Tortoise QuickTake Credit Podcast

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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 this week's Tortoise credit podcast. I'm John Heitkemper, portfolio manager for high yield bonds and leveraged loans at Tortoise.

Like many of you out there, I'll be hitting the road with my family this Thanksgiving weekend, heading to see my wife's relatives in what has become an annual tradition. Before you jump to any conclusions and start cracking in-law jokes, I'm actually looking forward to this weekend. Thanks to the precedent set by my brother-in-law, I'll get to watch countless hours of football and eat leftover pie for breakfast.

This year's trip should also be lighter on the wallet than it might have been a few months ago, with gasoline prices dropping precipitously along with oil. I'll let my colleagues on the energy side go through the details of the recent decline in oil, but suffice it to say, the drop from its recent peak around $76/barrel for WTI on October 3rd to around $54 today corresponds almost perfectly to the recent sell-off in the high yield market. In fact, the spread over Treasuries for the high yield market also hit a post-crisis tight of 303 basis points (on the Bloomberg Barclays U.S. HY Index) on that same day, October 3rd. Since then, spreads have widened over a hundred basis points, pushing up the average yield from 6.17% to 7.19%, the highest level since mid-2016. The high yield index is now down around 2.5% in the fourth quarter, erasing the previous year-to-date gain, with the energy sector underperforming the broader market, is down approximately 4.75%.

Some of you may now be having flashbacks to your Thanksgiving indigestion four years ago when OPEC, at the behest of Saudi Arabia, declined to cut output in the hopes that the market forces would balance production with demand. That ill-fated decision ultimately led to a 25% default rate in high yield energy over the next few years. Although we normally do not subscribe to the "this time is different" maxim, we believe that the high yield energy sector is much better positioned today than it was back in 2014.

First, the sector's bankruptcy cycle flushed out the weakest constituents from the pre-2014 era. In addition to those that cut debt through the bankruptcy process, several issuers completed debt-for-equity swaps or sold assets to repay debt. The result is that the energy sector currently carries less leverage than it did back in 2014; according to Wells Fargo, the high yield E&P sector leverage topped out at 5.2x debt-to-EBITDA, and it's currently down to 3.6x, with the median at 2.7x. As a result, high yield issuers don't need oil prices to be as high to cover debt burdens. Similarly, the energy downturn in 2015 and 2016 forced companies to become leaner, and they in turn pressured the oil field service sector to cut costs as well. While those costs have rebounded some as drilling has resumed, the sector as a whole enjoys lower operating costs. The combination of a lower debt burden and operations that are more efficient dramatically lowered break-evens, or the oil price that's needed to generate positive cash flow.

Another factor to consider is the change in mentality of oil & gas management teams, particularly when it comes to managing cash flow. For high yield issuers, this has translated into more disciplined capital budgets. In most cases, management teams are now confining spending to within expected cash flow, which is a significant change from the pre-2014 era when many high yield E&Ps used debt to fund drilling. If today's oil price environment persists, we'd expect to see E&Ps lay down rigs to preserve cash. Related to this, high yield issuers are also more likely to hedge now, locking in prices for a certain amount of their production, thereby providing some cash flow certainty. As oil ran up to the mid-70s range a few months ago, it's likely that companies put on additional hedges for the coming quarters.

In addition to the fundamental picture, high yield energy valuations are also meaningfully different than before the commodity crisis started in 2014. In the preceding years, the energy sector traded approximately 80 basis points inside the broader high yield market, according to Wells Fargo. In the years since, that relationship reversed, with energy trading 80-90 basis points wide of the market. Today, that figure is more than 100 basis points. It's hard to say how much wider the energy sector could go versus the broader high yield market, but we don't see another default wave on the horizon.

Lastly, we'd be remiss if we didn't point out that while oil prices are down more than 25% from the peak, natural gas prices have actually spiked nearly 50% higher in recent weeks, driven by lower-than-normal inventory heading into the heating season, which is starting out on the frigid side. Whether this cold streak continues is anyone's guess, but even this short spike should help the gas-focused high yield issuers, yet recent bond prices don't seem to reflect this.

Aside from weather patterns, the next major catalyst for energy market is OPEC's next meeting on December 6th. Our best guess is that reports will begin leaking out that they'll look to rebalance the market, which could stabilize the high yield energy sector as well. That news, and another piece of my mother-in-law's pie, will make for a good Thanksgiving.

Happy holidays and thanks for listening.

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.

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