Tortoise QuickTake
Credit Podcast

Tortoise

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Narrator: Welcome to the Tortoise Quick Take podcast. Thank you for joining us. Today, senior members of Tortoise provides a timely update on trending topics in the market.

Brad Beman: Hello everybody, I'm Brad Beman, Chief Investment Officer at Tortoise Credit. I would 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 are going to discuss recent trends and our outlook for 2019. During 2018, we saw a significant pick up in volatility from previous years as trade tensions increased, global growth slowed and the Fed became more engaged in a disciplined path to higher rates. Additionally, the market is becoming increasingly worried about the timing of the next recession. With that said, let us get started talking about where we are going in the economy and any specific trends we see in global and U.S. growth. Graham, can you spend a few minutes discussing your outlook from the macro side for both the U.S. and Global economies.

Graham Allen: I think there is clear evidence of a general slowdown in growth outside of the U.S. Generally, world growth forecasts have been slightly cut to around +3.5% for 2019 and 2020, respectively. There are various reasons for this. China is beginning to feel the effects of the existing trade tariffs already imposed by the U.S. The threat of future tariffs is also affecting business confidence in China and the US. Recent stimulus by the Chinese government has had a limited effect on growth.

European data is also slowing reflecting the withdrawal of European Central Bank stimulus, as well the constrictions of the European rules on fiscal deficits. This has increased political instability which is further exacerbated by the uncertainty of current Brexit negotiations. That said, an imminent European wide recession is not expected in 2019. Surprisingly some emerging market countries, after a period of currency depreciation are experiencing a better economic outlook next year.

We believe in the U.S., a slowing economic growth scenario is likely but is not as pronounced as elsewhere. As the effects of the tax cuts diminish, corporate earnings and sales are likely to slow in the new-year. Record low unemployment and strong wage growth will ensure that U.S. economic growth remains firmly positive. Our present forecast is for 2019 U.S. GDP of +2.7%.

Brad Beman: Thanks Graham. Jeff, given that we expect growth to slow, albeit modestly, can you give us your thoughts on inflation expectations, interest rates and the Fed?

Jeff Brothers: Sure. Given the macro outlook Graham just described, we expect only modest inflation pressures in 2019. Core inflation measures have stabilized around the Fed's 2% target, but capacity constraints still exist in the U.S., especially in the tight labor markets. One thing to keep a close eye on is the market expectations for future inflation from the TIPS market, which have fallen dramatically over the past two months. Our view on the Fed is that they will raise rates tomorrow and then pause in March. We believe that slower economic growth and stable inflation will give the Fed cover to pause and then only raise one more time in 2019. Lastly, the interest rate forecast that comes out of our big picture view is that rates are still modestly biased higher. The combination of the U.S. economy slowing, but still growing above trend and the heavy treasuries supply to fund the growing budget deficit should keep rates on a gradual path higher.

Brad Beman: Thanks Jeff. Well with that backdrop, it looks like it might be an interesting year for risk assets. Greg, could you spend a few minutes discussing your outlook for IG credit and any opportunities you see in the market place. John, if you could follow with your thoughts about high yield and leveraged loans as spread volatility has not been isolated to just the IG credit markets.

Greg Haendel: Thanks Brad. Our 2019 IG Corporate Credit Outlook in general remains defensive, consistent with our 2018 outlook, although select opportunities still exist.

From a fundamental standpoint, we expect positive yet decelerating revenue and earnings growth (given our decelerating global and U.S. growth outlook), some margin pressure and a continuation of corporate behavior returning cash to shareholders at the expense of the debt holder. Further, balance sheet leverage and corporate debt remain near cyclical peaks although this phenomenon is concentrated in a handful of industries and issuers as opposed to the entire IG market.

From a technical standpoint we expect IG corporate credit issuance to decline 5-10% in 2019 although competing supply of treasuries and agency MBS from increased deficit funding and the Fed's quantitative tightening could crowd out demand for IG credit. We expect foreign buying to remain tepid given prohibitively expensive foreign currency hedging costs. We expect retail demand to be focused primarily on short maturity credit at the expense of intermediate and long maturity, although we do expect insurance and pension demand to modestly pick-up given the increased attractiveness of yields.

Valuations have significantly improved over the course of 2018 from the cyclical spread tights reached on February 1st, 2018. However, IG corporate credit spreads are now only back to the average spread level over the last 8 years and still marginally rich versus the 25-year average. Given the fundamental headwinds previously identified as well as the continued technical supply demand imbalances, we believe that corporate credit spreads in general must further widen in order to compensate for the various headwinds. The rapid sell-off in credit spreads that has occurred during Q4 could prompt a tactical short-term improvement in credit spreads early in 2019 although we believe this will be short lived. However, we believe valuations and total return prospects do look attractive within short maturity corporate credit as well as in some higher credit quality issues and a handful of long maturity corporate bonds that are trading with a dollar price in the 80's or lower. Further, we believe there are select issuers and industries whereby credit spreads already fully compensate for their perceived risks.

John Heitkemper: On the high yield and leveraged loan side, we see some similar themes to investment grade credit. Certainly, weaker economic growth and an earnings slowdown will be optical challenges, at a minimum. That being said, in contrast to the IG market, we've seen high yield issuers continue to bring leverage down over 2018. That trend is readily apparent in new issue stats for 2018, which will likely end up being down close to 40% year-over-year. At this point, it looks like 2019 could be another slow year for deals, so the technical picture likely remains relatively firm. But if we're right that the Fed's balance sheet unwind crowds out IG corporates and pushes those spreads wider, it's hard to see investors get too enthusiastic about high yield unless it offers an attractive pick up for the incremental credit risk. As Greg just mentioned, valuations are definitely more attractive, as we've obviously seen high yield spreads and yields go wider over the past few months, and we do think it makes sense to position for more volatility in 2019, given the uncertain macro backdrop and a somewhat questionable Fed path. We don't seen an imminent end to this cycle, but on a sector level, we think it's prudent to start positioning more conservatively. Just to touch on one key high yield sector, with oil now trading right around $50/barrel, the energy sector is once again front and center for high yield investors. Our house view is for oil to trade in the $55-65 range, which could mean there are some attractive opportunities on beaten up credits. Lastly, just a couple thoughts on the leveraged loan market, where we've seen a number of negative headlines recently. Yes, the recent vintage of LBO deals is highly leveraged and void of many standard credit protections, but the loan market still offers opportunities to move up in the capital structure of reasonably leveraged credits without giving up much yield relative to high yield. We would not be surprised, however, if demand for the asset class slows in 2019 if CLO issuance slows and a potential end to Fed tightening reverses flows to floating rate funds. With the recent volatility, it's certainly setting up to be an exciting 2019 for the leveraged finance market.

Brad: Thank you for your observations Greg and John. Jeff, while credit volatility has been more substantial in 2018 it appears that most securitized sectors have seen more moderate spread volatility. Could you shed some light on that issue and tell up where you see value?

Jeff Brothers: Yes, the securitized markets continue to benefit from their high quality, strong liquidity and shorter average maturities and we expect more of the same next year. We are still defensive on the agency mortgage market where the heavy new supply and the Fed's portfolio runoff will probably pressure spreads wider. We remain positive both the ABS and CMBS sectors where solid fundamentals and positive supply and demand technicals support current valuations.

Brad Beman: Thanks Jeff. I would just like to take a minute to wrap up everybody's comments into Tortoise Credit's house view and outlook for 2019. Our view can be thought of in three general areas; first continued strong but slowing global and U.S. economic growth. Second, we expect mixed inflationary signals and look for interest rates to migrate modestly higher for 2019 with a target of 3.3% on the ten year. Lastly, as it relates to the Fed, we expect them to reflect a more cautious mindset towards their aggressive rate policies and while the market may be too bearish in reflecting only one rate increase next year, our house view is closer to one to two. Finally, in spite of valuations becoming more attractive, we remain cautious and see only select tactical opportunities to add risk in the portfolios.

What could go wrong? The key risk relates to a policy mistake, either by the Fed or from the government. Given the large disconnect between the expectations in the market on the Fed outlook and the current dot plot I can imagine there is significant room for disappointment. Additionally, the lingering risk that growth slows more than modestly and pulls forward a recession sooner than expected remains on the list of concerns for 2019.

With that, I just want to thank everybody for taking the time to listen to the 2018 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@tortoiseadvisors.com.