Tortoise QuickTake Podcast

November 14, 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.

Welcome to this week's Tortoise QuickTake podcast. I'm John Heitkemper, portfolio manager for high yield bonds and leveraged loans at Tortoise Credit Strategies.

In what seems like a month-long marathon comprised of daily sprints, each earnings season is an exhausting experience for buy- and sell-side analysts. Days are crammed analyzing early-morning press releases, jumping between company-hosted conference calls, and synthesizing thoughts to communicate to clients or portfolio managers. On a day-to-day basis, it's easy to focus on the trees and lose sight of the forest.

With Q3 earnings season now winding down – over 90% of the S&P 500® Index has reported – we thought it would be timely to see how earnings are shaping up. Using the S&P 500 reporters to date as a proxy, earnings per share are up nearly 8% year-over-year, which is about 2 percentage points ahead of expectations. Even excluding the energy sector, which is experiencing a sharp earnings recovery, EPS is up nearly 6% versus a consensus 1% gain. Nearly 75% of companies have beat expectations this far, with less than 20% missing estimates. At the sector level, technology companies are showing continued strength, with earnings up over 20%, while on the flip side, financials are lagging due to expected declines in the insurance sector as a result of several devastating natural disasters in the past few months.

As we've highlighted on prior podcasts, the retail sector continues to be very topical in credit markets, both investment grade and high yield. Within the S&P 500 retailers, earnings are up 9% in Q3, based on companies that have reported so far. One of those is Amazon, which now represents a staggering 25% of the sector, highlighting the fact that the 9% growth figure is an amalgamation of retailers with sharply diverging trends.

This past week, four department store retailers that are credit market bellwethers – Macy's, Nordstrom, JCPenney and Kohl's – all reported, giving credit investors their first look at Q3 earnings trends and a peek into what the all-important holiday season might hold in store for the sector. By and large, Q3 results from those four came in mixed, but better-than-feared. Same-store sales growth – a key retailing metric – came in positive at Kohl's and JCPenney but declined at Nordstrom and Macy's. The companies noted that hurricanes negatively impacted sales results during the quarter, with trends improving post these events. Of the four, only Macy's was able to post better margins than last year, as stiff competition and bloated inventories continue to pressure profitability.

While Q3 results were definitely important data points for analysts, the companies' outlook for the make-or-break holiday season drove the share price of all four higher last week. Macy's held to its prior earnings guidance, a win in today's retail environment, and gave upbeat color on the U.S. consumer and holiday spending. That sentiment has been corroborated by recent forecasts from industry consultants, which call for holiday sales growth to accelerate in 2017 from 2016's rate in the mid-3% area.

We remain skeptical, however, that a rising tide will lift all boats this holiday season. Despite some relative bright spots out of last week's department stores earnings, we think the industry continues to face incredible secular challenges, many of which boil down to one word – Amazon. To stand a chance against this growing behemoth, we think retailers will need to successfully build out an omnichannel presence and focus keenly on managing their store count and inventory in order to preserve margins, all of which must be attempted against a backdrop of declining customer foot traffic and an extremely promotional environment. As the holiday season begins, we remain highly cautious on the sector in the face of these challenges, particularly in the high yield space where overleveraged balance sheets add a further barrier to overcome.

But before your analyst instincts call for a sell on every retail bond out there, let's end with one more intriguing and newsworthy headline out of the retail sector this week. According to a mergers and acquisition rag, Amazon should consider buying Macy's for its premier brick and mortar presence, a strategy akin to its recent acquisition of Whole Foods in the supermarket space. Lest you scoff at the idea, consider that it follows, by just a week, another story suggesting that Amazon may buy Kohl's, with whom it already partners for selling certain items. If Amazon were to buy either, we think it would most likely be a home run for the target's bond investors. But short of intercepting a certain letter to the North Pole, it's going to be difficult to predict who might be on Amazon's holiday wish list.

Thanks for listening and please tune in for next week's Tortoise Credit podcast.

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.

The S&P 500® Index The S&P 500® Index is a market-value weighted index of equity securities.