Tortoise

Tortoise QuickTake Podcast

November 7, 2017

Welcome to the Tortoise QuickTake podcast. Thank you for joining us. Today, a senior member of Tortoise provides a timely update on trending topics in the market.

Hello and welcome to the Tortoise Credit Strategies weekly podcast. I'm Greg Haendel, one of the Senior Portfolio Managers on the investment team at Tortoise Credit Strategies.

I often like to think of the economy and the financial markets as a gigantic puzzle whereby we are always putting together new pieces of the puzzle to try to get a clear view of what the constantly changing picture on that puzzle will show. Further, I like to think of our political process as an intense game of chess. With these similes in mind, this past week we got several pieces to this puzzle, including the first detailed look at our country's proposed tax reform plan. However, I would note that this initial version of tax reform from the House of Representatives Means and Ways Committee is just the first move in what will likely be an intense game of political chess before we truly know the end result.

This past week's puzzle pieces, from an economic data perspective, had a slew of important, yet mixed, data. The "soft economic data" which is survey and confidence based, was mixed with strength in consumer confidence yet some deceleration in the ISM Manufacturing Index (although that index remains elevated). The business and manufacturing "hard economic data" showed positive momentum as factory orders and non-defense durable goods orders and shipments, less aircrafts, showed strength. On the consumer side, personal spending improved while vehicle sales remained elevated, although there are some post hurricane distortions imbedded. Inflation remained subdued as seen through the PCE, although there were mixed signs of wage pressure as the Employment Cost Index and unit labor costs improved from depressed levels, while average hourly earnings continued to show a weak wage picture. On the labor and employment front, non-farm payrolls continue to be distorted by the impact of the hurricanes, although averaging the last two months of payroll data shows decent, but not stellar, employment growth. While the unemployment rate fell to 4.1%, the lowest level since December 2000, the decline was largely a result of the labor force participation rate falling. We continue to believe the U.S. economy remains in an improving trend while we also expect some pricing pressures in the intermediate to longer term.

The puzzle pieces with regard to the Federal Reserve include an open market committee meeting as well as the nomination of a new Federal Reserve Chairman. As expected, the Fed left the fed funds target rate unchanged, while their statement leaned a little more hawkish as they upgraded their assessment of growth, while acknowledging, yet dismissed the recent softness in pricing pressures. As a result, the market priced in roughly a 90% chance of a December rate hike, along with a decent probability of a couple rate hikes in 2018. In addition, as expected and predicted in last week's podcast, President Trump officially nominated Jerome Powell to Chair the Federal Reserve. We do not believe he will face much difficulty getting confirmation and in short, we do not expect much change in monetary policy under his leadership going forward. The second most important seat on the Fed Open Market Committee, the Vice Chairman, remains empty and according to the White House will be addressed at a later date. In short, both the results of the FOMC meeting, and nomination of Powell as the new Fed Chairman, were largely expected and priced into the market.

The final piece of the puzzle we will discuss this week is the detailed tax reform plan from the House Ways and Means Committee. First, using the simile from earlier, keep in mind that this is the first move in what could turn out to be a fierce game of chess. Changes will be made to this proposal both within the House of Representatives and once it gets compared to, or merged with, the Senate version of a tax reform bill before it ever hits the President's desk. As such, what is signed into law, if anything, will likely be different and watered down versus this initial plan, and it could take several months for the process or chess game to play out.

While the individual tax reform proposal has interesting implications for the various income brackets, states of residence, as well as the housing market, we will stick to covering the corporate changes and implications today. In general, we believe that corporations are the major beneficiaries of the proposed tax reforms, although that is industry and company dependent. The major corporate changes include the following; a reduction in the top corporate tax rate from 35% to a flat 20%, a reduction in the tax rate for pass-through businesses (less professional services) to 25%, the ability to immediately expense capex for at least the next five years, repatriation of past foreign earnings at a 12% tax rate on cash and 5% rate on illiquid assets, and going forward there will be no tax on active foreign profits but a 10% tax on high profit foreign subsidiaries. While the aforementioned is positive to a varying degree for most companies and industries, lowering the corporate deductibility of interest expense for most companies to a maximum of 30% of adjusted taxable income (or essentially EBITDA) could have a negative effect on some highly leveraged companies.

Looking at each of the highlighted corporate changes, the decrease in the corporate tax rate will improve corporate profitability and primarily help those companies and industries that currently have high effective corporate tax rates, such as telecom, banks, energy companies and retailers. In addition, the lower corporate tax rate should make the tax regime competitive in the U.S. relative to its OECD peers thereby encouraging U.S. companies to execute more business in the U.S. and encourage international companies to do the same. The lower corporate tax rate could reduce the attractiveness of debt financing on the margin, thereby reducing debt issuance. Further, some companies may retire high coupon debt early in order to reap the benefits of the tax rate change. The reduction in the pass-through business tax rate from the ordinary income rate to 25% should be positive for REITs and MLPs as it lowers their cost of capital and makes investments in those industries more attractive for some investors.

The immediate expensing of capex will benefit those companies and industries in the near term that have high capex needs such as energy, telecom, mining, cable companies, transports and utilities to name a few. This could also incentivize more near term debt issuance for high capex industries to fund their capex investments. In addition, the increased capex spend should benefit providers of capital investment, such as industrials and technology companies, as sales of capital equipment increases.

The repatriation provision will effect primarily those companies and industries with high levels of overseas earnings, such as technology and pharma companies. In turn, these companies could be flush with cash to spend on M&A, special dividends, share repurchases or debt repayment. This may hurt or help the credit profile of these companies depending upon how that cash is spent. In general, as a result we would expect reduced corporate bond issuance out of these companies. On the M&A front, given the higher repatriation tax rate of overseas cash versus the rate for illiquid investments, we may see a near term increase in these cash rich companies buying non-U.S. companies (illiquid assets). Also, as a second derivative result of repatriation, we would expect significant selling pressure on short duration, high quality fixed income assets as these repatriation companies liquidate portions of their "overseas cash equivalent" investment portfolios. The transition toward a territorial tax regime would allow U.S. companies to invest overseas at a local tax rate without the burden of U.S. tax, but it also encourages U.S. companies to bring profits back home.

The lowering of the corporate deductibility of interest expense for most companies to a maximum of 30% of adjusted taxable income (essentially EBITDA) should reduce the incentive for corporations to use excessive amounts of leverage to finance themselves. Regulated utilities and the real estate sector are exempt from this cap while it is speculated that banks will also be exempt either as a result of interest paid to depositors being considered as business expense and not as an interest expense or the cap could be based upon interest expense net of interest income. This 30% cap equates to companies with an interest coverage ratio of roughly 3.33 times or less. As such, the cap will impact very few investment grade companies but may impact several companies within the lower rated portion of the high yield market, particularly in certain industries such as chemicals and gaming. However, for those highly levered companies with high capex needs or a high corporate tax rate, the partial loss of interest deductibility may be more than offset by the aforementioned; otherwise, the partial loss of interest deductibility will hurt cash flow and may accelerate a restructuring. Over the long term the cap may accentuate the volatility of highly leveraged companies as any substantial decline in EBITDA or increase in borrowing costs for highly leveraged companies could also result in less interest deductibility at a time when they need it the most.

Again, we see corporations as the largest beneficiary of the initial tax plan, industry and issuer dependent. While this may extend the length of this business cycle, it is also too early in the chess game to know for sure where all of the pieces land.

Thank you for listening to the Tortoise Credit Strategies podcast and hopefully you will join us for next week's edition.

Thank you for joining us. And stay tuned for our next cast. Have topics you want covered or other feedback to share? Write us at info@tortoiseinvest.com.

ISM Manufacturing Index - PMI Surveys
PMI Surveys track sentiment among purchasing managers at manufacturing, construction and/or services firms. An overall sentiment index is generally calculated from the results of queries on production, orders, inventories, employment, prices, etc.

Employment Cost Index
The Employment Cost Index measures changes in employee compensation costs (or labor costs). These costs in

PCE Deflator
PCE deflators (or personal consumption expenditure deflators) track overall price changes for goods and services purchased by consumers. Deflators are calculated by dividing the appropriate nominal series by the corresponding real series and multiplying by 100.