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 the weekly Tortoise credit podcast. I'm Greg Haendel, Senior Portfolio Manager at Tortoise. A famous philosopher once said "be wise enough to learn from the past, shrewd enough to capitalize on the present, and clever enough to prepare for the future." As third quarter earnings season begins we will review some of the takeaways from second quarter earnings within the investment grade corporate bond markets, discuss our initial read on third quarter earnings thus far, and then prepare for and anticipate fourth quarter earnings and beyond.

Yesterday says, "Forget me, but learn from me." Second quarter earnings season left some very important takeaways for investment grade corporate bond investors. In general, credit metrics for investment grade companies as a whole continued their slow and steady deterioration during the second quarter. Starting from the top, revenue growth as a whole slowed considerably. Revenue growth decelerated for the third consecutive quarter and experienced its largest quarterly deceleration since the third quarter of 2015. Keeping things in context, although revenue growth is decelerating, it remained positive and experienced its tenth consecutive quarter of positive growth. However, more than half of the revenue growth experienced in the each of the last six quarters was driven by the recovery in commodity related industries, thereby discounting some of the revenue growth in non-commodity related industries. Ebitda growth also slowed in the second quarter with year-over-year ebitda growth decelerating to its slowest pace since late 2016. Further on a quarter-over-quarter basis, ebitda growth was negative both including and excluding commodity related industries for the second consecutive quarter. Unfortunately at the same time debt growth increased during the second quarter. This resulted in leverage, both overall and excluding commodity related industries, reaching its highest levels in over fifteen years. In addition, interest coverage continued to decline and it reached its lowest level in the last fifteen years despite the secular declining interest rate environment over that period. The deterioration in credit metrics excluding the volatile commodity related industries has been a result of M&A activity, increasing payouts to shareholders (often at the debtholders expense) and due to some deterioration in credit metrics for the utility industry. Keeping this fundamental picture balanced, profit margins do remain near their post financial crisis peak, the recent deterioration in credit metrics has been focused more toward single A rated companies than BBB rated companies, and not all industries and companies are experiencing the deterioration of the overall market.

Today says, "Embrace me, yet utilize me." We are still in the early stages of third quarter earnings season with Q3 numbers released by fewer than 15% of S&P index constituents as of October 18th. The majority of those companies that have reported have been financial firms and to a lesser extent industrial companies. By the time you have listened to or read this podcast we will already be deep into the second week of earnings season with many more companies having reported. However, some takeaways thus far include the following. In general, early earnings indications certainly point to a slowdown however not an earnings recession as some have feared. Earnings per share surprises have been modestly stronger than the normal 80% that beat estimates. One large caveat is that at the start of earnings season, year-over-year S&P earnings per share growth estimates had been revised down to -3.8% with reported EPS growth thus far of -3.1%. Given previously quoted earnings are on a per share basis and companies have been buying back a decent amount of stock recently, the contracting share count has historically added 1-2% to EPS growth annually. Although revenue growth thus far has been mildly positive, yet decelerating, this has been very industry dependent with industrials and technology firms reporting modest negative revenue growth, financials modest positive revenue growth, and the few communications and real estate related firms having reported thus far with very strong revenue and earnings growth. Within the largest cohort of companies having already reported earnings, financials and specifically the banking industry, there have been a few key takeaways thus

far. Most banks have reported a shrinking net interest margin, many have offset this NIM weakness with strength in their investment banking and market facing businesses, some have reported reasonable loan growth, and most continue to experience strong credit quality. One notable exception on the financials front was Goldman Sachs, which reported a drop in revenues and earnings, mainly as a result of surprisingly weak investment banking results as well as a valuation markdown on several companies that Goldman owns a stake in, such as Uber, WeWork, Avantor, and Tradeweb. As third quarter earnings season continues it will be important to see how the more cyclical industries fair, how the consumer is holding up, and whether companies continue to increase or start to decrease their balance sheet leverage.

Tomorrow says, "Anticipate me, then prepare for me." Looking forward to the fourth quarter and beyond we believe revenue and earnings growth will continue to decelerate amid slowing US and global growth as well as the lagged effects of the trade war. Further, with long term treasury interest rates hovering near the all-time lows, incentives remain strong for companies to continue to use debt to buy back shares and engage in additional M&A in order to keep the Wall Street earnings treadmill moving forward. Currently market consensus calls for earnings to slow prior to year-end, and then pick up again in 2020 with S&P projected earnings growth of roughly 10%. This market consensus may be too optimistic given the slowing global growth outlook, ambiguous trade backdrop, and significant political and policy uncertainty as we head into an election year.

In general we believe there is a clear trend toward slowing revenue and earnings growth as well as stretched or excessive corporate leverage in many industries within the investment grade corporate market. This weakening trend in earnings and credit metrics has occurred during a reasonable economic environment. When economic growth slows, which we are already starting to experience, this deterioration in credit metrics will likely accelerate. As a result, we believe investors should be focused on industry and issuer selection within the investment grade corporate bond markets while also being mindful of overall corporate credit exposure within a multi-sector fixed income portfolio. At some point in the not so distant future, deteriorating corporate credit fundamentals will overpower the strong technical demand tailwinds in the market thereby resulting in a repricing of investment grade corporate bond valuations and potentially some downward ratings migration.

Thanks for listening and we will 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.