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INSIGHT

MONTHLY COMMENTARY

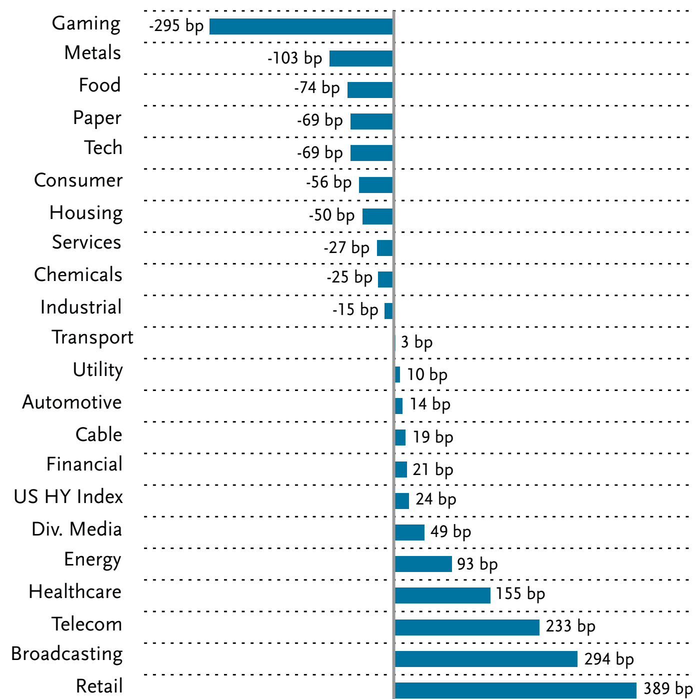
October High Yield Credit Update

BRIAN GELFAND | NOVEMBER 14, 2017

It would not surprise me if a casual observer of the high yield marketplace concluded that little of consequence had taken place this past month. Indeed, market averages *signaled* nothing extreme – average credit spreads were modestly tighter *(fundamental risks moderated)*, aggregate bond prices were effectively unchanged *(a coupon clipping month)*, net fund flows and dealer inventories were balanced *(low volatility)*. Reasonable conclusions given the aggregate data no doubt, though they fail to account for the meaningful dispersion underpinning these averages. This is not unique to October, as sector and single-name decompression has been building for some time (and is seemingly accelerating thus far in November following evidence of broadening fundamental deterioration in the most recent quarter).

Meaningful Dispersion in Sector Performance Has Occurred Between June 2014 and Recent Tights

(Change in OAS Between June 2014 and November 2017)



Source: J.P. Morgan

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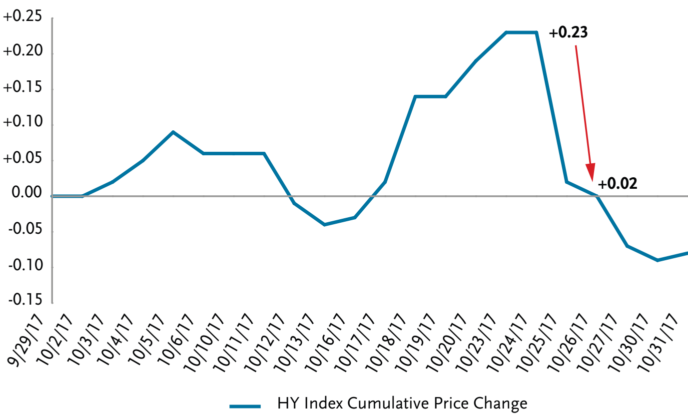
Mr. Gelfand is a Vice President in the Fixed Income group, where he trades high yield securities. Mr. Gelfand joined TCW in 2014 as a Credit Analyst responsible for research in the telecom, technology, and media sectors. Prior to joining TCW, he interned at PIMCO in the Portfolio Management Group and 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.

While sector and credit-specific dislocation has created renewed opportunities to invest in undervalued credits (babies thrown out with the bathwater), we remain acutely aware of the efficiency of the capital markets (particularly the marketplace for leverage finance) in transmitting a growing list of discrete fundamental issues into broader systemic risk.

Market Performance

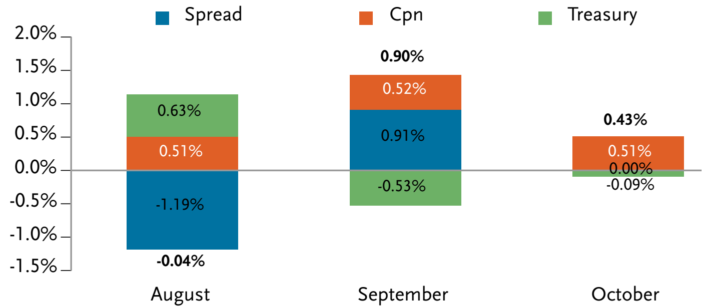
High yield bonds in aggregate realized steady price gains through most of October before surrendering nearly all of the upside in a single day as the one-two punch of rising interest rates (10yr treasuries spiked above the psychologically relevant 2.40% threshold) and a growing tally of weak quarterly results took prices lower. The +0.43% total return for the month was the result of ~50bps of recurring monthly coupon less a small net decline in price due to rising rates (despite bouncing off the tights, credit spreads still compressed modestly on the month).

+0.23 pts of Cumulative Price Gains Was Wiped Out by Month End...



Source: Barclays

...With Coupon Buttressing October Total Return



Source: Barclays

There was very little differentiation in performance across ratings cohorts during the month as performance dispersion in October was less a product of systemic risk-on/risk-off sentiment, but driven more acutely by credit and sector-specific fundamentals. Notable, however, is despite already extremely tight absolute credit spreads for BB-rated bonds coming into the month, a yet unwavering bid for quality kept prices relatively stable even in the face of rising interest rates.

HY Performance	HY	Ba	B	Caa	Ca-D
October 2017 Total Return	0.42%	0.37%	0.49%	0.36%	1.15%
2017 Total Return	7.45%	7.30%	6.62%	9.65%	14.15%
October 2017 OAS Chg	-12bps	-4bps	-12bps	-10bps	
2017 Excess Return	5.89%	5.59%	5.10%	8.36%	

Source: Barclays

As we have seen (and discussed) for several months now, idiosyncratic factors are (correctly) creating real differentiation in bond-level performance (i.e. security selection is key as fundamentally worsening credits are buoyed less and less by a general rising tide, and bonds with idiosyncratic optionality can offer opportunities to generate alpha). November specifically is seeing fairly meaningful price rifts, particularly to the downside, in large capital structures and sectors – but more on this in next month's commentary. As for October, there were several notable catalysts driving relative performance during the month. In IPPs (independent power producers), the announced merger between Vistra Energy (formerly TXU) and Dynegy caused Dynegy bonds to rally >5pts as investors viewed the pro-forma combined credit to be meaningfully de-risked versus the status quo. Industry consolidation themes lifted stressed credits in the IPP space in sympathy. Wirelines took a (short) reprieve in October led by Windstream bonds, which rebounded off oversold levels with support from an announced exchange offer by the company in an attempt to combat activist investor Aurelius' attempt to force the company into bankruptcy. Finally, Bombardier alone tightened the average credit spread of the Aerospace/Defense sector by ~50bps as the company's bonds rallied >7pts (at the long end) off local lows following an announced joint venture with Airbus to manufacture and sell C-Series aircraft in the U.S. Underperforming this month were Pharmaceutical bonds. Concordia International missed payments on its unsecured bonds with a plan to restructure its debt. Also, the unsecured bonds of industry benchmark Valeant were quietly down -4pts during the month on little discrete news, more reflective of wavering sentiment towards the sector. Broader healthcare underperformed amid mixed signals from the White House and Capitol Hill relating to exchange subsidy payments as well as the disclosure of weaker than expected earnings and forward guidance from bellwether hospital operators. Finally, Sprint bonds weighed on the Wireless sector as evidence began to emerge that negotiations between Softbank and Deutsche Telekom (majority owner of T-Mobile) were beginning to sour.

Best Sectors	October	YTD
Electric	2.20%	11.55%
Wirelines	1.79%	3.82%
Aerospace / Defense	1.40%	8.31%
Supermarkets	1.31%	-3.20%
Banking	1.25%	11.78%

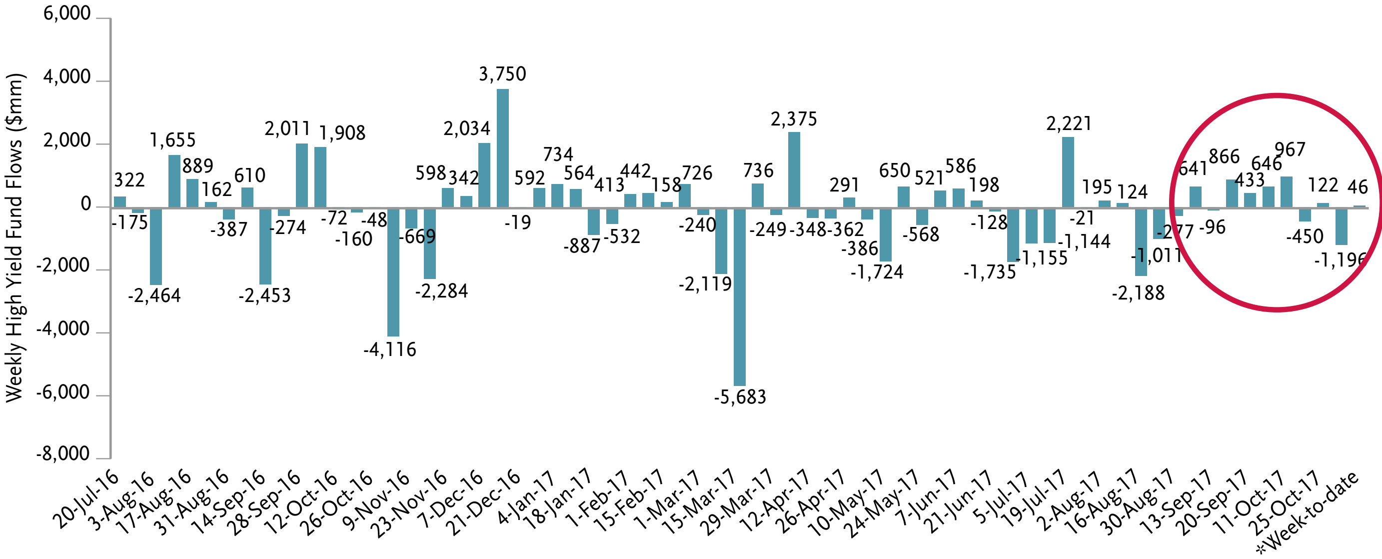
Worst Sectors	October	YTD
Pharmaceuticals	-1.04%	11.97%
Wireless	-0.67%	7.45%
Healthcare	-0.51%	7.50%
Consumer Products	-0.49%	3.80%
Cable Satellite	-0.47%	7.95%

Source: Barclays

Market Technicals

Capital flows for high yield mutual funds and ETFs were net positive and therefore generally supportive of asset prices for a second straight month. October saw +$1bn in net inflows into high yield funds, following a revised +$1.9bn net inflow for September. The decompression that has emerged (and is accelerating) in discrete, though large, sectors/capital structures has yet to follow through into a broad-based sell-off. This is similar to what started in 2015 as disruption in the Energy sector that eventually gave way to a more systemic risk-off. The missing link thus far has been the absence of meaningful outflows forcing sales, though we do wonder how much longer general sentiment will remain sanguine as evidence of fundamental weakness spreads and macro uncertainty increases.

Fund Flows Remain a Stabilizing Force in the Marketplace



Source: Lipper, JPMorgan

The active new issue calendar in September carried into the first two weeks of October as issuers scrambled to place deals before earnings blackouts rolled in. The marketplace cleared $23bn in USD-denominated high yield bonds during the month. With investor optimism at a local high heading into what many expected to be a market-friendly earnings season, new bonds met sizeable demand resulting in continued issuer-friendly terms. Moreover, October saw the return of coal issuers with Warrior Met Coal (formerly Walter Energy) and Consol Mining proving the market is once again open to financing this once-scorned industry.

High Yield Net Supply ($MM)

Month	New Issue	Redemptions	Net Supply	Monthly Returns
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	17,723	19,252	(1,529)	-0.04%
9/30/17	36,993	22,548	14,445	0.90%
10/31/17	23,176	32,135	(8,959)	0.42%

Source: Barclays

Fundamental Trends

High yield bond default volumes doubled month-over-month from a single issuer in September (Toys“R”Us) to two issuers in October (Concordia International and Appvion). Concordia, an international pharmaceutical business that has seen prices and sales volumes of its specialty drug portfolio fall precipitously over the past several quarters, missed interest payments on its unsecured bonds as the company plans to restructure its inflated debt load. Appvion is a small paper manufacturer that filed for bankruptcy. Looking in the rearview mirror, corporate bond default volumes through October remain depressed (indeed, JPM strategists calculate the trailing LTM default rate, including distressed exchanges, to be ~1.3%); however, as more and more sectors/credits experience fundamental headwinds (retail, supermarkets, healthcare, telecom to name several), the ground for forward default activity appears to be increasingly fertile. ■

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