

Tortoise QuickTake Podcast

September 19, 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 QuickTake podcast. This is John Heitkemper, portfolio manager for high yield bonds and leverage loans at Tortoise Credit Strategies. It's that time of year again – the kids are back in school, weekends are filled with football games and tailgates, and pumpkin spice lattes have returned at Starbucks.

As the Federal Reserve convenes for its back-to-school meeting this week, we at TCS are wondering whether FOMC members have filled their backpacks with pencils or pens. The distinction is important, we believe, as the bond market will be paying close attention to the FOMC's dot plots and whether any committee members have erased their old forecast following a string of softer than expected inflation data. Changes to the dot plot are likely to get overshadowed, however, by the FOMC's widely anticipated official plan to start winding down its \$4.5 trillion balance sheet, a move that's been telegraphed to the markets for some time.

The consensus view holds that the Fed will begin tapering its reinvestment of Treasuries and MBS securities in October, starting small at first – just \$6 billion of Treasuries and \$4 billion of MBS – before increasing the amount that will roll off the balance sheet over coming quarters. At TCS, we've become more comfortable that this initial level of QE reversal will have a muted market impact, given the Fed's gradual approach and focus on forward transparency.

Another focal point for tomorrow's FOMC statement – and Yellen's subsequent news conference – is whether the committee is leaning toward another rate increase at the December meeting, which would be the third increase of 2017. Over the past few months, speeches from Fed officials suggested that the FOMC may have reservations about that third hike, but the market-implied probability of an increase jumped from just 20% to about 50% recently, helped in a large part by last week's stronger-than-expected inflation reading for August. TCS is in the camp that thinks the FOMC will raise rates for a third time this year, as we're generally constructive on the U.S. growth outlook despite temporary disruptions that will surely arise from the two recent hurricanes.

But looking past the market's 50/50 call on December, we think the more interesting debate is on 2018, which brings us back to those infamous dot plots. For a quick refresher – call it the Cliff Notes version – recall that the dot plots are a visual representation of where each FOMC member believes the Fed Funds rate will shake out at the end of a given year. The market often takes the median of those points to be the FOMC's "forecast". We think that the current discrepancy between the FOMC's own forecast for three more hikes in 2018 - and the market's view of just one - represents one of the most critical questions for the bond market going forward.

So when the Fed releases its statement tomorrow, our focus will be on whether any committee members pulled out the eraser to revise down their projections for next year's rate increases. If not, we think that financial markets may start to believe that those dots are written in ink, which could put the bond market and Fed on a collision course next year, a scenario that is sure to test the resolve of risk assets here in the U.S. as well as globally.

Before we go, there's one last twist to this story that shouldn't be overlooked, and that's the potential for a couple new kids in class next year. Most importantly, Chairman Yellen's term ends in February 2018, and as of now, the President has yet to decide on her reappointment. With Vice-Chair Fischer's recent and unexpected resignation, the President has the opportunity to nominate up to 5 of the 7 spots on the Fed's Board of Governors. Those nominations could dramatically change the overall stance of the FOMC, of course, potentially leaving moot the question of pencil vs. pen.

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.

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