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INSIGHT

MONTHLY COMMENTARY

November High Yield Credit Update

BRIAN GELFAND | DECEMBER 13, 2016

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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.

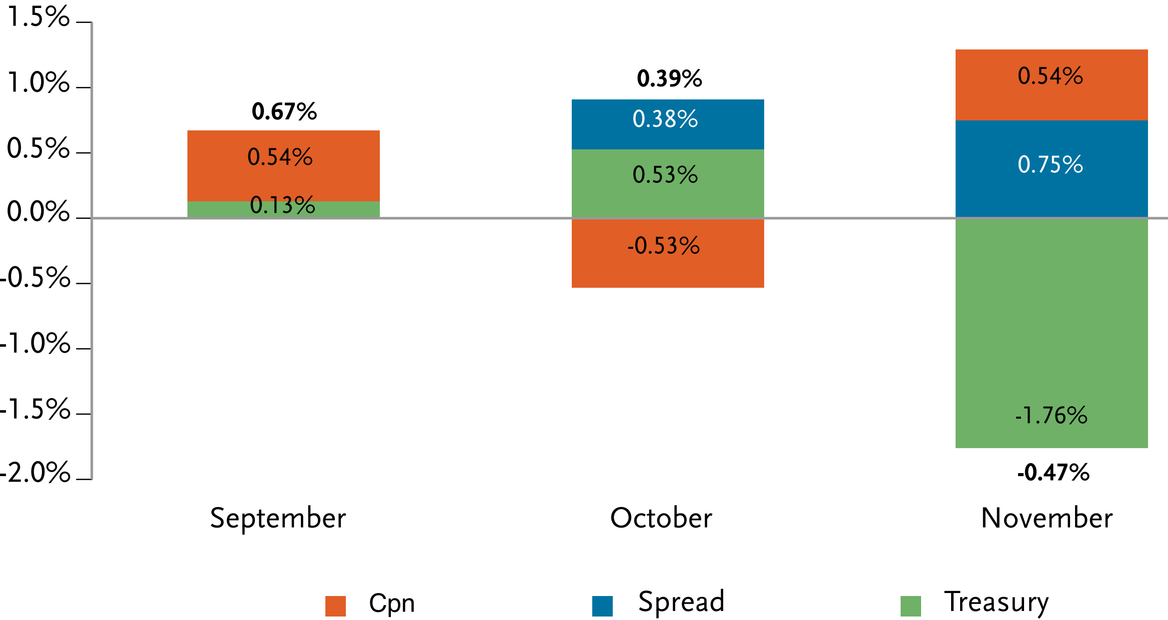
On November 8th, Americans voted for Donald J. Trump to be their 45th President and also installed Republican majorities in both the House and Senate. From November 9th through today, capital markets have unambiguously voted that this is a good thing. While the sense of optimism (whether willing or reluctant) is apparent from our seat in the marketplace, one need not look further than the data for confirmation of how the average investor is interpreting the new world order – S&P 500 touching all-time highs up +6.2% (Russell 2000 up +15.2%) from already lofty valuations with cyclicals and financials leading the charge, 10yr UST yields +63bps higher on growth, inflation and Feb policy normalization expectations, and HY bond prices (+$0.83) and spreads (-73bps) bucking the rate sell-off and embracing the virtuous reflation thesis. To be clear, the marginal impact of fiscal stimulus would indeed be positive in the short-run, and the rollback of regulation would also be stimulatory, plus after years of distortion to market-based pricing mechanisms and pressure on financial business models at the hand of policy-induced low interest rates, rising Treasury yields are a welcomed occurrence. That being said, the re-pricings in the marketplace have been quick, meaningful and linear, while the stimulatory effects of what is being priced in are lagged, the multiplier uncertain and the path most likely volatile.

Though a continued melt-up into year end may be the most probable scenario for high yield bonds, as I write today we remain mindful of where valuations have run and what expectations are embedded in current spreads. We stand ready to capitalize on volatility in 2017.

Market Performance

The sell-off in interest rates was the clear headwind to performance in November, leading to the first negative monthly total return for high yield bonds since January 2016. The total return for the Barclays US HY Index in November was -0.47%. However, this first leg higher in Treasuries did little to dissuade risk appetite, largely due to the fact the move was born out of a thesis of good, demand-push inflation. As such, spreads tightened on the month, earning an excess return of +128bps in November.

The Sell-Off In Rates Outweighted Positive Return Contributions From Spread And Coupon In November

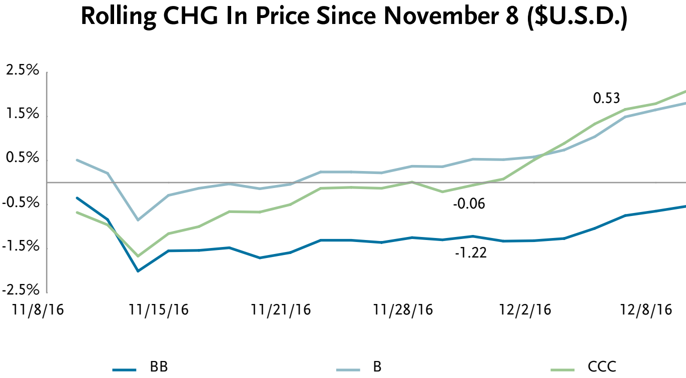


Source: Barclays

Underpinning the headline total and excess return figures was distinct bifurcation in performance across ratings and industry buckets. Looking at ratings, BBs underperformed lower quality credits as tight spreads and a high degree of interest rate sensitivity left bonds vulnerable to volatility in treasuries. BBs sold-off ~2pts the week following the election and prices have been slow to recover (still trading below November 8th levels today). On the other hand, higher spreads of Single-Bs and CCCs absorbed the blow from the spike in interest rates, resulting in a smaller drawdown in the immediate aftermath of the election. This was quickly followed by a resumption of the compression trade now reinforced by the expectation of a virtuous cycle of fiscal expansion. The result was lower quality credits outperformed on price and spread.

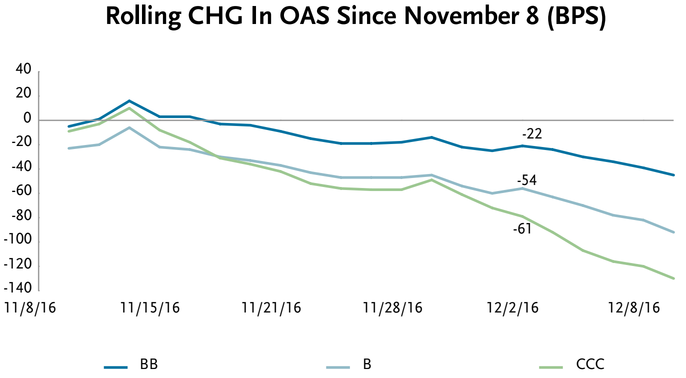
Interest Rate Sensitive BBs Notably Underperformed Higher Risk Credits Post-Election

Rolling CHG In Price Since November 8 ($U.S.D.)



Source: Barclays

Rolling CHG In OAS Since November 8 (BPS)



Source: Barclays

HY Performance	HY	Ba	B	Caa	Ca-D
November 2016 Total Return	-0.47%	-0.94%	-0.20%	0.25%	0.67%
2016 Total Return	15.01%	11.45%	13.56%	27.26%	74.11%
November 2016 OAS Chg	-22bps	-19bps	-41bps	-34bps	
2016 Excess Return	13.57%	10.00%	12.13%	25.79%	

Source: Barclays

Turning to industry performance, if you were to create a list of each of the 'gut reaction,' first-order derivatives of an unexpected Trump victory / Republican sweep, you would likely accurately identify which industries out- and under-performed during the month:

- Infrastructure fiscal spend – positive for construction-linked and metals
- Rollback of financial and environmental regulation – positive for specialty finance and mining (coal)
- Prospectively more amenable M&A governances – positive for previously hamstrung targets (ex. Sprint and T-Mobile)
- Repeal (and replace?) ACA – uncertainty is negative for hospitals
- Sharp rise in interest rates – immediately negative for tight-spread, long-duration subordinated bank bonds

Away from the political catalysts, Independent E&Ps benefited from a meaningful recovery in the price of natural gas as well as a late-month rally in crude (November 30th) after OPEC / Non-OPEC members agreed on production cuts amounting to ~2% of global supply. Specialty Pharma again topped the charts for worst performing sector as idiosyncratic headlines affecting Concordia and Valeant pushed those structures lower.

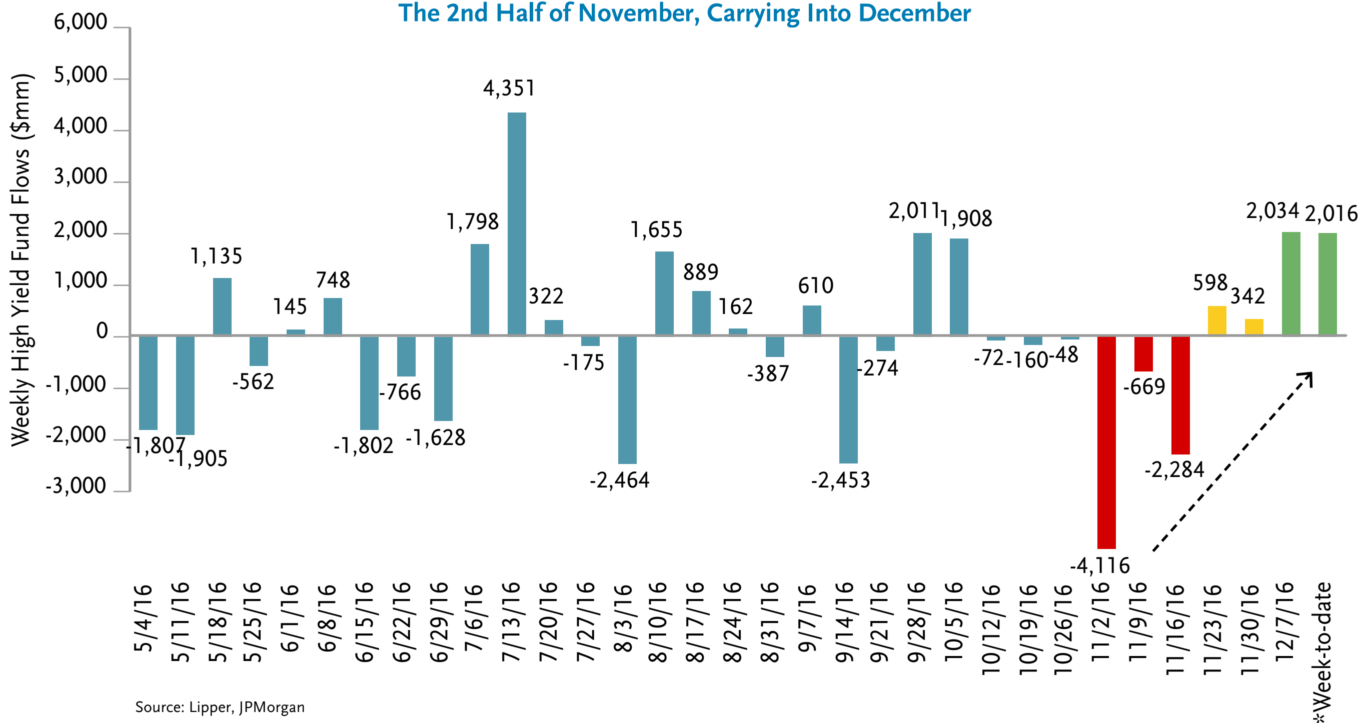
Best Sectors	November	2016 YTD
Financial Other	2.24%	13.70%
Construction Machinery	1.31%	11.22%
Independent E&P	1.29%	40.43%
Metals & Mining	1.21%	44.40%
Wireless	0.86%	19.10%

Worst Sectors	November	2016 YTD
Pharmaceuticals	-2.86%	-4.76%
Healthcare	-2.75%	4.36%
Banking	-1.96%	1.95%
Wirelines	-1.76%	11.65%
Electric	-1.68%	12.77%

Source: Barclays

Market Technicals

Fund flows were mixed during the month, though the excess liquidity in the marketplace from generally higher cash balances, sizeable coupon cash flows and an underwhelming new issue calendar, absorbed nearly all of the volatility. Indeed, the capital flight experienced during the first half of the month seemed to exert very little in the way of selling pressure in the cash bond market, reinforcing our thesis that a true risk-off, characterized by a sustained exodus from the high yield asset class, is required to break the technical stronghold in place today. This turned out not to be the case in November. Although fund flows were net negative for the month (net outflows of -$5.4bn), the momentum unambiguously inflected to the positive post-election as the reflation thesis signaled all-clear for risk, overwhelming near-term concerns over rising rates. That trade has continued into December, seemingly solidifying what many market pundits have argued will be a steady grind into year-end.



Although it outpaced October's new-issue calendar, November's primary activity was still notably quiet. The impetus is clear – pre-election, the prospective uncertainty kept issuers sidelined in early November, and post-election, the surprise outcome and subsequent volatility in rates forced both issuers and advisors to pause and consider the new world order. Throw in some turkey and stuffing, and the result was only ~$15.3bn of USD-denominated high yield bonds priced during the month. Deals that did come, particularly at the lower end of the quality spectrum, found a buyer base able and willing to underwrite risk as the marketplace quickly anchored around the virtuous reflation narrative. Activity has picked up in early December, however, as the combination of year-end housecleaning (before the holidays) and a firming consensus that we may be at the beginning of a sustained rise in nominal interest rates, has pulled opportunistic issuers into the market.

High Yield Net Supply ($mn)

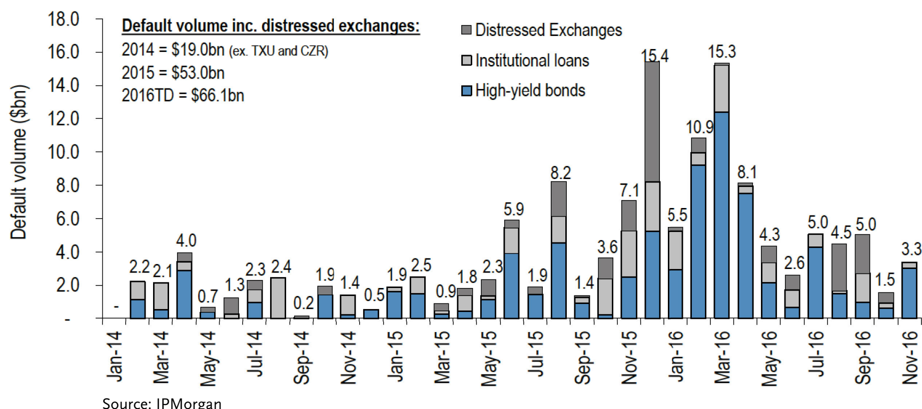
Month	New Issue	Redemptions	Net Supply	Monthly Returns
12/31/15	3,077	28,406	(25,329)	-2.52%
1/31/16	5,923	12,449	(6,526)	-1.61%
2/29/16	7,557	15,556	(7,999)	0.57%
3/31/16	18,226	12,920	5,306	4.44%
4/30/16	31,176	18,454	12,722	3.92%
5/31/16	28,355	31,534	(3,179)	0.62%
6/30/16	22,334	31,021	(8,687)	0.92%
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%
10/31/16	13,452	35,225	(21,773)	0.39%
11/30/16	15,282	22,208	(6,926)	-0.47%

Source: Barclays

Fundamental Trends

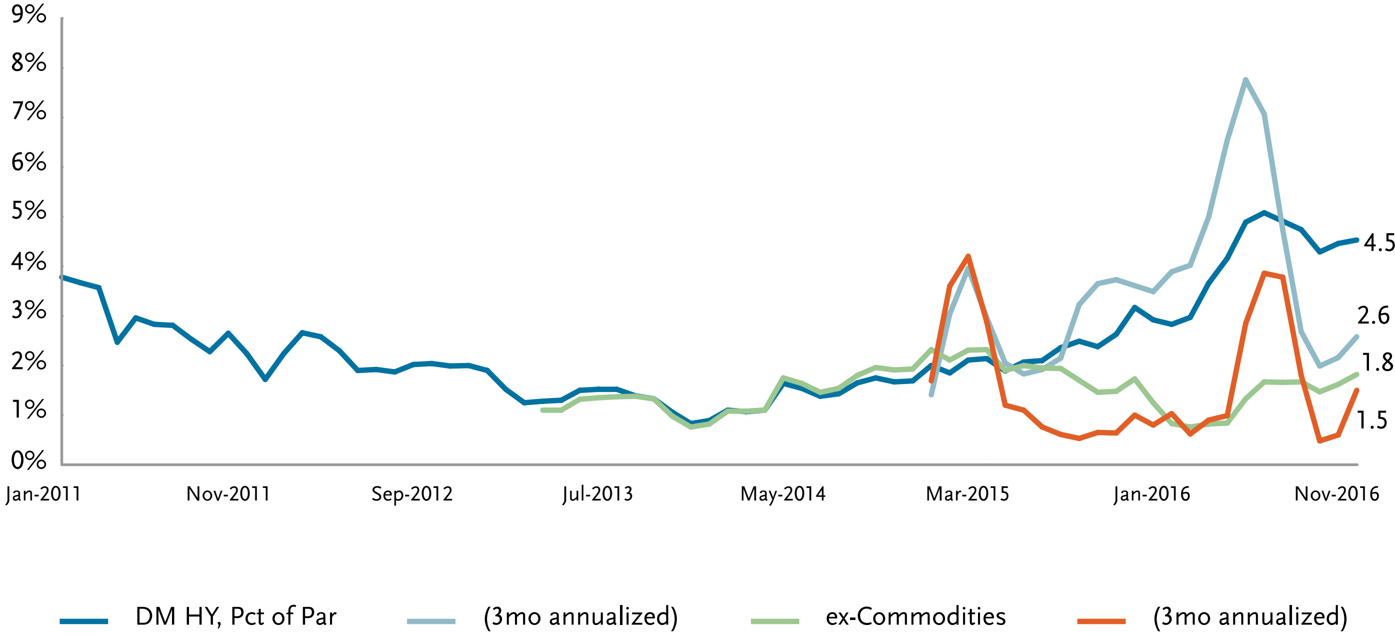
The clear sense of optimism filtering through the high yield marketplace has afforded a second chance to previously (currently) untenable credits / capital structures. Whether through exchanges or vanilla refinancings, these companies are finding opportunities to 'kick the can down the road' at astonishingly accommodative costs of capital (especially compared to where their securities were trading just a few months prior). The result has been, and was again the case in November, a relatively meager menu of default activity. For the month, six high yield bond issuers defaulted on ~$3.0bn of debt (seven issuers and $3.3bn of debt including leveraged loans). Although a step-up from the circa $1-1.5bn in volume in each of the last three months, the absolute level is nonetheless well below the pace seen in early 2016. Indeed, corporate defaults, while at the forefront of the narrative in the high yield market earlier this year, are a negligible concern of the average investor today. The sectors represented in the data set this month were actually quite diverse, reflecting idiosyncratic situations across Healthcare, Paper and Packaging, Industrials and of course Energy (still the highest representation accounting for three of the six issuers). With November now in the rearview mirror, the trailing 12-month par-weighted default rate stands at 4.5%, while the higher frequency, trailing 3-month annualized default rate is 1.5%.

Looking Back At The Last Twelve Months, Default Activity Has Inflected Materially: From December To May An Average Of $8.3bn Per Month Defaulted, While An Average Of $2.6bn Defaulted From June To November



Source: JPMorgan

Trailing Default Rates Continue To Trend Lower Through Year-End



Source: Deutsche Bank

Looking forward, credit strategists at the major banks are out with their 2017 default forecasts. The consensus appears to be a linear extrapolation of the recent run-rate over the next twelve months. Risk premia in the marketplace seem to agree with this forecast (or the forecasts agree with the market), which average ~3%, suggesting lower than historical average default risk in 2017. ■

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