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INSIGHT

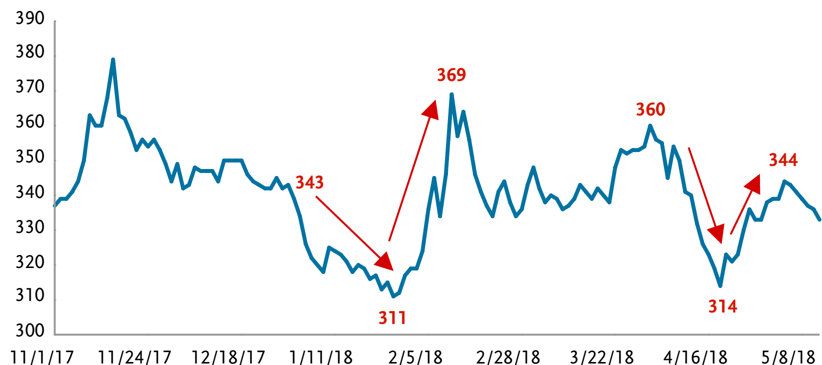
MONTHLY COMMENTARY

April High Yield Credit Update

BRIAN GELFAND | MAY 16, 2018

The high yield market sounded like a broken record in April. A steady bid for risk during the first two weeks of the month pushed the average option-adjusted spread of the Bloomberg Barclays U.S. HY Index within a few basis points of this cycle's lows, only to experience a sharp remediation amid pressure from rising interest rates and macro (international trade/tariffs, Syria) flare-ups.

Sound Familiar...HY Credit Spreads Re-Tested Post-Crisis Lows Reached During January's Risk Grab



Source: Bloomberg Barclays

Much investor attention remains focused on the macro, and deservedly so, as an attempt by global central banks to unwind a near decade of unprecedented monetary stimulus runs the real risk of *destabilizing* intricately intertwined global markets (a reasonable expectation considering the policies themselves proved extremely *stabilizing*). Though equally important is the micro, where prolonged investor complacency continues to result in the erosion of credit fundamentals, seemingly at an accelerated pace. High yield investors have grown increasingly permissive of a number of adverse practices, including weak covenant language, which limits the future enforceability of creditor protections; aggressive "add-backs" to underwritten EBITDA, which mask true financial leverage; and complex corporate structures, which disguise embedded structural leverage. Financing for negative-earning enterprises is also being made available?! Calm waters hide fundamental defects, while choppy seas expose them, typically to the detriment of principal. We continue to believe a discerning underwriting processes is paramount to the preservation of principal and will serve as a differentiator when the cycle turns.

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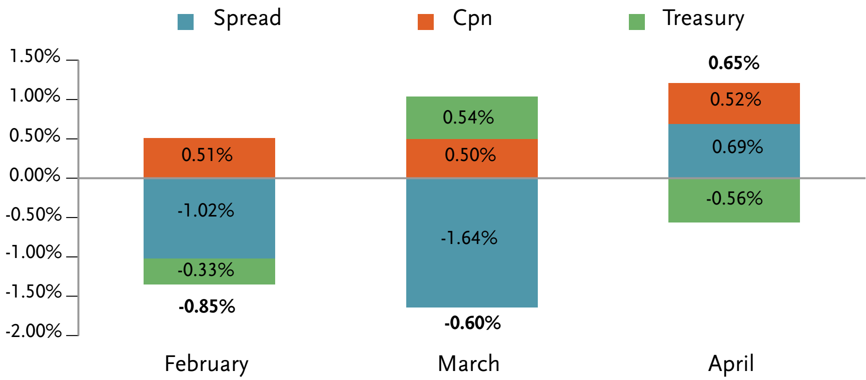
Mr. Gelfand is a Credit Trader in the Fixed Income group, focused on trading high yield securities. He joined TCW in 2014 as a Credit Analyst responsible for research across the telecom, technology and media sectors. Previously, while working towards his MBA, Mr. Gelfand completed internships in the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

Market Performance

April saw high yield bonds recover modestly from a cumulative drawdown in February and March of -1.5%, impressively the worst two-month return for the asset class in over two years. Early gains faded as the month progressed, with headwinds from rising interest rates, though high yield bonds still earned a total return of +0.65% in April. Excess returns were more robust at +1.21%.

Gains From Tightening Credit Spreads and Coupon Were Pared by the Effects of Rising Interest Rates



Source: Bloomberg Barclays

Interest rate sensitive higher quality bonds (BBs) continued to underperform lower fundamental credit quality CCC-rated risk in April, following a brief reversal the month prior. Year to date, BBs have lost -1.5%, standing in stark contrast to CCCs which on average are up +1.3%. While dispersion at the credit and sector level remains elevated, the overarching dynamic of rate concerns overwhelming credit concerns continues to dominate general price action in the marketplace.

HY Performance	HY	Ba	B	Caa	Ca-D
April 2018 Total Return	0.65%	0.13%	0.95%	0.99%	9.64%
2018 Total Return	-0.21%	-1.48%	0.40%	1.29%	12.07%
April 2018 OAS Chg	-16bps	-18bps	-21bps	-9bps	
2018 Excess Return	1.03%	0.00%	1.52%	2.19%	

Source: Bloomberg Barclays

A few themes at the sector and credit level were in the spotlight this month. Principal among them was the announced merger between high yield bellwethers Sprint and T-Mobile. Following (years of) on again, off again negotiations, parent companies Softbank and Deutsche Telekom agreed on terms to create a formidable third competitor in the U.S. wireless market. Sprint bonds rallied meaningfully around the headlines, given the substantially de-risked credit profile of the prospective enterprise, though have since given back more than half the gains as investors handicap what will likely be a contentious, uncertain and politically charged regulatory review process. We estimate Sprint bond prices currently imply ~40% probability the contemplated deal is approved. Away from the Wireless sector, oil-linked credits were in focus with market commentators highlighting the recent underperformance of Energy bonds relative to the rally in the underlying commodity. However, as the sustainability of the oil rally began to gain acceptance and industry M&A incited a bit of investor FOMO, particularly with respect to pure-play Permian Basin credits, E&P and Oil Field Services bonds caught a bid and prices accelerated higher throughout the month. Notable underperformers during the month were Autos and Consumer Products, with the latter under pressure as sector-wide Q1 earnings felt the pinch of rising input costs, specifically freight, and downstream pressures from struggling retail partners. Risk premiums reset wider across the sector as a result.

Best Sectors	April	YTD 2018
Wireless	2.84%	0.27%
Oil Field Services	2.58%	1.62%
Supermarkets	2.05%	-0.33%
Wirelines	1.51%	2.52%
Independent	1.42%	0.17%

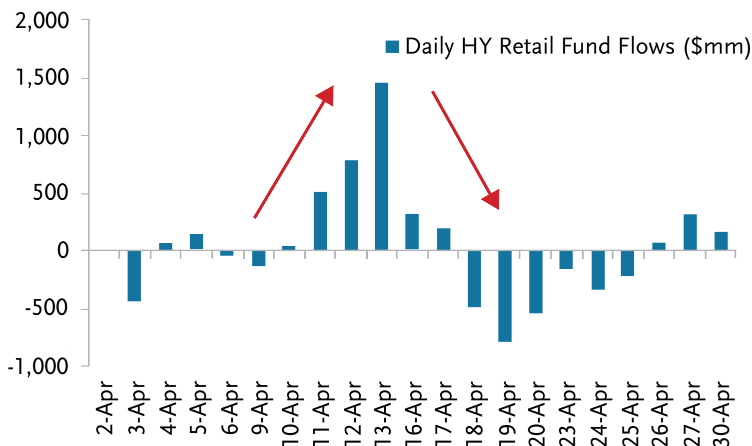
Worst Sectors	April	YTD 2018
Automotive	-1.40%	-3.63%
Paper	-0.26%	-0.55%
Construction Machinery	-0.21%	-0.84%
Consumer Cyclical Services	-0.18%	-1.26%
Consumer Products	-0.12%	-0.08%

Source: Bloomberg Barclays

Market Technicals

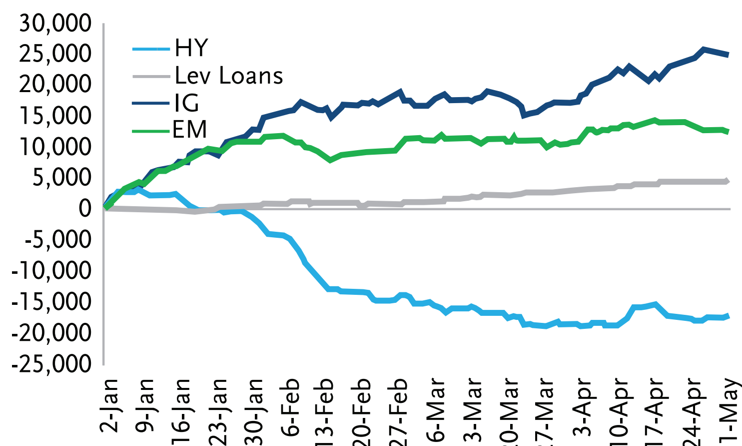
Fund flows were choppy during the month, though notably high yield bond funds experienced a week of sizeable net inflows, breaking trend momentarily before seeing assets continue their exodus from the asset class (high yield funds have lost ~$19bn in assets year-to-date). Specifically, the second week in April recorded net inflows of near $3bn into ETFs and mutual funds, and while the remainder of the month saw the majority of those assets leave the sector, the final tally for April was a net inflow of just over $1bn (the first month of positive net fund flows for the high yield market since September 2016).

High Yield Bonds Were Back En Vogue Briefly in April...



Source: Credit Suisse, EPFR

...Though the Asset Class is Decisively Out of Favor Thus Far in 2018



Source: Credit Suisse, EPFR

The primary calendar was seasonally light and the confluence of earnings-driven blackouts and intermittent credit and interest rate volatility kept opportunistic issuers on the sidelines. As such, just over $17bn in USD-denominated high yield debt was issued in April. While the primary market remains open for regular-way high yield issuers (and is somehow even accessible to negative EBITDA enterprises such as VC unicorn WeWork), this past month saw two bridged deals struggle mightily to get across the finish line. Global engineering and construction firm McDermott was forced to syndicate its 10.625% coupon unsecured bond at a 5.25 point discount to par, while American Greetings was only able to clear its 8.75% coupon unsecured bond 15pts below par! While two data points does not a trend make, hung bridge loans are more commonplace at cycle inflections.

High Yield Net Supply ($MM)

Month	New Issue	Redemptions	Net Supply	Monthly Returns
3/31/17	42,879	32,555	10,324	-0.22%
4/30/17	16,275	33,967	(17,692)	1.15%
5/31/17	25,797	28,265	(2,468)	0.87%
6/30/17	19,764	37,114	(17,350)	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	37,394	22,548	14,846	0.90%
10/31/17	23,321	32,135	(8,814)	0.42%
11/30/17	27,003	15,210	11,793	-0.25%
12/31/17	17,622	24,511	(6,889)	0.30%
1/31/18	24,141	31,692	(7,551)	0.60%
2/28/18	12,238	23,591	(11,353)	-0.85%
3/31/18	26,509	22,949	3,560	-0.60%
4/30/18	17,414	30,052	(12,638)	0.65%

Source: Barclays

Fundamental Trends

Default volumes subsided in April following two months of (relatively) elevated activity. Just two companies (in the Energy sector) defaulted on $1.1bn of bonds and loans. Trailing default rates continue to hover around a benign 2.25% and the current outlook is similarly sanguine, with the percent of high yield bonds trading below $70 (a traditionally good leading indicator of forward defaults) in the low single digits. That said, fundamentals in the world of leveraged finance can shift swiftly and painfully as the market was most recently reminded in the case of American Tire Distributors. Bonds of this levered distributor traded down over 50pts in a day after it was announced the company lost its contract with one of its largest customers (Goodyear Tire). Yes, it was an idiosyncratic event, although it serves as a wake-up call against complacency and a reminder of how quickly the market can re-price risk, particularly when prevailing valuations leave little margin for error. ■

ATD 10.25 2022 – A Recent Reminder of the "Jump" Risk Inherent in Leveraged Finance

Source: Bloomberg

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