TCW

INSIGHT

MONTHLY COMMENTARY

September High Yield Credit Update

BRIAN GELFAND | OCTOBER 16, 2018

With *micro* fundamentals little disturbed, high yield investors ceded control to favorable technicals in September as secondary bond prices held firm and risk premiums gapped tighter amid the sell-off in treasuries (5yr and 10yr treasury yields rose 0.22% and 0.20%, respectively, during the month). Indeed, the high yield marketplace appeared unfettered by the volatility in interest rates, which contrasts with February, when the shift in rate regime drove credit spreads +60 basis points (bps) wider in a hurry. To be fair, now two weeks into October, it might appear the response function was simply delayed as high yield bonds have traded lower (and credit spreads wider) with the yield on the 10yr treasury hitting seven-year highs. However, taken in context, this drawdown has proven (thus far) shallow and short-lived as the strategy of 'buy the dip' has been rewarded consistently this past year, conditioning investor behavior. While recent price action and absolute valuations in general speak to favorable sentiment (and/or investor complacency), one need not look further than the underwriting standards applied to September's bevy of LBO financings to handicap the times. Despite pushing the boundaries of excessive leverage, weak covenant protections and egregious pro-forma earnings calculations, akin to the terms of the mega-LBOs late in the prior cycle, these sponsor-led financings amassed investor support with little resistance. In contrast, it is exactly times like these when the marketplace begins to accept such terms freely and fade scrutiny when we believe deep credit work and disciplined underwriting is of the utmost importance.

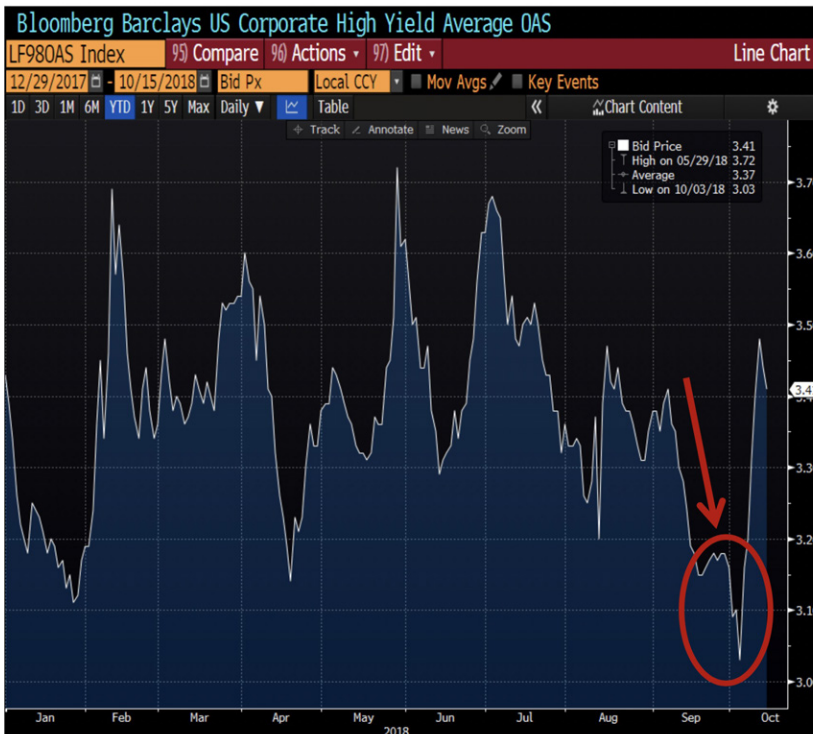
Market Performance

Supportive technicals from recent (relative) stability in fund flows and continued underwhelming primary issuance buoyed high yield bond prices in the face of rising interest rates. With a total return of +0.56% in September, high yield bonds effectively earned their coupon, a fine showing compared to negative returns for U.S. treasuries (-0.93%) and investment grade credit (-0.34%). As such, excess returns were +1.04% for the month as benchmark spreads gapped towards cyclical tights.

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.

Option-Adjusted Spreads on the Bloomberg Barclays HY Index Set Cyclical Lows (+303 bps) Amid the Rate Move in Late-September/Early-October



Source: Bloomberg

Returns were positive across the quality spectrum in September, though as one would expect from a coupon clipping month, higher yielding CCC-rated credits outperformed lower yielding BB-rated credits. The higher beta cohort also benefited from a modest relief rally after trailing in August as the overhang of pending LBO deals proved digestible and less disruptive than originally feared, whereas higher quality bonds felt the impact of the rate move most acutely. CCCs returned +1.2% on the month, while Bs and BBs returned 0.61% and 0.56%, respectively.

HY Performance	HY	Ba	B	Caa	Ca-D
September 2018 Total Return	0.56%	0.26%	0.61%	1.20%	2.28%
2018 Total Return	2.57%	0.51%	3.17%	5.99%	30.05%
September 2018 OAS Chg	-22bps	-15bps	-23bps	-27bps	
2018 Excess Return	3.27%	1.46%	3.74%	6.35%	

Source: Bloomberg, Barclays

There was less to glean from sector performance in terms of relative fundamentals in September, save for the Energy sector and rising oil prices, as the overarching themes of favorable market technicals offset by rising interest rates, in addition to select issuer specific catalysts, drove performance. With respect to the Energy sector, commodity-levered Oil Field Services and higher beta Independent E&P credits outperformed as spot WTI trended above $70/bbl on supply concerns as geopolitical tensions stirred. Elsewhere, yogurt manufacturer Chobani saw its unsecured bonds trade up +6.5pts in a FOMO-esque rebound following comments from the founder that he wouldn't rule out an eventual IPO. On the other end of the spectrum, the bonds of now bankrupt American Tire Distributors took another -8.25pt dive after the company missed an interest payment ahead of its bankruptcy filing (more on this below).

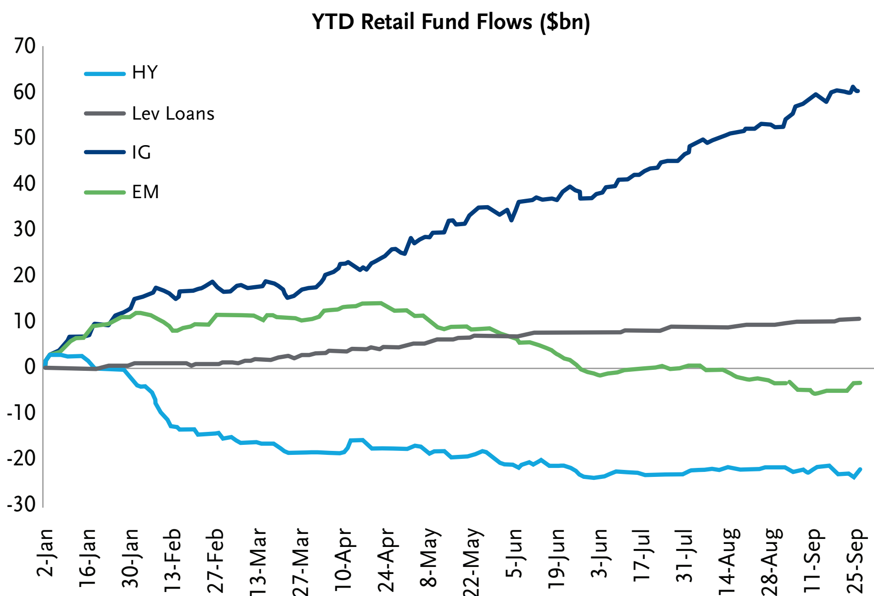
Best Sectors	September	YTD 2018
Oil Field Services	1.85%	6.62%
Pharmaceuticals	1.47%	8.52%
Wirelines	0.96%	5.71%
Independent	0.94%	3.28%
Cable / Satellite	0.85%	3.96%

Worst Sectors	September	YTD 2018
Lodging	-0.44%	-0.87%
Automotive	-0.39%	-4.25%
Health Insurance	-0.34%	1.62%
Building Materials	-0.04%	-0.65%
Transportation Services	0.01%	3.39%

Source: Bloomberg, Barclays

Though October kicked off with renewed market volatility and a concurrent pick-up in outflows from high yield funds (as we write, HY ETFs and mutual funds saw ~$5bn in outflows in just this past week), September concluded what proved to be a relatively stable third quarter in terms of net capital flows. That stability not only stands in stark contrast with the aggressive rotation away from the asset class in the first half of the year, but offered meaningful technical support which, when coupled with the dearth of new issuance (discussed below), resulted in a firm bid for bonds during the month (and for most of the quarter). High yield bond funds saw net outflows of -$1.8bn in September, fully attributable to ETFs as mutual fund flows were effectively flat on the month. When combined with the approximately $1bn net inflow in August, however, the past two month trend has been fairly sanguine (notably in the context of a year that has seen -$26bn in capital exit the sector).

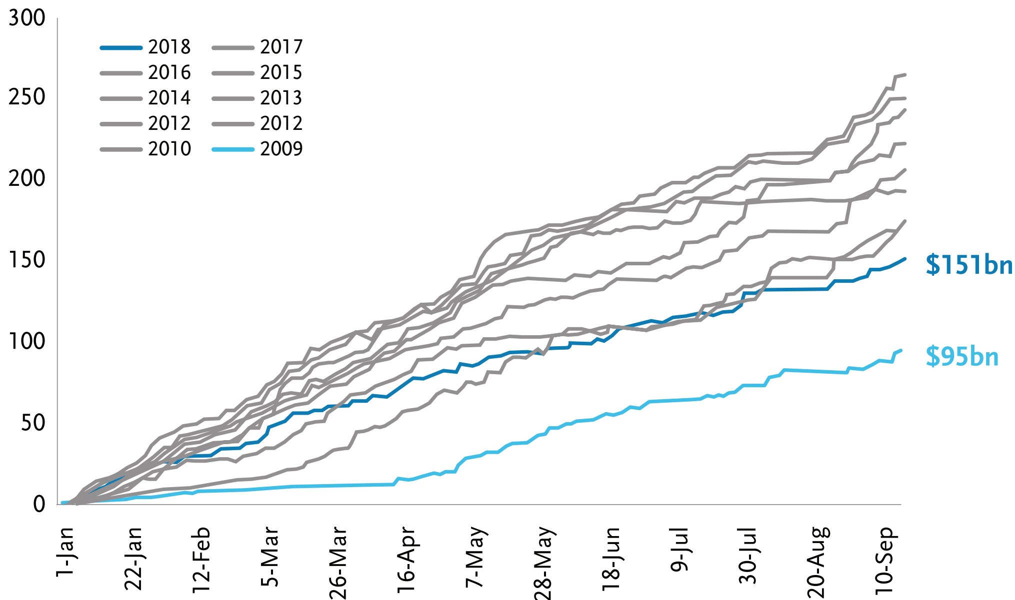
HY Funds Have Seen Assets Stabilize in Recent Months Following Sizeable Redemptions From Q4'17 to Q2'18



Source: Credit Suisse, EPFR

Investors were wary of supply technicals heading into September with consensus expectations for heavy issuance given typical seasonality plus a visible backlog of bellwether LBO deals looking to print. Concerns abated quickly, however, as issuance disappointed expectations yet again, extending the drought we have seen throughout 2018. The benchmark LBO financings for Thomson Reuters, Akzo Specialty Chemicals and Envision Healthcare were easily cleared by a marketplace light on opportunity and heavy on cash. Just $18.3bn in USD denominated high yield debt was ultimately issued in September, down ~50% year-over-year, resulting in the lowest volumes through the third quarter since 2009. Interestingly, while in 2009 the dearth of issuance was demand driven (risk aversion, capital markets seizure) today's trends are more aptly characterized as supply-driven, given less frequent opportunistic refinancings in a now rising rate environment and cannibalization from the leverage loan market (companies, notably those that are sponsor-owned, are favoring terms and conditions when issuing loans versus bonds, a trend we are closely monitoring).

Supply Drought – Lowest Year-to-Date High Yield Bond Issuance Since 2009



Source: Credit Suisse

Fundamental Trends

Default activity remained subdued in September, extending the recent drought, though the single corporate default this month was noteworthy. American Tire Distributors (ATD) saw a meteoric collapse in the value of its enterprise (and market value of its debt) in April after it was announced that its largest suppliers launched a wholesale JV and planned to terminate their business with the distributor. Following negotiations with its lenders on a plan of reorganization, the company missed an interest payment on its bonds in September and officially filed for bankruptcy in October. With $1.7bn in debt (bonds and loans), ATD is the fourth largest default this year, and the ATD 10.25 22 have been the worst performing U.S. high yield investment of 2018. While default activity is showing signs of picking up (filings from stressed borrowers such as retailer Sears and helicopter operator PHI appear imminent), volumes remain at cyclical lows. Through September, the trailing twelve month default rate stood at 2% (1.3% excluding iHeart). ■

Jump Risk in Investments With Significant Degree of Supplier Concentration

Source: Bloomberg

This material is for general information purposes only and does not constitute an offer to sell, or a solicitation of an offer to buy, any security. TCW, its officers, directors, employees or clients may have positions in securities or investments mentioned in this publication, which positions may change at any time, without notice. While the information and statistical data contained herein are based on sources believed to be reliable, we do not represent that it is accurate and should not be relied on as such or be the basis for an investment decision. The information contained herein may include preliminary information and/or "forward-looking statements." Due to numerous factors, actual events may differ substantially from those presented. TCW assumes no duty to update any forward-looking statements or opinions in this document. Any opinions expressed herein are current only as of the time made and are subject to change without notice. Past performance is no guarantee of future results. © 2018 TCW

865 South Figueroa Street | Los Angeles, California 90017 | 213 244 0000 | @TCWGroup