TCW

INSIGHT

MONTHLY COMMENTARY

October High Yield Credit Update

BRIAN GELFAND | NOVEMBER 14, 2016

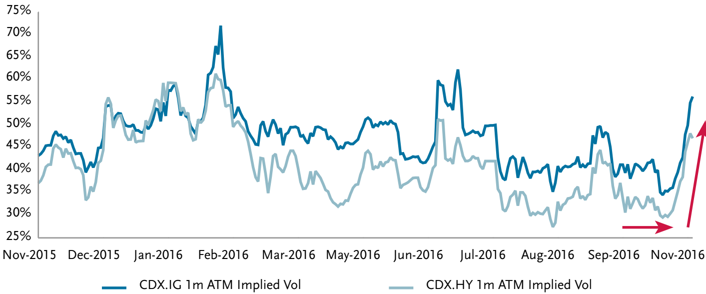
Brian G. Gelfand
Vice President
U.S. Fixed Income

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.

The pick-up in volatility in the credit, rates and equity markets over the past two weeks can easily distract from the reality that, for the most part, the month of October experienced little in the way of disruption to the narrative to which we have grown accustomed in the marketplace for high yield bonds. Indeed, for 25 of the 31 days of the month, volatility was subdued, particularly in credit, as equities responded more acutely to the daily barrage of election-related headlines. Fund flows were balanced, preserving the significant technical asymmetry in the marketplace, and the rise in interest rates (5yr and 10yr Treasury yields were +16 bps and +23 bps in October, respectively) was largely absorbed by spread. Fundamentals also provided support, as commodity prices rose (more on this below) and corporate earnings for Q3 revealed a modest return to growth following five straight quarters of negative earnings growth through Q2. As a result, spreads on high yield bonds continued to grind lower, touching a 2016 low of +453 bps on October 25. Fortunes reversed in the final trading days of the month, however, as the move in rates stretched valuations and the fundamentals inflected sharply (crude and natural gas sold-off and negative healthcare/pharma risks emerged), weighing on risk appetite and inciting the largest weekly outflow from high yield ETFs in over two years.

The Calm Before the Storm, Market Volatility was Dormant Until the Final Days of the Month

CDX.HY 1mo ATM Implied Vol



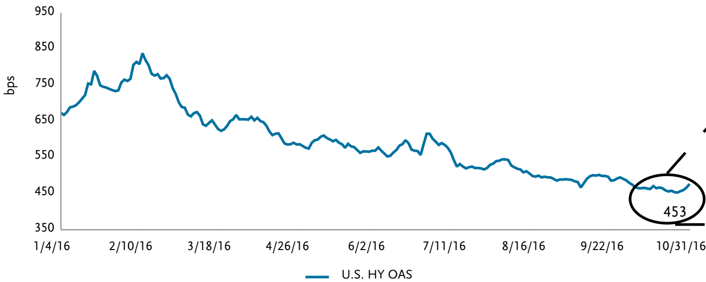
Source: Barclays

VIX

Source: Bloomberg

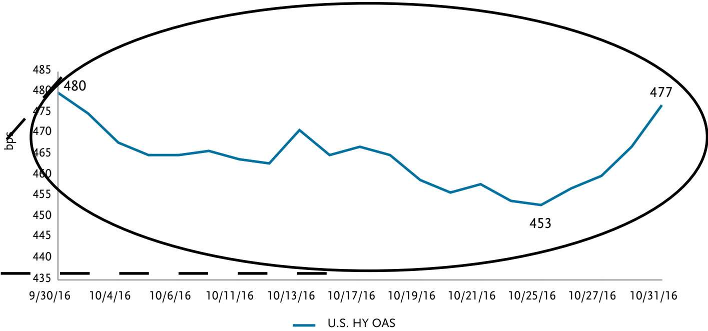
HY Spreads Touched a Year to Date Low in October Before Reversing Nearly All the Gains for the Month

YTD 2016



Source: Barclays

October

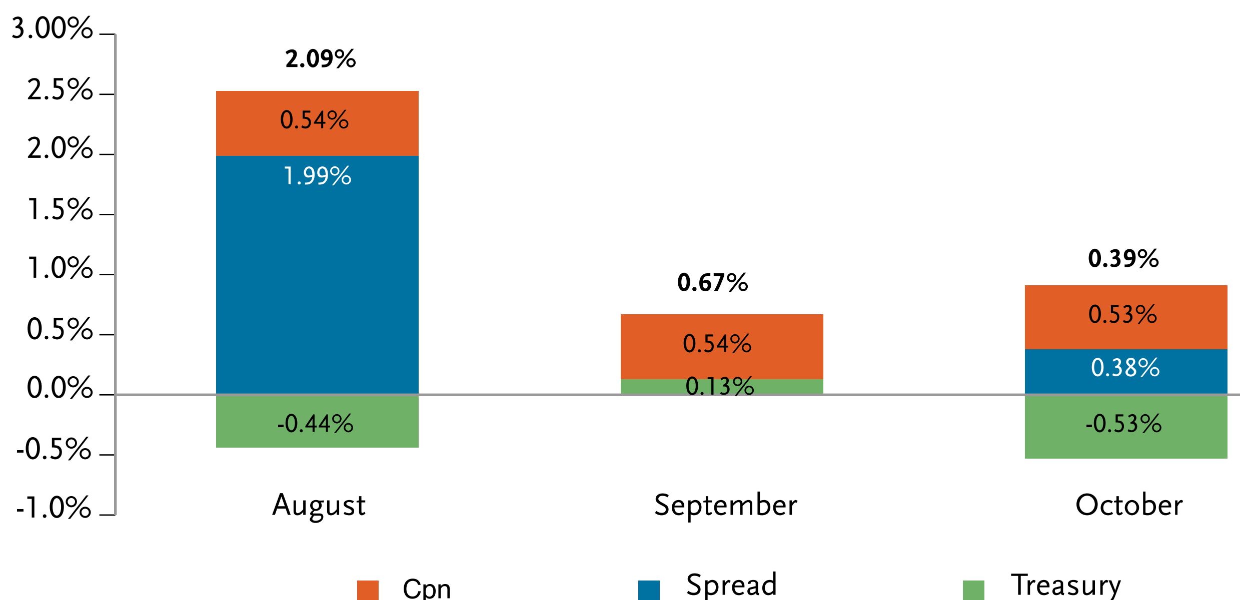


Source: Barclays

Market Performance

Total return for the Barclays U.S. HY Index in October was +0.39%. Treasuries were a clear headwind to performance, balancing, though not overwhelming, the positive contributions to returns from both price and carry. As such, excess return for the month was closer to +1% (+0.92% specifically).

Total Return Attribution – HY Generated Positive Returns in October Despite the Sell-off in Treasuries



Source: Barclays

The rank of total return across quality buckets in October was consistent with the trend we have seen since the mid-Feb wides – distressed outperformed CCCs, CCCs outperformed Single-Bs, Single-Bs outperformed BBs. However, spread compression was not the driver of relative performance in October, as had been the case in recent months, but rather coupon and interest rate sensitivity.

HY Performance	HY	Ba	B	Caa	Ca-D
October 2016 Total Return	0.39%	0.19%	0.24%	1.11%	5.92%
2016 Total Return	15.56%	12.50%	13.79%	26.94%	63.29%
October 2016 OAS Chg	-3bps	-6bps	-2bps	-1bps	
2016 Excess Return	12.30%	9.04%	10.60%	24.13%	

Source: Barclays

Among the top performing sectors for the month were the usual suspects of commodity-linked credits (i.e. Oil Field Services, Independent E&P and Metals & Mining). Sitting here today, with WTI below $45.5/bbl and the prospects of an OPEC/non-OPEC production deal being reached on November 30 seemingly far less likely (members appear to be happy to see others cut so long as they can hold/grow production), it may be difficult to recall the Energy sector was on the upswing in October. WTI was above $50/bbl for most of the month as weekly EIA stockpile data showed further rationalization of domestic crude supply and headlines relating to the prospective production freeze were skewed to the positive. Natural gas also rallied above $3/mmbtu for the first time since the winter of 2014, benefiting gas-levered E&Ps. Finally, coal risk is back in focus with spot hard-coking coal prices on a parabolic uptrend, breathing life back into previously left-for-dead securities (debt and post-reorg equities). These positive fundamental developments were compounded by the comparably high nominal yields of energy (and metals) credits, which continue to benefit from investors' bid for yield. This technical benefit to commodity-linked sectors from higher relative yields is starting to fade, however, as spreads have compressed significantly year-to-date. Underperforming on the month was healthcare, specifically specialty pharma and rural hospitals. In pharma, Concordia bonds remained under pressure following the emergence of legislation in the UK which would impose price restrictions on its generic drug portfolio. Moreover, the sector sold-off following commentary from drug distributor McKesson on its earnings call identifying price competition in its channel (the read-through being that price competition downstream will eventually flow upstream to the manufacturers). Within hospitals, Community Health bonds traded down following a big earnings miss which caused investors to re-price both the asset value and earnings power of the enterprise.

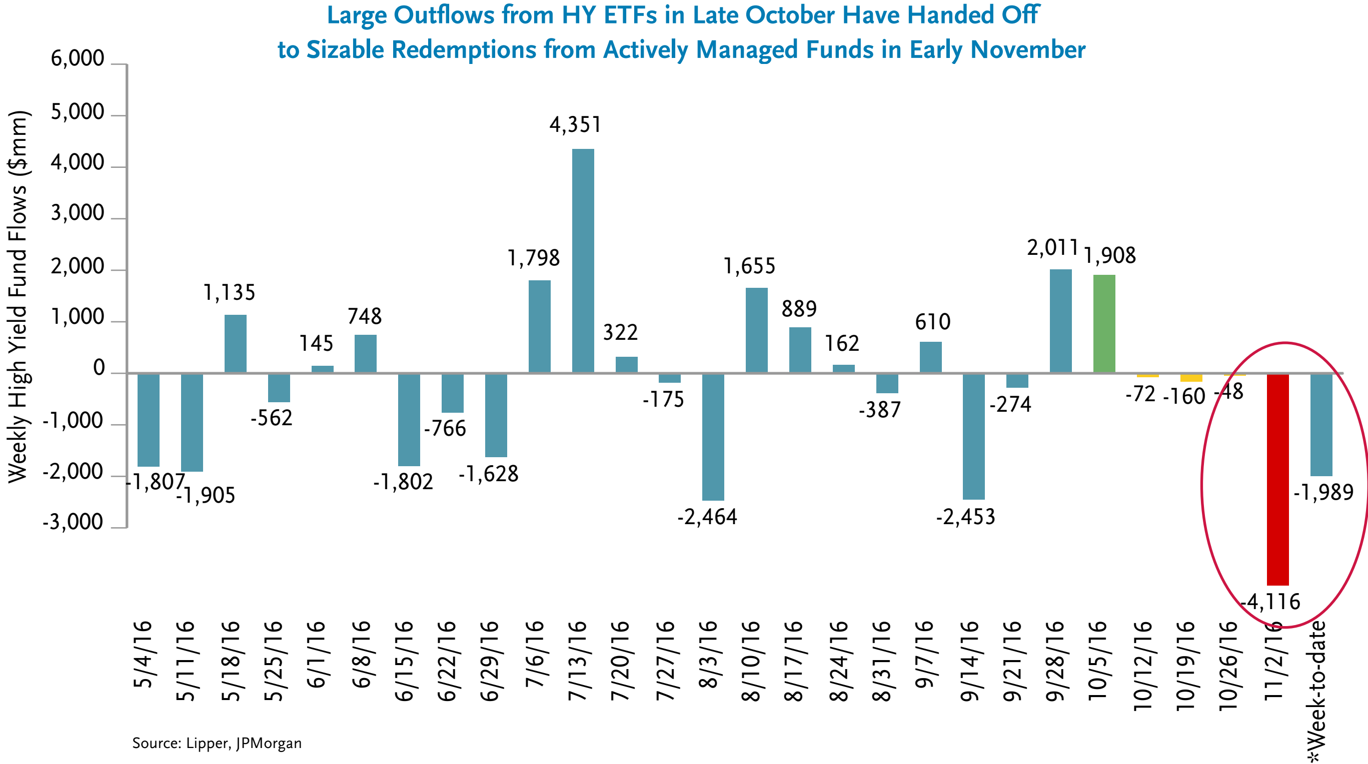
Best Sectors	October	2016 YTD
Oil Field Services	4.34%	28.71%
Independent	2.20%	38.65%
Financial Other	1.20%	11.21%
Metals & Mining	1.10%	42.67%
Diversified Manufacturing	0.95%	12.66%

Worst Sectors	October	2016 YTD
Pharmaceuticals	-4.40%	-1.96%
Healthcare	-1.07%	7.30%
Wirelines	-0.39%	13.66%
Media Entertainment	-0.16%	11.06%
Retailers	-0.14%	12.77%

Source: Barclays

Market Technicals

Fund flows were dormant for most of the month (on a net basis), as generally balanced news flow did little to alter the prevailing market narrative. That balance was disturbed, however, in the last week of the month in a meaningful way as the confluence of rising interest rates, softening crude and natural gas prices and election-related headlines, pressured investors to shed high yield beta. The -$4.1bn net outflow for the week ending November 2, was the largest single-week outflow since August 2014. Notably, 86% of the redemptions were out of ETFs (principally HYG). The bond sales resulting from the ETF arbitrage mechanism, however, were easily absorbed by the excess liquidity in the marketplace, exerting minimal pressure on trading levels. This first leg of ETF selling has subsequently given way to not insignificant redemptions from actively managed funds in November. A sustainable trend or simply noise...time will tell, though we note the importance of this driver given the incredible influence the technicals currently exert in the marketplace.



Source: Lipper, JPMorgan

Supporting the technical backdrop in the secondary market last month was a dearth of new issue supply. Earnings blackouts and general hesitation on the part of issuers to market a new deal given the immediacy of the election kept the primary calendar in check (we saw a similar trend in the lead-up to the UK referendum). That being said, ~$13.5bn of high yield bonds were syndicated during the month. New deals that did come were easily absorbed by the marketplace, with bonds clearing at tight levels relative to comparable risk in the secondary, as investors are willing to pay-up for liquidity/size. Examples include the CCC-rated ADSWST 24s at 5.625% and the B-rated NFLX 26s at 4.375%, which we believe are the lowest coupons ever underwritten for new issues in these ratings and duration buckets. As I write today, however, the primary market has virtually ground to a halt, as issuers remain on the sidelines post-election waiting for some sign of stability from interest rates before testing the water. We would expect that even a brief reprieve from this relentless move higher in the term structure will bring new deals to market, though this has yet to be the case.

High Yield Net Supply ($mn)

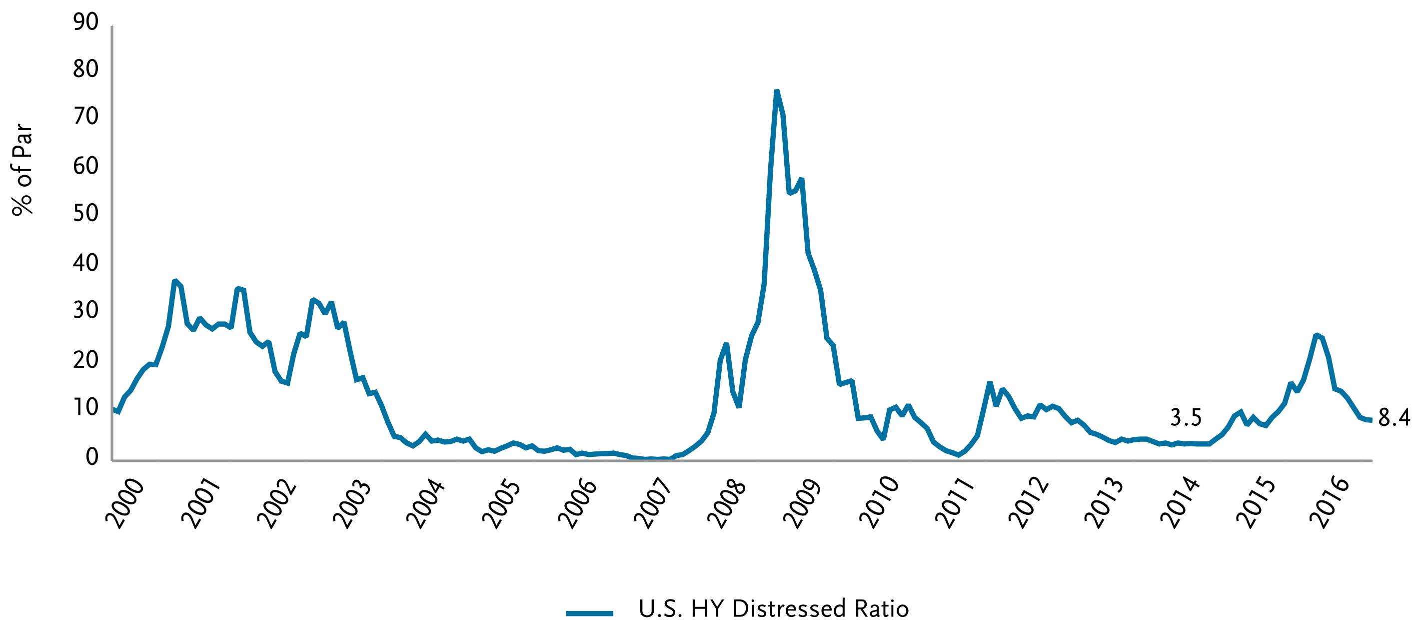
Month	New Issue	Redemptions	Net Supply	Monthly Returns
12/31/2015	3,077	28,406	(25,329)	-2.52%
1/31/2016	5,923	12,449	(6,526)	-1.61%
2/29/2016	7,557	15,556	(7,999)	0.57%
3/31/2016	18,226	12,920	5,306	4.44%
4/30/2016	31,176	18,454	12,722	3.92%
5/31/2016	28,355	31,534	(3,179)	0.62%
6/30/2016	22,334	31,021	(8,687)	0.92%
7/31/2016	13,327	22,719	(9,392)	2.70%
8/31/2016	16,647	22,606	(5,959)	2.09%
9/30/2016	25,207	29,030	(3,823)	0.67%
10/31/2016	13,452	35,225	(21,773)	0.39%

Source: Barclays

Fundamental Trends

With capital markets open for business, corporate bond defaults remain at bay; a condition the marketplace seems confident will prevail over the medium-term as implied levels of pending distress/default activity are currently low. Specifically, the distressed ratio (the percent of corporate bonds with option-adjusted spreads in excess of 1,000 bps) currently stands at 8.4%. Although higher than the local lows reached during the summer of 2014 in absolute terms, in relative (beta-adjusted) terms, we would argue it to be more benign given the weaker fundamental backdrop.

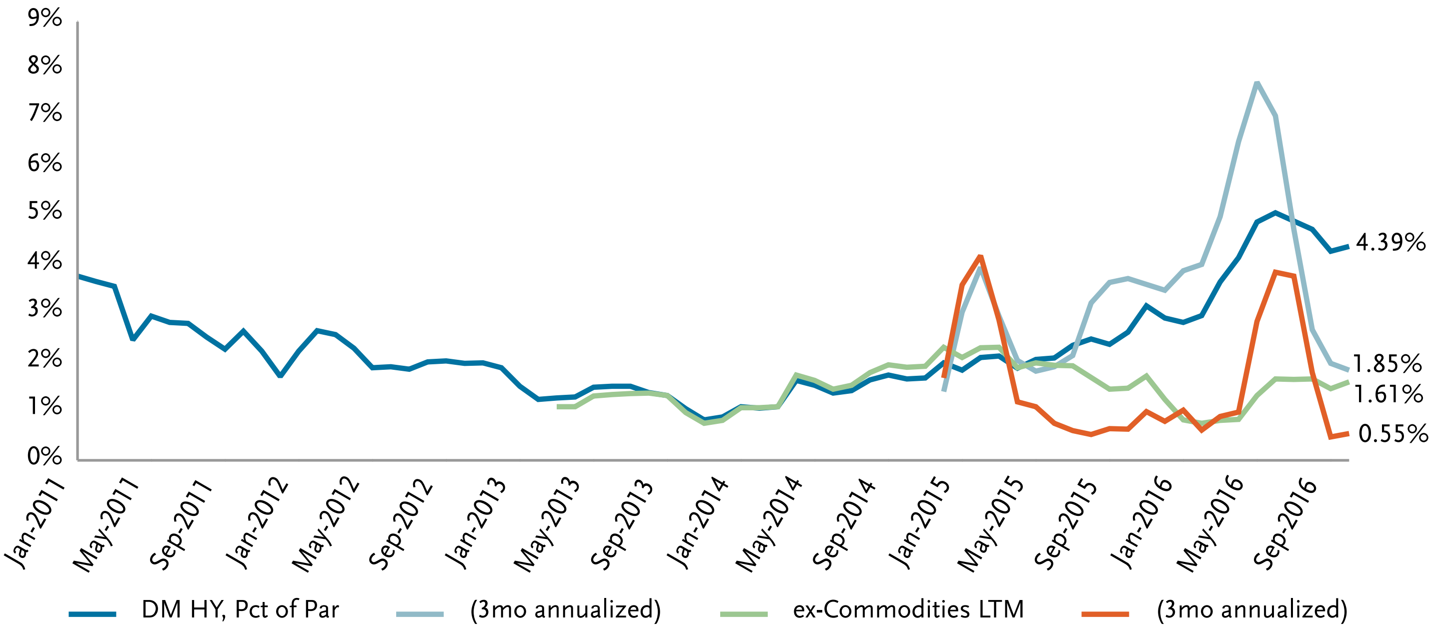
Current Distressed Ratio Implies a Benign Outlook for Default Activity



Source: Deutsche Bank

This sense of complacency is being validated by suppressed default volumes today. Indeed, October saw just three high yield issuers default on their contractual obligations, consistent with the pace of default activity we saw in Q3, and representing the third lowest monthly volume over the last twelve months. The par amount of defaulted paper in October totaled $1.4bn, which followed ~$1bn and $1.6bn of par volume in September and August, respectively. Year-to-date default volumes (based on notional dollar amounts) are already 82% higher than all of 2015, although the pace of default activity has slowed considerable in the last five months of the year as compared to the first five. Looking at the composition of the three issuers that defaulted this month, one is a merchant power producer (a coal fired power plant), and the other two are energy-linked credits. The trailing twelve-month par-weighted default rate through October increased +10 bps to 4.4%. Although, looking at higher frequency data, namely the trailing 3-month annualized default rate, we see the recent pace of activity is much lower at 1.9%. ■

Trailing Default Rates (Both Total and Ex. Commodities) Remain Low



Source: Deutsche Bank

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. © 2016 TCW