TCW

INSIGHT

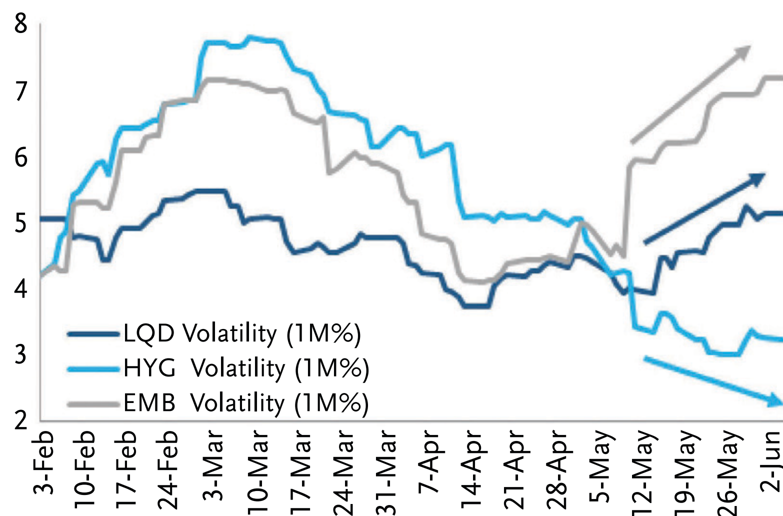
MONTHLY COMMENTARY

May High Yield Credit Update

BRIAN GELFAND | JUNE 14, 2018

It's quite possible the old axiom of "sell in May *and go away*" may have resonated too well with high yield bond investors this past month, at least when reflecting on our market's responsiveness to recent global developments. While risk assets broadly, though specifically credit, experienced an uptick in volatility these past several weeks, the result of political and financial instability in Europe and monetary pressures in emerging markets (with a side of trade disputes), U.S. high yield bond prices were relatively unamused – save for an ultimately fleeting disturbance in the final few days of the month.

Recent Collapse in U.S. HY Volatility, Decoupling From Other Credit Markets



Source: Credit Suisse

This isn't to say the U.S. high yield market has been void of activity. Though currently less concerned with developments in the periphery, market participants remain acutely responsive to idiosyncratic events, with earnings, corporate actions and sector activity creating several pockets of dispersion across and within capital structures both in May and thus far in June. In recent weeks, we have seen very large moves in response to discrete catalysts in the bonds of satellite operators, pharmaceutical companies, wireless and wireline telecoms and specialty retailers, to allude to a few. Our market's efficiency at pricing the micro compared to its difficulty handicapping the macro is a feature on which we have previously commented and remains a reason for caution given emerging disruption in the latter and the speed at which that stress can be transmitted to the former – a risk that doesn't appear to be discounted in current valuations.

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.

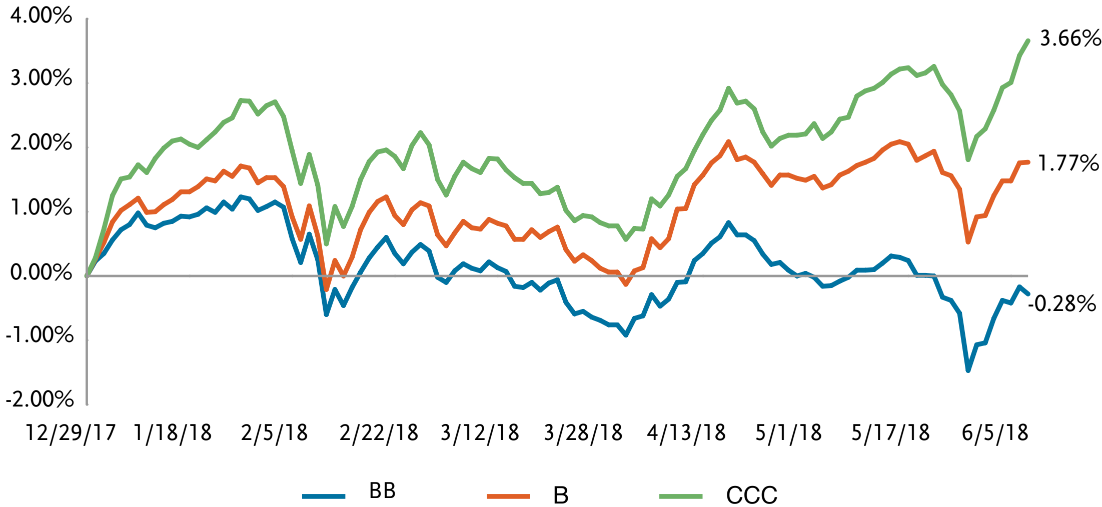
Market Performance

As discussed above, an otherwise range bound trading month in the aggregate was (briefly) disturbed later in the month by Italy's and Spain's political and financial uncertainty, which transmitted to interest rate and credit spread volatility domestically. The result: ultimately uninspired performance in U.S. HY credit in May with a benchmark (Bloomberg/Barclays U.S. High Yield Index) total return of -0.03%.

The outperformance of CCCs relative to BBs thus far in 2018 is well documented. Through the end of May, CCCs have earned investors +376bps above BBs year to date, with the outperformance extending thus far in June. Though high fundamental quality, tight credit spread BB-rated bonds have disproportionately felt the pressure from rising interest rates (given high empirical duration), it is interesting to note that even when isolating the effects of the rate move, CCCs have still outperformed meaningfully year to date. Indeed, higher carry, risk-on investor behavior, and importantly, recent large fundamental improvements in bellwether CCC-rated capital structures (Intelsat S.A. and Valeant Pharmaceuticals to name a couple) are also key drivers of the relative performance.

Interest Rates Aren't Fully To Blame as CCC-Rated Bonds Have Earned Greater Excess Returns vs. Higher Quality Cohorts Year-to-Date

YTD Excess Return by Ranking



Source: Bloomberg Barclays

HY Performance	HY	Ba	B	Caa	Ca-D
May 2018 Total Return	-0.03%	-0.37%	0.00%	0.62%	6.63%
2018 Total Return	-0.24%	-1.84%	0.40%	1.92%	19.50%
May 2018 OAS Chg	24bps	29bps	28bps	6bps	
2018 Excess Return	0.39%	-1.04%	0.94%	2.29%	

Source: Bloomberg Barclays

Issuer and sector performance bifurcation was prominent in May. Outperforming on the month were Pharmaceuticals, a sector dominated by three credits, Valeant, Endo and Mallinckrodt. Valeant earnings and forward guidance were better than expected giving investors greater confidence the new management team has the wherewithal to right the ship. Endo and Mallinckrodt results were less spectacular, though bested skeptical consensus expectations. Supermarkets also received a boost from The Fresh Market which saw bonds rally +8pts from distressed levels after better-than-feared earnings fueled short covering and emboldened those who believe in the turnaround. Also, merchant power producers with assets in the PJM region were delivered a win with favorable results out of the annual capacity auction, re-pricing risk across the sector. Notable detractors for the month included Retailers, specifically PetSmart, which saw its unsecured debt continue to leak lower, principally in reaction to Amazon's launch of a generic dog food brand. JC Penney also reported decidedly weak SSS numbers, reduced full-year guidance and announced the unexpected departure of its CEO, all of which drove bonds lower on the month. Finally, ADT, a large constituent of Consumer Cyclical Services, became the most recent victim of the 'Amazon Effect' as fears of disruption emerged following Amazon's acquisition of Ring, sending bond prices lower.

Best Sectors	May	YTD 2018
Pharmaceuticals	2.11%	2.24%
Supermarkets	1.99%	1.66%
Oil Field Services	1.46%	3.10%
Health Insurance	0.71%	-0.57%
Electric	0.61%	0.71%

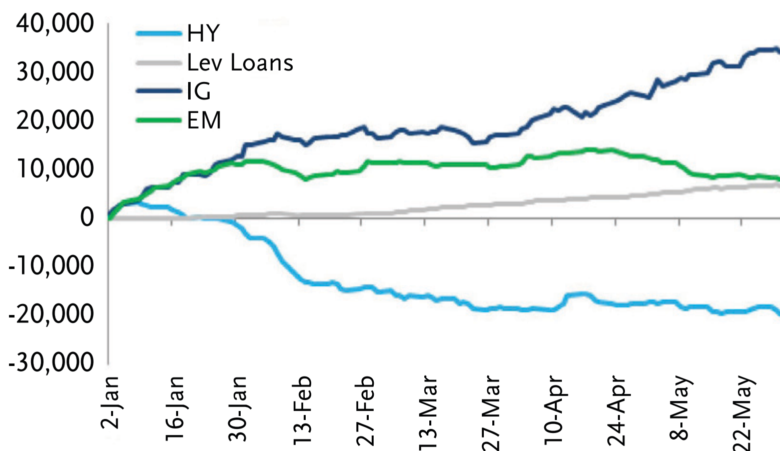
Worst Sectors	May	YTD 2018
Retailers	-1.38%	0.26%
Industrial Other	-1.35%	-0.80%
Building Materials	-1.01%	-2.01%
Consumer Cyclical Services	-1.00%	-2.24%
Diversified Manufacturing	-0.91%	-0.55%

Source: Bloomberg Barclays

Market Technicals

Capital flows into U.S. High Yield funds in April proved short-lived as the exodus from our asset class resumed in May. Net outflows from HY funds were -$843mn for the month, bringing the full-year total to -$20bn. While emerging concerns over EM credit fundamentals are inciting outflows from that sector, capital flight from U.S. high yield continues to stand in stark contrast to flows in other domestic fixed income markets, specifically loans and investment grade debt. Whether or not we see a flip of the script with U.S. leveraged finance the beneficiary of EM investor capital, only time will tell. In the meantime, we note the exit year to date has remained extremely orderly with little in the way of a protracted technical disturbance.

Outflows From U.S. High Yield Extended in May



Source: Credit Suisse, EPFR

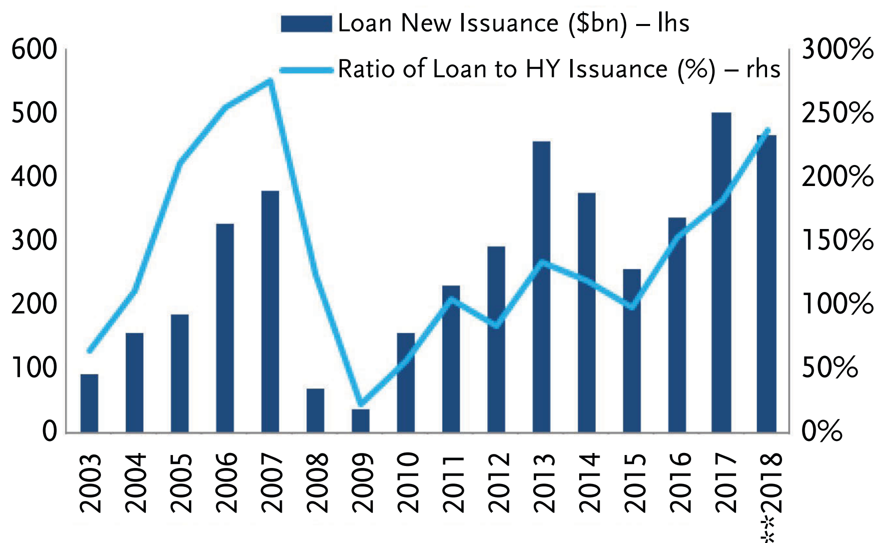
While seasonality can be blamed for light primary volumes in April (indeed, blackout periods around earnings release dates limit issuers' ability to tap the capital markets), what was the excuse in May? Extremely uncharacteristic for what is historically one of the most active calendar months for primary issuance, USD-denominated new issue volumes were just $14bn this past month. It would appear a few factors may be at play. First, the move higher in interest rates has increased the all-in cost of capital, changing the calculus for opportunistic refinancings of callable debt (i.e. the call option is less 'in-the-money'). Second, loan issuance has accelerated, particularly for M&A and LBO transactions, in response to significant demand and appealing terms (from the debtors' perspective), cannibalizing on would-be bond issuance. Indeed, year-to-date loan issuance is ~2.4x that of high yield bond issuance, levels not seen since the lead-up to the financial crisis.

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%
5/31/18	14,355	31,611	(17,256)	-0.03%

Source: Barclays

Loan Issuance Continues to Take Away Share From HY

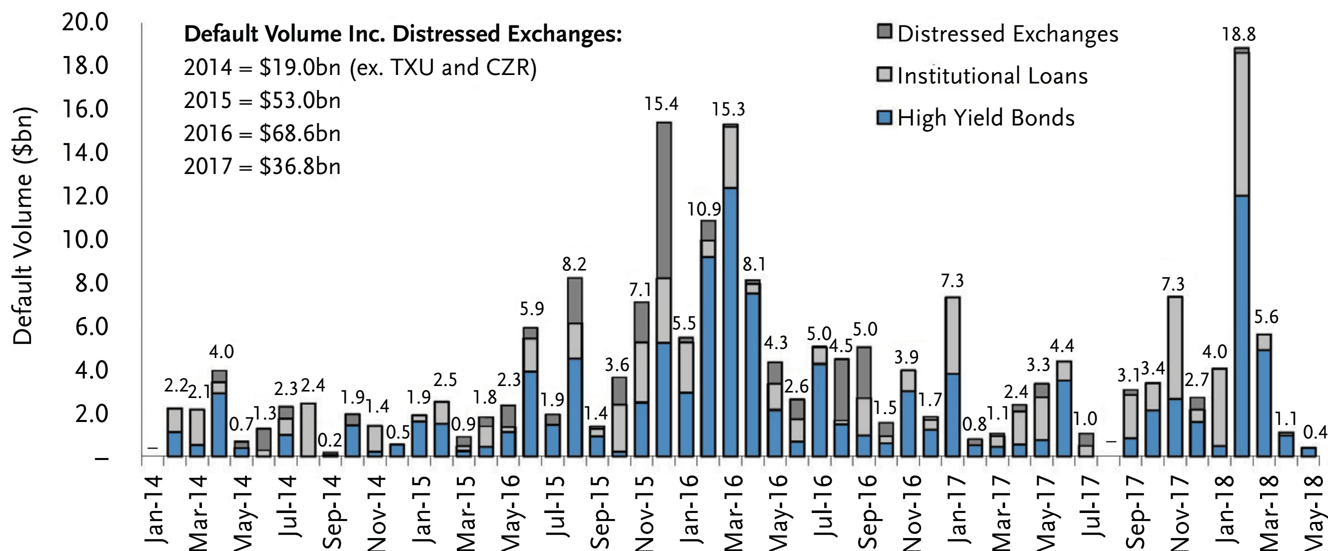


Source: Credit Suisse, ** YTD issuance annualized

Fundamental Trends

High yield defaults remain less of a theme these days as only a single issuer, Gibson Brands, filed for bankruptcy, defaulting on $375mn of debt obligations in May. The global manufacturer and distributor of musical instruments was forced into a restructuring, right-sizing its capital structure and operations in response to generational shifts in consumer interest / discretionary spending. Trailing U.S. HY default rates continue to trend around a benign 2% (2.26% per JPM, 1.53% excluding iHeart). ■

Near Void of Default Activity, May Extended Recent Trends



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

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