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Leveraged Capital & Distress

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Q&A TCW, Predicting Junk-Bond Rout, Boosts Cash and Buys Health-Care Bonds

Jerry Cudzil, head of U.S. credit trading, TCW

- The U.S. high-yield market could drop by 10-15 points in the medium term, says Los Angeles-based Cudzil.
- Move out of retail, autos and commodities and buy defensive, higher-quality bonds in sectors like health care.

Interviewed by Tania Chen and James Crombie on Oct. 12. Comments have been edited and condensed for clarity.

Q: What's your junk-bond outlook?

A: We expect a deleveraging event in high yield. Our medium-term outlook is for wider spreads, lower prices and an increase in defaults — ultimately a significantly better entry point for investors. We're in unprecedented territory. From global central bank policy you've created arguably some of the biggest distortions you've seen in history and how does that end? We think it ends in a very volatile way.

Q: What's "medium term" to you?

A: Certainly when we look into 2017, we're not constructive. We can see a scenario when it happens faster than that.

Q: How much could the market fall?

A: I'm not an equity manager, but valuation looks very stretched. To think about down 20 percent or 30 percent in the equity markets doesn't sound crazy. High yield could see levels it saw in February — maybe 10-15 points pretty easily. It sounds almost fantastical, but if you think about it, we were just there.

Q: Why now?

A: Fundamentals got significantly worse since the lows of February. We've seen significant remediation in the most vulnerable sectors — commodities — and we've not seen the support from fundamentals.

Q: What are the possible triggers?

A: There's a litany of things that could happen: maybe it's a central bank error globally, maybe it's the Fed raising rates into a slowing economy, maybe it's the fact that the earnings recession takes hold and leverage spikes, maybe the market actually folds under the notional amount of debt. Maybe it's Brexit or China. There's the election in the U.S. which could bring a lot of volatility into the marketplace.

Q: But rates are expected to stay low and maturities look manageable?

A: Maybe we can continue kicking the can down the road. If there's credit risk in the market there's credit risk — no rate will solve an un-economic business model. Markets are very fragile globally. What you're saying is the Fed can't raise rates because the markets can't handle it and that should be positive for risk assets. I would turn that on its head a little bit and say, if the markets can't handle it and the growth isn't there, maybe that will ultimately be a negative for risk assets. We're seeing that in earnings and the lack of revenue growth.

Q: But still cash flows in.

A: Technicals are really supportive but as a fundamental investor the technicals can change in a very quick fashion. You're supposed to be protecting your principal at a time like this.

Q: How are you defensive?

A: We're removing any kind of cyclical risk from the portfolio. If you look at consumer and industrial cyclical risk, we're not heavily invested in retailers, we're not heavily invested in autos, energy and commodities — which have been some of the best performing in high yield — we're underweight those sectors. We've moved up in quality, with high yield moving into double B credits. We tend to like health care, cable media.

Q: How do you play health care?

A: When we invest in health care it's specific to first-lien health care and high yield so we're not yet moving down into the lower part of the capital structure. First-lien hospital paper is kind of an area that we favor.

Q: How is your portfolio weighted?

A: We are underweight credit, we're defensive in investment grade. We're shortening duration in credit curves. We're getting more defensive every day. We are carrying higher levels of cash across our portfolios. It's historically as high as our cash balance has been.

Q: What about distress?

A: I think there'll be a lot of opportunity to invest distress dollars in the marketplace at really attractive levels. There will be in the marketplace about $1 trillion dollars worth of debt that will trade like stressed or distressed in the U.S. The opportunity set will far overwhelm the amount of capital that's been raised.

Q: Do you like loans?

A: We have a little higher allocation to leveraged loans in our portfolio. The problem is loan liquidity and loan settlement is an arduous process. Credit quality in the loan market has deteriorated as well. Recoveries have been lower than they have been historically. It's higher quality than high-yield bonds, but it's still taking on credit risk.

At a Glance

AUM: $4.6 billion TCW Unconstrained Fixed Income Strategy; $260 million TCW Constrained Core Fixed Income Strategy (both as of Sept. 30)

Lesson Learned: There is just as much — if not more — risk associated with high-quality assets priced to perfection as distressed assets priced as if they will never recover

Recommended Book: "Economics in One Lesson," by Henry Hazlitt

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