TCW

INSIGHT

JUNE HIGH YIELD CREDIT UPDATE

A Rising Tide

BRIAN GELFAND | 25 JULY 2023

Lifts all boats. That's a cliché opening to this month's memo I'll admit, although with the three major cruise line operators leading the rally (in both equity and debt markets) to close out the first half 2023, it was too easy a pun to pass up. Ultimately, the first half of the year concluded similarly to how it began. Optimism the Fed will actually "soft land" this thing (i.e., deflate the economy without pushing it into recession) was as much *en vogue* by the end of June as it was during January and February. You know, before the whole regional banking crisis and Credit Suisse take-under thing. And why shouldn't it be? Recent indicators of inflation and employment on the whole (sure, there are nuances, but on the whole) certainly affirm that narrative more than refute it, do they not? The result is the cadence of risk-seeking behavior and the pricing of risk assets we observed thus far this year. Specifically, this included a systemic rally in January and February taking high yield bond spreads down to the high-300 basis points (bps), followed by a (transitory) systemic dislocation in March, which took spreads 125 bps wider in a little over a week, followed by a systemic recovery that accelerated in June, and which took spreads back to the high-300s. The chart below will clear up any confusion.

Cadence of Systemic Spread Volatility Year-to-Date
(Bloomberg U.S. Corporate High Yield Bond Index Option-Adjusted Spread (OAS))

Source: Bloomberg

Brian G. Gelfand
Senior Vice President
Fixed Income

Mr. Gelfand is a Senior Vice President in the Fixed Income group where he trades high yield securities and is a portfolio manager for the MetWest High Yield Bond Fund, the MetWest Opportunistic High Income Credit Fund, and the TCW High Yield Sustainable Bond Fund. He joined TCW in 2014 as a credit analyst responsible for research across the telecom, technology and media sectors. 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.

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So what is our current stance? Well, same as it has been 1) monetary policy works in lags, and 2) we don't really care. I'll expand on both. With respect to the first point, the economy really hasn't fully felt the impact of the 500 bp increase in borrowing costs. Not yet at least. The logic here is clear, and one interesting data point is evident in the high yield bond market. I will thank my friend Oleg Melentyev at Bank of America for framing the data in this manner. Since the Fed's hiking cycle began, just 8.5% of the coupons in the high yield bond market have reset (i.e., the overwhelming majority of borrowers are still benefiting from the era of low borrowing costs). However, 35% of coupons are set to reset over the next 24 months (i.e., a debt service coverage and free cash flow margin pinch is on the precipice of taking hold). Does this mean the lagged effects are 24+ months out? Probably not. Recall, the $1.4 tn syndicated loan market is comprised of floating rate coupons which have been resetting real-time, and about 40% of high yield bond borrowers have also borrowed in this market as well. Moreover, much of the borrowing by small and mid-sized businesses is on a floating rate basis as well (private loans, bank loans, etc.). The point of the illustration is to highlight how things sometimes take time to work through the system. We are looking forward to that 35% to be certain. There should be significant opportunity to extend credit on attractive terms to borrowers needing to roll their debts.

With respect to the second point, I'll refer back to the chart of high yield spreads above. Whether or not the Fed can engineer a soft landing is less a focus for us than what is priced in to the market. At +/-380 bps in the aggregate (and low-300 bps excluding distressed bonds), high yield bonds systemically price in this outcome with a high degree of certainty as we head into the second half of 2023. Said succinctly, it's priced in. As such, with a narrowing margin for error, we are de-emphasizing systemic risk (beta) in our portfolios, while concentrating in our thematic and credit-specific value opportunities.

Market Performance

High yield bonds staged an impressive rally in June as credit investors seemingly moved far enough past the car accident that was the regional banking crisis to re-board the soft-landing bandwagon. Indeed, the total return for high yield debt in June was +1.67%, though this took place in spite of a material back-up in interest rates. With spreads collapsing back to 2023 tights, the excess return earned by high yield bonds was an impressive +2.54%. By rating, BB bonds held their own despite their empirically long interest rate durations; however, the month was all about CCC reflation with the lowest-rated bonds in the marketplace returning ~3.1% on average. As our own Chet Malhotra will point out, you don't need to know much beyond the ~10% gain in CCC-rated debt this year to get a pulse of current sentiment towards risk and the economy. Chet's CCCs as we have come to know them on the trade floor.

HY Performance	HY	Ba	B	Caa	Ca-D
June 2023 Total Return	1.67%	1.26%	1.69%	3.13%	4.39%
2023 Total Return (as of 6/30)	5.38%	4.36%	5.44%	9.35%	7.53%
June 2023 OAS (as of 6/30)	+392 bps	+251 bps	+400 bps	+837 bps	
June 2023 OAS Change	-73 bps	-49 bps	-69 bps	-124 bps	

Source: Bloomberg, Barclays

At the sector level, June saw out-of-favor become in-favor and cruise lines continued their meteoric ascent from the depths. See what I did there. Wirelines was the best performing sector in June, driven by what can be technically characterized as an oversold bounce off a low base. Indeed, the wireline sector, and certain parts of the cable sector, are as out-of-favor in the levered credit markets as I have seen a sector in the past seven to eight years. You have to go back to energy and metals and mining in late-2015 to early-2016 (and natural gas-linked E&Ps in 2019) to find sectors this panned by the market. To be certain, for the avoidance of doubt, we like the opportunities this has presented as the risk factors feared by our peers are, in our opinion, more than appropriately discounted in the prices of the debt of these borrowers. If we are right, the prospective returns on offer are excellent. If we are wrong, the downside from here isn't all that severe (i.e., the payout profiles are highly asymmetric at this point). Finally, the year-to-date returns of the leisure sector cannot be ignored as the bonds of the cruise line operators have staged a material recovery off the lows reached late last year and very early this year. Hence the rising tide cliché.

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Best Performing Sectors	June	YTD 2023
Wirelines	5.15%	1.20%
Brokerage Asset Mgmt Exchanges	2.75%	8.12%
Media Entertainment	2.72%	3.43%
Leisure	2.70%	15.41%
Building Materials	2.65%	9.70%

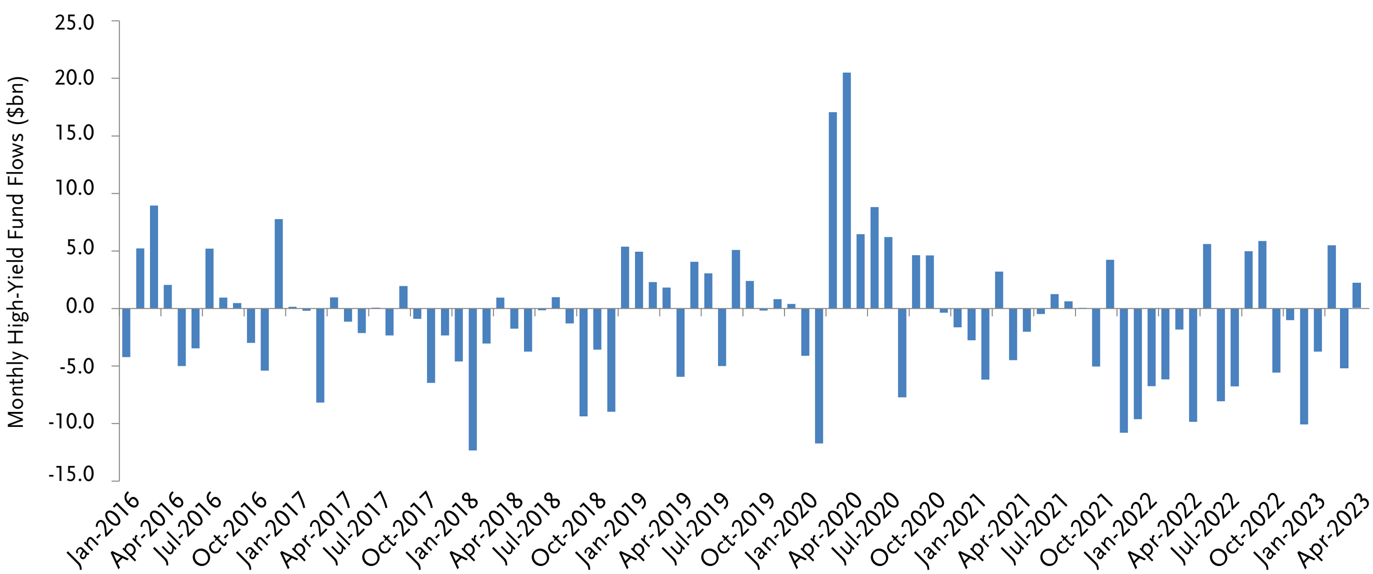
Worst Performing Sectors	June	YTD 2023
Pharmaceuticals	-1.03%	1.25%
Electric	0.30%	3.38%
Supermarkets	0.34%	4.90%
Food and Beverage	0.49%	4.63%
Chemicals	0.49%	4.87%

Source: Bloomberg, Barclays

Market Technicals

Unfavorable demand technicals in May proved to be short lived as capital poured into our asset class in June, offering technical support to the reflation trade. Both high yield ETFs and mutual funds took in over $1 bn in assets during the month, resulting in combined net retail inflows of +$2.7 bn. While we would argue flow-driven technicals have not exerted much influence on day-to-day price action in the marketplace throughout this year (as they have in the past), save for maybe during a brief period in March, the combination of improving investor sentiment and funds having more capital to put to work is clearly not a bad cocktail to support asset price inflation. Case in point, high yield bonds have earned attractive returns year-to-date despite retail funds seeing net outflows of -$11.2 bn during the first six months of the year.

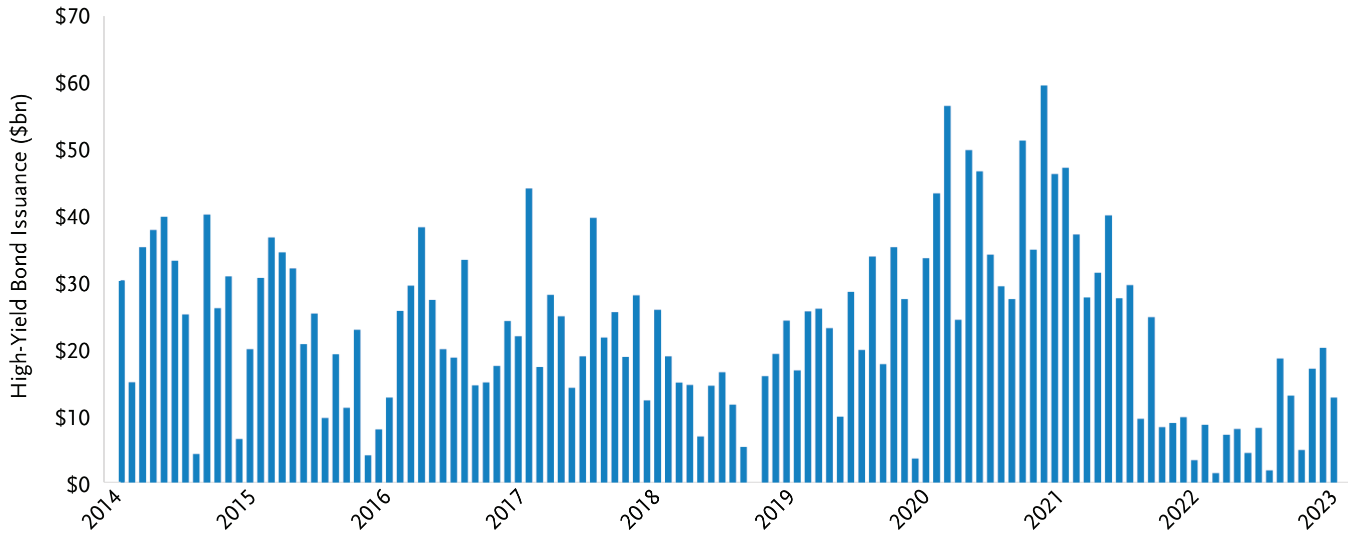
Retail Flows Have Been Net Negative Since the Start of the Fed Hiking Cycle, but This Hasn't Put a Damper on 2023 Returns for HY Bonds



Source: JP Morgan, Lipper FMI

Deal flow moderated in June, which actually felt more impactful to market technicals than did fund flows as offer-side liquidity evaporated as the reflation trade ramped and the lack of new issue supply to liquefy the system was noticeable. Approximately $14.1 bn of USD-denominated debt was syndicated in June across 21 deals. This still reflected more "normal" volumes than not after the drought that was 2022 but was still fewer deals than most months this year. Of note was our view of the quality of deals, or lack thereof, but not so much with respect to structural quality. Indeed, issuance this year continues to be skewed toward secured deals as borrowers are offering better terms in order to access the lowest cost of capital possible. With respect to the quality of the investment, however, bonds that did clear the primary market were doing so at prices which reflected the current momentum in the secondary market. As such, little value was offered by new deals and hence we remained on the sidelines for most, though not all, of them.

Issuance Was Light in June, but Still Within the Realm of "Normal" Deal Flow



Source: JP Morgan

Fundamental Trends

High yield default activity was elevated in June with trailing default rates beginning to ramp as we shed the low volume months of 2022. Indeed, although trailing default rates remain just below 3% on an LTM basis, the annualized run-rate over the past two months is actually closer to 4-5%. The two high profile defaults in June were Exela Technologies, which executed a distressed exchange, and Diebold, which filed Chapter 11. I bring these up, not solely because they represent two of the 10 largest defaults of 2023, but because they are representative of the types of businesses we have seen default this year (i.e., those that have been zombie-esque for quite some time). Many systemic default cycles tend to follow a similar cadence where bad businesses with bad balance sheets fall first, followed by good businesses with bad balance sheets, followed by good, though cyclical, businesses with balance sheets appropriate for certain parts of the cycle, but not others. An overly simplified framework for sure, but one that helps illustrate the point that thus far in this cycle, defaults have largely been confined to bad businesses with bad balance sheets (i.e., the first movers). Where we go from here, time will tell. ■

The Top 10 Defaults of 2023 Can Largely Be Characterized As "Bad Business, Bad Balance Sheet"

Date	Company	Bonds ($mm)	Loans ($mm)	Total ($mm)	Industry	Action
15-Apr-2023	Envision Healthcare	938.9	9,413.7	10,352.6	Healthcare	Filed Chapter 11
15-Feb-2023	Diamond Sports	4,783.5	3,819.6	8,603.1	Broadcasting	Filed Chapter 11
15-May-2023	Wesco Aircraft Holdings	3,026.8	–	3,026.8	Industrials	Filed Chapter 11
14-Feb-2023	Avaya	1,000.0	1,893.3	2,893.0	Technology	Filed Chapter 11
1-Jun-2023	**Diebold**	**1,100.0**	**934.1**	**2,034.1**	**Technology**	**Filed Chapter 11**
23-Jan-2023	Serta Simmons Bedding	–	1,889.3	1,889.3	Consumer Products	Filed Chapter 11
23-Apr-2023	Bed Bath & Beyond Inc	1,029.9	547.1	1,577.0	Retail	Filed Chapter 11
17-Apr-2023	Lumen Technologies	1,556.3	–	1,556.3	Telecommunications	Distressed exch.
29-Jun-2023	**Exela**	**1,270.7**	**–**	**1,270.7**	**Technology**	**Distressed exch.**
5-May-2023	WeWork	1, 047.8	–	1,047.8	Financial	Distressed exch.
	Total	**15,754.0**	**18,496.8**	**34,250.8**		

Source: JP Morgan

865 South Figueroa Street | Los Angeles, California 90017 | 213 244 0000 | TCW.com | @TCWGroup