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INSIGHT

MONTHLY COMMENTARY

November High Yield Credit Update

SIMON PARK | DECEMBER 7, 2015

__Reflexivity__ refers to circular relationships between cause and effect. A __reflexive__ relationship is bidirectional with both the cause and the effect affecting one another in a relationship in which neither can be assigned as causes or effects.

Most economists and market participants think of a right price for a security, a price in equilibrium that correctly reflects its objective underlying fundamentals and that the market gravitates to. The theory of reflexivity runs counter to the theory of equilibrium prices, instead describing a market that is constanting seeking disequilibrium, as the market is a positive feedback loop that through price action self-reinforces itself out of equilibrium states. Brought to prominence in relation to capital markets by George Soros, it mostly simply describes the inconvenient market phenomenom that rising prices create a signal to buy, thus further increasing prices. Falling prices causes investors to sell, thus further reducing prices. Once it reaches disequilibrium on one extreme end of the spectrum, the deviation from equilibrium becomes too unstable, subequently collapsing. This is often what we see in credit boom and bust cycles.

In high yield most recently, this has been seen in the boom of issuance in recent years, particularly in the energy space, as positive performance reinforced the desire to lend, which then pushed up asset prices, which in turn reinforced the desire to lend more at even better prices to the borrower, and so on. This created a virtuous cycle where lower costs of financing allowed more projects to become profitable, which in turn improved profitability, which further lowered financing costs. This kept on until the overproduction allowed by loose financing markets then started the fundamental process of destabilizing the physical oil market. Increased U.S. shale supply overwhelmed demand, and with that came a collapse in prices. The reversal in oil prices then created a shift in the financing markets, as overleveraged companies, and countries, found their financing costs start to rise as sentiment shifted. At first cost cuts lowered the cost curve, maintaining short-term credity quality, but at the same time putting lower cost oil onto the market. This reinforced the positive (I know, doesn't feel positive) feedback loop, where producers then increase their production of oil to make up for the lower than budgeted prices, thus worsening the disequilibrium in the underlying physical market, which increases the cost of financing, and so on, a self-reinforcing loop. This year, we've seen the market seek extremes in disequilibrium on the negative end of the spectrum. Year-to-date, BB, B, and CCC-rated Energy bonds are down -3.41%, -13.53%, and a monstrous -43.31%, respectively, accelerating the reversal started last year.

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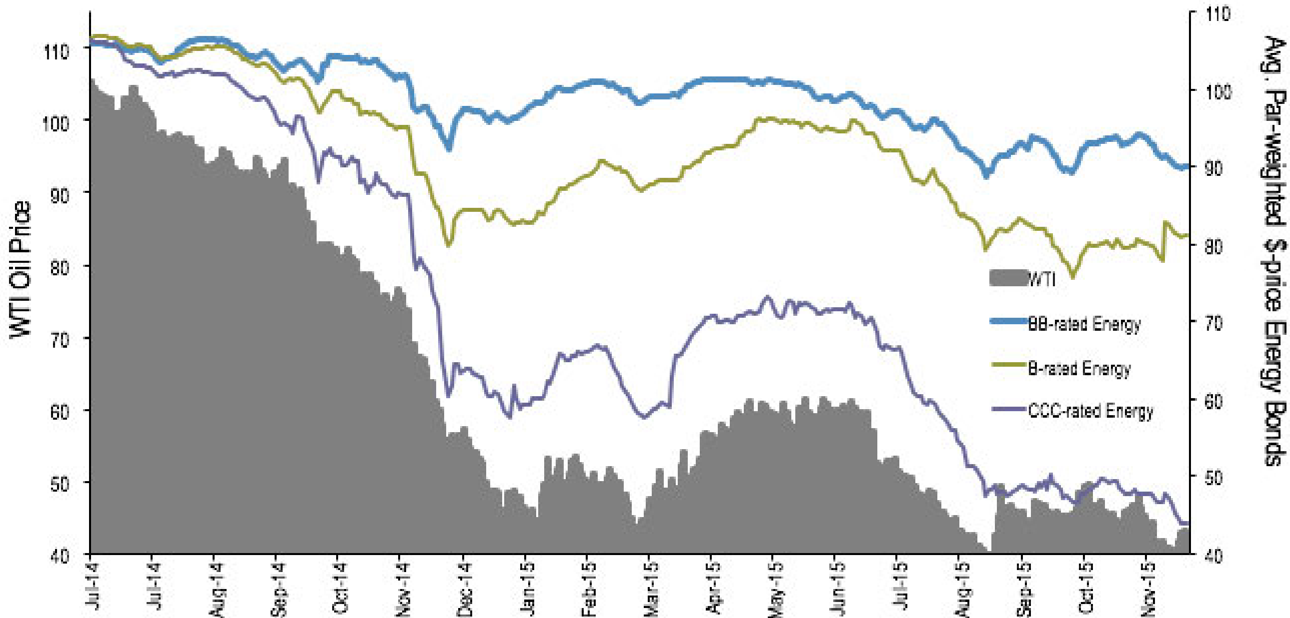
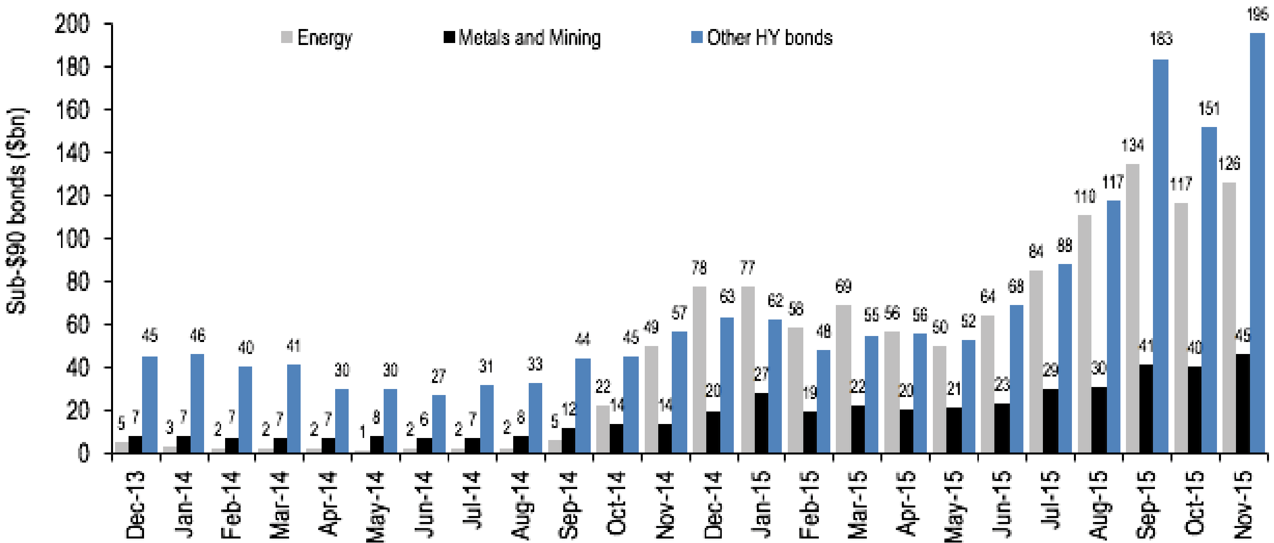
Mr. Park is a Managing Director in the U.S. Fixed Income group, where he trades high yield and cross over securities and CDS. Prior to joining TCW in 2015, Mr. Park was a portfolio manager and the fund risk manager for the hedge fund JAE Credit Management, focusing on U.S. corporate securities and derivatives Previously, Mr. Park was a Managing Director and portfolio manager in relative value corporate credit for the internal investment unit at UBS and its externally run hedge fund, Dillon Read Capital Management. Mr. Park started his career at Goldman Sachs and was a Managing Director focused on crossover credit on its corporate bond trading desk. Mr. Park earned his BA in Economics from Harvard College.

Drop in Oil and Energy wBond Prices



Source: JP Morgan

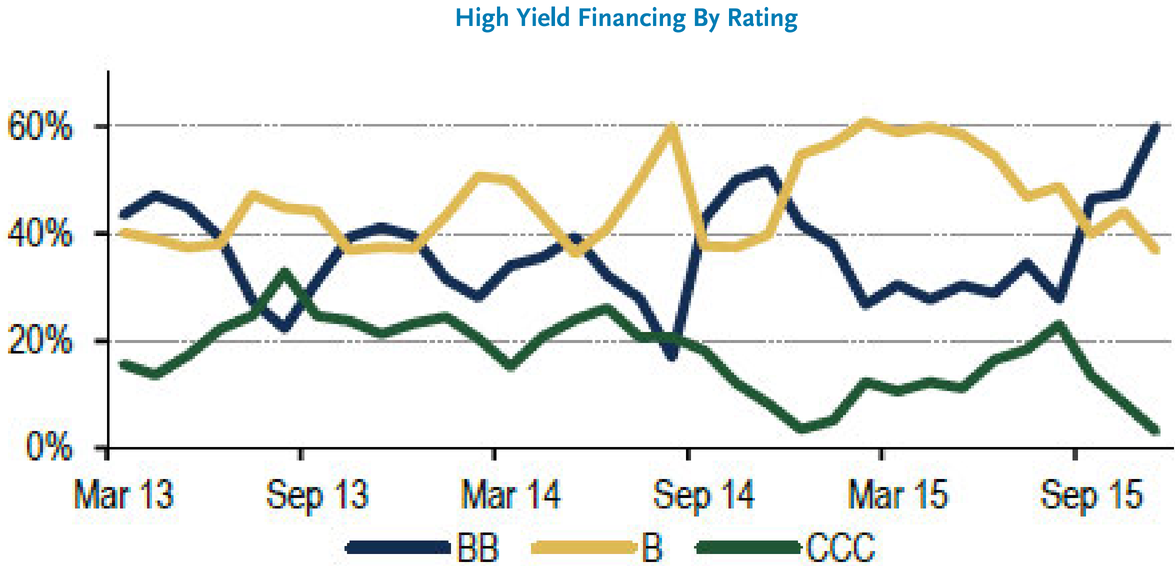
As seen above, reflexivity between the financing markets and real world has so far been most acute in the energy space, with the capital markets shut down for all but the most sturdy high yield energy issuers. Distressed exchanges have become the base assumption for the weakest companies, rather than the exception. But the negative price action in energy has also started to spread, with non-energy/mining an increasing proportion of the distressed universe.



Source: JP Morgan

As sentiment in high yield gets worse, CCC companies have also largely been shut out from the public high yield debt markets, with a markedly increased percentage of the new issuance accounted for by BBs.

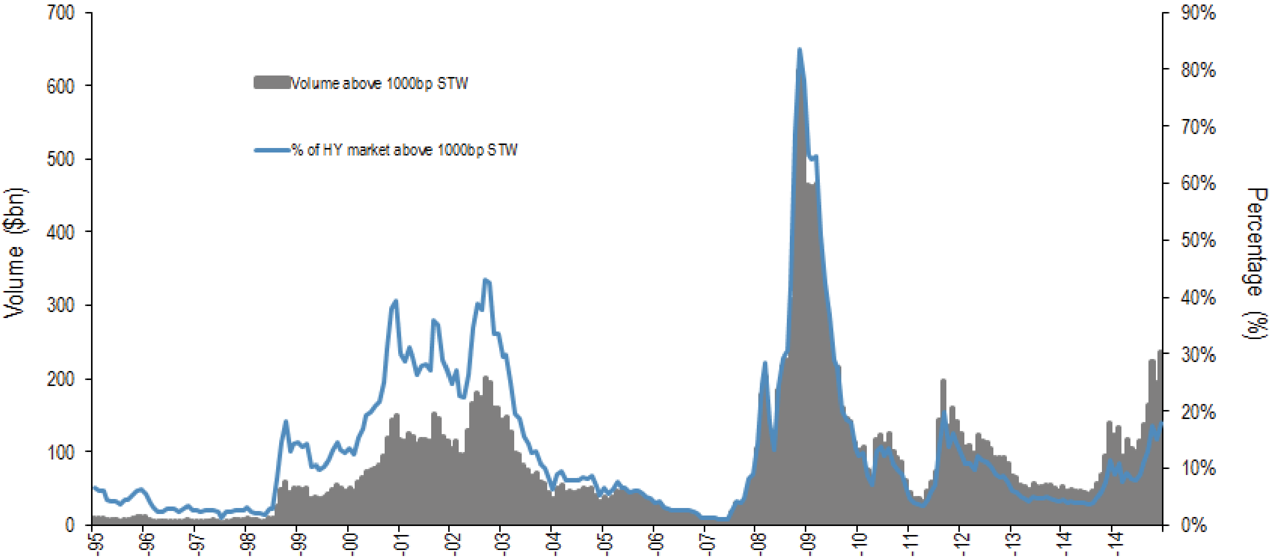
High Yield Financing By Rating



Source: BAML

The difficulty in obtaining financing then becomes a fundamental change in the creditworthiness of companies, and as investors look out to the future, bond prices decrease further, making them more unable to refinance, as investors anticipate increasing bankruptcies and restructurings. As evidence, we can see that the volume of bonds trading as distressed has increased to the highest levels since the Great Recession, with the percentage of the HY market trading as distressed nearly 20%.

Volume and Percentage of HY Trading Distressed



Source: JP Morgan

Banks have not been immune to this negative sentiment, with more banks reporting tightening rather than loosening lending standards for the first time since 2011, and only the second time since the credit crisis.

Percentage of Banks Reporting Tightening Lending Standards

Source: BAML, Federal Reserve

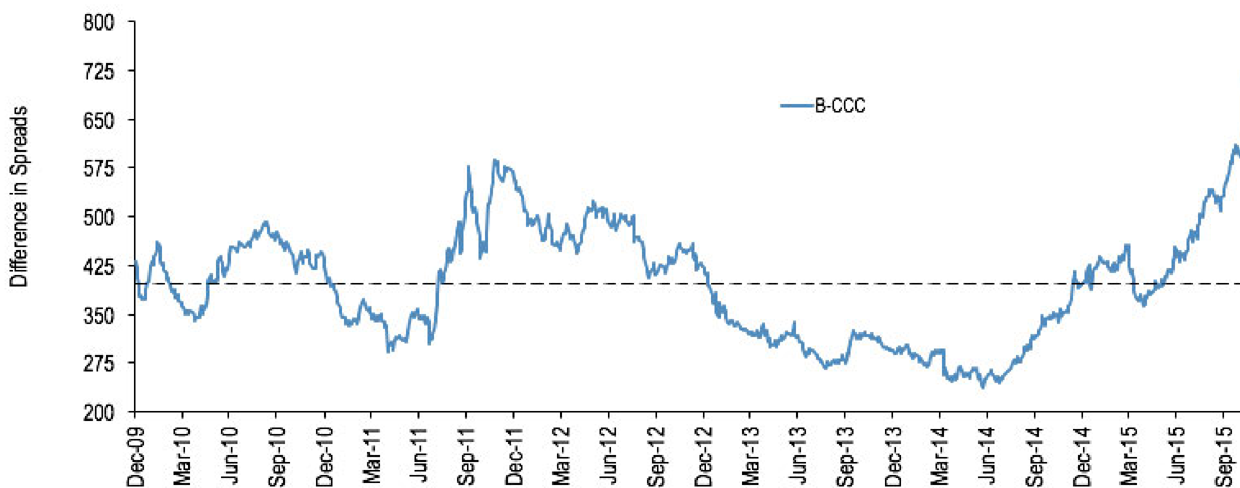
Despite still low current defaults, weakening sentiment directly impacts the ability for broad groups of companies to get financing in the future, which weakens the economy, which impacts sentiment further, and so on… A vicious positive feedback loop.

November Market Performance

On the back of a 2.75% positive return in October, the High Yield market gave back much of it in November, returning a -2.22%. Coming after the worst quarterly return since 2011(-4.9%), High Yield returns are now down a cumulative 6.01% since May, the worst 6 month performance for the asset class since the credit crisis, and only trailing the periods during the bursting of the telecom credit bubble in 2002 and fall of LTCM in 1998. After October's eye-popping 60bps tightening of yields and 64bps tightening in spreads, November saw an equally impressive 69bps widening of yields and 48bps widening of spreads. There was definitely a bounce in October, it's just still to be determined whether there was a feline involved. Barring a very Merry Christmas and ebulliant Santa Claus, High Yield is now set to post only its 3rd negative annual total return in the last 20 years (2008 -26.6%, 2002 -6%).

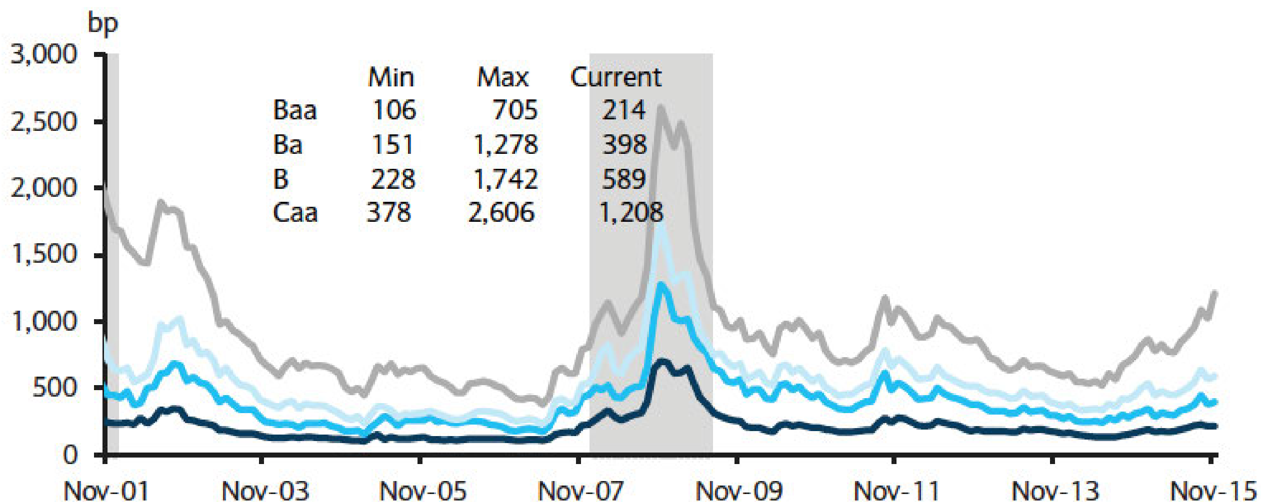
	HY	Ba	B	Caa
November Total Return	-2.22%	-1.50%	-2.25%	-4.18%
YTD 2015 Total Return	-2.00%	+0.90%	-2.31%	-8.01%
November Excess Return	-189bps	-114bps	-192bps	-389bps
YTD Excess Return	-348bps	-65bps	-382bps	-932bps

Weakness was led by the increasingly weak CCC space, with risk aversion leading to a relative flight to Bs and BBs.



Source: JP Morgan

High Yield Spreads by Credit Quality



Source: Barclays Research

Although weakness was broad, with nearly all sectors posting negative returns, performance was dragged down the most by those sectors that led the market in October, with E&P, Chemicals, and Wireless going from best performing sectors in October to worst performing in November. A near 15% drop in oil prices certainly didn't do any favors for market sentiment.

Best Sectors	November	2015 YTD
Restaurants	0.45%	8.44%
Banking	-0.01%	+5.07%
Pharmaceuticals	-0.12%	-3.70%
Supermarkets	-0.29%	+6.83%
Transportation Services	-0.39%	+2.29%

Worst Sectors	November	2015 YTD	October
E&P	-6.08%	-21.21%	+4.21%
Metals and Mining	-5.53%	-19.51%	
Wireless	-3.40%	-0.35%	+5.92%
Media Entertainment	-3.27%	-1.44%	
Chemicals	-3.20%	-4.42%	+4.19%

Source: Barclays

Market Technicals

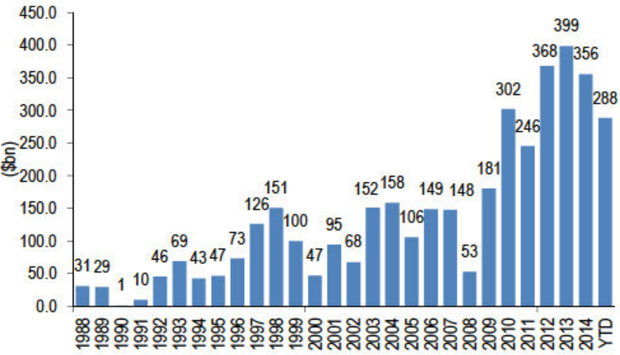
The new issue market awoke from its stupor for a bit despite the general weakness in the market, chalking up its best month since May. Volumes nevertheless remained tepid at $23B, versus average monthly volumes of $30B+ in the beginning of the year and in 2013 and 2014, as high financing rates hold back a lot of opportunistic issuers, and with CCCs and many industries increasingly having the public markets door shut on them, BBs are left as the main product available, or even wanted.

High Yield Net Supply (U.S.$mm)

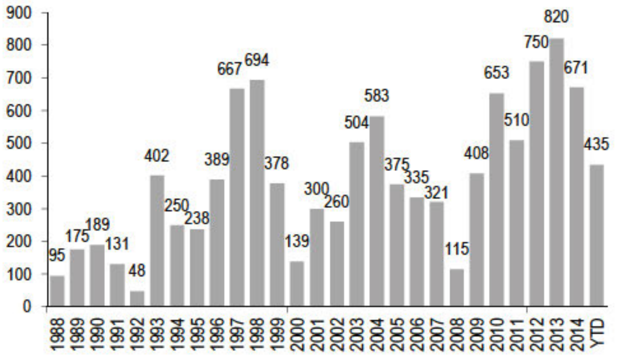
Monthly	New Issue	Redemptions	Net Supply
1/31/2015	19180	7743	11437
2/28/2015	30888	15562	15326
3/31/2015	36631	25154	11477
4/30/2015	34331	33253	1078
5/31/2015	33551	29863	3688
6/30/2015	20781	21828	-1047
7/31/2015	12120	26654	-14534
8/31/2015	10141	21507	-11366
9/30/2015	19171	12492	6679
10/31/2015	9106	14504	-5398
11/30/2015	23014	20435	2579

Year	New Issue	Redemptions	Net Supply
2010	262,654	134,536	128,119
2011	228,256	150,703	77,553
2012	344,566	180,024	164,541
2013	325,735	206,782	118,953
2014	303,249	251,733	51,515
Ann 2015	272,017	249,813	21,729

Source: Barclays



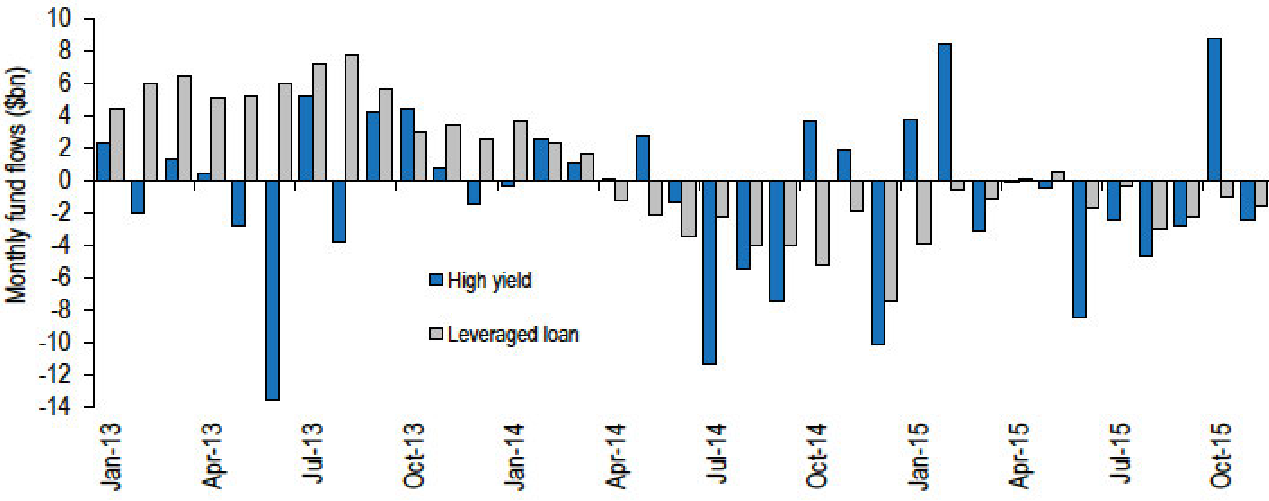
Source: JP Morgan



Source: JP Morgan

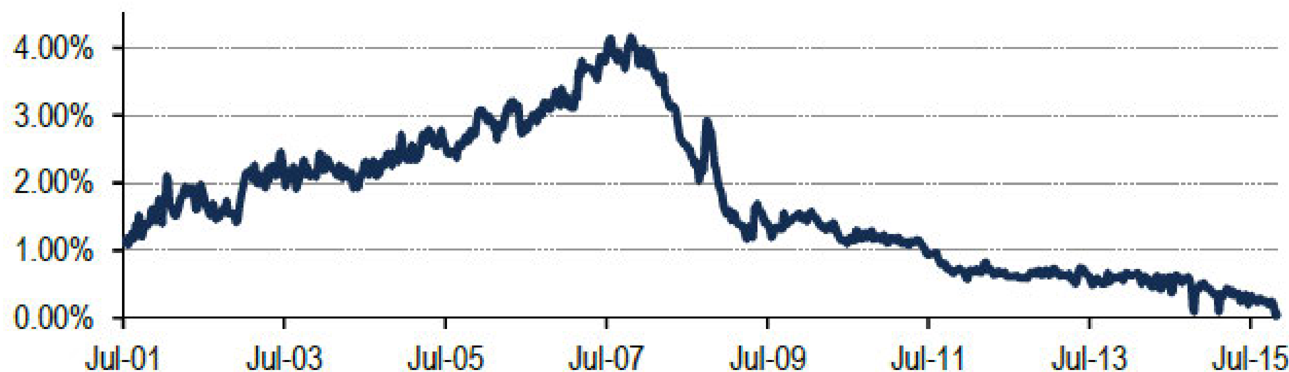
Outflows were manageable overall for the month, but accelerated in the last 3 weeks, as $3.7B of retail high yield outflows in November unwound nearly 40% of the monstrous inflows in the month of October. Year-to-date outflows are now -$3.5B, so far surprisingly resilient after last year's record $23.8B withdrawal. On the bright side, investors have stayed in the asset class. On the downside, the market wasn't really tested with massive outflows this year, and with dealer balance sheets shrinking as they make progress to an agency model, it is still to be seen how risk transfer occurs if/when outflows hit en masse.

High Yield and Loan Funds Resume Outflows in November



Source: Lipper FMI, JP Morgan

Dealer Inventories Continue to Shrink as a Percentage of the Market



Source: BofA Merrill Lynch Global Research, NY Federal Reserve

Summary

Markets sunk back in November after a very strong October. We expect volatility to remain a strong trait of an unsettled market in disequilibrium. We believe for the market to find its way to a level of extreme disequilibrium from which it can reverse, prices must go to an extreme, thus finishing off the last part of the boom and bust credit cycle.

Reflexivity is a theory that demonstrates the power of the financial markets to impact fundamentals, and vice versa, thus intertwining the two. In many other markets, reflexivity also describes the ability of the market in question to reverse from this extreme state of disequilibrium. In high yield, the problem is that the bad extreme state of disequilibrium is a place many companies do not come back from.

Given the nature of the survivorship dynamic in High Yield, we remain focused on investing in high quality companies that are not dependent on the kindness of strangers, and wait for the markets to find its unsustainable negative extreme to get more aggressive.

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