Tortoise QuickTake Credit Podcast

Tortoise

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Welcome to the Tortoise QuickTake podcast. Thank you for joining us. Today, Tortoise provides 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.

March is one of my favorite months of the year for sports. The NCAA basketball tournament is undoubtedly the highlight, but I also like the contrast between the nail-biting tension of March Madness and spring training baseball, where the numbers on the scoreboard are almost an afterthought. Although it's still early in the year, the high yield market has been the scoreboard leader, posting gains that are outpacing the other fixed income sectors by a wide margin. Through February, the JP Morgan U.S. High Yield Index returned 6.33%, the strongest start to a calendar year since 2001, and with the firm tone continuing last week, the year-to-date return in high yield is now 6.65%. Granted, those gains follow a dismal Q4 2018, when high yield lost nearly 5%. During that sell-off, the riskier parts of the high yield market, namely CCC-rated bonds, underperformed higher-rated bonds, as you'd probably expect. The interesting stat thus far in 2019 is that CCCs haven't outperformed on the rebound. In fact, returns across the ratings spectrum – from BBs all the way down to CCCs – are tightly wrapped around the 6.3% index return.

There are a couple potential explanations for the recent underperformance of CCCs relative to their historical beta versus the overall high yield market. The first and possibly most apparent reason is that high yield investors are concerned with the outlook for credit trends and a potential increase in defaults going forward, a stance that's not unjustified if you simply consider that the current economic expansion is a decade old now. While the markets have had on- and off-again fits of anxiety that the next recession is looming just around the corner, one data set that high yield investors watch closely is the Fed's quarterly senior loan officer survey. The most recent reading, reflecting the Q4 survey period, showed a sharp spike in those reporting tighter lending standards, a trend that if sustained could point to a higher default rate based on historical correlations. This data point alone led a couple of sell-side strategists to raise their default forecasts for 2019, despite the fact that the trailing 12-month default rate actually dropped in February to just over 1%. The next senior loan officer survey should be out next month and will be highly scrutinized to see whether the tightening trend continues or reverts back, which would suggest that the prior reading was an anomaly that reflected Q4's market volatility.

Another plausible factor in explaining the relative weakness in CCC returns in 2019 is the underlying make-up of the rating bucket itself. Energy credits account for over 20% of the CCC universe, higher than their 15% weighting in the overall HY market. Although the overall high yield energy sector has posted above-index returns thus far, with oil languishing in the $50/barrel range, investor sentiment towards the riskier, CCC-rated energy credits has soured, as evidenced by the number of energy bonds that are down 20 or more points after reporting underwhelming Q4 earnings. The telecom sector – and the legacy wireline operators in particular – are another large constituent sector in the CCC space, and these issuers continue to face secularly challenged profits and over-leveraged balance sheets. One of them, Windstream, filed for bankruptcy protection in February, causing bonds to plummet as much as 30 points. As in energy, high yield investors remain reluctant to add exposure to the lower-rated credits in the telecom space.

Finally, the inability of CCC-rated issuers to access the new issue market for the past few months has also weighed on that segment of the market. Just 7% of 2019 new issue volume has been CCC-rated, down from over 9% in 2017 and 2018, and according to JP Morgan, just 10% of this year's new deals are split-B or CCC-rated, the lowest since 2002. In recent weeks, however, this trend appears to be defrosting with several CCC-rated deals pricing in the primary market. If the new issue market continues to accommodate CCC-rated deals, as it has been for BB-rated and secured bonds in particular, investors

may start dipping their toes in the CCC secondary market, given its nearly 12% yield, which equates to a rather large 700 basis point premium over the yield on BBs.

Like the veteran slugger who can't seem to get his timing down during spring training, CCCs have whiffed thus far in 2019. But unless high yield investors start getting more tolerant of risk, lower-rated bonds may be stuck on the bench for the rest of the season.

Thanks for listening, and please tune in for future Tortoise credit podcasts.

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.