Tortoise QuickTake Credit Podcast

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Welcome to the Tortoise QuickTake podcast. Thank you for joining us. Today, Tortoise provide a timely update on trending topics in the market.

Greg Haendel: Welcome to the weekly Tortoise credit podcast. I'm Greg Haendel, Senior Portfolio Manager at Tortoise. With the 4th of July holiday upon us, many Americans celebrate our nation's Independence Day by attending or hosting a party, eating barbeque, drinking a couple cocktails and capping the night off by watching a fireworks show. Not only does the 4th of July mark our nation's Independence Day, but it also roughly marks the end to the first half of the calendar year and beginning to the second half. As the financial markets embark upon the second half of 2019 there is also a lot to celebrate in the markets in the near term, however, when the party is over, the corporate credit markets may find themselves with a bit of a hangover. In today's podcast, we will discuss our outlook for the investment grade corporate bond market in the second half of 2019 and beyond.

In our podcast, dated December 12th, 2018, we outlined many of our longer-term fundamental credit concerns within investment grade corporate credit, many of the supply/demand technical headwinds (some of which are now tailwinds), our positive view on valuations at the time and some of the larger macro uncertainties. This led us to a modestly constructive view on the investment grade corporate bond market near-term (largely due to valuation) with a defensive longer-term outlook. At the time of writing this podcast, some of the macro uncertainties remain; the trade war, slowing global growth and Brexit while others have percolated; geopolitical instability with Iran and a looming debt ceiling. However, we have received more clarity over future monetary policy from many global central banks which have largely been dovish and accommodative. Heading into our 4th of July parties, Mario Draghi, President of the European Central Bank (The ECB) and Jerome Powell, Chair of the Federal Reserve (The Fed), have spiked the markets 4th of July beverage in an attempt to make the party larger and last longer. This has and will likely continue to have a large positive near term effect on credit market technicals with what I believe to be misguided hopes it also flows into investment grade credit fundamentals.

From a fundamental perspective, earnings growth, while still positive, is decelerating, year over year comparisons are more challenging and the effects of tariffs will likely eat into margins (which remain healthy) for many industries. Slowing global growth remains a headwind, especially for multi-national companies. The direct impact of the trade war, as noted, could eat into corporate margins as well as boost consumer prices. We believe the largest impact of trade tensions will be the indirect effect upon corporate confidence. The longer the trade war drags on the larger long-term effect although there is relatively strong political motivation to find a resolution by the end of this year due to the U.S. presidential election in 2020. Balance sheet leverage remains near its post crisis high while interest coverage has weakened over the last five years for the IG Corporate Credit market as a whole. Shareholder enhancement at the expense of debt holders remains pervasive within the IG corporate markets and specifically single A and higher rated companies. The recent move lower in yields, all else equal, incentivizes additional shareholder enhancement and increases M&A activity at the expense of debt holders simply due to cheaper financing costs. Essentially today's party could create tomorrow's hangover. Further adding alcohol to this party beverage has been the inflated corporate credit ratings within some industries and issuers that appear inconsistent with historical ratings methodologies. The potentially positive effect on earnings fundamentals from increased Central Bank accommodation and looser financial conditions will face a tug of war versus elevated existing leverage and adverse credit incentives caused by low interest rates. It is important to note, the stretched balance sheets, decelerating earnings growth, poor corporate behavior and inflated rating are market generalizations and there are various industries and issuers that are bucking this trend.

Investment grade corporate bond demand technicals are the largest beneficiary of the dovish Central Bank policy shift in the U.S. and Europe. The increase in the amount of negative yielding debt globally, from roughly $8 trillion in October 2018 to

well over $11 trillion today, largely a result of a dovish ECB and slowing growth, is reigniting the crowding out effect and pushing global investors into the highest yielding developed market bonds; that being those of the United States. The dovish pivot from the U.S. Federal Reserve, combined with potential rate cuts on the horizon in the next several months, has and will continue to decrease the currency hedging costs for many investors in Europe and Asia. Although a declining yield differential between the U.S. and Europe and Japan offsets some of the improvement in currency hedging costs, we believe foreign demand for U.S. investment grade corporate bonds should increase near term. Additionally, the telegraphed end to quantitative tightening (Fed balance sheet shrinkage) by the Federal Reserve later this year ends the reversal of the crowding out behavior in U.S. markets.

U.S.-based investor demand is expected to be mixed. U.S. retail demand has been strong year to date which we expect to continue given strong year to date returns combined with reasonably low volatility, partially offset by a dearth of yield due to the recent interest rate rally. U.S. institutional demand will likely be mixed given lower demand from yield sensitive buyers such as insurance companies and pension funds partially offset by increased demand from other institutional investors near term given high cash balances, relatively moderate existing exposure and increased optimism due to forthcoming Central Bank stimulus. In fact, several recent money manager surveys show institutional positioning being relatively modest with spread sentiment becoming excessively negative early in the month. When sentiment and positioning become too lopsided, the short-term path of least resistance tends to favor the opposite or contrarian view.

We expect new issue supply within investment grade corporate bonds to remain relatively modest in the near term due to a seasonal summer slowdown, the forthcoming second quarter earnings new issuance blackouts and the increased incentive for multinational companies to raise money in Europe or Asia as opposed to the U.S. when possible. However, in the intermediate to longer term we anticipate increased supply as companies seek to take advantage of lower interest rates once again. Further, increased incentive for shareholder enhancement and increased M&A activity, should it be at the expense of debt holders, also means more corporate debt issuance in the intermediate to longer term.

From a valuation perspective, as of the market close on June 27th, investment grade corporate bond spreads are modestly expensive from a historical standpoint although still roughly 31 basis point wide of their post financial crisis spread tights achieved on February 1st 2018. Specifically spreads are 38 basis points tighter year to date, and approximately one half standard deviation rich versus there average over the last five and 25 years according to the Bloomberg Barclays US Investment Grade Corporate Bond Index. Investment grade corporate bond spreads have come a long way, almost 100 basis points tighter, since the energy meltdown in early 2016. However, investment grade corporate bonds spreads have modestly lagged the rally year to date versus both the S&P 500 Index and versus the Bloomberg Barclays US Corporate High Yield index. This makes sense given the decline in U.S. Treasury interest rates and yield shock by many groups of buyers. A 3.18% yield, as of market close on June 27th, for the Bloomberg Barclays US Corporate Bond Index isn't especially inspiring although that is still 58 basis points higher than the all-time yield low reached in 2013. In addition, 3.18% is attractive relative to European investment grade corporate bond indices yielding approximately 0.55%, Japanese corporate bond indices yielding roughly 0.3% as well as relative to over $11 trillion of negative yielding debt globally. Despite some valuation challenges, there are still several industries and issuers that remain attractive from a relative value standpoint.

In the near term, the Federal Reserve and ECB have spiked the punch and the party rages on. As a result, technical demand tailwinds should outweigh fundamental credit headwinds in the short-term and cause modestly expensive valuations to become more expensive. From an intermediate to longer-term basis, we can't lose sight of the reasons for more accommodative Central Bank policy; slowing global growth, the trade war and below trend inflation. These, combined with stretched corporate leverage, decelerating earnings growth and modestly rich valuations leaves us marginally underweight from a longer term perspective with an intense focus on industry allocation and issuer selection.

At this point in the credit cycle we choose to avoid picking up pennies in front of a steamroller that now has the acceleration of a Ferrari due to reduced market liquidity post the financial crisis. Our largest question remains; when does the proverbial 4th of July party end and how bad of a hangover will the market suffer.

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 S&P 500® Index is a market-value weighted index of equity securities.

The Bloomberg Barclays US Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below. Bonds from issuers with an emerging markets country of risk, based on Barclays EM country definition, are excluded.

The Bloomberg Barclays US Corporate Bond Index measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD-denominated securities publicly issued by US and non-US industrial, utility and financial issuers. The US Corporate Index is a component of the US Credit and US Aggregate Indices, and provided the necessary inclusion rules are met, US Corporate Index securities also contribute to the multi-currency Global Aggregate Index. The index was launched in July 1973, with index history backfilled to January 1, 1973.

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