TCW

# INSIGHT

MONTHLY COMMENTARY

## February High Yield Credit Update

**BRIAN GELFAND** | MARCH 15, 2018

**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.

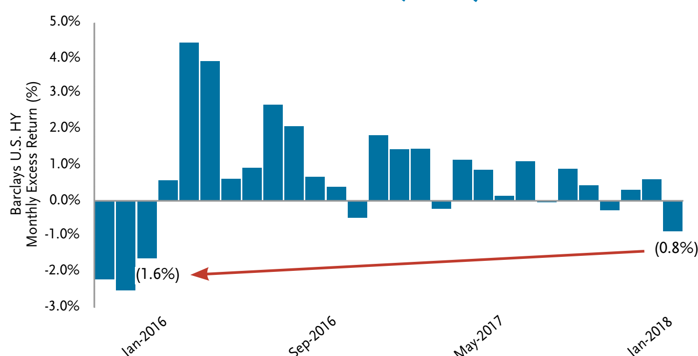
Volatility re-emerged across global asset markets in February with U.S. Treasuries and equities (and volatility itself) at the epicenter of the quake. The yield on the 10yr rose +0.14% during the month, +0.24% in a discrete two and a half week period mid-month, and is now +0.41% higher year-to-date. The Dow was down as much as -12% from the highs intra-month (evaporating ~$800bn of market value), before bouncing off the lows and closing down -4.3% for the month (+1.3% for the year). Finally, VIX spiked over 40pts from historic lows, decimating returns of (levered) short volatility-linked ETF and ETN products.

The tremors emanating from those "other" markets were by no means ignored by high yield investors, though the reaction function ultimately proved relatively measured and orderly, at least thus far. Indeed, market-clearing prices were guided lower as benchmark yields rose +0.36%, attributable to both rising interest rates and widening of credit spreads, but void of any measurable outbreak of panic selling (although it felt close to the tipping point on more than one occasion). Spreads widened +17bps on the month to +336bps (option-adjusted), moderating from intra-month highs of +369bps. After the dust settled, average high yield bond price, yield and spread stood at $99.59 (-$1.3 year-to-date), 6.14% (+0.42%) and +336bps **(-7bps)**, respectively. With risk premiums still tighter on the year, the volatility in February may have unwound the excesses reached in January, though valuations remain at cyclical peaks.

## Market Performance

High yield bonds returned -0.85% in February as rising interest rates and widening credit spreads (during the first half of the month) drove bond prices lower with ~50bps of monthly coupon unable to recoup the delta. Notably, the negative price action this month was the worst since the depths of the commodity-led downturn – less a comment on the magnitude of the negative performance this month as it is on how much volatility has been dampened for the past two years.

**High Yield Bonds Total Return in February Was the Worst Since January 2016**




Source: Barclays

While not immune from interest rate volatility, wider spread, lower duration Single-B and CCC-rated bonds outperformed tighter spread, empirically interest rate sensitive BB-rated credits. BBs returned -1.1% while Single-B and CCC cohorts returned -0.7% and -0.8%, respectively. While decompression in credit spreads across the quality spectrum did emerge amid the macro volatility (stocks, interest rates and HY fund flows), the initial move was modest and partially remediated by the end of the month. Indeed, while rising interest rates may eventually prove destabilizing for credit fundamentals and drive risk premiums much higher, this was not the case in February.

| HY Performance (%) | HY | Ba | B | Caa | Ca-D |
|---|---|---|---|---|---|
| February 2018 Total Return | -0.85 | -1.11 | -0.71 | -0.80 | 3.65 |
| 2018 Total Return | -0.26 | -1.07 | -0.01 | 1.14 | 4.99 |
| February 2018 OAS Chg | 17 bps | 21 bps | 14 bps | 15 bps | |
| 2018 Excess Return | 0.97 | 0.39 | 1.09 | 2.04 | |

Source: Barclays

Although the impact of rising interest rates and macro volatility was fairly systemic in its impact on market prices, a few idiosyncratic catalysts drove (modest) dispersion at the sector and credit level. Retailers were the best performing sector this month led by Rite Aid as the company's unsecured debt rallied upwards of +8pts after it was announced the company has agreed to merge with Albertsons. Restrictive covenants in the Rite Aid bonds require the debt be taken out at a premium to effect the merger and, as a result, the market quickly re-priced the debt higher. Other sectors buttressed by positive moves in large (predominantly stressed) capital structures include Consumer Products (Revlon), Media (Clear Channel Outdoor) and Cable/Satellite (Intelsat). The latter saw both senior and subordinate bonds rally +8pts and +12pts, respectively, as investors re-underwrote the probability the company will be able to monetize its excess C-band spectrum for use in terrestrial 5G networks someday. Underperforming on the month was the Energy complex (Oil Field Services and Independent E&Ps), remediating with crude oil prices following solid gains in January. Also, Supermarkets were in the red as regional grocer Tops Markets filed for bankruptcy protection.

| Best Sectors | February (%) | YTD (%) | Worst Sectors | February (%) | YTD (%) |
|---|---|---|---|---|---|
| Retailers | 0.16 | 1.95 | Oil Field Services | -2.47 | 0.90 |
| Consumer Products | 0.07 | 1.12 | Supermarkets | -2.28 | -0.67 |
| Media Entertainment | -0.09 | 0.88 | Independent | -1.98 | -0.76 |
| Financial Other | -0.17 | 0.59 | Banking | -1.56 | -1.91 |
| Cable Satellite | -0.22 | -0.92 | Wireless | -1.56 | -2.07 |

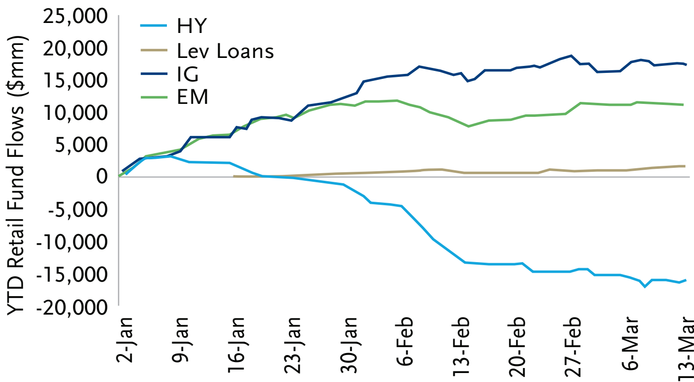
Source: Barclays
Green Text= Best Performing; Red Text= Worst Performing

## Market Technicals

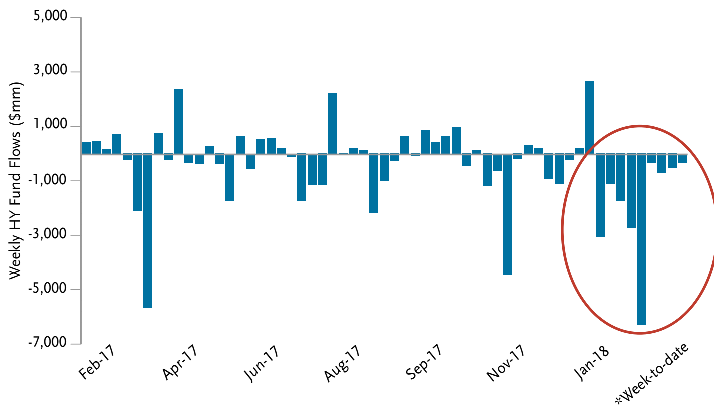
The exodus of investment from the high yield market stands in stark contrast with positive inflows into virtually all other risk asset classes. High yield mutual funds and ETFs had net outflows of over $18bn in 2017 and thus far in 2018, net outflows have totaled an incremental $14bn. The majority of the exodus this year was realized in February with over $9bn in net outflows from active and passive funds (excluding some likely double counting as active fund managers pulled money parked in ETFs to satisfy liquidity demands). Notably, the targeted outflows from HY are a bit puzzling. Fear over rising interest rates seems to be a reasonable driver, particularly with the concurrent inflows into floating rate loan funds, though higher duration / higher interest rate sensitive IG credit did not see commensurate outflows. Fear of credit loss is also a historical driver, particularly this late in the cycle, though spreads near cyclical tights would argue an impending default cycle is of little concern currently. Quite possibly the reason for the exodus is simply very poor absolute (and relative) value?

Whatever the driver, underlying technicals currently create fertile ground for disruption.

### The High Yield Market Has Seen Targeted Outflows Over the Past Several Months




Source: Credit Suisse, EPFR




Source: Lipper, JP Morgan

The primary market nearly ground to a halt this past month as seasonally light volumes were further depressed by market volatility. Fourth quarter earnings blackout periods typically slow primary issuance, however, the pipeline for opportunistic deals was stalled as issuers, citing poor market conditions, opted to wait for better execution. Only $12bn in USD-denominated high yield debt was issued this month, a two-year low (comparable to the low issuance seen during the peak of the commodity-led downturn in late-2015/early-2016). Those deals that did brave the storm were skewed towards the Energy complex (a consistent theme thus far in 2018) and lower credit quality issuers that are less concerned with paying an extra 0.25-0.5% than they are with not missing this window when the capital markets remain extremely accommodative.

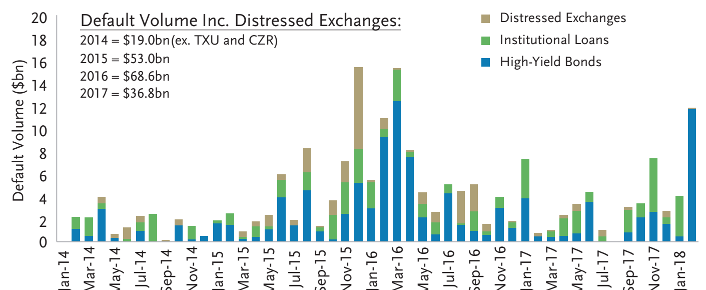
| Month | New Issue | Redemptions | Net Supply | Monthly Returns (%) |
|---|---|---|---|---|
| Dec-16 | 18,581 | 26,359 | -7,778 | 1.85 |
| Jan-17 | 19,028 | 20,783 | -1,755 | 1.45 |
| Feb-17 | 20,075 | 26,891 | -6,816 | 1.45 |
| Mar-17 | 42,879 | 32,555 | 10,324 | -0.22 |
| Apr-17 | 16,275 | 33,967 | -17,692 | 1.15 |
| May-17 | 25,797 | 28,265 | -2,468 | 0.87 |
| Jun-17 | 19,764 | 37,114 | -17,350 | 0.14 |
| Jul-17 | 11,006 | 28,127 | -17,121 | 1.11 |
| Aug-17 | 17,723 | 19,252 | -1,529 | -0.04 |
| Sep-17 | 37,394 | 22,548 | 14,846 | 0.90 |
| Oct-17 | 23,321 | 32,135 | -8,814 | 0.42 |
| Nov-17 | 27,003 | 15,210 | 11,793 | -0.25 |
| Dec-17 | 17,622 | 24,511 | -6,889 | 0.30 |
| Jan-18 | 24,141 | 31,692 | -7,551 | 0.60 |
| Feb-18 | 12,238 | 23,591 | -11,353 | -0.85 |

Source: Barclays
Green Text = Best Performing; Red Text = Worst Performing

## Fundamental Trends

February saw an uptick in corporate default activity, anchored by the ~$16bn capital structure of iHeartMedia. One of the few remaining pre-crisis LBOs, iHeart is in negotiations with lenders to restructure its over-leveraged balance sheet following several years of "kick the can down the road" capital markets transactions and liability management maneuvers. iHeart represents the largest corporate default since Caesars filed for bankruptcy in December 2014. In addition to iHeart, four companies defaulted on their debt obligations this month, representing ~$2.3bn of bonds and loans. The trailing 12-month high yield default rate of ~2%, remains at cyclical lows, with the consensus call among market strategists for an extrapolation of the low default environment into the foreseeable future. ■

### iHeartMedia Missed an Interest Payment On February 1st, Triggering Restructuring Negotiations for One of the Last Remaining Pre-Crisis LBOs




Source: JP Morgan
Excludes the record setting defaults of Energy Futures' $36bn default in April 2014 and Caesar's $18bn default in December 2014.

Bloomberg Index Services Limited. BLOOMBERG® is a trademark and service mark of Bloomberg Finance L.P. and its affiliates (collectively "Bloomberg"). BARCLAYS® is a trademark and service mark of Barclays Bank Plc (collectively with its affiliates, "Barclays"), used under license. Bloomberg or Bloomberg's licensors, including Barclays, own all proprietary rights in the Bloomberg Barclays Indices. Neither Bloomberg nor Barclays approves or endorses this material, or guarantees the accuracy or completeness of any information herein, or makes any warranty, express or implied, as to the results to be obtained therefrom and, to the maximum extent allowed by law, neither shall have any liability or responsibility for injury or damages arising in connection therewith.

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