Tortoise QuickTake Credit Podcast

Dec. 12, 2018

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. Another year is almost behind us and for many market participants it is probably a year worth forgetting. As we put 2018 behind us, we also take out the crystal ball in order to try to predict what's in store for 2019. In today's podcast we will discuss our outlook for the investment grade corporate credit asset class for calendar year 2019 and potential risks to that outlook.

First, reflecting upon the past, in our podcasts dated December 5th, 2017 and August 22nd, 2018, we outlined our "lukewarm" or generally weak outlook for the investment grade corporate bond market in 2018 and the second half of 2018 respectively. While we didn't predict every twist and turn this year, the general premise within each pillar of our analysis (fundamentals, technicals, valuation) supporting our defensive positioning was correct. At this point I would love to say that the investment grade corporate credit markets will get a fresh start in 2019, however, we anticipate a continuation of the volatility and some of the periodic weakness we experienced in 2018 although some of the drivers of our thesis have changed and all against a backdrop of reduced market liquidity. In sum, volatility will remain elevated with periods of tactical spread rallies (such as what we are predicting for Q1 2019) as well as sell-offs. While the technical supply and demand factors will continue to negatively influence corporate bond markets, a weakening fundamental outlook partially offset by modestly improved valuations supports our longer term defensive positioning.

From a fundamental perspective we expect positive, yet decelerating revenue and earnings growth within investment grade corporate credit. Calendar year 2018 started off with an earnings bang which in turn provides tough year-over-year growth comparisons for 2019. Further, we expect a strong, yet decelerating economic growth backdrop in both the U.S. and much of the developed world. Corporate margins have been robust although we also foresee some modest margin pressures for many companies and industries due to the impact of tariffs as well as other rising input costs such as distribution. Many investment grade companies have been focused on M&A as well as on returning cash to shareholders in the form of dividends and record share buybacks and typically all at the expense of their balance sheet. We believe this equity shareholder focus could continue given the equity valuation correction experienced in Q4 although a more severe market correction could change corporate behavior to become more balanced. Non-financial investment grade corporate leverage, excluding commodity industries, remains near post financial crisis highs. In fact, non-financial corporate debt as a share of GDP has achieved a cyclical peak and all time high of approximately 46%. Interest coverage is near its lowest level post financial crisis despite historically low interest rates for much of the past decade. With the yield on investment grade corporate bonds now exceeding the average coupon in the market, those companies that chose to refinance their debt as opposed to repaying debt will likely face higher interest costs as they approach a large maturity wall over the next couple of years. However not all industries and companies exhibit the same degree of leverage stress as we outlined in our market insights commentary entitled "The Storm Surrounding BBB-Rated Corporate Credit."

From a technical perspective we expect investment grade corporate bond supply to decline 5-10% in 2019 due to a modest slowdown in M&A and opportunistic issuance as a result of increased market volatility and higher financing costs. More than offsetting this potential decline in corporate bonds issuance is the increase in supply within the treasury and to a lesser extent agency mortgage-backed securities market as a result of the Fed's quantitative tightening (i.e. shrinking balance sheet) as well as the increased treasury issuance to fund the deficit. We expect this increasing supply of treasuries and agency mortgage-backed securities as well as the increasing attractiveness of short maturity securities to compete for the marginal investment grade corporate dollar, essentially crowding investors out of some parts of investment grade corporate credit. From a technical demand perspective, we expect retail demand to remain tepid given poor calendar returns in 2018 and relatively low overall yields. However, within retail, we believe short maturity bonds such as investment grade corporate credit will continue to garner substantial inflows due to the competitive yields of short maturity as a result of a relatively flat yield curve and due to its defensive nature. We believe foreign demand for investment grade credit will remain challenged in 2019 despite large yield differentials due to excessively expensive foreign currency hedging costs. These lofty hedging costs are largely a result of significantly higher U.S. short term rates versus most foreign developed countries. Should Federal Reserve policy become substantially less restrictive in 2019, hedging costs could decline although this is not our base case. From an institutional demand perspective, pension funded status continues to improve and could be a source of increased long maturity demand if interest rates or spreads continue to rise, thereby assisting fiduciaries in surmounting their yield hurdles. Similarly insurance demand could also improve if yields drift substantially higher. We expect mutual fund demand to remain depressed until credit spreads or yields in general provide a more compelling entry point.

From a valuation perspective, investment grade corporate bond credit spreads have substantially improved from their February 1st 2018 cyclical spread tights. More specifically the Bloomberg Barclays US Corporate Investment Grade Index credit spread has widened roughly 60 basis points since this cyclical peak. However, keeping this in context, the current credit spread of the index referenced is 70 basis points tighter than the post crisis cyclical credit spread wides reached in February 2016. In addition, it is now roughly equal to the average spread since 2010, a period of Fed quantitative easing, and still 10 basis points tighter than the average over the past 25 years. Further the credit spread difference between the Bloomberg Barclays Baa Corporate Index and the Bloomberg Barclays A Corporate Index is now roughly equal to the average over the last 25 years, thereby lessening the relative attractiveness of BBB rated corporates in general. Given the fundamental headwinds previously identified as well as the continued technical supply/demand imbalance, we believe that corporate credit spreads in general must further widen to compensate for the various headwinds as well as reduced market liquidity. However, we believe valuations and total return prospects do look attractive within short maturity corporate credit as well as a select group of high quality, 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.

We remain defensive on investment grade corporate credit due to deteriorating fundamentals and continued supply/demand technical headwinds, partially offset by decent valuations. A significant improvement in valuations, through widening credit spreads or higher overall yields, could incentivize corporate America to partially improve fundamentals through balance sheet deleveraging and could enhance technicals through less supply and improved demand across all investor types. Further, a dovish Fed could prompt a technical demand tailwind due to reduced foreign currency hedging costs as well as yield reaching behavior by investors. However, while that circumstance could cause a temporary reprieve, it would only delay several of the headwinds identified. On the flip side, an escalation in the trade war, slower global growth, a U.S. recession, a hard Brexit, an overly hawkish Fed or a wave of corporate fallen angels could all cause credit spreads to deteriorate more than expected. With reduced market liquidity post the financial crisis, any substantial change will likely be rapid and cause the market to overshoot fair value. The rapid selloff in credit spreads that occurred during Q4 combined with the seasonal year end risk aversion effect could prompt a short-term improvement in credit spreads early in 2019 although we believe this will be short lived. As such we continue to have a defensive, longer term outlook within investment grade credit. Within our defensive allocation we favor short maturity credit, some low dollar price long duration corporate bonds, prefer high credit quality companies, and believe a continued focus on industry allocation and issuer selection are of the utmost importance.

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

About Bloomberg Barclays Baa Corporate Total Return Index Value Unhedged USD
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.

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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.

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