Tortoise QuickTake
Credit Podcast

Aug. 21, 2018

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. Summertime is quickly coming to an end with the Labor Day holiday typically marking a clear end to summertime and beginning to the fall season. For many folks with kids, this also marks an end to summer vacation and a return to school, with a fresh start in a new school year. For the financial markets, summertime often, but not always, results in a seasonal slowdown in trading volume, volatility and new issuance as many market participants take much needed vacations. While the volatility since Memorial Day seems like anything but a vacation, we expect the typical reengagement in the markets post Labor Day. The big question is will we get a fresh new start, like our kids entering a new grade at school, or will the markets just reflect a continuation of what we experienced pre-Memorial Day? In today's podcast we will discuss our outlook for the investment grade corporate credit asset class for the remainder of the year.

In our podcast, dated Dec. 5th, 2017, we outlined our "lukewarm 2018 outlook for the investment grade corporate bond market." While we didn't predict every twist and turn thus far this year, the general premise within each pillar of our analysis (fundamentals, technicals, valuation) supporting our defensive positioning was correct. At this point I would love to say the investment grade credit markets will get a fresh start post Labor Day, however, we anticipate a continuation of the volatility and weakness we experienced pre-Memorial Day although some of the causes have changed and all against a backdrop of reduced market liquidity and some large market overhangs.

From a fundamental perspective, we continue to expect corporate earnings to remain healthy in many industries although year-over-year earnings comparisons will become much more challenging and the effects of tariffs and higher energy prices on input costs could eat into margins for many industries. As such, we may be nearing the peak or at least a deceleration in earnings growth. More pertinent to the corporate credit side is the elevated balance sheet leverage and historically low interest coverage for the market as a whole. Despite relatively strong corporate earnings and increased cash flow as a result of lower corporate taxes, most companies are focusing on returning cash to shareholders or M&A as opposed to debt reduction. In fact, some companies are pushing the envelope in balance sheet leverage due to M&A activity as outlined in our May 15th podcast. Further, for the first time since 2009, new issue corporate bond coupons are higher than maturing bond coupons meaning corporate interest expenses are rising all else equal as companies refinance maturing debt. More worrisome from a longer term perspective is the amount of investment grade corporate credit debt maturing in the next three years; over $2 trillion. As such, corporate credit fundamentals remain okay although there are some clouds on the horizon.

From a technical perspective, we continue to expect a supply/demand imbalance in the months to come. From a new issue supply standpoint, issuance typically picks up post Labor Day and we expect a continued heavy new issue supply given the continued increase in M&A activity, pressure to return cash to shareholders and pressure by corporations to lock in funding costs, all partially offset by the positive effects of tax reform. Further, we expect the sum of the total investable supply of dollar-denominated investment grade debt (U.S. treasuries, mortgages, corporates, etc.) to increase in the second half of 2018, as the Fed's tapering of quantitative easing (QE) becomes much more material and the U.S. Treasury has to finance a larger deficit. This, in turn provides a larger investable opportunity set across asset classes which could cause a reversal of the crowding in effect into corporate bonds originally as a result of QE. From the corporate bond demand perspective, we continue to expect tepid foreign demand unlike the past few years. Despite large interest rate differentials between U.S. dollar corporate bonds and several developed market foreign alternatives, foreign currency hedging costs are prohibitively high thereby making currency hedged investments in other markets, like Europe, a more attractive yield proposition for many non-U.S. investors. Further, mutual fund inflows year-to-date are only roughly 1/3rd of what they were last year and we

expect that to continue. However, we do expect some pension fund rebalancing into fixed income given improving funded status and we expect some insurance and pension demand for corporate bonds should interest rates continue to drift higher although the timing of each remains questionable. We also do expect relatively strong demand for short maturity corporate bonds given the flatness of the yield curve (meaning short maturity interest rates are nearly the same as longer maturity interest rates). In fact, despite the weaker mutual fund inflows year-to-date, the bulk of those corporate bonds inflows have been directed toward short maturity corporate bonds strategies. In sum, from a technical perspective we have already seen significant cracks in the technical picture and we expect that to continue and potentially worsen although there are some areas, such as short maturity corporate bonds, where the technical landscape remains robust.

From a valuation perspective, investment grade corporate credit spreads are only 20 basis points wide of their post-financial crisis cyclical spread tights achieved in late January 2018 and almost 45 basis points tighter than the 25 year average according to the Bloomberg Barclays U.S. Investment Grade Credit Index. Further, comparing investment grade corporate credit spreads to the past two pre-financial crisis cyclical peaks in early 2007 and 1997 and adjusting for market differences such as credit quality and duration, corporate bond credit spread valuations are within 25 basis points of these valuation peaks. It is however worth noting that several other fixed income asset class valuations are hovering near their cyclical valuation peaks. Despite these valuation challenges there are several industries that remain attractive from a valuation standpoint, such as midstream energy and insurance, and there are maturity tenors that also remain attractive, such as 5 years and less given their competitive total yield.

The near term challenges for investment grade corporate credit are centered around both the technical supply/demand imbalances as well as valuations whereas challenges may arise further down the road from a fundamental perspective. Overlaying our lukewarm corporate credit outlook includes broader market risks such as the Turkish debt and currency crisis, emerging market weakness, an escalation of the trade war, the shift toward quantitative tightening (the Federal Reserve and European Central Bank in particular), BREXIT, and the looming U.S. midterm elections. Despite some of these potential challenges, a strong U.S. economic expansion could provide some cushion. Regardless, we believe it is best to continue positioning defensively in investment grade corporate credit through a modest underweight, a bias toward shorter maturity bonds and active management of industry allocation as well as issuer selection.

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 U.S. Credit Index measures the investment-grade, U.S. dollar-denominated, fixed-rate, taxable corporate and government-related bond markets. It is composed of the U.S. Corporate Index and a non-corporate component that includes non-U.S. agencies, sovereigns, supranationals and local authorities. The U.S. Credit Index was called the U.S. Corporate Index until July 2000, when it was renamed to reflect its inclusion of both corporate and non-corporate issuers. The U.S. Credit Index is a subset of the U.S. Government/Credit Index and U.S. Aggregate Index.

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