Tortoise

Tortoise QuickTake Podcast

June 6, 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 the tortoise credit podcast for the 6th of June 2017. I'm Graham Allen, Senior International Portfolio Manager for Tortoise Credit Strategies.

For anyone watching the America's Cup right now you can only marvel at the advancement of sailing technology in the AC72 America's Cup boats (known as foils) that are being used by all the teams. These vessels when finely tuned can reach speeds of 50 mph in winds of only a quarter of the speed. It is truly kinetic poetry. However, the trick is that everything has to perfectly tuned to achieve these speeds, and even then the experience is only fleeting.

Today that analogy could be used for the U.S. bond markets in that we are enjoying healthy growth, low inflation and yields among the highest in the developed markets around the world. Perfect conditions at least for now! Clearly it may not last, but is it reasonable to ask if these are the best of times for U.S. corporate bonds, or are they under any near term threat.

Despite a widespread feeling earlier in the year that interest rates would go higher, the reality is that in that U.S. interest rates have remained relatively range bound, while economic conditions continue to improve both globally and in the U.S.

Let's look at why this is a great environment for U.S. bonds, especially corporate bonds, at least for the time being.

As of the end of May, the Bloomberg Barclay's US Aggregate Bond Index achieved a total return of 2.38% year-to-date. Given the widespread concern about rising interest rates at the beginning of the year this was probably a higher return than most expected.

So what can we expect for the remainder of the year? Well briefly discuss three things. Growth, inflation and yields.

Judging by fundamental data reported so far this year, there appears to be acceptance that a global growth recovery is well underway. This is in response to the combination of monetary and fiscal stimulus implemented last year and this year around the globe. In addition to that, the result of the U.S. election buoyed confidence in anticipation of pro-growth policies being enacted in the U.S. starting in 2017. So far the progress of actual legislation has been somewhat challenged, although confidence remains high. Despite a mature credit cycle, these conditions generally should continue to improve credit quality and be supportive of prices in the U.S. corporate bond markets.

Outside of the U.S., there is clearly a concerted recovery underway. Large countries like Russia and Brazil are finally emerging from recession and in mature economies such as the Eurozone, Japan and China, we are clearly seeing an acceleration of growth. Indeed Chinese monetary authorities are taking actions to slow the rate of growth to a more manageable level in China. Which is not surprising given that the 1st quarter nominal GDP in China was 11.8%. I do emphasize that was nominal GDP before adjusting for inflation. Chinese actions included raising short term interest rates and strengthening the Renminbi currency. Interestingly both of these actions are bond-friendly as they encourage global disinflation.

Here in the U.S. I would say actual data has been less convincing of a recovery but nevertheless positive. The Purchasing Managers Index (PMI) is presently running at +54. Anything over 50 implies growth and is a good measure of business confidence. U.S. growth is on track to accelerate to between 2-3.0% in 2017. Perhaps the positive economic outlook is best supported by the strength in the U.S. stock market which has recently hit an all-time high. However, future optimism in the U.S. could be dependent on the rate of economically positive legislation actually enacted. It may be a while before that happens. So from a fundamental perspective therefore it looks as though for the time being, credit conditions will continue to improve.

Now let's look at the inflation environment.

Although the expectation is that inflation will rise, the reality is that the data does not yet support this. In fact the PCE which is the main inflation indicator studied by the Federal Reserve actually declined from 1.6% to 1.5% in its last report. Elsewhere commodity prices have generally been soft driven by lower oil prices as well as iron ore and copper which have also experienced a correction from the recent highs, seen earlier in the year.

The reason for the recent commodity price declines could be technical, and by that I mean not necessarily demand-driven but driven by the technicalities of production. Nevertheless they will offset other inflation pressures in the pipeline, such as wages.

There has been some uptick in wage costs in the U.S., although as yet this has not crept into the headline inflation data. Wages do however remain a notable risk going forward, especially here in the U.S.

Having said that, with a reasonable level of growth it appears for the time being that rising inflation is somewhat absent from the near term outlook and could explain why generally global interests rates have been stable to declining.

Finally, although low by historic standards, U.S. rates remain attractive on a global basis. Firstly, the entire U.S. yield curve has a positive yield, unlike much of the short end of Europe and Japan. Secondly, The U.S. has the highest 10 year yield in the G7 by a wide margin.

For example as of the 5th, June 2017, compared to +2.18% for the U.S. ten year Treasury bond, Germany is at 0.27%, Japan at 0.05% and Canada is at 1.41%. This means that in a yield starved world, there is still demand for U.S. bonds even if yields feel particularly low. In fact the Chinese authorities have indicated that they are once again prepared to buy U.S. treasuries after a hiatus, as they judge that the assets are becoming more attractive than other sovereign debt.

So in summary, for the time being, U.S. bond market is sailing well and enjoying a sunny day. But as we all know, the weather can change quickly.

Thanks you for listening and we hope you've found this helpful.

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 **Bloomberg Barclays US Aggregate Bond Index** is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS (agency and non-agency). Provided the necessary inclusion rules are met, US Aggregate-eligible securities also contribute to the multicurrency Global Aggregate Index and the US Universal Index, which includes high yield and emerging markets debt. The US Aggregate Index was created in 1986 with history backfilled to January 1, 1976.

The **Purchasing Managers' Index (PMI)** is an indicator of the economic health of the manufacturing sector. The PMI is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment.

The **PCE Price Index** is defined as personal consumption expenditures (PCE) prices excluding food and energy prices. The core PCE price index measures the prices paid by consumers for goods and services without the volatility caused by movements in food and energy prices to reveal underlying inflation trends.