Tortoise QuickTake Podcast

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Welcome to the Tortoise QuickTake podcast. Thank you for joining us. Today, senior members 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 and I'm responsible for setting the strategy for the Investment Grade Credit sector within the portfolio. For today's podcast, we will start with a brief review of the economy and fixed income markets over the past week and then discuss a very timely issue within the corporate bond markets today –potential corporate tax reform, the potential effect of those reforms on corporate behavior and the corporate bond markets in general.

U.S. economic data continued to mostly underwhelm market expectations during last week. The Empire Manufacturing survey, the Philadelphia Fed Business Outlook survey and U.S. Housing Starts all underwhelmed market expectations and weakened versus their prior month reads, however, existing home sales did improve and capacity utilization edged slightly higher. Although first quarter GDP growth is tracking relatively weak at around 1%, this is consistent with a seasonal trend we have witnessed over the last several years whereby the first quarter economic growth data has been the weakest quarter of the year. Regardless, some of the recent weakness in economic data has been centered within the soft data which is confidence and survey-based data as opposed to hard data which is based on hard economic results. This soft data had shown strength over the last several months as a result of optimism over potential pro-growth and pro-business policies coming out of the new administration, while the hard data hasn't shown significant improvements over the same time period. The underwhelming U.S. economic data, combined with the markets discounting the likelihood and timing of some new policies from the new administration as well as continued geopolitical concerns and nervousness ahead of the first round of the French elections, caused weakness in riskier assets early last week while interest rates continued to dip lower. However, late last week, Treasury Secretary Mnuchin announced that the Trump administration would produce an ambitious plan to overhaul the U.S. tax code very soon. This in turn helped reinvigorate the markets, sending riskier assets a bit higher and U.S. interest rates a bit higher from their mid-week low. Further, by Monday of the current week some of the global nervousness surrounding the first round of the French elections declined as Macron and Le Pen advance to round two, helping to validate the election polling which had predicted this outcome and currently predicts a Macron victory over Le Pen. As a result, riskier assets rallied on Monday of the current week while flight-to-quality assets such as U.S. treasuries and German Bunds sold off.

Switching gears now to potential corporate tax reform and, if enacted, its potential effect on corporate behavior and on the corporate bond markets in general. First, I'll outline some of speculated corporate tax reforms. Those reforms include 1) mandatory overseas cash repatriation and the elimination of taxation on overseas corporate profits going forward, 2) a lowering of the corporate tax rate to 15 or 20% from a current maximum of 35% while also eliminating many deductions in the tax code, 3) immediate expense deductibility of capital investment in the year the investment is made as opposed to that investment expense being depreciated and amortized over several years, 4) elimination of interest expense deductibility on newly issued corporate debt going forward, and 5) Border adjustment taxes on imports into the U.S.

From a fundamental basis, in general, we believe that the corporate tax reforms as I just briefly outlined would be a modest net positive for the overall creditworthiness of most U.S. corporations. We believe that the cumulative effect of lower corporate tax rates, tax-free overseas earnings, unencumbered overseas cash balances and capital investment incentives would more than offset the loss of the corporate interest tax shield. Further, the elimination of interest expense deductibility for newly issued corporate debt should incentivize companies to use less debt going forward all else equal and hence incentivize companies to use less financial leverage on their balance sheet. However, not all U.S. companies would enjoy the same benefit and some could, on the margin, have increased business risk as a result. For example, companies heavily dependent upon imports as well as highly leveraged companies that are also light in capital investment could see their financial health deteriorate. Further companies that are already low corporate taxpayers, have minimal cash held overseas, or have minimal capital investment needs may not benefit as much from some of these corporate tax reforms discussed. Within investment grade corporate credit, we believe that those industries that stand to benefit the most from this corporate tax reform include technology, pharmaceuticals, oil and gas exploration and production, metals and mining and telecom. We believe those industries that are at the most risk from this corporate tax reform include retailers, autos, auto parts, REITs and utility holding companies.

From a technical perspective, we believe corporate tax reform as outlined could cause corporate bond issuance to increase near term, followed by a moderate decline in issuance in the longer term. We believe this would occur as companies may rush to issue as much debt as possible in order to secure tax deductibility for previously issued debt if there is a grandfathering date. A moderate decline in issuance longer term could result due to more use of unencumbered cash from overseas earnings as well as less use of debt in corporate funding strategies as a result of a higher after tax cost of debt. Another technical nuance could occur with selling pressure in short maturity securities as a result of overseas cash substitutes, such as short maturity corporate bonds, being repatriated and liquidated to fund corporate investment.

In sum, we believe that if corporate tax reform is enacted as we have outlined, in general corporate credit fundamentals and long term technical issuance patterns should improve, and all else equal this should lead to modestly improved corporate credit spreads overall. However, this is industry and company specific and as we all know, the devil is in the details and we are still lacking both the details as well as the ultimate timing of such corporate tax reforms.

Thank you for listening, we'll talk to you 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@tortoiseinvest.com.