Tortoise

# Tortoise QuickTake Podcast

December 5, 2017

**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.**

Hello and welcome to the Tortoise Credit Strategies weekly podcast. I'm Greg Haendel, one of the Senior Portfolio Managers on the investment team at Tortoise Credit Strategies.

When I assign one word to describe my outlook for the investment grade corporate bond market in 2018, "lukewarm" would be that word. Further, as I think about how an investor within investment grade corporate bonds can generate alpha given our "lukewarm" outlook for 2018, words such as nimble, tactical, proactive, measured, and active industry and security selection (as opposed to passive strategies) come to mind. Further, performance in today's fixed income markets are as much about having the right call as having the right timing given the post crisis reduction in financial market liquidity. In today's podcast, we will briefly review some of the market highlights over the past week followed by a review of our 2018 investment grade corporate bond outlook.

Over the past week, post the Thanksgiving holiday, market-related news centered around the Senate's tax bill, the OPEC meeting, another North Korean missile test, the guilty plea by former National Security Adviser Michael Flynn, and some mixed and uneventful U.S. economic data. Early Saturday morning, the Senate passed their version of the tax reform bill which differs from the tax bill passed by the House of Representatives in mid-November. Those differences must now be reconciled into a final piece of legislation and then voted on by both chambers of Congress. Reconciliation could take a couple of weeks to even months, although Republicans are racing to have something on President Trump's desk by Christmas. To hear more about the potential corporate effects of the tax reform plan please listen to our Podcast dated Nov. 7th, 2017. On Wednesday, Nov. 29th, North Korea test fired their most sophisticated inter-continental ballistic missile (ICBM), which allegedly has the ability to strike virtually any target around the world. While we continue to believe the North Korean nuclear and ICBM missile tests are primarily a form of brute negotiations to limit sanctions against the rogue nation as well as protect the reign of their political leader, the advancement of the their nuclear and missile capabilities continues to pose a risk for the financial markets and the world as a whole. Late in the week, former National Security Adviser Michael Flynn pleaded guilty to lying to federal investigators about his contacts with Russia's ambassador to the United States and he is now cooperating with special counsel Robert Mueller's investigation into whether there was collusion between the Trump campaign and Moscow. Flynn is the first member of the Trump administration to be implicated in the special counsel's investigation, which will likely continue for many more months and maybe even years. For our thoughts on market implications should the investigations find their way to the top, please listen to our podcast dated May 23rd, 2017. Further, for more information and thoughts on the OPEC meeting and their 9-month extension of their supply cuts, please listen to our podcast dated Dec. 4th, 2017.

Looking forward into 2018, some of the factors that led to strong investment grade credit performance in 2017 remain intact, while other factors showed some cracks in their foundation, all against a backdrop of reduced market liquidity and valuations near their cyclical highs. We will break down our view and outlook between fundamentals, technicals and valuations.

From a fundamental perspective, we expect corporate earnings to continue to remain healthy in many industries and improve given a continued improvement in U.S. and global growth as well as potential tailwinds from corporate tax reform and continued deregulation, although year-over-year earnings comparisons should become more challenging. However, we expect debt for many corporate industries to rise nearly as fast as earnings as companies fund buybacks, dividends and M&A. As a result, we believe aggregate balance sheet leverage will remain elevated, near multi-decade highs. Despite the elongated credit cycle, we do not expect any meaningful increase in the general corporate bond market default rate. However, we do continue to expect late cycle credit behavior in most industries with a focus on shareholder return as opposed to balance sheet management and a weakening of financial covenants. Further, a continued removal of accommodative monetary policy over the year could fundamentally slow earnings growth in some industries, in particular homebuilders. Notable industry exceptions from a positive credit standpoint included the energy and MLP markets as well as the metals and mining industries, which continue to focus on balanced spending and balance sheet deleveraging.

Further, financials, and in particular, banks and life insurance companies should benefit from an expected rising interest rate environment, deregulation and natural protections from some forms of shareholder activism. Notable industry exceptions from a negative credit standpoint include retail due to the Amazon effect, pharma due to significant pricing and regulatory pressures and telecom (specifically wireline) due to structural headwinds and too much leverage.

From a technical standpoint, we expect investment grade corporate gross new issue supply to increase marginally versus the record pace in 2017. While a corporate tax reform plan could incentivize the use of less debt, especially in industries such as tech which will be effected by repatriation, we believe increased pressure to return cash to shareholders as well as an increase in M&A will more than offset the positive effect on supply from tax reform. In addition, we expect the sum of the total investable supply of dollar denominated investment grade debt (U.S. treasuries, mortgages, corporates, etc.) to increase in 2018, primarily in the second half of 2018, as the Fed's tapering of quantitative easing (QE) becomes much more material and the U.S. Treasury has to finance a larger deficit. This, combined with potentially higher interest rates, increases the investment grade investable universe thereby reversing the crowding-in effect into corporate bonds. Over the past few years, the technical demand for investment grade corporate bonds has been robust due to foreign buying in U.S. corporate bonds as well as retail purchases as seen through the Lipper mutual fund flow data. Given we expect the yield differentials globally among developed countries to largely remain intact, we do expect a continuation of foreign buying of U.S. investment grade debt. However, we also expect this foreign demand to slow as foreign exchange hedging costs have increased and the opportunity set for investment alternatives versus U.S. corporate bonds increases in the second half of 2018 (again a reversal of the crowding in effect). Offsetting some of this potential demand reduction could be pension and insurance company buying of U.S. corporate bonds once interest rates increase enough to help them achieve their yield hurdles although that will primarily benefit longer maturity bonds. Conversely we expect shorter maturity corporate bonds to suffer from reduced demand or selling pressure from corporate treasurers as a result of repatriation as well as suffer from a reduced value proposition for "cash-like equivalents" as the Fed normalizes the front end of the treasury curve. In general, while the technical supply and demand dynamics within the corporate bond market have helped drive the strong performance over the last few years, we see cracks in the technical foundation, especially in the second half of 2018 as a result of the Fed tapering. For more information on our thoughts on the Fed tapering, the reversal of QE and crowding in/out effect please listen to our podcast dated June 19th, 2017.

From a valuations standpoint, overall investment grade corporate bond credit spreads have recently reached a post-financial crisis cyclical spread tight. Digging in further, there are several industries that remain cheaper than their post crisis spread tights, such as energy, midstream, telecom, cable, media, automotive, retail and pharma. When comparing the credit spread valuations in the investment grade corporate bond universe to that of prior cyclical peaks over the last 25 years, early 2007 and early 1997 notably, corporate credit spreads today are modestly cheaper. However, the average duration of the corporate bond market was shorter and the average credit rating of the corporate bond market was of higher quality in both 1997 and 2007. When adjusting for the quality and duration differences, corporate bond credit spread valuations today are within several basis points of the past cyclical spread tights over the last 25 years. On a historical basis, corporate credit spread valuations appear expensive although when comparing corporate credit spreads to other sectors, such as commercial and residential mortgages and government agency debt, it appears that most fixed income asset classes are cyclically near their peak valuations. When comparing U.S. dollar investment grade corporate bond yields to local currency denominated investment alternatives in the developed markets in continental Europe and Asia, U.S. investment grade corporate bonds appear attractive, although less so from a currency hedged standpoint.

Our lukewarm 2018 outlook for the investment grade corporate bond market is one of relatively strong earning fundamentals, offset by stretched corporate balance sheets (industry dependent), positive yet questionable forward looking supply/demand technicals and full valuations from a historical basis, yet still modestly attractive valuations versus global alternatives. We believe the potential catalyst to a sentiment change within the investment grade corporate bond market lies within a changing technical picture although the timing is uncertain. In the meantime, we believe it is best to concentrate on industry allocation and name selection, remain nimble and proactively manage overall credit risk. Given the reduced liquidity within the corporate bond market, as discussed in our Oct. 10th, 2017 podcast, we believe in being early and measured in portfolio repositioning.

Thank you for listening to the Tortoise Credit Strategies podcast and hopefully you will join us for next week's edition.

**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.**