Tortoise QuickTake Credit Podcast

Tortoise

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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. With the premier of the final season of Game of Thrones only days away, we can finally say "winter is here." For the financial markets, winter seems to have been averted at least for the time being, largely due to a recent dovish shift in global central bank policy and in particular a dovish shift in Federal Reserve policy. This shift in Fed policy includes a telegraphed near term end to quantitative tightening as well as a potential end in rate hikes for this business cycle. Does this mean we are back to a goldilocks scenario for the financial markets and in particular for the corporate credit markets? In 1948 Winston Churchill said "those who fail to learn from history are condemned to repeat it." As such, in today's podcast we will review the history of corporate credit spreads in time periods between the end of Fed rate hiking cycles and the beginning of the next easing cycle as well as the implications for today's corporate credit markets.

Briefly reviewing the Federal Reserve's recent policy shift on March 20th, the Committee left the fed funds rate unchanged at 2.5% as they didn't believe growth and inflation were strong enough to warrant another increase. In fact, according to their forward forecasts they no longer expect to raise rates in 2019 and only expect one rate hike in 2020 although 7 of the 17 FOMC members think that rates will be on hold next year as well. Further, the Fed also announced their phase out of quantitative tightening, the process by which they shrink their balance sheet, to be completed around the end of the third quarter of 2019. The substantial dovish policy shift left some market participants believing that the next move in Federal Reserve monetary policy would be a cut in the Fed Funds rate. In fact, the Fed Funds futures market is currently pricing in roughly a 55% chance of a rate cut by the end of 2019.

Unfortunately corporate credit often performs poorly between the period when the Fed stops hiking rates and when they begin their next rate cutting cycle. Looking at the investment grade corporate credit market, credit spreads have widened 100% of the time within 2 years of the conclusion of each of the last six Fed rate hike cycles. Looking back, the conclusion of the last six rate hike cycles occurred on May 1974, March 1980, May 1981, August 1984, February 1989, May 2000 and June 2006. Similarly in high yield, looking at data from the last three Fed cycles starting in the mid 1980's (given the advent of the high yield market in the 1980's) credit spreads were always wider within a year post the conclusion of the Fed rate hiking cycle. In fact, on average, investment grade credit spreads widened 32 basis points and high yield widened 182 basis points between the last Fed rate hike and first Fed rate cut.

Many market participants are surprised by these statistics, forget about history, or profess that this time is different. However, the reasons for these results are very logical and intuitive when looking at the business cycle and monetary policy. The initial reaction to less restrictive or easier monetary policy is typically thought to be supportive of the economy and the markets. However, one must dig deeper and understand the reasons behind the shift in monetary policy. Typically, as economic growth slows the Fed stops tightening monetary policy and may even start cutting rates shortly thereafter as growth is rolling over. At the same time, earnings growth rolls over as a result of slower economic growth, weaker corporate balance sheets gets exposed, credit fundamentals deteriorate, default expectations increase and credit spreads widen. In short, weakening fundamentals become the driving force within the corporate credit markets as opposed to many of the technical supply and demand drivers influencing the credit markets today.

In the short term, clearly a dovish Fed and less restrictive monetary policy or even the prospect of more accommodative monetary policy should be a positive for credit markets and equity markets. Indeed we have seen this reaction as of late. However, is this policy pivot a pause in the rate hike cycle, with additional rate hikes in late 2019 or even 2020 or is the next Fed policy move going to be a rate cut as the treasury market expects? Ultimately in the medium to longer term, the reasons

for the monetary policy shift, should it be a shift towards easing, matter much more than the policy shift itself. To put it another way, if Fed policy has pivoted due to weaker U.S. and global growth expectations and an increasing probability of a recession (even if that probability remains low) then this should ultimately mean weaker earnings and wider credit spreads over the medium to longer term. However, although I don't believe it to be the case, maybe this time is different given we have no historical examples of the interplay between traditional monetary policy, quantitative easing / tightening, and corporate credit spreads.

As Jeff Brothers outlined in last week's podcast, the stock market/corporate credit markets and the U.S. treasury markets are sending dramatically divergent signals. As Jeff noted, at least for the time being we are siding with the stock market/ corporate credit markets and believe the U.S. treasury market may have gotten ahead of itself in pricing in the next Fed rate cut. However, within investment grade credit, valuations currently leave little margin for error when the handoff occurs from supply and demand technicals driving the market to weakening fundamental driving the market. As such we are treading cautiously, focusing on industry allocation, issuer selection and continue to upgrade the portfolio quality.

If history is any guide, the most bullish outcome for corporate credit spreads over the next year or two would be an improvement in growth even if it means a further Fed rate hike or two. The bearish outcome for corporate credit spreads would be growth rolling over even if it means an end to Fed policy tightening or even Fed rate cuts.

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.