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

Well, that was quick. Summer is already over, and the kids are back to school. This is a momentous year, not because my older daughter started junior high, but because the younger one informed me that I wasn't allowed to walk her to school on the first day. "You're too embarrassing, dad!" My response, which I didn't say out loud to her, was "just you wait." Yeah, my feelings are a little hurt, but at least I wasn't called an enemy of the state – like Jay Powell – in a Presidential tweet. That has to be rough on anyone's ego, let alone the Chair of the Federal Reserve Board.

On the topic of Presidential tweeting, the last few weeks of the summer saw a dizzying flurry of trade-related pronouncements that left Wall Street traders who were not fortunate enough to be out of signal range wondering whether to buy or sell. While we don't anticipate that trade headlines are going to dissipate anytime soon, we thought it would be useful to use the long holiday weekend to return to the fundamentals, which for those of us on the credit side of the business, means corporate earnings.

The second quarter earnings season is pretty much a wrap at this point, with 497 of the S&P 500 companies tallied. The good news is that in similar fashion to the first quarter, earnings growth topped estimates, coming in slightly positive at +2.2% year-over-year, ahead of the -2% estimate back in May. The Financials and Communications sectors drove much of the better-than-expected results, offsetting a very disappointing quarter for the broad Energy group. Overall, about three-quarters of companies in the S&P 500 beat expectations, slightly higher than the typical rate.

Despite the relatively solid second quarter results, market expectations for future earnings continue to weaken. Whereas in May, expectations called for earnings to trough in Q2 at -2%, that trough is now pushed out to the third quarter, with earnings growth projected to bottom at -3%. And although both the first and second quarters beat estimates, the projections for 2019 as a whole have continued to drop, from +7% growth back in January to now just over +2.5% in the latest reading. Meanwhile, as 2019 estimates weaken, the outlook for 2020 appears relatively solid, with analysts still projecting over 10% growth.

It is easy to point to a lingering trade war to argue these 2020 estimates might be overly optimistic, but we'd also point out that a more bottoms-up approach may lead one to the same conclusion. In the second quarter, sales growth underperformed expectations, with multi-national companies unsurprisingly driving the deterioration. Revenue estimates for Q3 and Q4 have come down as well. With projections of tepid top line growth, implicit in the anticipated rebound in corporate earnings is an underlying expansion of corporate margins.

If earnings are going to rebound against a backdrop of lukewarm revenue growth, companies will need to execute on cost discipline in coming quarters, whether that means cutting back on spending or hiring. These actions may not bode well for the overall U.S. economic growth in the next year or so. To that end, recently revised government data, released with the second quarter GDP report, show that corporate profits over the past few years have been much worse than originally reported. This is a problematic trend, both for the near-term earnings outlook and for the larger U.S. economic outlook.

According to the government data, second quarter corporate pre-tax profits rose 2.7% year-over-year to $2.1 trillion, implying a better picture than the S&P 500 data that showed 2.2% EPS growth. This isn't entirely a surprise, as the S&P 500 includes a higher concentration of companies exposed to global trade, which is currently a weak link for U.S. companies. However,

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revisions to that government data set shaved Q1 corporate profits by about 10%, from $2.2 trillion to $2.0 trillion, meaning that profits actually remain below the 2014 peak. According to a recent analysis by CreditSights, the revisions imply that corporate pre-tax profit margins have been steadily declining since 2015. On an after-tax basis, the story is slightly more encouraging – margins are roughly steady in the past few years, thanks largely to the recent tax cuts.

As it turns out, declining corporate profit margins, like the frequently cited inverted yield curve, tend to foreshadow U.S. recessions, albeit with varying time lags. The mechanism connecting the two sits in the corner office; management teams react to weaker top-line performance and margin pressure by pursuing cost savings measures, such as cutting capital expenditures or limiting hiring plans. The latter move is the potential contagion that could spread relative weakness in corporate America to the consumer portion of the U.S. economy, which has been the primary driver of growth in recent quarters. We'll get an update on how the U.S. labor market is holding up with Friday's nonfarm payroll report; economists expect the economy to add 160,000 jobs in August, which would be slightly below the monthly average this year.

The next few quarters may prove to be a crossroads for corporate profitability. It appears that margins have been contracting over the past few years, and unless companies take actions to reverse that trend, earnings expectations may continue to deteriorate in coming quarters. But it's these same actions – particularly those that impact the U.S. consumer – that could prove to be the final straw for the current economic expansion.

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.

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