Tortoise QuickTake Podcast

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

Welcome to the Tortoise Credit Strategies weekly podcast, the first one from our new offices in downtown Los Angeles. I'm John Heitkemper, portfolio manager for high yield bond and leverage loan strategies. After some minor disruptions, we are back up and running in our new space, and I'd like to say a special thanks to all of the people who made the move happen.

Speaking of disruption, our colleagues on the energy side of Tortoise have talked a lot recently about the dislocation that U.S.shale is causing in the global energy markets. With advancing technologies in drilling, the breakevens for U.S. shale are increasingly on par with the lowest cost sources of oil in the world. Despite OPEC's supply-side efforts to support oil prices, the markets seem to be increasingly of the belief that rising shale production will offset lower production elsewhere.

This past week, with the WTI benchmark oil price dipping below $43 dollars per barrel, the disruptive forces of shale were once again felt in the U.S. high yield market. Seemingly unfazed as oil prices trended from $55 to $45, high yield investors finally started to hit the sell button last week as oil dropped nearly $2 or - 4.4% - from Monday to Wednesday. Notably, most of last week's weakness was contained to oil & gas bonds, and by the end of the week, the energy sector had lost over 2% and widened 50 basis points to nearly 8%, the highest yield the sector has seen since September. The energy sector is now one of only two high yield industries – the other being retail – to post negative year-to-date returns.

Outside of the energy sector, it was reassuring to see that the rest of the high yield market seemed to hold in relatively well. As of last Friday, the yield on high yield ex-energy remained inside of 6% and just 18 basis points wider than the multi-year low reached in mid-June. We think this divergence between the high yield energy sector and the rest of the market may continue, as credit fundamentals in most industries remain positive, supported in part by solid, albeit unspectacular, U.S. economic growth.

Switching gears, although the financial market press isn't typically the place to go for stories of romance, "Love at First Sight" may have been Bloomberg's most eye-catching headline last week. Those were the words Whole Foods CEO John Mackey reportedly used to describe his first meeting with Amazon executives about six weeks before they consummated a $13.7 billion dollar deal to bring together the two heavyweights of upscale groceries and ecommerce. While neither company is a high yield issuer – in fact both have investment grade ratings – the transaction could cause significant disruption in the U.S. supermarket space, where there are a number of high yield issuers.

To get a sense of the market's perception of the disruptive power that this combination might unleash, just take a quick look at the stock performance of some of the grocery industry heavyweights. Wal-Mart, the country's largest purveyor of groceries, dropped nearly 5%, while Costco and Target also saw mid-single digit declines. Grocery-specific retailers such as Kroger, Supervalu and Smart & Final saw steeper declines of 9%, 14%, and 19% in just one day. In those six companies alone, the combined market value loss exceeded $20 billion dollars. And what those companies lost, Amazon gained, as its equity market value jumped over 2% or $11.2 billion dollars, nearly equaling the Whole Foods purchase price. In the high yield bond market, benchmark grocery credits such as Supervalu and Albertsons experienced 2-4 points of price decline initially with several more points on subsequent days.

The equity and bond price declines to-date precede any disclosure from Amazon or Whole Foods as to how the transaction might impact either company's strategy or operations. But investors know full well Amazon's disruptive impact in other retail segments, from books to music to clothing more recently. Why hold onto those grocery stocks or bonds when the end result could well be substantial margin pressure if not bankruptcy in a worst case scenario.

We think Amazon's move into brick-and-mortar grocery might actually have a small silver lining. When the 800-pound ecommerce gorilla acquires 460 prime retail locations in affluent markets across the U.S., is it a concession that Amazon's decade-long, online-only push into fresh foods didn't gain enough traction? Is it a signal that Amazon is conceding that it needs local distribution points that provide the last mile between Amazon's famous logistics network and U.S. consumers that still want to see and touch their produce and meat? If the answer to these questions is yes, it suggests that all hope isn't lost for the legacy grocery players. Undoubtedly, they will have to adapt, streamline, and in all likelihood, consolidate to a group of larger, more competitive players.

We may never know in advance exactly what Amazon has up its sleeve for Whole Foods, as the company is historically tight-lipped about its strategic and operational plans. But there is a whole list of possibilities that provide fodder for the investment community. How aggressively will Amazon tackle the Whole Foods business model and bring down prices to squash the "whole paycheck" moniker? Will Amazon reconfigure Whole Foods stores and utilize square footage for distribution of its traditional non-grocery goods? How successful will Amazon be in converting Whole Foods shoppers and Prime customers, where there's substantial overlap, to the Amazon Fresh service offering?

It may be another decade before these issues play out, but in our view, there is no question that the incumbent grocers need to start preparing now for the coming disruption. For the management teams set to compete with the Amazon and Whole Foods in coming years, this combination should be anything but love at first sight. Thank you for listening.

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@tortoiseinvest.com.