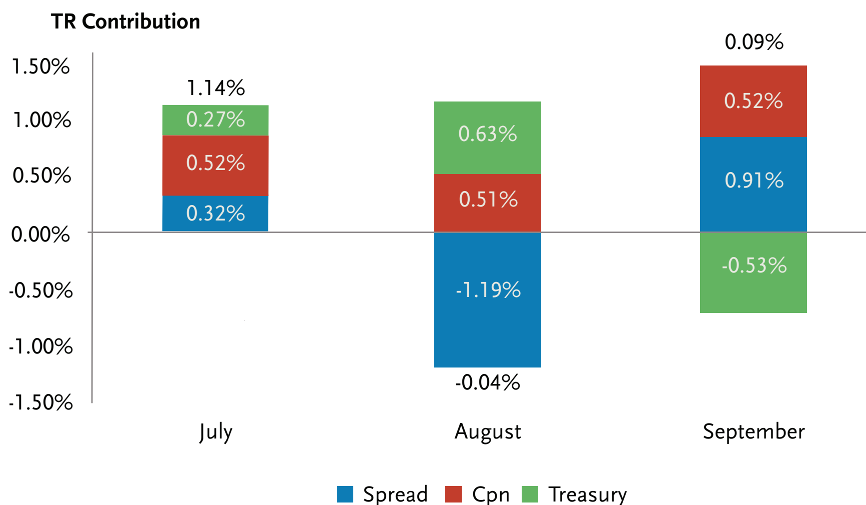
Mr. Gelfand is a Credit Trader in the Fixed Income group, focused on trading high yield securities. He joined TCW in 2014 as a Credit Analyst responsible for research across the telecom, technology and media sectors. Previously, while working towards his MBA, Mr. Gelfand completed internships in the 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.

The benefit of the doubt...a phrase that came to mind as I considered how to characterize sentiment in the high yield marketplace today. To not assume the worst while there is uncertainty, or said another way, to assume all is fine until there is clear evidence to the contrary. While investors do appear wary of valuations today -- and rightly so, given the maturity of the credit/ business cycle, elevated economic (China) and now thermonuclear (North Korea) risks abroad, political/fiscal output at home underwhelming initial optimism and significant uncertainty as the Fed ventures to unwind nearly a decade of monetary stimulus -- they seem willing to give the market the benefit of the doubt (and take a lot more risk to earn a little extra yield). This sentiment feels counterintuitive to us as uncertainty would seem to prescribe caution and warrant sufficient compensation, not the opposite. Moreover, while evidence to the contrary may not be apparent on the surface, sector and single name decompression has started to emerge, specifically in retail, supermarkets, media, wirelines, energy and transportation services. Just as poor breadth in equity markets is often cited as evidence of fundamental weakness, performance dispersion in credit often represents the tremor before the quake (recall early 2015).

MARKET PERFORMANCE

High yield bonds returned a respectable +0.90% in September. With reflation themes back in vogue, sufficient excess liquidity in the marketplace and rising oil prices emboldening investors to take incremental risk in the energy patch, a sustained bid for high yield bonds buoyed prices throughout the month (and in the case of higher risk energy bonds, lifted prices higher) despite the dual headwind of rising rates and heavy new issue supply.

Spreads Absorbed a ~20bp Shift in the Belly of the Treasury Curve



Source: Barclays

Across ratings categories, CCCs generated the highest total return for the month, aided by the stark outperformance of higher beta, lower credit quality E&P and oil field Services bonds. Already tight spreads of BB-rated credits coming into the month put a cap on further price appreciation for this cohort in the face of rising interest rates. At best, the healthy bid for high quality paper held prices stable, translating to even further spread compression for BB bonds.

CCC-Rated Energy Outperformed Highter Quality Comps Following Several Months of Underperformance...

Issuer	Bond	Rating	Bid (8/31)	Bid (9/29)	$ Delta
Select Low Beta E&P					
Diamondback Energy	FANG 5.37 25	B1/BB-	102.75	104.50	+1.75
Newfield Energy	NFX 5.375 26	Ba2/BB+	104.25	105.25	+1.00
Parsley Energy	PARSLY 5.375 26	B2/BB-	100.50	102.00	+1.50
Select High Beta E&P					
EP Energy	EPENEG 8 25	Caa1/CCC-	66.50	77.50	+11.00
Denbury Energy	DNR 4.625 23	Caa2/CCC+	44.00	53.00	+9.00
California Resources	CRC 8 22	Caa3/CCC+	55.00	65.00	+10.00

Source: TCW, Bloomberg

....Underpinning the Risk Rally During the Month

HY Performance	HY	Ba	B	Caa	Ca-D
September 2017 Total Return	0.90%	0.72%	0.83%	1.61%	1.13%
2017 Total Return	7.00%	6.90%	6.11%	9.26%	12.85%
September 2017 OAS Chg	-23bps	-26bps	-31bps	-52bps	
2017 Excess Return	5.35%	5.09%	4.50%	7.89%	

Source: Barclays

However, beneath the surface of the positive September performance was a fair bit of sector and single name dispersion. As discussed, the energy sector, concurrent with rising oil prices, was lifted out of its funk from the past several months as investor perception of industry trends improved following reports of steady global crude demand growth by the IEA as well as evidence of lower than expected production growth from U.S. shale producers. Add in the uncertainty from the Kurdish independence referendum and a little noise from Hurricane Harvey, and the market was left inspired to bid for oil-linked risk. Away from energy, the fallout from Harvey and Irma was a mixed bag for different industries. Transportation Services saw car rental constituents HTZ and CAR recover on expectations for rising used vehicle prices as replacement demand is pulled forward. On the flip side of the coin, hospital bonds, particularly the unsecured debt of more levered operators THC and CYH, traded heavy as prices began to embed expectations for earnings cuts compounding an already tenuous situation as Congressional Republicans made a last ditch effort to salvage ACA reform. Supermarkets were yet again the worst performing sector (three months running with a negative total return year-to-date), as poor earnings and forward guidance from The Fresh Market weighed on already rock bottom sentiment towards the industry in the wake of Amazon's foray into the space. Secularly challenged wireline bonds were searching for a floor yet again this month after a large activist holder of Windstream unsecured notes sent a notice of default to the company in regards to its separation of network assets into Uniti (fka CSAL) in 2015. Another notable detractor from market performance this month was Bombardier (Aerospace/Defense) which saw its capital structure trade down following news a 220% tariff will be applied to sales of its C-Series aircraft in the U.S. (in addition to an announcement that the two principal competitors of its railcar business in Europe had reached a merger agreement).

Best Sectors	September	YTD
Oil Field Services	5.44%	6.63%
Independent	4.14%	3.54%
Transportation Services	1.87%	11.61%
Pharmaceuticals	1.64%	13.14%
Leisure	1.36%	6.35%

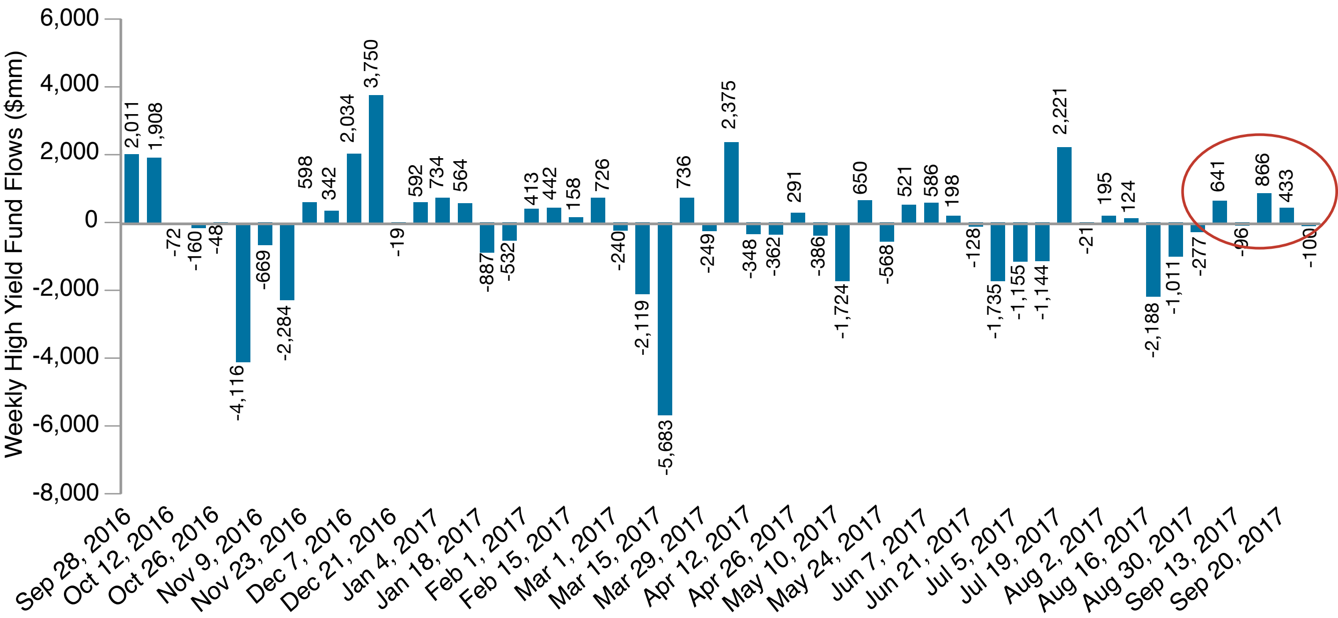
Worst Sectors	September	YTD
Supermarkets	-3.52%	-4.45%
Wirelines	-0.78%	2.00%
Aerospace/Defense	-0.71%	6.82%
Healthcare	-0.24%	8.06%
Restaurants	0.27%	5.80%

Source: Barclays

MARKET TECHNICALS

Fund flows in the high yield marketplace were generally supportive of asset prices during the month with +$1.7bn (net) added to already cash-rich fund balance sheets. September's experience contrasts distinctly with that of March, when sizeable outflows (-$8.2bn) coalesced with heavy new issue supply, creating a technical imbalance that sent liquid benchmark bond prices down -3pts in short order. Instead, stable-to-positive fund flows aided the marketplace in absorbing the calendar without any discernible disruption to secondary trading levels.

Fund Flows were a Stabilizing Force in the Marketplace in September



Source: Lipper, JP Morgan

On the supply side of the equation, the new issue calendar was very active this month with the market clearing $37bn of USD-denominated bonds, a stone's throw away from the $43bn that priced in March. The supply was largely taken in stride, inciting very modest selling of cash bonds (and ETF holdings) by fund managers to fund the calendar. Any selling that did occur appeared to be easily digested by the dealer community having entered the month with sufficient capacity to absorb the incremental inventory. Performance of newly minted bonds in secondary trading was also generally positive, despite clearing the primary market at low absolute and relative yields.

High Yield Met 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%
9/30/17	36,993	22,548	14,445	0.90%

Source: Barclays

FUNDAMENTAL TRENDS

Consistent with benign default activity realized over the past several months, only one high yield bond issuer defaulted in September, though it grabbed the attention of the entire market. Toys "R" Us had been burdened by declining sales, a bloated cost structure and an over-levered balance sheet for some time. The company had, until September, stayed a Chapter 11 restructuring through creative measures permitted by forgiving capital markets. However, as rumors circulated that the company would have trouble covering its bills, vendors pulled critical financing lines, inciting a liquidity squeeze that forced the company into bankruptcy in a little over a week. Observing the fact pattern through the lens of TOY CDS offers a clear delineation of the situation with the cost of insuring $100 of unsecured credit risk for 3 months jumping from less than $2 upfront to $80 in short order. Financing markets giveth, but can also taketh away ...swiftly. The jump risk represented in the TOY situation is a prime example of why we are reticent to lend at these low absolute yields and high dollar prices to fundamentally weak credits that are expressly reliant on extremely accommodative financial markets to remain solvent this late in the credit cycle.

The Cost of 3 Month Insurance on TOY Unsecured Credit Risk Spiked as the Company was Forced into Bankruptcy

Source: Bloomberg

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