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. Last week, a group of us from Tortoise attended one of the larger leveraged finance conferences of the year, and many panelists, in addition to speculating about where we are in the credit cycle, discussed the stark divergence of performance within the high yield market this year. With a total return approaching 12% on the ICE BAML U.S. HY Index, you'd normally expect lower-quality tiers of the high yield market to be driving the rally. But in fact, the predominant theme in 2019 is the strong performance of BBs, which are up about 14%, outpacing Bs at 11.3% and handily outgaining CCCs, which are up just 6.2%. The strong run for BBs leaves valuations less than compelling, with a yield-to-worst of just 4.2%; over 80% of the BB universe is call-constrained, limiting further upside. Even on a relative basis, valuations are tough. BB spreads are at all-time tights vs. BBBs, the lowest tier of the investment grade market, and conversely, BBs are near cyclical tights compared to CCCs. Understanding the factors that have contributed to the demand for higher-quality high yield is key to positioning for the remainder of 2019, as well as important for setting up to outperform in 2020.

One of the easiest drivers to point to in explaining BB returns this year could be the substantial rally in rates. Among high yield investors, BBs are considered to have the most rate sensitivity, and the 10-year Treasury yield has dropped about 100 basis points this year to 1.68%, briefly dipping below 1.5% right after Labor Day. But a recent analysis by Barclays shows that BBs have only benefitted marginally more than Bs and CCCs from the rate move, and that advantage is more than offset by smaller coupon returns for BBs. The principal differential between BBs and lower-quality high yield, and CCCs in particular, if a significant dispersion in spreads this year. Through last week, BB spreads have tightened over 125 basis points year-to-date, compared to just 80 bps of tightening for CCCs. Clearly, investors have been more comfortable taking BB-type credit risk, and we'd argue this sentiment is justified based on current fundamentals.

In prior podcasts, we've covered developments in corporate earnings growth, but just as a quick recap, the trend is pretty negative. Now that corporate tax cuts have rolled off the annual figures, earnings have expanded just 1-2% in recent quarters, and current projections for the third quarter are negative and falling. Bloomberg's most recent Q3 estimate for the S&P 500 is a 3.2% year-over-year drop. With slowing earnings, the gradual balance sheet deleveraging that we'd seen from high yield issuers over the past few years is stalling, if not reversing. With more and more talk of the "R" word – recession – it is understandable why high yield buyers have focused on higher quality credits. One last point on fundamentals, not only does the CCC universe have issuers with more challenging credit stories, it's overweighted – relative to the overall market – to challenged sectors, such as energy, the weakest-performing industry year-to-date.

While fundamentals seem challenged, investors have still flocked to the high yield market this year, which brings us to technicals, possibly the least-discussed driver of BB outperformance this year. Perhaps the largest technical force in global markets right now is the extreme dearth of positive yielding debt instruments, a phenomenon created by global central bank policies. In an effort to pick up yield, it's apparent that foreign, investment grade, and other "non-core" buyers are dipping their toes into U.S. high yield, but swimming only in the less fraught, BB end of the pool. Additionally, the U.S. high yield market has seen a steady stream of retail inflows this year, and of late, passive ETF products benchmarked to indices tilted toward the BB space have dominated these flows. The last point on technicals is the size of the BB pie itself. Despite nearly 50% of this year's high yield new issuance being BB-rated, the highest proportion during the current cycle, the BB universe itself has only grown marginally. On the other side of the ledger, ratings upgrades to IG have drained the BB space of $33 billion through August, a pace that would make 2019 the largest year for rising stars in excess of fallen angels. To date, the

fears of massive BBB downgrades – Ford and GE, for instance – haven't materialized, and in fact, have gone the opposite direction.

As we said at the top of the podcast, BB valuations are currently highly challenged, and it appears that both fundamentals and technicals are behind the divergence in high yield performance year-to-date. As we enter the fourth quarter, is there anything that can knock the BB train off the tracks to close out 2019? On the technical side, central banks appear intent on anchoring risk-free rates at extremely low levels, which means BBs in the low 4% area probably remain relatively attractive to investors who might otherwise own any of the $17 trillion of bonds with negative yields.

Fundamentals, however, are more difficult to handicap. Risks still seem skewed to the downside, favoring a continued bid for quality. Earnings growth will likely remain tepid, if positive at all, and as we get closer to the end of the year, more companies will give an initial glimpse into 2020. With S&P 500 projections calling for 10% earnings growth next year, current estimates appear set up for disappointment, particularly against a backdrop of weaker global growth, dragged down by China and Germany. Given the nearly 12% return that high yield investors have pocketed thus far, it's hard to see managers swinging for the fences in Q4 against that backdrop, and if additional cracks appear on the economic outlook, investors who are currently just "renting" BBs for the incremental yield are likely to scatter quickly. On the flip side, while seemingly unlikely, a resolution to the trade war or another catalyst for higher rates likely favors Bs, and possibly CCCs, over BBs. We saw a mini version of this when the 10-year backed up 45 bps over 10 days in early September.

In sum, with a lot of variables in play, the fourth quarter is setting up to be an exciting conclusion to a year of remarkable dispersion in high yield. Will it be rates, oil, trade, earnings, or the economy that dominates the narrative as we enter 2020? Or maybe something new? Impeachment hearings, you say?

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.