TCW

INSIGHT

OCTOBER HIGH YIELD CREDIT UPDATE

Landmines

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Mr. Gelfand is a Specialist Portfolio Manager, Co-Head of Global Credit, and Head of Credit Trading in TCW's Fixed Income group. Previously, Mr. Gelfand traded high yield securities and was a portfolio manager for several of TCW's high yield bond funds. He joined TCW in 2014 as a Research 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.

An interesting observation in the high yield debt markets this earnings season is the triggering of a handful of landmines. A resurging theme really. It is starting to feel a bit like 2019, when we last took note of what we characterized as a growing list of car accidents along otherwise clear roads. Here is the link to that memo for reference – Beneath the Aggregates: Growing List of "Idiosyncratic" Collapses. Sure, roads were not all clear in the high yield bond market in October with both rate and spread volatility rearing their heads. However, both remediated sharply in November and the overarching backdrop for levered corporate credit risk, with high yield spreads holding in the high-300 basis points (bps) over Treasuries, does indeed remain calm. So why the landmines? A search for a common thread that links the triggering events reveals that there really isn't one. The drivers of dislocation in these instances are quite unique. CommScope faces a maturity wall at the same time it's experiencing an accelerating cyclical decline in earnings. Lumen Technologies/Level 3 Communications engaged in a coercive liability management exercise that pitted certain creditors against others. Ardagh Packaging guided down its year-end profitability forecast, calling into question whether the current earnings headwinds to its glass business are transitory (the result of downstream inventory destocking) or structural (the result of permanent loss of final sales volumes). Hawaiian Airlines faces competitive threats. Spirit Airlines' merger with JetBlue is being threatened by regulators. Enviva is simply offsides on its business model – selling its product at prices that are below costs...but they will make it up in volume...

Landmines

CommScope Senior Unsecured Bonds – COMM 6 25

Source: Bloomberg

Level 3 Communications Non-TSA Senior Secured Bonds – LVLT 3.875 29

Source: Bloomberg

Landmines

Ardagh Packaging HoldCo PIK Toggles – ARDFIN 6.5 27

Source: Bloomberg

Spirit Airlines Secured Loyalty Bonds – SAVE 8 25

Source: Bloomberg

Landmines

Hawaiian Airlines Senior Secured Bonds – HA 5.75 26

Source: Bloomberg

There are a few more landmines beyond these high-profile situations, though the trend remains nascent. The barbell strategy we have been employing for most of the year, one of de-emphasizing systemic risk (beta) while emphasizing idiosyncratic and thematic risk (alpha), has now morphed into a three-legged stool with the third leg being: avoid the landmines. Indeed, avoiding losers has become as important as picking winners in recent weeks and our emphasis on business/credit fundamentals first should be a distinguishing factor for our portfolios as was the case in 2019 and has been over our 20+ year history of investing in levered credit markets.

Market Performance

High yield bonds delivered investors a total loss for a second straight month in October as higher interest rates and wider spreads weighed on bond prices. Higher interest rates and higher interest rate volatility did indeed weigh on prices for a second straight month; however, we would argue that unlike in September, rates were not necessarily in the drivers' seat in October. Rather, risk aversion, as reflected in the growing list of landmines discussed above as well as wider credit spreads in general, hit risk asset prices hardest in October. Rising geopolitical tensions also appeared to be an intra-month driver of spread volatility, though we would simply argue that the starting point for risk premiums in the high-300s bps was itself asymmetrically vulnerable to spread widening than spread tightening.

The relative contribution to loss from risk versus rates was further evidenced in the relative performance of BB-rated bonds versus CCC-rated bonds in October. We essentially observed the mirror opposite of the performance pattern in September, with CCC-rated bonds drastically underperforming BB-rated bonds by almost 300 bps. Part of that underperformance was the impact of discrete landmines as many of the most severely hit credits intra-month carried ratings of CCC. To be certain, even after October's loss, CCC-rated bonds have in the aggregate trounced higher quality high yield bonds thus far in 2023. See the table below for the performance pattern across the ratings spectrum in October and year-to-date.

Landmines

HY Performance	HY	Ba	B	Caa	Ca-D
October 2023 Total Return	-1.16%	-0.59%	-1.14%	-3.41%	-4.10%
2023 Total Return (as of 10/31)	4.63%	3.33%	5.11%	8.27%	6.21%
October 2023 OAS (as of 10/31)	+432 bps	+279 bps	+443 bps	+986 bps	
October 2023 OAS Change	+37 bps	+14 bps	+47 bps	+140 bps	

Source: Bloomberg

There are a few themes to highlight from returns at the sector level in October. First, nearly all ships sank during the month with only a sliver of the Energy sector (E&Ps) edging out a slightly positive return. Second, dispersion at the sector level was heavily impacted by dispersion in the performance of individual constituents. Essentially, we observed the landmines theme discussed above peer through in the performance pattern at the sector level. Airlines were impacted by both the macro (geopolitical plus softening outlooks for passenger travel) and the micro (the discrete outsized selloffs of the bonds of Hawaiian Airlines, Spirit Airlines and VistaJet, among others). Packaging was impacted by the weakness in Ardagh's bonds in addition to poor performance from the debt of Labl which catalyzed concerns over forward earnings across a sector that has historically been championed as having low earnings variability through a cycle. As a result, it is our opinion the recent dislocation in this sector has created attractive opportunities to invest.

Best Sectors	October	YTD 2023
Independent E&P	0.05%	7.07%
Supermarkets	0.00%	5.33%
Aerospace & Defense	-0.16%	3.57%
Leisure	-0.19%	15.45%
Brokerage Asst Mngrs Exchanges	-0.33%	10.50%

Worst Sectors	October	YTD 2023
Pharmaceuticals	-3.47%	-2.47%
Airlines	-3.38%	2.13%
Packaging	-3.02%	2.23%
Wireless	-2.49%	-0.54%
Transportation Services	-2.31%	1.95%

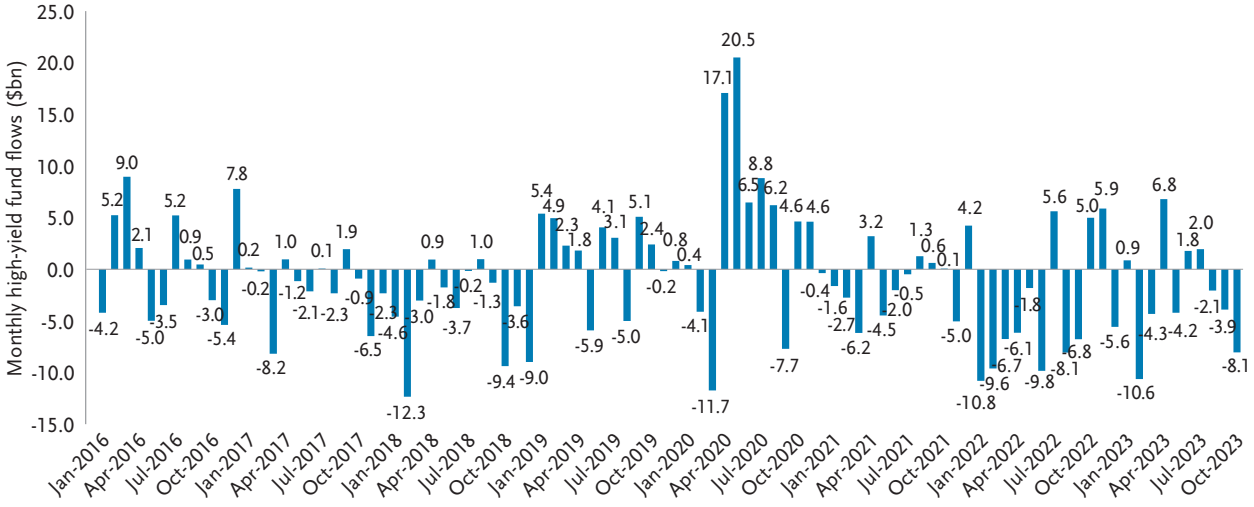
Source: Bloomberg

Market Technicals

Negative fund flows accelerated in October with high yield mutual funds and ETFs observing -$8.1 bn in capital flight. Looking at the chart below, the pace of outflows has accelerated over the past three months as loss begets redemptions, which results in greater loss and hence more redemptions. It has been a while since we have seen demand-side technicals weigh this heavily on intra-day trading patterns, but the impact of this exodus was indeed apparent as we navigated the market volatility in October. The reality, however, of this reflexive behavior of markets is that it can just as easily inflect and work in the other direction (gains drive inflows, which accelerate gains that result in more inflows). As such, our process looks to simply react in a contrarian manner to these technicals rather than derive any insight from them.

Landmines

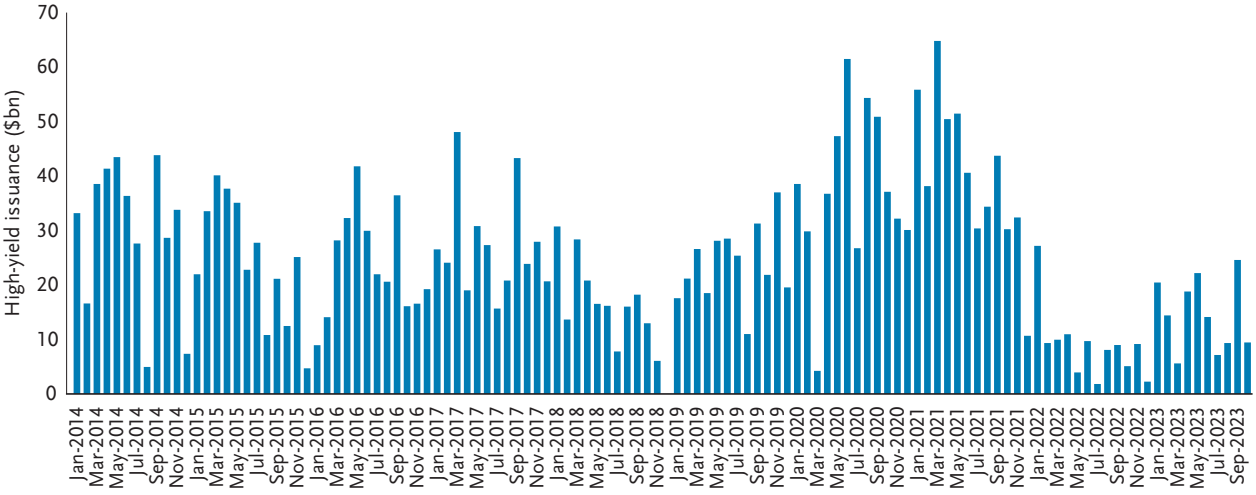
Outflows From High Yield Funds Have Accelerated in Recent Months



Source: JP Morgan, Lipper FMI

October (and early November) issuance has been light relative to historical standards, but notably the quality of deals was a standout. Just $9.4 bn of USD-denominated high yield bonds were issued in October. We have been pleased to see our thesis of extending credit on favorable terms for current capital needs, whether for refinancing or other corporate purposes, begin to play out. Whether it's ultra-high quality levered borrowers refinancing low yielding debt at historically high all-in yields, or companies that have historically borrowed on an unsecured basis now needing to mortgage high value collateral/cash flows, or borrowers that have to concede favorable terms such as stricter covenants or non-call features, the overall quality of deals has improved and the negotiating leverage between borrower and lender skews favoring the lender. That being said, it still remains early days for this "good bonds" theme that we believe represents a multi-year opportunity in the levered credit markets as both refinancing and M&A/LBO activity accelerate from historic lows.

Following Active Deal Flow in September, October Issuance Was Light



Source: JP Morgan

Landmines

Fundamental Trends

Default activity picked up in October, with six borrowers in the high yield bond market either missing a coupon payment, filing Chapter 11, or effecting a distressed exchange. A few high-profile distressed credits finally broke during the month. Air Methods, which provides emergency medical transportation services (medical helicopters), filed for bankruptcy after struggling for years to manage its difficult business model with a levered balance sheet. The passing of the No Surprises Act ended up being the final straw that broke the camel's back as it were. Rite Aid filed Chapter 11 as well, with multiple options on the table for the future of the business (i.e., liquidation or going concern). Finally, WeWork gets added to the list of repeat offenders having filed for bankruptcy or executed a distressed exchange more than once. The storied office sublessor turned tech company turned office sublessor continues to remind lenders that some business models simply cannot support debt. The trailing 12-month high yield bond default rate continues to hover in the mid-2% range, even after the October pick-up in activity (2.60% including distressed exchanges). ■

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