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.

My wife's birthday falls at the end of November, and I have enough trouble coming up with gift ideas for that, but then I turn around and have to come up with more ideas for Christmas, which follows just a couple weeks later. The transition between the 4th quarter and 1st quarter earnings seasons seems similarly short. A few laggard high yield issuers were still reporting 4th quarter results last week as JP Morgan and Wells Fargo kicked off 1st quarter reporting on Friday. One of the themes that we've talked about in our recent credit podcasts is the differing outlooks imbedded in the U.S. equity and treasury markets. In sum, lower treasury rates reflect the Fed's dovish turn on the back of tepid global economic signals, minimal headline inflation and near-term risks, while the equity market appears focused on potentially positive catalysts like a trade deal with China and an expected upturn in earnings growth later in 2019. Whether that last thesis holds water is just one of several questions that we may get answers to during Q1 earnings, which is poised to be one of the most consequential reporting seasons in the past few years. Here are a few things that we'll be watching for as we get an updated look at U.S. corporate fundamentals.

First, will we see the first year-over-year decline in corporate earnings growth since early 2016, when the energy, metals and mining sectors were still suffering from depressed commodity prices? As this earnings season began, analyst projections called for a 4% decline in average earnings per share of S&P 500 companies, when just a few months ago, expectations were for about a 2.5% increase; either figure represents a marked slowdown from 15% growth in Q4 2018. Some of the most cyclical sectors in the economy, including autos, energy and materials are projected to drive that negative figure in Q1. In general, there are a host of potential reasons to blame for the negative revisions to earnings expectations, including the partial government shutdown, tariffs, poor weather, Europe's anemic economy and fears of a hard Brexit. But let's not forget that we're lapping an exceptionally strong Q1 2018, when earnings were up over 25%, or nearly 20% even backing out the corporate tax cut (according to Credit Suisse). Also, companies historically beat analyst projections by about 4%, and if that's the case in Q1, earnings growth could remain on the positive side of the ledger.

Regardless, analysts are going to be highly focused on management guidance for the rest of the year, and in particular, whether earnings growth can rebound from expected Q1 weakness. Current S&P 500 estimates show EPS growth accelerating to nearly 9% by the fourth quarter of 2019 and 15% in the first quarter of next year. Part of the driver is an expectation that revenue growth can speed up from 2.5% to nearly 4.5% as the year progresses, which could prove tough if U.S. GDP growth slows from about 3% last year to around 2.5% in 2019, as currently forecasted by economists.

Profit margins, which have been a bright spot for corporate fundamentals, could make up for challenged top line growth, of course, but here again, the outlook may be challenged. Wage inflation appears to be climbing, with average hourly earnings up about 3.5% year-over-year, while broader inflation measures imply that companies are not passing through higher labor costs to end customers. A stronger dollar as well as rising transportation and raw material costs, such as oil, are additional hurdles to profit margin improvements.

In my last podcast, I mentioned the Fed's senior loan officer survey, and specifically, that tightening lending standards foreshadow a pick-up in high yield defaults. As it turns out, Citigroup research also suggests that lending standards are correlated with future corporate margins, with the implication that tighter lending in Q4 could portend weaker margins in the second half of 2019, just when the market expects earnings growth to reemerge.

As a result, we think this earnings season is particularly important for investors, especially if forward guidance suggests we could be on the precipice of a so-called earnings recession caused by weaker revenues and declining margins. The implications will be meaningful for equity investors, of course, but credit investors should pay attention as well. Corporate debt has grown rapidly during this cycle, and with a few exceptions (namely, a handful of over-levered BBB credits), companies have generally seen earnings expand even faster, thereby keeping leverage metrics under control. But negative earnings trends will no doubt pose a challenge to balance sheets, and for investment grade companies in particular, force management teams to choose between protecting their credit ratings or cutting dividends and share repurchases. At current lofty equity valuations and corporate credit spreads again nearing post-crisis tights, neither equity nor corporate credit markets appear to be giving much heed to such a scenario.

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

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