TCW

# INSIGHT

VIEWPOINT

## Beneath the Aggregates: Growing List of "Idiosyncratic" Collapses

**BRIAN GELFAND** | 14 JUNE 2019

- Backward looking indicators of credit market stress, such as trailing default rates, are anchored at cyclical lows, though these, by definition, embed little information about prospective conditions and activity.
- Still, concurrent and leading indicators, such as credit spreads and distress ratios, while elevated relative to this time last year, aren't yet flashing red in the aggregates.
- Beneath the surface, however, an appreciable number of (seemingly) disjointed sectors and capital structures have begun to break ... and the list continues to grow.

Important inflections in the credit cycle are rarely observed initially in the aggregates, but rather are found in the idiosyncrasies underpinning the market. Our bottom-up investment process extends beyond our fundamental credit analysis to an appreciation for trends emerging beneath the surface. One such observation has been the complete collapse of a growing number of high yield capital structures. Though not yet apparent in the aggregates, these occurrences may prove prescient regarding prospective market conditions.

**Brian G. Gelfand**
Vice President
Fixed Income

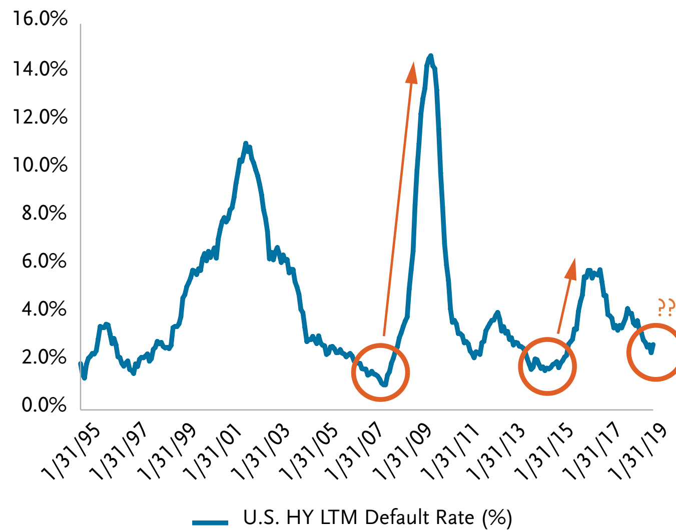
Mr. Gelfand is a Credit Trader in the Fixed Income group, focused on trading high yield securities. He joined TCW in 2014 as a Credit Analyst responsible for research across the telecom, technology and media sectors. Previously, while working towards his MBA, Mr. Gelfand completed internships in the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

TCW

### Default rate near cyclical lows, but what does this tell us?

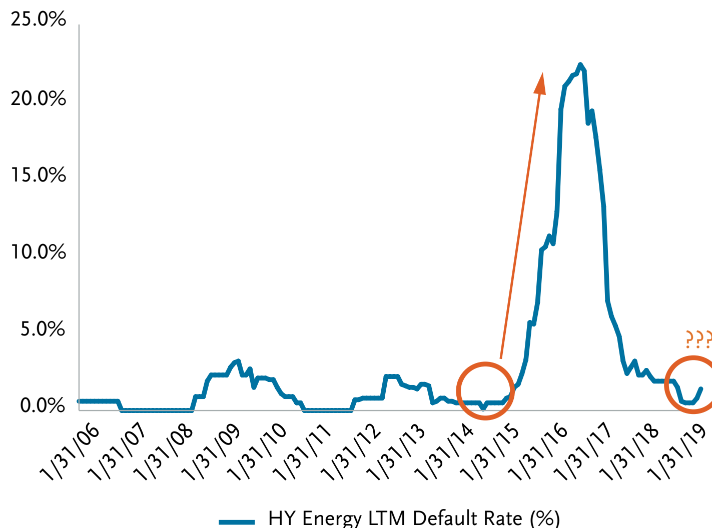
Few high yield issuers defaulted over the trailing 12 months. Indeed, just 22 borrowers in the context of a marketplace of near 2,000 credits. In terms of the quantum of debt, the last 12-month default rate, as of the end of May, stood at 2.3%. But what insight does this data embed? Information about the past no doubt. Capital was available for a broad universe of leveraged borrowers, allowing even marginal credits to "kick the can down the road" and remain current on their debts. But what does that tell us about prospective risk tolerance and capital market conditions? Well, empirically very little. Looking at the last two significant default cycles – one broad-based during the financial crisis and the other more acute to the Energy sector in late-2015/early-2016 – trailing default rates hit local lows before exponentially increasing over the subsequent months:

**LTM HY Default Rate (1995-2019)**




Source: Bloomberg / Barclays US HY Index

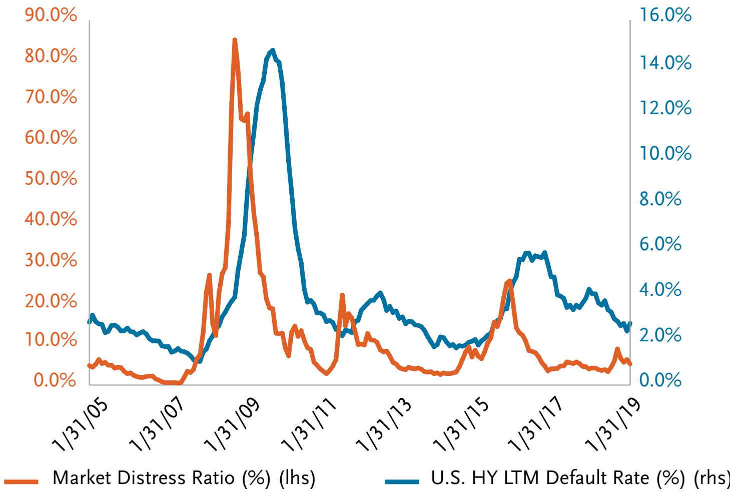
**LTM HY Energy Default Rate (2006-2019)**



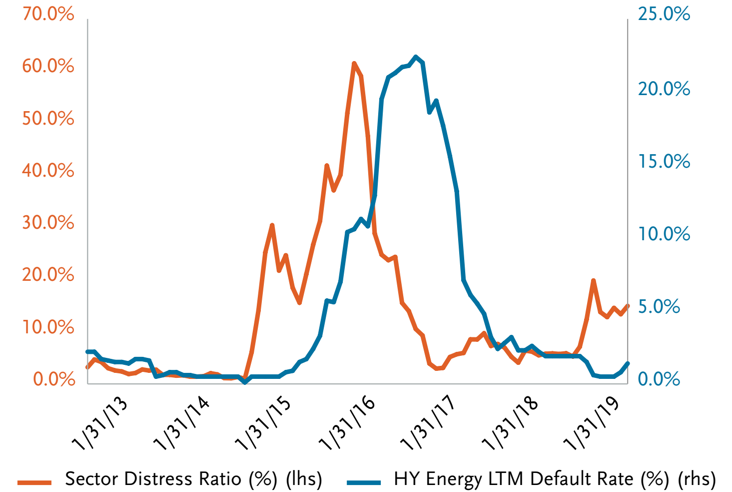

Source: ICE BofAML US HY Energy Index

## Credit Spreads and the Distress Ratio

Prevailing credit spreads for high yield bonds (i.e. the premium over the risk-free rate demanded by lenders to compensate for credit risk), in addition to the percent of bonds trading with a spread greater than 1,000 basis points (bps) (defined here as the distress ratio), are far more informative of the path forward, particularly the latter. This intuitively makes sense, as growing risk aversion inflates credit spreads and tightens lending conditions. This, in turn, restricts capital to only the most creditworthy borrowers, shuts out marginal credits and forces restructurings. Empirical correlations are evident as well:

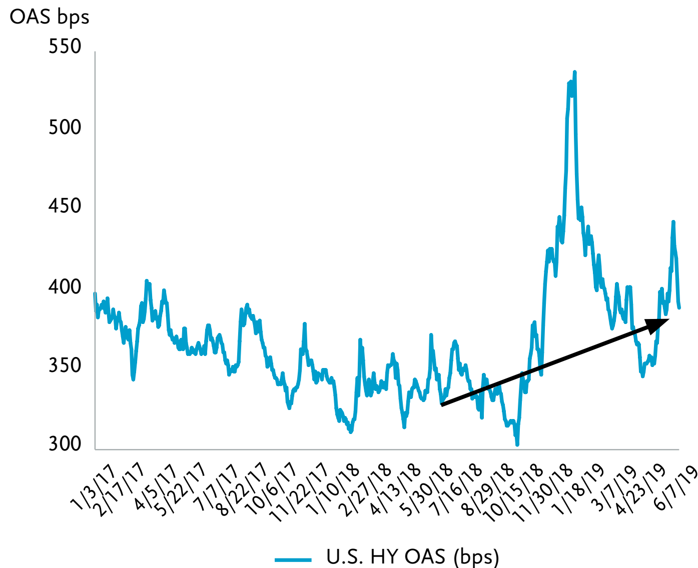



Source: Bloomberg / Barclays US HY Index

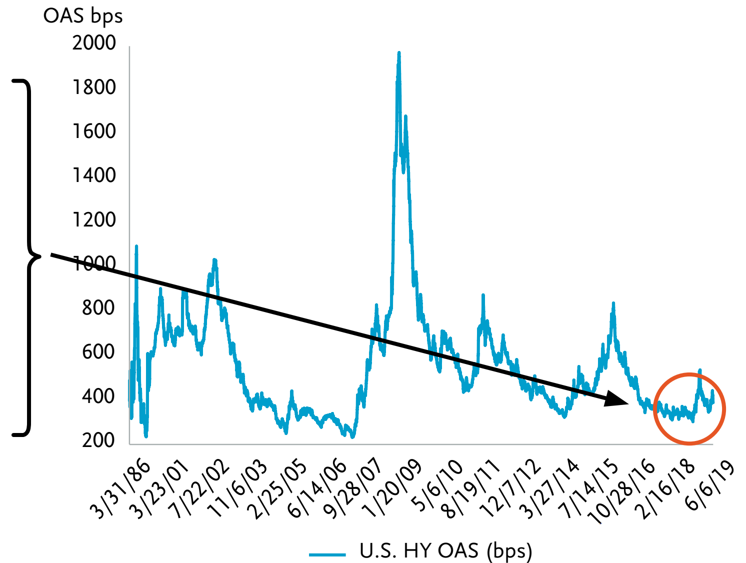



Source: ICE BofAML US HY Energy Index

As is evident above, building credit stress (distress ratio) foreshadows defaults, whereas trailing default rates are just that, "trailing," and therefore lack predictive power. On average, high yield credit spreads currently sit around +400bps, and the market distress ratio is ~6%. Both are higher than a year ago (credit spreads were inside of +350bps in June 2018 while the distress ratio was ~4%), but taken in the context of a full-cycle continuum, still remain near the lows:




Source: Bloomberg / Barclays US HY Index




Source: Bloomberg / Barclays US HY Index

TCW

## Beneath the surface, however, appreciable stress is building

While the aggregates appear to register relative stability and muted systemic credit stress, we have observed a number of capital structures this year that have begun to topple (and with increasing regularity). Year to date, a total of 21 high yield issuers have seen the price of their debt drop by 10 points or more. This is significant considering where risk asset prices stood at the start of the year following the December sell-off. Since the cyclical tights in spreads on October 3, 2018, there have been 86 issuers that have fallen by 10 points or more in price, with several experiencing drawdowns between 40-50 points! Though more interesting than the number of incidences, is its composition and evolution. What appeared initially isolated to the Energy sector, specifically Independent Exploration & Production and Services companies, has broadened to Retail, Autos, Pharmaceuticals and Metals & Mining. Moreover, the size of capital structure has begun to grow, with early stress confined to smaller credits such as Jones Energy (JONE), Alta Mesa (ALTMES), Bristow (BRS) and Sanchez Energy (SNEC), whereas recently, larger, more widely syndicated bonds have collapsed (including, Weatherford (WFT), EP Energy (EPENEG), Mallinckrodt (MNK), US Steel (X) and JC Penney (JCP)):

**Number of Issuers with > -10pt Drawdown in Price Since October 3, 2018**

| Sector | Issuer Count |
|---|---|
| Independent | 23 |
| Oil Field Services | 14 |
| Metals and Mining | 7 |
| Retailers | 4 |
| Automotive | 4 |
| Food and Beverage | 3 |
| Transportation Services | 3 |
| Consumer Products | 2 |
| Finance Companies | 2 |
| Healthcare | 2 |
| Home Construction | 2 |
| Other Financial | 2 |
| Paper | 2 |
| Technology | 2 |
| Midstream | 2 |
| Pharmaceuticals | 2 |
| Building Materials | 1 |
| Chemicals | 1 |
| Diversified Manufacturing | 1 |
| Electric | 1 |
| Other Industrial | 1 |
| Tobacco | 1 |
| Cable Satellite | 1 |
| Retail REITs | 1 |
| Wireline | 1 |
| Wireless | 1 |
| **Total** | **86** |

Source: Bloomberg / Barclays U.S. HY Index

But are these sell-offs unrelated/purely idiosyncratic, or indicative of a systemic trend? On the surface, the various drivers appear rather disjointed – lower oil prices, underwhelming well results and service price deflation (Energy) versus opioid litigation and Medicaid reimbursement pressures (Mallinckrodt) versus trade-related commodity price volatility (U.S. Steel). However, evident across each case is a swift and significant withdrawal of investor sponsorship. This lack of willingness to extend credit has a

powerful ability to compound. When companies lose incremental access to the capital markets, investors rush to sell before the next domino falls (as loss aversion fuels risk aversion). Capital therefore becomes less readily available, resulting in distress, defaults and principal loss. Said another way, the capital market itself has the ability to transmit seemingly isolated incidences of credit stress systemically. As such, elevated levels of distress, observable in select sectors/capital structures, has the potential to permeate more broadly:

**Distress Ratio by Sector (May 31, 2019)**

| Sector | Distress Ratio |
|---|---|
| Other Industrial | 15.7% |
| Energy | 15.0% |
| *Independent* | 18.0% |
| *Oil Field Services* | 26.9% |
| Transportation | 12.8% |
| Consumer Non-Cyclical | 11.5% |
| *Pharmaceuticals* | 18.2% |
| REITS | 10.4% |
| Other Financial | 9.5% |
| Finance Companies | 9.0% |
| Consumer Cyclical | 5.4% |
| Communications | 5.2% |
| Basic Industry | 3.3% |
| Insurance | 1.2% |
| Capital Goods | 0.6% |
| Electric | 0.0% |
| Banking | 0.0% |
| Brokerage Assetmanagers Exchanges | 0.0% |

Source: Bloomberg / Barclays U.S. HY Index

## Conclusion

To end with an analogy:

*Picture driving along a multilane highway. You observe an accident just ahead, so you change lanes. You are driving more cautiously now but remain on the highway. You then observe another accident, so you change lanes again. How many more iterations before you just get off the highway?*

Credit-specific collapses are becoming more frequent (and greater in scale and sector reach). While idiosyncratic in their drivers, disjointed they are not. Each credit event compounds a growing risk aversion which has the potential to transmit broadly. ■

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. © 2019 TCW

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