TCW

INSIGHT

MONTHLY COMMENTARY

June High Yield Credit Update

BRIAN GELFAND | JULY 16, 2018

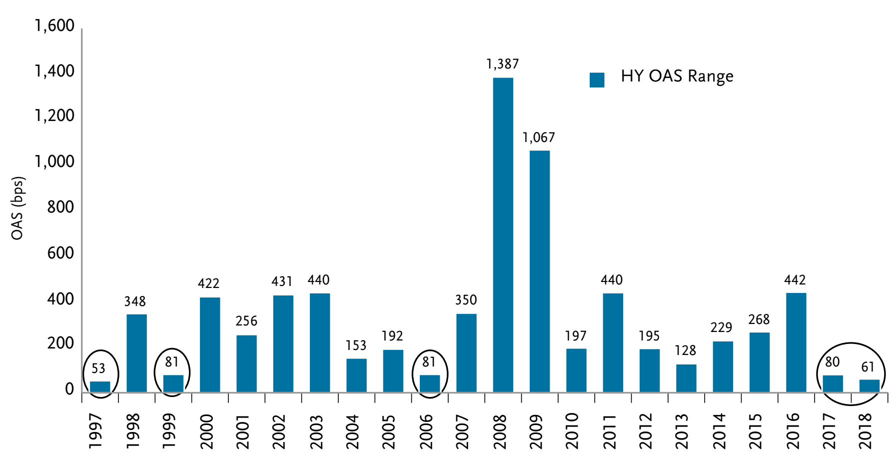
Interestingly, the narrative in high yield credit in June was very consistent with that of the first six months of the year. A microcosm if you will, with:

- Aggregate credit spreads oscillating within a very narrow band (33bps for the month and just 61bps year-to-date), though masking greater divergence at the sector, credit and notably CUSIP levels
- Price action taking its cue from the micro more so than the macro as high yield investors remain, at least thus far, desensitized to developments elsewhere (escalating trade disputes, emerging market stress), while maintaining heightened sensitivity to idiosyncratic catalysts (corporate earnings, liability management exercises, sector activity)
- Countervailing technicals with large capital outflows (-$3bn in June and -$24bn year-to-date) balanced by a dearth of new issuance (year-to-date down -22% y/y)
- And lackluster, though still positive, market returns

To that last point, while true the U.S. high yield asset class has turned in one of the lowest first half returns since 2005 at +0.16%, it has not been the worst game in town. Save for leveraged loans (+2.28% on the S&P/LSTA Performing Loan Index) and U.S. stocks (+2.65% for the S&P 500), U.S. HY has bested much of the rest of global fixed income – U.S. IG Credit (-2.99%), U.S. Treasuries (-1.08%), Pan-Euro HY (-1.42%), EM High Yield (-3.75%).

The decoupling of U.S. high yield volatility from other asset classes was an acute theme in May and June, and while the dislocation has remediated somewhat in recent weeks as investor jitters in other markets have calmed, complacency in our market remains ever-present. High yield bond spreads have trended in a near historic tight range of 61bps thus far this year, extending a year and a half period of suppressed market volatility. At the tails, however, security level dispersion continues to reinforce a credit intensive, bottoms-up investment approach to avoid breakable assets (American Tire Distributors) and uncover value (Intelsat).

Very Tight Credit Spread Trading Range Over Last 18 Months…



Source: Bloomberg

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.

...However, Beneath the Surface There has Been Sizable Dispersion at the Tails

Outperformers

		YTD 6/30/18	
Issuer	**Issue**	**Price Change ($)**	**Total Return (%)**
Intelsat S.A.	INTEL 7.75 21	40.50	80.1%
Murray Energy	MURREN 11.25 21	9.00	29.0%
Frontier Communucations	FTR 10.5 22	15.00	26.5%
Neiman Marcus	NMG 8 21	8.75	21.1%
PetSmart	PETM 7.125 23	7.75	19.8%

Underperformers

		YTD 6/30/18	
Issuer	**Issue**	**Price Change ($)**	**Total Return (%)**
American Tire Distributors	ATD 10.5 22	-80.25	-76.50%
Juniper Resources	JPRSRC 8.5 22	-21.50	-26.70%
Sanchez Energy	SN 6.125 23	-17.25	-15.8%
Telecom Italia	TITIM 7.2 36	-22.13	-13.8%
Dish Networks	DISH 7.75 26	-18.00	-13.3%

Source: Barclays
Note: sample of large (~$1bn+ issue size) outperformers and underperformers

Market Performance

High yield bonds generated positive returns in June despite the mid-month selloff as just over 50bps of monthly coupon buffered ultimately net negative price action. Surprisingly (or not), the +0.4% total return in June was one of the better showings for the high yield market year-to-date, bringing cumulative performance for the asset class out of the red and into the black. Spreads were "volatile" intra-month as the OAS of the benchmark (Bloomberg/Barclays U.S. HY Index) tightened -32bps from 362bps to 330bps before widening +33bps to close the month nearly unchanged at 363bps.

Bonds with elevated credit risk (CCCs) extended their gains relative to fundamentally higher quality credits (BBs) in June by another +114bps. During the first half of 2018, CCC-rated bonds in aggregate have outperformed BBs by +494 bps. Big moves in bellwether higher beta capital structures have led the charge for the CCC-rated cohort, including credits we have previously highlighted such as Intelsat S.A. and Valeant Pharmaceuticals, in addition to recent outperformers like PetSmart and Ultra Petroleum (more on sector and single-name performance below). In contrast, tighter credit spread, more interest rate sensitive BBs have borne the brunt of current investor aversion to interest rate risk.

HY Performance	**HY**	**Ba**	**B**	**Caa**	**Ca-D**
June 2018 Total Return	0.40%	0.07%	0.46%	1.23%	1.74%
2018 Total Return	0.16%	-1.77%	0.86%	3.17%	21.57%
June 2018 OAS Chg	1bps	5bps	1bps	-42bps	
2018 Excess Return	0.79%	-0.97%	1.40%	3.54%	

Source: Bloomberg, Barclays

Few sectors generated sizably negative returns during the month, though there were a few which saw outsized gains. Retailers in particular outperformed, most notably driven by PetSmart unsecured bonds which rallied ~15pts off distressed levels over the course of a few weeks after the company posted better than feared earnings and announced it had moved a portion of the equity in its high-growth Chewy.com business into an unrestricted subsidiary (presumably to effect an exchange with unsecured bondholders sometime in the future, a la J.Crew). Pharmaceuticals extended gains in June with Endo leading the charge on the back of analyst upgrades, improved data and sentiment around generic drug pricing and moderating fears around opioid litigation. Energy credits were also in focus as a result of crude price volatility around the OPEC summit. The announced 1mn bb/d lift to production targets was a relief to the market which had priced in a more bearish tail scenario heading into the meeting. The Energy sector repriced higher in concert with the recovery in oil prices.

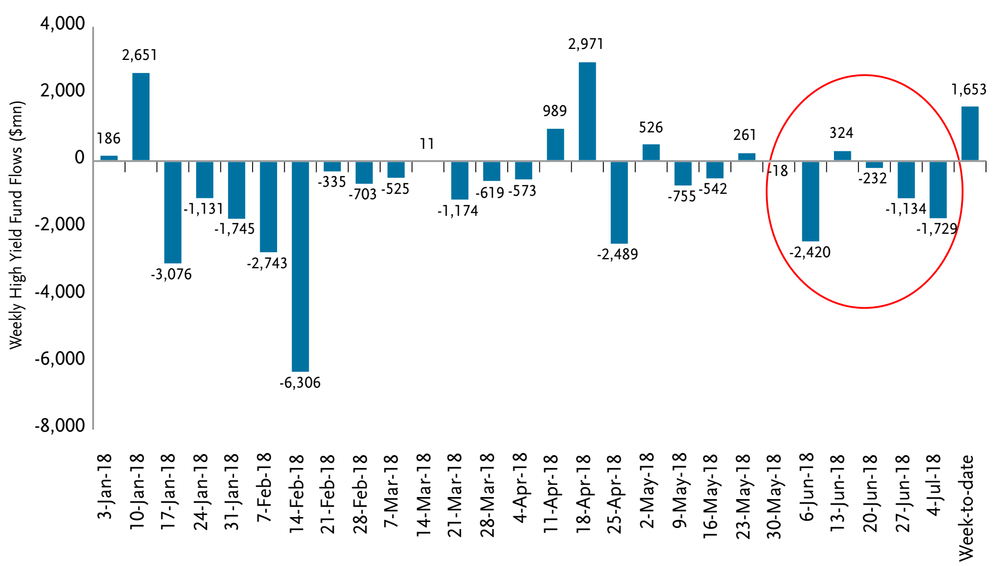
Best Sectors	June	YTD 2018
Retailers	2.05%	2.32%
Pharamceuticals	1.59%	3.87%
Supermarkets	1.34%	3.02%
Independent	1.08%	1.48%
Leisure	0.84%	0.21%

Worst Sectors	June	YTD 2018
P&C	-0.42%	-0.54%
Food & Beverage	-0.34%	-2.68%
Financial Other	-0.17%	1.84%
Construction Machinery	-0.16%	-0.99%
Metals & Mining	-0.08%	-0.99%

Source: Bloomberg, Barclays

Retail outflows, a recurring theme throughout 2018 (notably for actively managed funds), reaccelerated in June following relatively muted net fund flows over the last few months. High yield bond funds reported -$3bn in outflows this month, bringing the full-year tally to a not insignificant -$24bn. While the principal driver for the move away from high yield credit over the last nine months may be unclear – a rotation into equities, demand for floating rate loans, the relative value of investment grade vs. sub-investment grade credit – what has been proven is the market's ability to absorb the requisite selling without meaningful price dislocation. The combination of below average issuance, sufficient cash levels and importantly a still risk-seeking investor consciousness has offered ballast not always seen during such sustained periods of capital flight.

Net Outflows of ~$24bn YTD Have Proven Less Disruptive Than One Would Have Expected



Source: Lipper, JPMorgan

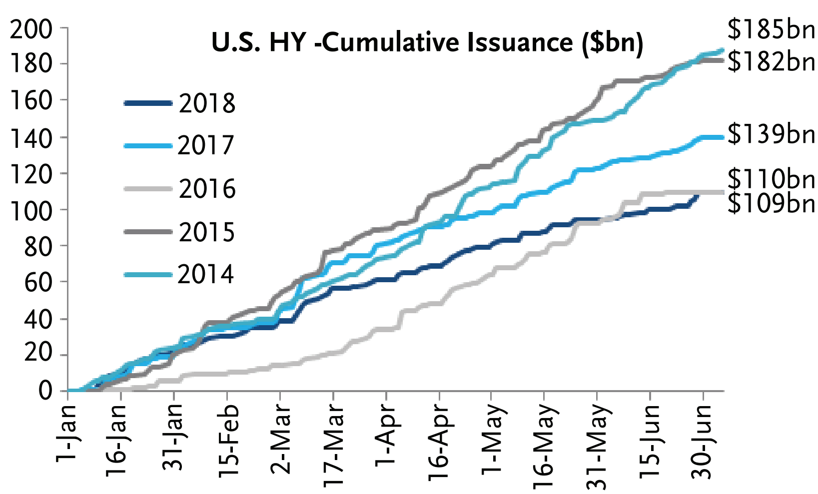
Just as was the case in April and May, primary activity in June left investors wanting, with less than $15bn in USD-denominated debt issued during the month. New issue volumes for the first half of 2018 are down -22% compared to the same period last year. While a few benchmark deals found their way onto the calendar this month, Community Health Systems' secured bond deal for example, many (though not all) of the deals brought to market were smaller ($300-500mn) offerings from marginal issuers looking to raise capital out of necessity rather than opportunistically.

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	17,360	30,052	(12,692)	0.65%
5/31/18	15,202	31,611	(16,409)	-0.03%
6/30/18	14,994	18,107	(3,113)	0.40%

Source: Barclays

Year-To-Date Gross Issuance is Down -22% Y/Y

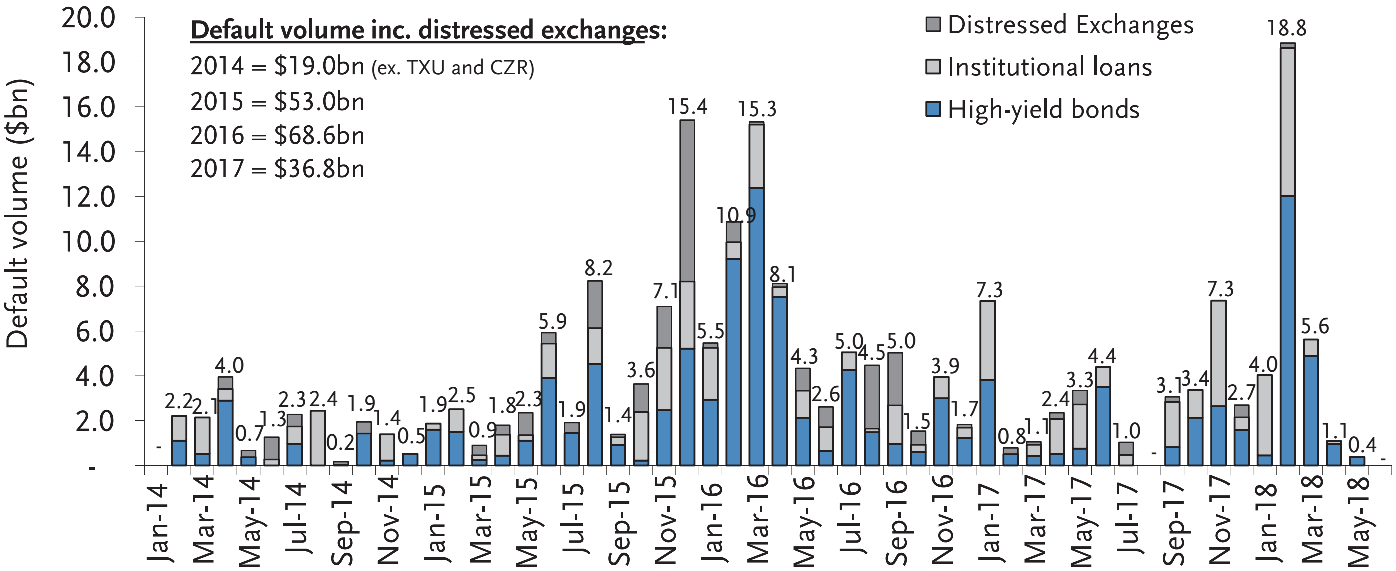


Source: Credit Suisse

Fundamental Trends

High yield defaults were non-existent in June as no U.S. high yield bond and loan issuers defaulted on their contractual obligations during the month. Per JPM, this is only the third month since 2012 that leveraged finance has seen no default activity. While striking in its own right, this represents the extension of a theme we have witnessed this past quarter (just two defaults in April and one default in May) and even for much of the year. Excluding the bankruptcy filing of iHeart with its $16bn in debt obligations, the trailing 12-month default rate stands at a benign 1.26% (1.98% including iHeart). What information does this typically embed regarding where we are going? Very little. Though it is clearly indicative of where we have been over the past year. ■

Zero Corporate Defaults in June is Eblematic of Accomodative Market Conditions Over the Past Year



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