Tortoise

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 this week's Tortoise Credit podcast. I'm John Heitkemper, Portfolio Manager for high yield bonds and leveraged loans at Tortoise Credit Strategies.

We'd like to start this week by saying that our thoughts are with all of those affected by the recent fires burning around Southern California, a few of which were actually visible from our downtown Los Angeles office. With the unseasonably warm and windy weather that's causing the devastation, it's hard to believe that we're in December and 2017 is nearly a wrap. But the calendar doesn't lie, and here we are at that time of year when our email inboxes are full of Wall Street prognostications on the year ahead. After reading through a handful of these outlook pieces, it seems like one's position on 2018 could best be summarized by a series of over/under bets, just like you might make in a Vegas sports book. For instance, will the number of Fed rate hikes be over or under the 3 shown in the dot plots? With the Fed Funds rate moving up, will the 10-year Treasury yield finish the year over or under 3%? Or will high yield returns be over or under the current coupon of about 6.5%? It's this last question that we'll try to tackle on this podcast.

To begin with, we believe the fundamental backdrop for U.S. credit in general, and high yield specifically, is largely constructive. Although this credit cycle is definitely showing its age, coordinated global quantitative easing has taken hold and both U.S. and global GDP growth should accelerate in 2018, providing the underpinning for continued top-line revenue growth for U.S. high yield issuers. Animal spirits could get a further boost if the House and Senate can pass a reconciled tax reform package that lowers the U.S. corporate tax rate to 20%. Another likely feature of the tax bill is a cap on the deductibility of interest expense, which theoretically incentivizes companies –particularly more indebted high yield issuers - to use less debt when funding acquisitions or capital spending. This may further the recent trend we've already seen of deleveraging among the high yield universe, led by the energy and metals & mining sectors. With the commodity-driven default cycle now clearly in the rear view mirror, we anticipate the high yield default rate staying in the 2-3% range, below historical averages.

Turning to high yield market technicals, we expect the picture to dim slightly in 2018. On the back of stronger economic growth and tax reform, we would expect elevated corporate confidence in 2018, which likely results in a pick-up of M&A activity and also high yield issuance. Whereas the predominance of this year's issuance has been used to refi existing debt, next year could see a jump in net new supply. We think this supply can be easily absorbed in the context of a global investment universe still starved of yield, but U.S. high yield may see more competition in 2018 as central banks take their foot off the gas pedal by slowing or reversing their quantitative easing programs.

Having now covered fundamentals and technicals, let's turn to valuation. The Bloomberg Barclays U.S. Corporate High Yield Bond Index currently yields 5.7% with an average spread of about 350 basis points, about 60 basis points tighter on the year. This is a good starting point for thinking about potential return outcomes in 2018, essentially setting the baseline for our original "over/under" question. We think the primary challenge to a high yield return above 6.5% is higher underlying Treasury rates in 2018. Admittedly, forecasters have been calling for higher rates for several years now and been wrong. What makes 2018 different? The short answer – Fed policy, both winding down its balance sheet and raising its benchmark rate possibly as many as four times this year, if certain forecasts are to be believed.

With a supportive fundamental backdrop described earlier, we anticipate that high yield spreads can contract some next year to partially offset the negative impact of higher Treasury rates. But as regular listeners will know, high yield spreads are already tight on a historical basis. At about 350 bps today on the Bloomberg Barclays U.S. Corporate High Yield Bond Index, spreads are just 25 basis points wide to post crisis lows; single- and double-Bs are even closer to recent tights. Therefore, our bet is that high yield returns come in somewhat below the starting yield in 2018; it could be a good year in high yield, but probably not as strong as 2016 and 2017.

Lastly, we don't want to sign off without pointing out a few risks that we're thinking about as the calendar turns. First, we think the lower-rated segments of the market could see some challenges in the coming year. That bucket of high yield is more heavily exposed to secularly-challenged industries, including a few that we've mentioned on the podcast before like retail and wireline telecom. Even with faster economic growth, we expect these industries to continue struggling. Additionally, the aforementioned tax reform could negatively impact highly-leveraged credits to the extent capping their use of interest deductions pressures cash flow. Second, volatility has been extremely low in 2017, thanks in part to the Fed's quantitative easing program. Given the number of uncertainties out there – whether they be around geopolitical instability, shifting central bank policy or potential spillover effects from distressed industries – we shouldn't be surprised to see volatility increase in the year ahead. But as long as the fundamentals appear favorable, we think high yield investors will use those moments as opportunities to put money to work.

Thanks for listening, best wishes for 2018, 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@tortoiseinvest.com.

The Bloomberg Barclays US Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below. Bonds from issuers with an emerging markets country of risk, based on Barclays EM country definition, are excluded.

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