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 the weekly Tortoise credit podcast. I'm Greg Haendel, senior portfolio manager at Tortoise. What a difference a year makes. At this time last year, the investment grade corporate credit market was euphoric with the index spread level setting a cyclical and post financial crisis spread tight. At that time, although there were several clouds on the horizon, the market showed irrational exuberance and chose to let "FOMO" (fear of missing out) dictate valuation as opposed to a balanced analysis of fundamentals, technicals and valuations. Fast forward to the beginning of 2019 and the market is now, to some degree, factoring in many of these clouds on the horizon within investment grade credit thereby representing a more balanced valuation. However, as we all know, the markets tend to overshoot fair value in both directions. In today's podcast we will briefly discuss some of these market clouds as well as a couple of industries that have overshot fair value.

As 2018 came to a close, there was no shortage of clouds on the horizon. Front and center, the trade war with China reared its head in corporate revenue growth as well as within some corporate input costs while little progress to a resolution was in sight. Further, both U.S. and to a greater extent global growth appeared to have peaked with some deceleration imminent which also weighed on corporate earnings. Adding fuel to that fire was a U.S. Federal Reserve that was believed to be on autopilot with regards to increasing short-term interest rates and shrinking their balance sheet. Outside the U.S., the European political environment remained volatile while the deadline for Brexit quickly approached with no clear resolution in sight. Other notable clouds during some of 2018 included the Mueller investigation, the government budget debate, a volatile oil market, excessive IG corporate leverage and a couple of large and notable companies rapidly deteriorating, specifically Pacific Gas & Electric and GE.

Some of these clouds on the horizon have since dissipated while others have become darker. As Jeff Brothers discussed in last week's podcast, the Fed took their communication mulligan and reflected a more dovish and data-dependent policy outlook as opposed to one on autopilot. While certainly a market positive as it relates to interest rate policy, the Treasury and MBS supply overhang and the resulting crowding out behavior remain as we still believe there is a very high bar to stopping the Fed's balance sheet shrinkage in the near future. On the oil front, the recent OPEC supply cut finally appears be making its way through the supply channel thereby supporting oil prices. However, storm clouds remain prevalent to some extent around virtually all of the other issues identified.

Index valuations within investment grade corporate bonds widened by 60 basis points over the course of 2018 according to the Bloomberg Barclays U.S. Corporate Bond Index from a level near the cyclical spread tights to a level consistent with the average spread level over a 25 year period. To put credit spread levels in context, investment grade credit spreads at the end of 2018 were still roughly 60 basis points tighter than the index spread level reached in February 2016 which was also a level typically associated with a recession. Given that we do not forecast a recession in the near term, we believe that index valuations within investment grade corporate bonds more properly reflect several of the clouds on the horizon.

Despite the improvement in the overall index valuation, some investment grade corporate industries and issuers reflect minimal valuation change after reaching the cyclical credit spread tights while other industries and issuers reflect valuations typically seen in recessionary environments. Specifically, cyclical industries such as automotive, aircraft lessors and home builders and building products reflect valuations closer to those experienced during recessions while industries such as waste management services, transportation services (Fedex and UPS) and taxable municipal bonds have valuations closer to their cyclical spread tights.

On the side of attractive investment grade industry valuations, index spreads within the automotive industry widened 110 basis points during 2018 with valuations ending 2018 only 10 basis points tighter than their post financial crisis cyclical peak reached in February 2016. Worries over a global economic slowdown, the impact of the trade war and a feared downturn in the automotive SAAR all contributed to what we believe to be a market overreaction in automotive industry valuations. More specifically we believe the bond valuations for General Motors are excessively wide despite their low leveraged balance sheet and corporate initiatives to navigate the potential storm ahead. The home builders and building products industry index spreads are over 90 basis points wider in 2018, yet still 60 basis points tighter than the post financial crisis cyclical peak. However, some issuers, such as Owens Corning, are valued at levels near the cyclical peak. A fear of a severe U.S. economic slowdown, a pullback in foreign buying of U.S. real estate and worries over higher interest rates and the associated effect on the housing market have all resulted in what we believe to be an overreaction in valuations within the industry and more specifically with some select issuers. Lastly, index spreads for the finance industry portion of the credit index, which primarily represents aircraft lessors, were 129 basis points wider in 2018 and only 2 basis points tighter than the cyclical peak reached in February 2016. Fear of a global economic slowdown, the fallout from the bankruptcy of Brazilian airline Avianca and most notably a large bond supply overhang from a likely sale of General Electric's aircraft leasing business have all weighed on industry credit spreads although we now believe valuations more than compensate for these risks.

On the side of minimal valuation upside, the foreign local government portion of the credit index, primarily taxable municipal bonds, was only 15 basis points wider in 2018 and is 46 basis points tighter than their post financial crisis cyclical peak in February 2016. A significant portion of this index is weighted to the general obligation finances of California and to a lesser extent Illinois; both of which have experienced financial problems in the past. The transportation services industry, primarily Fedex and UPS, were 46 basis points wider in 2018 yet are 50 basis points tighter than their post crisis cyclical peak and 25 basis points tighter than the corporate index as a whole. The transportation services industry has benefited from the move toward e-commerce shopping, however, any significant global growth slowdown or hit to U.S. consumer spending would have a pronounced effect on this industry. Lastly, the environmental industry, primarily waste management services was 37 basis points wider in 2018 yet still over 50 basis points tight to their post crisis cyclical peak despite what some believe is an overleveraged, yet non-cyclical, industry.

In summary, there are still some large clouds on the horizon, some of these clouds may not disappear anytime soon, and some may even turn into large storms although we are not forecasting a recession in the near future. Unlike one year ago, valuations today within the investment grade corporate bond index reflect some of the clouds on the horizon. Within a handful of industries and issuers, valuations already reflect a full storm as opposed to clouds on the horizon while a handful of other industries reflect nearly clear skies leaving little room for a forecasting error. At Tortoise, we believe that actively managing our sector, industry and security selection allows us to both exploit opportunities where the market overshoots fair valuation and avoid the pitfalls where the market underprices the clouds on the horizon.

Thank you for listening, we'll talk to you again next week.

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.

The Bloomberg Barclays US Corporate Bond Index *measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD-denominated securities publicly issued by US and non-US industrial, utility and financial issuers. The US Corporate Index is a component of the US Credit and US Aggregate Indices, and provided the necessary inclusion rules are met, US Corporate Index securities also contribute to the multi-currency Global Aggregate Index. The index was launched in July 1973, with index history backfilled to January 1, 1973.*

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