Tortoise QuickTake Credit Podcast

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Welcome to the Tortoise QuickTake podcast. Thank you for joining us. Today, senior members of Tortoise provide 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.

Summer comes to an official end at our house this week as the girls head back to school. Finally. In a late – and futile – bid for Dad-of-the-Year honors, I took them back-to-school shopping recently. The good news is that it turns out shopping malls are not completely dead; the bad news is that most stores for tweens don't have couches for worn out dads. While I suffered through aisle after aisle of seemingly inappropriate school attire, the who's who of central banking convened in Jackson Hole last week for their annual summer camp, tossing aside pocket protectors for cowboy hats and other western garb.

Fed Chairman Powell's speech on Friday highlighted the gathering and offered his first public comments since the FOMC released somewhat dovish minutes from its August meeting. In his speech, Powell pretty much stuck to themes he's been communicating for some time: namely that U.S. economic growth is and should remain strong, and as long as there aren't shocks (think an emerging markets or trade crisis) or a turn in the economic data, the FOMC will continue along its gradual tightening path.

To bond market participants and Wall Street economists, the takeaway is that the next rate hike is almost surely a lock for the September meeting, with another likely to follow in December. With those two hikes to close out 2018, the FOMC will have raised rates a total of nine times this cycle, with potentially more to come in 2019. We think one natural question at this point is whether the Fed's tightening policy is influencing the economy. In a prior podcast, we covered part of the impact on the consumer side, specifically how higher mortgage rates are contributing to housing affordability issues and as a result, to the tepid macro housing data of late. What about on the corporate side, particularly the more indebted issuers in the high yield and leveraged loan markets? Are they being squeezed as rates move higher?

One of the best ways for thinking about a company's ability to handle its interest burden is comparing EBITDA, a proxy for cash flow, to interest expense; investors call this the interest coverage ratio. A trend that has been very noticeable in the leveraged finance world for the last few years is companies increasingly raising capital by issuing leveraged loans, which are floating rate and in strong demand by investors that are concerned about rising rates. Highly leveraged companies that need to raise debt funding naturally want to go where demand is strong, which of late has resulted in an increase in leveraged loan issuance and a decline in borrowing in the high yield bond market. So with borrowers' increasing reliance on floating rate debt, have the FOMC's rate hikes caused a weakening in the interest coverage ratio of highly leveraged borrowers?

The short answer is no, or at least not yet. In fact, it turns out that during the time that the Fed's been raising rates, interest coverage metrics have actually improved significantly. According to Goldman Sachs, the average interest coverage ratio for issuers in the LSTA Leveraged Loan Index improved to 4.4x as of the second quarter of 2018 from about 3.7x in 2016 and a cyclical low of 2.6x coming out of the last recession in early 2009. During this time, improved profitability and debt reduction, particularly by energy and other commodity-related issuers, drove the improvement in interest coverage, significantly outweighing the negative impact of higher interest rates.

A similar analysis by BofA Merrill Lynch, which included non-financial corporate issuers across investment grade, high yield and the leveraged loan markets, also found that interest coverage ratios are driven primarily by earnings and much less by Federal Reserve policy. Current coverage metrics are higher now than in December 2015, when the FOMC hiked for the first time this cycle, as earnings growth more than offset elevating interest costs. The BofA work suggests that it takes about three years for Fed Funds rate increases to fully materialize in high yield coupons, while changes in corporate profitability have a more immediate impact. The message here, we think, is that high yield credit fundamentals are currently in good shape and able to withstand continued rate increases as long as the economic backdrop is favorable for earnings growth.

That's not to say there aren't reasons to be cautious in high yield. On the technical side of the picture, high yield bond issuance has been noticeably light this summer, creating solid demand for bonds in the secondary market. As a result, high yield spreads are once again trading at the low end of the recent range and not too far off of post-crisis tights. We'll see if spreads can remain firm post Labor Day, when issuance is slated to pick up as several large M&A and LBO transactions seek debt funding. If the recent past is a guide, any softness in high yield could bring out more buyers looking to add credit. My daughters are not the only ones looking for good deals, after all.
Thanks for listening and please tune in for future Tortoise credit podcasts.

The S&P/LSTA Leveraged Loan Index is a market value-weighted index designed to measure the performance of the U.S. leveraged loan market based upon market weightings, spreads and interest payments.

Narrator: 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.