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.

Brad Beman: Hello everyone, I'm Brad Beman, Chief Investment Officer at Tortoise Credit Strategies. Today, joining me we have Jeff Brothers, Senior Portfolio Manager of Securitized Credit, Greg Haendel, Senior Portfolio Manager for IG Credit, and John Heitkemper, Portfolio Manager for Leveraged Finance. I will be providing a quick recap of the third quarter and then spend most of my time asking my esteemed colleagues about their market views going forward.

To start, the third quarter delivered mixed results across various fixed income asset classes as interest rates rose modestly across the curve, the Fed reiterated what the market interpreted as a continued hawkish tone, global growth showed signs of moderating and European theatrics continued with Brexit and challenges in Italy.

Today the market is clearly showing signs of risk-off as equity markets across the globe are under pressure, volatility is rising and credit spreads are starting to drift wider. In addition to the concerns that were unfolding in the third quarter, the market has become increasingly concerned about the slowing of the global economy and correspondingly earnings growth driven by many factors.

Looking forward this leaves market participants with many questions about the outlook going forward. Let's take a minute and ask some my colleagues their view of the world going forward.

Jeff, let's start with you. There has been increasing concerns about global growth slowing down across the market place, particularly if you look at global-leading economic indicators and the performance of equity markets across the globe. Can you give me your views on what we expect going forward as it relates to global real GDP growth rates and more specifically in the U.S. for the 4th quarter and into 2019?

Jeff Brothers: Thanks Brad. Sure, it's interesting, that it was just last year we were speaking to the global growth story. With improving growth in Asia, Europe and also in the U.S. And if we turn the page to today, it's really just a U.S. story. We've had a big divergence in terms of global economic growth. Asia is slowing, especially China. Europe economic growth is also slowing. And it's really now just the U.S. that continues to power ahead in terms of economic growth. In terms of our view, we do see another strong quarter, in the fourth quarter, with GDP between 3 and 3½%. But as we look into 2019, we do expect some moderation in terms of growth, partly due to less tailwinds from this year's tax cuts. Perhaps also some impact from slower growth globally weighing on U.S. growth. But overall we're still positive on U.S. growth but some moderation. We're expecting 2¾ GDP for the U.S. And for us, the big driver is really going to continue to be the consumer. The consumer fundamentals are very healthy with the job gains, with the net worth gains from stock and home price appreciation and consumers' balance sheets are in a very healthy condition. So we think that all adds up to another solid year for U.S. growth, but perhaps a slight moderation from the growth that we saw in 2018.

Brad Beman: Thanks Jeff! Greg with growth potential set to slow slightly, unemployment at record lows and tariffs potentially pressuring input costs, can you comment a bit about our outlook on IG fundamentals for the 4th quarter and for 2019?

Greg Haendel: Sure. In general corporate earnings remain strong with U.S.-based earnings as the primary driver although earnings growth is expected to decelerate going forward given GDP growth is set to slow. We have tough year-over-year earnings comps goings forward, and input cost pressures are increasing due to higher energy prices as well as tariffs. Despite strong, yet decelerating earnings growth, investment grade corporate credit metrics are stretched across many industries and issuers with corporate leverage near a post-crisis high and interest coverage near a post-crisis low. In general, most of the positive effects from corporate tax reform and strong earnings and strong cash flow growth has accrued to the shareholder as opposed to the debtholder through M&A, dividends and a record level of share buybacks.

Brad Beman: Great Greg! John are you seeing the same trends in the leveraged finance space?

John Heitkemper: I think the trends in high yield and leveraged loans are somewhat different than Greg just described in the investment grade market. We've seen pretty solid underlying GDP growth over the past two years or so, and while commodity sectors have certainly been a driver of those gains, the ex-commodity data has also been fairly robust recently. But to Greg's point, it feels like we're likely to see a deceleration in earnings growth in coming quarters, which probably explains part of the recent volatility in both equities and high yield.

That being said, I think that one noteworthy difference between high yield and investment grade fundamentals is what companies have done with their cash flow in recent quarters. While IG companies have been willing to stretch their balance sheets, you've actually seen the high yield market bring leverage down over the past couple of years, particularly as the energy sector has recovered. This trend probably flattens out somewhat as earnings growth slows, but the overall leverage appears manageable at this point in the cycle. As you'd expect, defaults are currently running relatively low at about 2%, and we don't see this moving up in a major way over the next few quarters as a lot of companies have used favorable borrowing conditions to push out maturities. As long as high yield management teams don't become aggressive with their balance sheets as earnings slow, as the companies are doing in IG, then we don't see the situation materially changing in the near term.

While the story is generally the same for credits in the leveraged loan world, one of the worrying trends in that market is the starting leverage we're seeing on new deals at this point in the cycle. It's potentially problematic that leverage on new loan deals is at a cyclical peak while we're talking about earnings slowing and how many innings are left in the business cycle. We think some loan issuers that are starting out with high leverage now, may not have the time to pay down debt before the cycle turns against them.

Brad Beman: Thanks John! Now let's spend a few minutes on the Fed and our interest rate outlook. Jeff can you talk a little bit about Tortoise's Fed and interest rate outlook, specifically where do you see rates going in 2019.

Jeff Brothers: Sure. Starting with the rate view, we've been positioned really for most of 2018 for higher interest rates. And we think 2019 is going to be more of the same. Our view right now is that we'll see a modest increase in terms of rates in 2019. We're targeting right now a 345 yield on the 10-year Treasury by the end of 2019. Really a combination of factors, first is as we mentioned, still expecting solid economic growth here in United States. That should put some pressure on U.S. rates. We see a hawkish Fed and a Fed that could be hiking more than the market currently anticipates. We also see gradually rising inflation, and then the last piece of the puzzle is we do see given the increasing budget deficit in the U.S., a need for a significant increase in U.S. Treasury issuance. So given the additional supply, we do expect that to put pressure on rates. So our view is modestly rising rates. In terms of the Fed, we believe December will be another hike and then three more in 2019. That's pretty much aligned with the view from the Federal Reserve dot plot. But is significantly more than is expected in the markets right now. The markets are expecting just a little bit over one hike in 2019. So it should be a year of a lot of uncertainty and volatility surrounding the Fed as they move toward the neutral rate for the Fed Funds.

Brad Beman: Thanks Jeff! Well given how flat the curve has become, it seems like there could be some interesting opportunities developing on the front end of the curve. Greg, you have spent a lot of time managing front end assets, what do you think?

Greg Haendel: Thanks Brad. In my opinion, investments on the front end of the curve are very appealing right now for a number of reasons. First, the interest rate sensitivity of short maturity bonds is much less than that of intermediate or long maturity fixed coupon alternatives. If you believe we are in a gradually rising interest rate environment you will incur a minimal price impact from rising rates while at the same time having the opportunity to reinvest near term maturities at higher interest rates. In addition, an investor can earn almost the same, albeit, a slightly lower yield, or carry, investing in a 2-year Treasury or various other 2-year spread assets versus a similar 10-year asset. Given the strong spread break-evens of short maturity corporate bonds and securitized bonds, investors can withstand substantial interest rate or spread shocks and still generate a positive total return over a one year horizon. In fact, even in one of the most extreme rising rate environments in the last 30 years, that being 1994, the ICE BofAML 1-3 year U.S. Corporate & Government Index, which is a common short duration index, was one of the only fixed income indices to generate a positive yearly return. Lastly, given the prolonged length of this business cycle as well as the recent market volatility and the more defensive nature of short maturity fixed income, we expect investor demand to remain extremely strong for front end fixed income assets.

Brad Beman: Thanks Greg! So let me get this right, our bias is to think rates rise gradually from here, the FED continues its march towards normalization, growth is slowing, valuations at least from my perspective seem tight, albeit they have been widening a bit recently. Where does this leave us on positioning our portfolios? Greg, can you take a shot at that one, specifically with relationship to IG positioning?

Greg Haendel: We are relatively defensive, remain less favorable on the investment grade credit sector, and are currently underweight the benchmark across most intermediate and longer maturity mandates although as previously mentioned within credit we do favor shorter maturity bonds. We already discussed investment grade credit fundamentals, which are stretched and valuations remain within a handful of basis points near the post financial crisis spread tights experienced at the end of January 2018. Further, from a technical supply and demand perspective, foreign buying has declined substantially due to extremely high currency hedging costs, retail fund flow demand is lower and concentrated primarily on short maturity credit, U.S. institutional demand is mixed, and new issue supply remains near record levels. However, select opportunities do exist, industry, issuer, ratings and maturity dependent.

Thanks Greg! John and Jeff, do you see it the same from you lens? John specifically in the leveraged finance space and Jeff in the securitized credit? John can you answer that first?

John Heitkemper: Sure. We've gradually brought our exposure to below investment grade credit down as spreads compressed to post-crisis tights in both high yield and leveraged loans. Recent market volatility has clearly caused spreads to back up, particularly in high yield, which has made valuations somewhat more attractive. The technical picture remains pretty favorable; in high yield, issuance remains muted – down almost 30% year-to-date – while loan demand from the CLO market and floating rate funds has been strong. We've been overweight loans relative to high yield, particularly as an alternative to more rate-sensitive BB high yield credits, which have underperformed B and CCC so far in 2018. But recent widening in high yield is causing the relative value between the two sectors to move more in favor of higher-quality high yield.

Jeff Brothers: In securitized, we've also been reducing some of the risk in the sectors. Primarily due to valuations, specifically in the commercial mortgage-backed sector and also in the agency mortgage sector. Typically the securitized products do benefit from their high-quality, shorter duration securities. But in our minds the valuations currently are not very attractive. The one area that we do like, is the asset-backed sector. And with ABS as we mentioned in the beginning, the fundamentals for the consumer are very healthy right now in much of the ABS world is consumer-related finance. It's also a very short, high quality asset. So it is a place as Greg mentioned, on the short end of the yield curve where we do find opportunities in the portfolio.

Brad Beman: Awesome! Well that's a lot of information to digest! So to recap the general view is a modest slowdown in growth across the globe, modestly higher rates driven by inflation pressures and supply/demand concerns and a general caution in most spread sectors albeit opportunities that could occur from the current market volatility. It should be an interesting and fun fourth quarter. Hopefully everyone on the call has found the information useful and productive and as always, if you have any questions please reach out tour Client Relations Manager Tracy DeAndrea at 213-694-4127 or tdeandrea@tortoisecredit.com for further questions!

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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