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.

Brad Beman: Hello everybody, I'm Brad Beman, CEO of Tortoise Credit. I'd just like to thank everybody for joining us for our year-end QuickTake Podcast. I'm joined today by the Tortoise Credit senior portfolio management team of Graham Allen, Jeff Brothers, Greg Haendel and portfolio manager John Heitkemper. We're going to discuss recent trends and our outlook for 2018. With that said, let's get started talking about the most topical thing in the market today which would be tax reform. Greg, could you make a few comments related to the current tax reform bill.

Greg Handel: Absolutely, thanks Brad. We believe corporations will be the major beneficiary of tax reform, industry and company dependent, although we expect much of the benefit to accrue to shareholders and not debtholders. Also tax reform may extend the length of the business cycle. Briefly walking through each of the proposed changes, the reduction in the top corporate tax rate from 35% to 21% should help industries with high effective tax rates such as telecom and banks, improve bottom line corporate free cash flow, reduce the attractiveness of debt financing and potentially increase M&A activity. The reduction in the pass through business rate to the low to mid 20% range, should be positive for REITs and MLPs as it should lower the cost of equity capital. The accelerated expensing of capex to 100% in the year spent for the next five years, should help industries with high capex spending such as energy, telecom and cable, should result in increased debt issuance to finance capex, should also help providers of capex such as industrials and tech companies and may incentivize a boom/bust investment cycle. The required repatriation of foreign profits at 15.5% on liquid assets and 8% on illiquid assets, helps companies with high levels of overseas earnings such as tech and pharma companies, could reduce debt issuance needs in those sectors, could also result in potentially more M&A activity or money spent on dividends and share repurchases in those sectors which could also erode the credit profile of companies as that cash is drawn down, and could also result in some selling pressure on short maturity fixed income assets. The 100% tax exemption on active foreign profits going forward, is a movement toward a territorial tax regime that would allow U.S. companies to invest overseas at a local tax rate without the burden of U.S. taxes, and also encourage U.S. companies to bring profits back home. Other international nuances attempt to dis-incentivize the creation of shell companies and tax-advantaged jurisdictions and prevent tax inversions. The limit on net interest deductions to 30% of EBITDA excluding utilities and real estate for the next 5 years and 30% of EBIT five years hence forward, we believe reduces incentive for leverage for companies, could hit some highly leveraged parts of the high yield market, but will have minimal to no impact on the investment grade credit market and could result in increased volatility of highly leveraged companies, as any decline in EBITDA or increase in interest expense could force the loss of some interest deductibility when companies need it the most. Lastly, we expect tax reform to result in increased U.S. Treasuries debt issuance to finance the deficit.

Brad Beman: Thanks Greg for that great outlook on tax reform. With that as a backdrop, Graham can you spend a few minutes talking to us about the U.S. and global economic outlook?

Graham Allen: Sure thanks, Brad. I think these tax cuts are very noticeable because as you can see by the world reaction of the markets it's really the first big fiscal package that we've seen globally for some time. The present coordinated global recovery that's going on has really largely been stimulated by monetary policy and low interest rates for the last six or seven years. And with the introduction of the fiscal package it could encourage other countries to do the same and as a result continue this credit cycle. With regard to the U.S., we do believe that the cycle could continue and certainly if this tax package passes, because growth rates in GDP since 2009-2016 averaged 2.1% in the U.S. That's well below the normal recovery rate of between 3-4% that we've seen after past recessions. Beginning in 2017, growth began to accelerate so third quarter GDP was finally reported at 3.3% and the expectation is even without the effects of the tax cuts we could see growth somewhere between 3-4% for the fourth quarter of 2017. Looking forward to next year, specifically in the U.S., we do continue to see the cycle evolve throughout the year. We expect growth to be higher than 3% in 2018. The deficit result will probably initially rise but depending on government spending and tax receipts should fall as it did similar to what happened in the 80s. So we do continue to see the U.S. growing next year. The tax cuts will be positive for growth. Valuations are very high, but we do expect more healthy markets certainly in the equity markets. On the bond markets, it all depends on what the Fed does. I think the perception right now is that the Fed is probably ahead of the curve a little bit, so we do expect more interest rates hikes from the Fed during 2018 as growth evolves.

Brad Beman: Thanks Graham. Certainly with the higher potential growth rate in the U.S. and globally, we should talk about inflation expectations, the current interest rate environment and other thoughts related to the Fed. Jeff, I'm going to turn it over to you to have that conversation.

Jeff Brothers: Sure, thanks Brad. Just starting with the Federal Reserve. To recap, the Fed continued on its path of gradually reducing accommodation in the U.S. economy over the past year with three rate hikes. And they also began this process of reducing their balance sheet. Our view for 2018 is a little bit more of the same. A couple of things we'll be closely watching. First is we do have a new composition on the Federal Reserve with the new Chairman, Jay Powell. Actually a very different background than the outgoing Chairwoman Yellen. We should also get two new members to the board. So at least initially we think policy will be status quo, but it will be interesting to see how the new leadership and new members on the board adjust to the changing environment in the U.S. economy. The other thing we'll be watching closely in terms of the Fed is this disconnect between Fed rate hikes and the absence of inflation. That is an important disconnect that will be resolved in 2018. Will it be resolved with inflation finally moving up to meet the Fed's expectations or will the Fed have to halt or back pedal from their current rate hike cycle with the view that the low inflation environment is more structural? At Tortoise Credit Strategies we expect two rate hikes in 2018 which is slightly less than the Fed's three hikes coming from the recent dot plot. Just to follow up and talk about inflation. Inflation continues to be surprisingly and stubbornly low here in the U.S., really despite the improved economic growth and the low unemployment rate. Inflation remains well below the Fed's target of 2% for PCE inflation. Our view, however though is that we are going to see in 2018 the beginnings of an increase or uptick in inflation really based on a couple of factors. First, as Graham mentioned, we do expect continued momentum in the U.S. and global economies that should reduce the slack in the U.S. economy, and put pricing pressures into the inflation outlook. Also we expect continued improvement in the labor markets and eventually do expect that to start to filter through into higher wages, again putting some pressure on prices here in the U.S. We also expect a continuation of the commodity upswing and perhaps the weaker dollar from this past year could put pressure on prices. Then lastly, I would follow-up back again to the tax reform. That does have the potential to be inflationary to the U.S. economy especially given that the economy already has pretty strong momentum and is close to operating at full capacity so this additional fiscal stimulus could potentially put some pressure on prices. So our outlook is it's going to be a gradual increase in inflation in the U.S. over the course of the next year or two. I guess, putting it all together, the growth, the Fed, inflation outlook and wrapping it up in terms of our interest rate view, we continue to have a view that rates here in the U.S. are going to be moving modestly higher over the next year. We are targeting 2.75% yield on the 10-year. Today we're at around 2.40% yield. Again, three main reasons for viewing pressure on rates. First, as we mentioned, the improved global picture in terms of economic growth, not just here in the U.S. but also around the world. Really the first time in quite awhile we've had a synchronized upswing in growth and that should put pressure on rates in the U.S. Along the same lines, we see a shift continuing from the easy monetary policy following the financial crisis, to more restrictive policy around the globe. Obviously in the U.S. we've already begun that process, but tighter monetary policy should put pressure on rates. And then really the last missing piece of the puzzle is this inflation outlook, and as I mentioned we do expect inflation to be gradually moving higher so that would be another factor to look for, for higher rates.

Brad Beman: Thank you Jeff. Now with the backdrop that we have already laid out for the economic outlook, inflation, interest rates and the Fed, I think it's time that we dive in and get a little bit more granular in our look at the individual asset classes. Greg, I'm going to turn it over to you to give a quick overview of the broad corporate investment grade credit market.

Greg Haendel: Absolutely, thanks Brad. As an investment grade recap, 2017 ended up as a very strong year for investment grade (IG) credit from a performance standpoint where this was driven by improved top line earnings fundamentals, especially in commodity-related companies, strong technical demand from non-U.S. buyers, as well as retail buyers and hopes for a better business environment coming out of Washington. Excess return for IG for the year was in excess of 300 basis points, driven by spread compression and lower rated credit and longer duration credit. Notable industry outperformance in metals& mining, energy and building products where there was notable industry underperformance and telecom, cable and retail. As we end 2017, general IG credit valuations are reaching a post crisis spread tight and they are near the last several cyclical tights over the last couple decades. Looking into 2018 at the IG credit markets, the best word to describe our outlook is lukewarm. From a fundamental perspective, we see strong top line earnings, however also stretched balance sheets. Top line earnings continue to improve and there are potential headwinds from tax reform and decreased regulation. However, year over year comparisons may be a bit challenged. From a credit standpoint, we expect a balance sheet leverage to remain at near multi-decade highs, and debt is expected to grow as fast as EBITDA as most of the benefits from improved earnings and tax reform flow to the shareholders in the form of M&A, share buybacks and dividends. We also expect late cycle credit behavior in many industries but not all, where shareholders are the main focus. From a technical perspective, we see things as mixed and could worsen in the second half of 2018. We expect new issuance to modestly increase versus 2017 as a result of increased M&A activity, despite a slow-down in issuance in some industries as a result of tax reform and specifically repatriation.

As the pace of tapering picks up in the second half of 2018, we expect the total supply of investment grade assets; U.S. Treasuries, mortgage backed securities and investment grade corporates, available to substantially increase. On the demand side, we expect continued foreign demand, as long as the U.S. markets remain substantially higher in yield than most other developed markets like continental Europe and Japan. In 2017, we saw strong retail flows, however we don't expect 2018 retail flows to remain quite as strong. Also, pension and insurance company demand for long maturity bonds should be strong as rates rise. Although short maturity demand may suffer as cash rich companies liquidate some of their portfolio as a result of repatriation. In sum, technicals should remain decent early in the year, but could crack in the second half of 2018 as a result of Fed tapering and asset rebalancing combined with robust new issuance. From a valuation perspective, we are at a post crisis spread tight for the market and for the investment credit market in general. However, we are still modestly cheap versus the early 1997 and 2007 cyclical peaks, but less so when adjusting for the lower credit quality and longer duration of the market today. Also, we are still cheap on a yield basis versus local currency denominated investment alternates in continental Europe and Japan, but less so when adjusting for a currency hedge. Luckily there are still several industries that remain cheap to their post financial crisis spread tights. In sum, the lukewarm investment grade credit corporate market outlook is based upon relatively strong earnings fundamentals, offset by stretched balance sheets, positive yet questionable forward-looking supply/ demand technicals and full valuations from a historical standpoint, yet still attractive versus global alternatives. As such, we believe it's best to stay close to home in our investment grade credit allocation, and concentrate on generating alpha through industry and name selection, while remaining nimble and proactively managing overall credit risk.

Brad Beman: Thanks Greg for that in depth look on the Corporate IG credit market. Now I'm going to turn it over to John Heitkemper to give an outlook on levered finance for the firm.

John Heitkemper: Thanks Brad. Many of the points I'll hit on I think are similar to what Greg just went over in the IG market. Let me start by just saying a few words about 2017. It's been a solid year for high yield. Returns are likely to come in around 7 .25 % for the full Bloomberg Barclay's High Yield Index. That is led by CCCs which have had a nice year up about 9.5%. BBs and Bs have put up more modest numbers at about 7% and 6% respectively. And about 350 basis points over, spreads are going to end the year about 60 basis points tighter.

We came within just a few basis points of the post-crisis lows back in October, but we are still more than a hundred basis points wide of pre-crisis tights. Leveraged loans have lagged the high yield market this year, with returns just short of 4%. And that's really due to significant repricing activity that's essentially capped the upside on prices. Outside of a few industries that are struggling, and we've gone over some of those in prior podcasts, the fundamental picture was largely positive in 2017. We saw a rebound in the commodity sectors; energy and metals & mining that's driven the high yield default rate down under 2%. And that's about 3% lower than the peak back in May 2016. Similarly, if you look at aggregate credit metrics, you can see that leverage has been coming down. If you take out those commodity sectors however, the rest of high yield issuers are actually seeing leverage increase, which is a little troubling at this point in the credit cycle.

So turning to 2018, we think it's going to be a little bit of a challenge to meet or exceed 2017 return numbers for high yield. We think single digit returns are probably more realistic given that we're starting from a lower yield level, just inside of 6%. And we expect a modest back-up in underlying Treasury rates. There is room for some spread tightening to offset higher rates, but we wouldn't be surprised to see more volatility in spreads after they traded in a very narrow 85 basis point range last year. In loans, we think returns could be in the same ballpark as high yield, maybe a bit lower if repricing trends continue. Loans, however, should benefit from higher rates, assuming that Libor continues to move up as the Fed raises rates. Our thoughts on high yield spreads grinding tighter is underpinned by expectations for continuation of favorable economic growth, both in the U.S. and globally. Most sectors, we expect to see solid top and bottom line growth. And we think defaults will remain muted, although certain sectors like retail may see more bankruptcy filings in 2018. Given the length of the credit cycle, we are paying close attention to late cycle behavior by companies, including more aggressively levered balance sheets, weak covenant protections and frothy M&A multiples.

Back to the tax reform story, we could see another big year of new issuance in 2108, but we'd expect more of a tilt towards other uses such as M&A, particularly if tax reform pumps up confidence in corner offices. Although the phrase is probably overused by people in our markets, it does seem to us that 2018 is setting up to be a credit pickers market. There's lots of negativity priced into bonds and the beaten up sectors like retail, healthcare and wireline telecoms. So picking a winner in one or two of those sectors could make a big impact on performance when yields in most other sectors are pretty low. Conversely, you don't want too many misses as bond prices can drop precipitously when a bond falls out of favor. We think the environment should favor managers like ourselves that are nimble and have a focus on thorough, independent credit research. Back over to you Brad.

Brad Beman: Thanks John. And now back to Jeff to talk about the broad securitized asset class. Jeff, take it away.

Jeff Brothers: Great. In the securitized products, we had strong performance over the past year. Probably the one exception though would be agency mortgage backed securities which only modestly outperformed U.S. Treasuries and agency MBS was held back by rich valuations and some concerns throughout the year about the Federal Reserve's balance sheet runoff. In general though, the securitized products benefitted from solid fundamentals, whether it was the improvements in residential housing, or commercial real estate, or in the asset backed sector, the fundamentals for consumer finance. The technical environment also benefitted securitized products. In general we had modest supply and that was easily absorbed by strong demand from investors for high quality yield in the securitized products. The big issue for our sectors has been the valuations in much like other sectors within the fixed income markets, the valuations in the securitized markets are ending the year at historically tight levels.

Turning to the outlook for next year, I think the overarching theme for us is to be a little bit more defensive and cautious, and that's mainly due to what we view as valuations stretched to the extreme. Just kicking off the major sectors here; agency MBS, we continue to be underweight that sector primarily because of valuations, but also some concerns as we get into the second half of the year in terms of supply and also the build-up in terms of the run off from the Fed's balance sheet could put pressure on agency mortgages. In the commercial mortgage-backed sector, in our minds there just very little reward left in the sector and very little upside potential in commercial mortgage backed securities. So we'll continue to be selective in our investments within that sector. And lastly, the one area that we do continue to be positive on would be the asset-backed sector. Asset backs are definitely benefitting from the fundamental improvements on the consumer side. This sector also tends to be a short maturity; high quality sector where we view the benefits of incremental yield over treasuries is the sector that we want to be in. We also expect a pretty modest supply in the asset-backed sector and again there is strong demand in the short maturity spectrum of the fixed income, and we think that will continue to benefit the overall ABS sector.

Brad Beman: Thanks Jeff. I'd just like to take a minute to wrap up everybody's comments into Tortoise Credit's house view and outlook for 2018. I think really it can be boiled down into three general comments; continued strong global and U.S. economic outlook and backdrop. I think the second comment that we would make is we expect modest increases in inflation and interest rates and continued progress by the Fed on the front end of the curve to continue to move rates diligently and cautiously higher. And then last but not least, in spite of what I think everybody would characterize as relatively tight valuations; probably and lower return expectations for 2018 across asset classes, we would expect a continued favorable environment for selective risk assets. Of course, what could go wrong is the common question that always gets asked. There's probably a couple key risks as we think about our outlook for 2018. The first key risk that we would reference is a policy error. The error that the Fed actually continues to progress and move rates higher in a fashion that isn't characteristic or supported by the inflation data and causes the economy to slow down. That would be probably one of the key risks. Global growth does not materialize as expected. I think the general consensus outlook across the market is continued strong global economic outlook or synchronized growth across the globe, in some way, shape or form that wouldn't materialize as expected. And probably last but not least, some sort of geopolitical event that could cause disruption in the marketplace.

With that, I just want to thank everybody for taking the time to listen to the 2017 Tortoise Credit podcast year-end wrap-up. Specifically, I want to thank Graham, Jeff, Greg and John for contributing to the podcast. And thank everybody and wish everybody a Happy Holidays. Thank you.

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.