Tortoise QuickTake Credit Podcast

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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 the weekly Tortoise credit podcast. I'm Greg Haendel, Senior Portfolio Manager at Tortoise. Is the grass always greener on the other side of the fence? Or as one of my old coworkers used to say is the grass brown on both sides of the fence. Low and declining interest rates are often seen as a positive, the grass is green, for the corporate bond market. However, low interest rates can also have adverse effects upon the corporate bond market in general and it often depends upon the reasons for the lower interest rates. In today's podcast we will discuss the positive and negative tradeoff from lower interest rates for the corporate bond market and hence why the grass may be blotchy on both sides of the fence.

First, briefly, why are U.S. treasury interest rates so darn low? As we have discussed on various podcasts in the last several weeks and months, there have been numerous catalysts contributing to lower interest rates. These include a lack of inflationary pressures, slowing economic growth in the U.S. and especially globally, headwinds from the seemingly never ending trade war between the U.S. and China, a global shift toward central bank policy accommodation and the crowding in behavior of foreign fixed income investors buying U.S. dollar fixed income assets. On that last point, some believe this crowding in behavior is the result of the global stock of negative yielding assets growing to approximately $16 trillion today from roughly $7 trillion one year ago. Others believe this crowding in behavior is a result of numerous global sovereign yields hitting their largest multi-decade yield differential between local currency government bonds and U.S. Treasury bonds. Regardless of which force is driving this crowding in behavior of foreigners, all the aforementioned factors have contributed to this decline of over 100 basis points year-to-date in the yield on the 10-year U.S. Treasury.

At first blush, lower interest rates may appear to be a positive for the corporate bond market and companies in general. Lower interest rates are typically associated with lower debt financing costs at companies. This can result from lower floating interest costs or potentially lower interest rates on debt that may be refinanced. In turn, lower interest costs mean improved interest coverage ratios and potentially better pre-tax earnings all else equal. In addition, lower interest rates combined with a relatively flat interest rate curve give some companies the ability to buy back or retire near term debt maturities and reissue or refinance that debt into longer maturities such as 10- and 30-year debt. This allows these companies to lock in extremely low interest rates while also eliminating any debt refinance risks over the next several years. We have witnessed several companies doing this recently including Juniper Networks, The Hartford, CVS and Sherwin Williams to name a few. Further, low interest rates, all else equal, should help increase consumer spending on goods and services if that spending is a result of lower consumer borrowing costs. This in turn should boost corporate revenues although if the decline in rates has been driven by slowing economic growth, consumer spending may actually decline irrespective of lower consumer borrowing costs. Lastly, there are several corporate industries that tend to be large beneficiaries of lower interest rates, such as REITs, utilities and home builders to name a few.

However, the grass is not always greener for the corporate bond market with lower interest rates. First and foremost, lower interest rates often increase the incentive for companies to increase their debt leverage on their balance sheets, many of which companies already have leverage nearing multi-decade highs. Often, these lower interest rates entice companies to enhance shareholder value through debt financed share buybacks. In addition, low interest rates tend to incentivize companies to engage in M&A or use more debt to finance the M&A, again resulting in higher corporate debt leverage. For companies with unfunded corporate pensions, lower rates may increase the unfunded portion of their pension or may incentivize companies to issue cheap debt (thereby increasing leverage) to cover the unfunded portion of their pension. In essence it may incentivize a company to take an off balance sheet liability and put it on their balance sheet. However, this is not always a bad thing if the cost of the debt to cover the unfunded pension liability is cheaper than the PBGC guarantee fee on the unfunded portion of the pension. Both Fedex and UPS are examples of companies that have recently issued debt to improve their pension funding. From an industry perspective, lower interest rates and especially a flatter interest rate curve tend to be a negative for both banks, given they borrow short and lend long, as well as insurance companies, in particular insurance companies with a large life insurance and annuity focus. Luckily bank equity capitalization is extremely strong today while charge-offs remain low; all partially offsetting the banks hit to their net interest margin.

From a technical supply and demand perspective, lower interest rates should incentivize companies to issue more corporate bonds, thereby potentially causing a mismatch between excess supply and a finite demand for those bonds at a given valuation level. In addition, as discussed earlier, the corporate incentive to refinance shorter maturity bonds by issuing longer maturity bonds tends to put excess supply pressure on longer maturity corporate bonds, and conversely helps short maturity supply technicals. At the same time, lower long maturity interest rates often reduce demand from longer maturity corporate bond buyers, specifically insurance companies and pension funds, given these bonds no longer meet their minimum yield requirements. This in turn can cause corporate credit spread curves to steepen, thereby hurting valuations for longer maturity corporate bonds. Further, lower interest rates and lower yields on corporate bonds can reduce the attractiveness of corporate bonds in general relative to other non-fixed income investments, thereby reducing the potential buyer base. Lastly, from a structural standpoint, as is the case with any bond with an imbedded call option, falling interest rates can limit an investors price appreciation potential in a callable corporate bond.

Should interest rates remain low or trend lower in the months to come we would expect corporate bond issuance to increase substantially, M&A activity to pick up (absent a severe growth scare or increase in regulatory or political uncertainty) and companies to term out debt and potentially increase balance sheet leverage. In this environment, we would be moderately defensive within corporate credit, minimize our longer maturity corporate bond exposure and focus on industries and issuers that benefit or at least are not hurt by low interest rates.

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.

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