Tortoise QuickTake Credit Podcast

Tortoise

Feb. 12, 2019

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

Welcome to the weekly Tortoise credit podcast. I'm Greg Haendel, senior portfolio manager at Tortoise. The investment grade and high yield credit market started the year with a bang boasting the best January performance since 2009. Despite our longer term concerns within investment grade credit as outlined in our 2019 investment grade corporate credit outlook, we also believed that the market would likely experience a near term bounce given that valuations to start the year were incorporating many of the market overhangs. In today's podcast we will briefly discuss year-to-date performance drivers followed by our thoughts regarding where we see the investment grade corporate credit markets headed in the near term. In short, we believe it's time to fade the IG corporate bond spread rally.

The investment grade corporate bond market experienced its recent peak in credit spreads on January 3rd, 2019, as represented by the Bloomberg Barclays US Corporate Bond index, with IG corporate bond spreads steadily tightening throughout the month. In fact, the spread on the corporate bond index tightened by 25 basis points, marking the best January performance since 2009. Further, this rebound in credit spreads during January essentially retraced a little over half of the credit spread widening experienced in the fourth quarter of 2018 and a little over one third of the credit spread widening experienced since reaching the post crisis cyclical spread tights in early February 2018. To note, I am quoting a general index spread while there are several industries and issuers that experienced significantly more and less spread tightening, thereby providing substantial opportunities for the savvy active manager.

We believe the primary catalysts for the rebound in corporate credit spreads were the perceived about face in Fed policy combined with less than expected new issuance volume, some rebound in demand by both U.S. and foreign investors, and relatively attractive valuations. Specifically on the valuation front, IG corporate bond index spreads reached levels last seen almost three years ago and yields last seen in late 2010/early 2011. Attractive yields combined with a modest decline in foreign currency hedging costs helped attract a moderate rebound in foreign buying of U.S. corporate bonds. The improvement in credit spreads and yields also helped attract increased buying from total return money managers and insurance and pension investors, respectively.

Going forward, the more dovish U.S. Federal Reserve is certainly positive and could extend the credit cycle all things equal. However, we must also keep in mind the reasons for their more dovish stance which is primarily decelerating U.S. and global growth; both of which serve as headwinds to corporate earnings. Despite relatively strong earnings announcements thus far, slowing U.S. and global growth, combined with very challenging year-over-year comps, has led to less favorable forward earnings estimate. Various other large overhangs continue to plague the IG corporate bond markets. The largest of these overhangs remains the U.S./China trade war which has already had a substantial effect upon Chinese economic growth and has also leaked into U.S. corporate earnings due to higher input costs on some products. March 1st stands as a near-term deadline for a trade deal or escalation in tariffs on Chinese goods. Another near-term date to keep in mind is February 15th, which could result in another government shutdown should a budget deal not be reached. In addition, the March 29th Brexit deadline remains, with seemingly little progress being made to avoid a hard Brexit although most market pundits believe some deal will be reached or the deadline will be extended.

We expect many of the aforementioned items to weigh on IG corporate spreads near-term while we believe the spark that may ignite this reversal in IG corporate spreads will likely be technical in nature. Specifically, with only a couple weeks of earnings season left, combined with a heavy investment grade maturity wall, a robust pipeline of M&A deal financings and a

decline in overall corporate yields, we expect a heavy new issuance supply calendar in March. Further, March has historically marked one of the strongest months of new issuance each year, averaging approximately $125 billion since 2014. On the demand side of the equation, we believe the rebound in corporate bond spreads may result in profit taking by some investors as well as diminishing demand from foreigners, pensions and insurance companies given a 30 basis point decline in corporate yields year-to-date.

We believe that we have already experienced most if not all of the near-term bounce in investment grade corporate bond credit spreads that we were predicting late last year. There are several large events that remain on the near-term horizon, each of which could have a bimodal outcome, and while each could have a positive resolution, we believe much is already priced into current IG corporate bond valuations thereby leaving little room for negative outcomes. Further, we expect technicals within the IG corporate bond markets to deteriorate in the near-term while earnings fundamental could also slow.

As a result, we expect some general IG corporate bond spread widening in the weeks and months ahead. Given this outlook combined with less compelling general valuations, we remain modestly underweight investment grade corporate bonds, continue to focus on improving the quality of our holdings, while also taking advantage of investment opportunities in select industries and issuers where we believe valuations don't properly reflect their fundamental and technical drivers. Further the rapid pace of this rebound in January as well as the pace of sell-off late last year exemplify both the liquidity challenges and resulting volatility inherent in today's corporate bond markets. We believe this market environment favors the investor that is early as well as the small and nimble managers.

Thank you for listening, we'll talk to you again next week.

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@tortoiseadvisors.com.

The Bloomberg Barclays US Corporate Bond Index *measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD-denominated securities publicly issued by US and non-US industrial, utility and financial issuers. The US Corporate Index is a component of the US Credit and US Aggregate Indices, and provided the necessary inclusion rules are met, US Corporate Index securities also contribute to the multi-currency Global Aggregate Index. The index was launched in July 1973, with index history backfilled to January 1, 1973.*