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.

Over the long MLK holiday weekend, my family lucked out and found a national park that wasn't closed by the partial government shutdown and spent three snowy days in the mountains. But getting there required a roller coaster of a drive up the side of California's Sierras, which led to a couple queasy stomachs in the back seat. The car trip – and the nausea that it almost induced – isn't too dissimilar from the ride that high yield investors have experienced over the past few months.

Given how gleefully the financial press reports on a market collapse, it's probably old news by now, but just to recap, high yield bonds lost 2.1% in December alone according to the Bloomberg Barclays U.S. High Yield Index. December's brutality left the high yield market down 4.5% in Q4, the worst quarter since Q3 2011, and erased the prior year-to-date gains, resulting in a 2.1% decline for the year as a whole. On a spread basis, the high yield index widened over 100 basis points in December and over 200 basis points for the quarter, leaving the market spread at 526 basis points at year-end, 183 basis points wider for the year and up 223 basis points from the post-crisis tight set in early October. At year end, the high yield market breached 8.0%, an attractive yield compared to the 6.0% average over the past two years but more in line with the ten-year average of 7.4%.

In last week's credit podcast, Greg Haendel discussed several macro drivers that contributed to the year-end sell-off, and among all of those dark clouds, plummeting oil prices certainly had an outsized impact on the high yield market, which remains heavily weighted to the energy sector. On top of that, a sharp spike in outflows from retail mutual funds proved to be another major contributor to the December weakness, with the deterioration in technicals magnified by a year-end reluctance to take on risk by both sell-side and buy-side trading desks.

The technical imbalance at the end of 2018 proved even more problematic for the loan market. During a period of seasonal slowdown in CLO new issuance, which typically represents as much as two-thirds of loan demand, retail fund outflows hit an unprecedented pace, totaling nearly $15 billion in December, double the next largest monthly outflow. These outflows led the average loan price to drop about 4 ½ points in December alone, leaving only 0.3% of the market trading above par, a stat that stood near 80% earlier in 2018. Like the high yield market, loans gave back much of their year-to-date gains in December, posting a 2.3% loss that left the annual return at just +1.1%, per the Credit Suisse Leveraged Loan Index, still one of the best outcomes for any fixed income sector in 2018.

As I said upfront, December's carnage is old news by now, as outdated as a day-old Presidential tweet. High yield investors came back from their winter holidays intent on buying into the dip, and we've seen the market rally nearly every day thus far in 2019. As of last Friday, spreads are over 100 bps tighter in January, essentially reversing December's sell-off, as if it had never happened. The high yield market has returned nearly 4% already this year, eclipsing many analysts' 2019 return estimates. Granted, most of those projections were conjured up around Thanksgiving, before December unfolded, and indeed, we've seen many estimates revised a couple of percentage points higher - to as much as +8% - just to take account for the lower starting point on January 1st.

While a general stabilization in the risk environment and a decent bounce in oil have undoubtedly supported January's high yield rally, we shouldn't overlook a quick shift in the technical picture. Last week saw a $3.3 billion inflow into high yield funds, the largest weekly gain in over three years. At the same time, new issuance is only now starting to trickle out after 40 consecutive days without a new deal, the longest such stretch in the market's history. In fact, this streak included a shut-out for all of December, the first time the market's gone an entire month without a new deal in a decade. So the market started the year with more attractive valuations, money starting flowing in and against a dearth of supply, the backdrop is set for a January rally. But where do we go from here?

The technical picture suggests the market could remain firm in the short term. On top of the recent inflows, high yield investors will get about $6 billion in cash coupons in January and will see three sizable issuers migrate towards investment grade as rising stars. After an upgrade from Moody's, HCA's secured debt totaling ~$14 billion will exit the high yield market at the end of this month, with Teck Resources (~$4.5 billion) and First Data (~$6 billion) expected later this year. On the flip side, there's been a lot of talk of potential fallen angels, as the BBB universe has ballooned in recent years and is now larger than the combined leveraged finance market consisting of high yield bonds and leveraged loans. High yield investors expected to get their first crack of a major fallen angel in 2019 with the multi-notch downgrade of PG&E, a California utility that's facing $30 billion in potential forest fire liabilities. With over $17 billion of debt, PG&E would have been a top five high yield index constituent, but instead, the company announced plans to file for bankruptcy protection at the end of January. With a filing, the credit will skip the high yield market altogether and go straight from IG to default, joining an infamous group that includes Enron and Lehman.

For now, technicals look to remain strong, but fourth quarter 2018 earnings season is just getting underway, giving high yield investors a chance to refresh on the fundamentals. Our view is that high yield credit metrics should remain stable, but street estimates call for earnings growth to slow in coming quarters. Weaker than expected guidance could expose a few cracks in the road. The high yield market already has a queasy stomach, we'll see if it can withstand a potential blown tire as well.

Thanks for listening, and please tune in for future Tortoise credit podcasts.

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