Tortoise

Tortoise QuickTake Podcast

October 17, 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. This is John Heitkemper, portfolio manager for high yield bonds and leverage loans at Tortoise Credit Strategies. We're now well into October, a favorite month for many sports fans, as all four major professional leagues are in action. My favorite, baseball, is peaking with four teams competing now for a coveted spot in the World Series.

Sports – and baseball in particular, it seems – have always provided good metaphors for other parts of life, including economics and finance. A few weeks ago, at a major leverage finance conference attended by several members of the Tortoise Credit Strategies' credit team, a discussion centered around the extended length of the current U.S. economic expansion, and falling back on an easy sports analogy, several panelists suggested we're late in the game, maybe in the 7th or 8th inning. But one speaker quipped, "What if this ballgame is going into extra innings?" At Tortoise Credit Strategies, we think that's a fair question, and internal debate around this very topic has intensified lately.

The current U.S. expansion is entering its ninth year, making it one of the longest periods of uninterrupted economic growth since World War II. But as we've discussed in prior podcasts, this expansion has been noteworthy for relatively lackluster growth rates, averaging just over 2%. This is well short of the mid-3s average growth in the 1990s and the 4-5% annual growth of other long cycles in the 60s and 80s. If we think about this on a cumulative basis, in prior lengthy growth periods, the U.S. economy grew as much as 40 or 50% overall from the prior trough, whereas this cycle's cumulative growth is just approaching 20%. Now, there are undoubtedly structural changes to the economy that account – at least in part – for the two-fold difference, but it does beg the question, is there more room to run? Why can't we play extra innings?

In fact, as my colleague Greg Haendel discussed on last week's podcast, recent economic data suggests that U.S. growth could improve in coming quarters. It now appears that economic growth is picking up outside the U.S. as well, which should provide further support to the domestic economy. Ahead of its annual meetings in D.C., the IMF last week raised its global growth forecast for this year and next by a tenth of a percent to 3.6% and 3.7%, respectively, up from 3.2% in 2016. The improved outlook is broad-based, as the IMF raised its forecasts for the U.S., Europe, Japan and China, which together account for three quarters of global GDP.

So, what does this all mean for a conference full of leverage finance professionals who like to fit their world into convenient baseball analogies? The implication of an extended U.S. economic expansion, reinforced by accelerating growth abroad, is that there is more room to run for the current credit cycle. In the U.S. high yield market, we've seen improving credit fundamentals over the past few quarters, driven in part by a rebound in commodity sectors including energy. According to JP Morgan data, high yield issuers saw an average EBITDA increase of 11% year-over-year in the second quarter, the second consecutive double-digit gain. With robust earnings growth, high yield issuers were able to deleverage for the fourth consecutive quarter, as average debt/EBITDA declined to 4.38 times from the post-crisis peak of 4.57 times in the second quarter of 2016. Looking forward, the earnings outlook is relatively positive, although there is sure to be some noise at the sector level following the recent natural disasters. According to S&P 500 earnings estimates, Q3 will likely be a blip with projected growth of just 3%, a figure dragged down by expectations for precipitous earnings declines in the insurance industry. But Q4 projections call for a return to double-digit growth – 11.9% – followed by an even higher 12.6% increase in 2018.

Against this economic and earnings backdrop, it's hard to see a meaningful increase in the high yield default rate, which sat at just over 1% at the end of Q3, a quarter that saw the fewest number of issuers default in over a decade. But there's no doubt that a continuation of today's benign credit environment is also priced into credit products like high yield, which is yielding around 5.5% currently, per the Bloomberg Barclays High Yield Index.

Is there meaningful upside from here? Likely not, but can an extended economic and credit cycle reward good credit managers, we think the answer is yes. It's the extra innings that are the most exciting to watch.

© 2017 Tortoise

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 is a market-value weighted index of equity securities.

The Bloomberg Barclays High Yield Index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below. Bonds from issuers with an emerging markets country of risk, based on Barclays EM country definition, are excluded.

Disclaimer: *Nothing contained in this communication constitutes tax, legal or investment advice. Investors must consult their tax adviser or legal counsel for advice and information concerning their particular situation. This podcast contains certain statements that may include "forward-looking statements." All statements, other than statements of historical fact, included herein are "forward-looking statements." Although Tortoise believes that the expectations reflected in these forward-looking statements are reasonable, they do involve assumptions, risks and uncertainties, and these expectations may prove to be incorrect. Actual events could differ materially from those anticipated in these forward-looking statements as a result of a variety of factors. You should not place undue reliance on these forward-looking statements. This podcast reflects our views and opinions as of the date herein, which are subject to change at any time based on market and other conditions. We disclaim any responsibility to update these views. These views should not be relied on as investment advice or an indication of trading intent.*

© 2017 Tortoise