Tortoise QuickTake Podcast

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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 the Tortoise Credit Strategies weekly podcast. This is John Heitkemper, portfolio manager for the firm's high yield bond and leverage loan strategies. Although many of us are in the throes of the end of summer and back to school, we are all deeply concerned with the devastating impact of Hurricane Harvey and now the potential destruction of Irma. Our thoughts go out to those in the Houston area following Harvey, and we're crossing our fingers that Irma's effects are minimal.

Our Tortoise colleagues have already covered Harvey's impact on the energy industry on a separate podcast, and we'll use this episode to think about how the hurricanes might impact high yield bond issuers. But before doing so, let's spend a few minutes covering how the high yield market performed at the end of the summer. Following a strong July, when the Bloomberg Barclays High Yield Index returned 1.1%, August was essentially flat, with the index losing 4 basis points. Spreads widened 26 basis points and touched a four-month high in mid-month. Higher-quality bonds outperformed during the month, with Double Bs posting a +0.3% return, while at the other end of the credit spectrum, Triple C rated bonds lost 0.7%. The High Yield market trailed other asset classes, including Investment Grade Corporates and Treasuries, which returned +0.84% and +1.08%, respectively.

Although the High Yield market ended August essentially flat, there was a decent amount of volatility during the month. At mid-month, in fact, High Yield was down more than a half percent, and while this doesn't sound like much at first blush, it would have marked the worst month for the sector since January 2016. The drivers of the mid-month sell-off included equity market volatility, fading confidence in the passage of pro-growth economic policies, and risk-off global headlines that included terror attacks in Barcelona and saber rattling on the Korean peninsula.

On top of all of this, High Yield market technicals were unfavorable, as there was a significant retail outflow at mid-month that was exacerbated by a heavy new issue calendar as bankers accelerated transactions before leaving for pre-Labor Day beach trips. With much of the HY market on vacation and the new issue machine shut down during the last two weeks of the month, spreads recovered as global anxiety subsided and stocks rebounded. By the end of August, spreads had regained 12 basis points from mid-month wides.

At the sector level, underperformers included Supermarkets, which continue to be out of favor post the Amazon-Whole Foods tie up; Wireline Telecoms, which remain under secular pressure due to cord cutting; and Energy, which was hit by a nearly 6% drop in crude prices during August. On the flip side, Transportation Services posted the best return during the month, due in part to a bounce from Hertz bonds, which we highlighted in a prior podcast.

As we think about High Yield performance over the next few months, its stands a good chance that Harvey – and potentially Irma – will contribute to the winners and losers at the sector level. As recovery from Harvey has just begun, it's still too early to know the extent of the damage or the duration of the effects, but here are a few high level thoughts to keep in mind as the situation develops.

Given its close relationship to the energy complex, the petrochemical sector is another industry with significant exposure to the Gulf Coast and Houston area specifically. Several High Yield chemical producers have already detailed which of their assets are offline, and at the industry level, a staggering 50% or more of production capacity for key commodity chemicals remains incapacitated. It will likely take at least a couple of weeks to get these massive, complex plants back up, and extended outages for the more leveraged HY issuers could be problematic. However, producers with minimal disruption are likely to benefit from higher chemical prices in coming weeks.

In the Consumer Cyclical space, High Yield homebuilder, automotive, and gaming issuers are also likely to feel a Harvey impact. Among the major homebuilder issuers, as much as 10-20% of construction is tied to Houston, which recently has been one of the largest metro areas for new home construction in the U.S. New home buyers could see prices rise due to labor and material shortages. In the Automotive industry, August and September sales are likely to take a hit as both dealers and consumers focus on recovery, but longer-term, sales could get a boost from increased scrappage and replacement at dealer lots.

Within the High Yield retail space, there are only a few issuers with outsized exposure to Texas, and these will likely see depressed sales results as the area recovers, compounded by costs to repair store damage. The one retail exception is the home improvement stores, which have benefitted from major storms in the past. While the major players in the space aren't High Yield issuers, there are several High Yield building materials producers that will likely get a bump from increased repair demand. Equipment rental issuers, of which there are several in the High Yield space, should also benefit from the repair work that will follow.

Taking a step back and thinking about the U.S. economy as a whole, early estimates from economists suggest that Harvey could negatively impact third quarter GDP growth from as little as a few tenths of a percent in the modest case to as much as 1.0-1.5% if the energy and chemical industries suffer from prolonged disruption. For the sake of the economy – but more importantly, for the sake of its people, we hope that Houston sees a quick recovery.

Thank you for listening, and please join us for next week's 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.