Tortoise℠

Global credit economic summary and outlook

Third quarter 2018

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Domestic

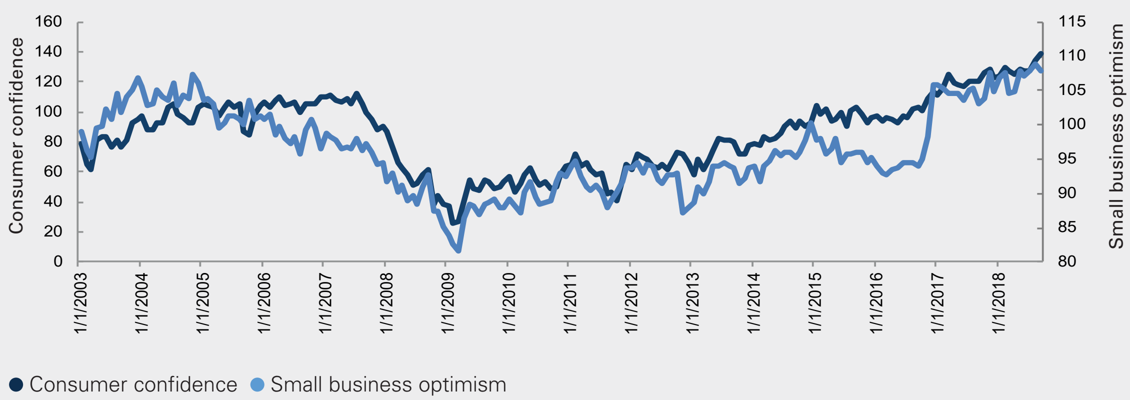
Summary

The economy continued to expand at an above-trend rate in the third quarter of 2018, following the seasonally adjusted annual rate of growth of 4.2% reported for the second quarter. According to the Federal Reserve Bank of Atlanta's GDPNow estimate (as of Oct. 16, 2018), real GDP advanced at a 4.0% annualized rate in the third quarter of 2018.

Despite similar headline numbers for GDP growth in the second and third quarters, the contributing elements of growth shifted rather dramatically. Consumer spending, as measured by the Personal Consumption Expenditures series, decelerated slightly from a 2.7% annualized contribution in the second quarter of 2018 to 2.2% in the third quarter (personal consumption comprises approximately 70% of the economy.) Business investment, which has been a strong marginal contributor to growth over recent quarters, downshifted as well. After contributing 0.98% annualized growth to second quarter GDP, business investment is currently estimated to contribute only 0.39% annualized growth to third quarter GDP. That said, the biggest swing factor, second quarter versus third quarter, is the contribution to growth from inventories. The current estimate is for inventories to flip from a 1.0% annualized drag on real GDP growth to a 2.2% annualized contribution to growth.

Inventories, net exports and government spending tend to be volatile and not sustainable, while consumer spending and business fixed investment are the backbone for consistent domestic GDP growth. Consequently, it will be important to monitor the health of the consumer and business' propensity to invest in the coming months. While the "hard data" economic reports were solid during the third quarter, the "soft data" surveys continued to appear exceptionally strong. In that regard, both consumer confidence and small business optimism appear supportive of GDP growth (see chart).

Consumer confidence and small business optimism surveys



As of 9/30/2018. Source: Conference Board, National Federation of Independent Business

For the consumer, both the Conference Board Consumer Confidence survey and the University of Michigan Consumer Sentiment survey reached levels last seen in the pre-dotcom 1990s. Such high consumer confidence combined with historically low unemployment should be supportive of continued solid consumer spending. Similarly, business surveys remain extremely elevated, including the CEO Confidence Index, the ISM surveys, and specifically, the NFIB Small Business Optimism Index. The NFIB survey hit an all-time high in August of this year. These strong survey results should also be supportive of strong business investment.

Outlook

We expect the economy to continue with solid growth, although moderating somewhat. While we expect GDP growth for 2018 to come in at 3.1%, 2019 is anticipated to post a solid 2.9%. Further, we see inflation remaining contained but somewhat higher. This should allow the Federal Reserve to continue normalizing interest rates with a final rate hike for 2018 in December and three rate hikes in 2019.

The implication from these forecasts is that the yield curve will not invert, although it will remain very flat. Curve inversion has been a popular leading recessionary indicator. Although reliable in predicting recessions, we believe that a more robust approach is to combine yield curve shape with other indicators such as the year-over-year percentage change in the Conference Board Leading Economic Indicators series and credit spreads. None of these three specific indicators point toward a recession in the coming quarters.

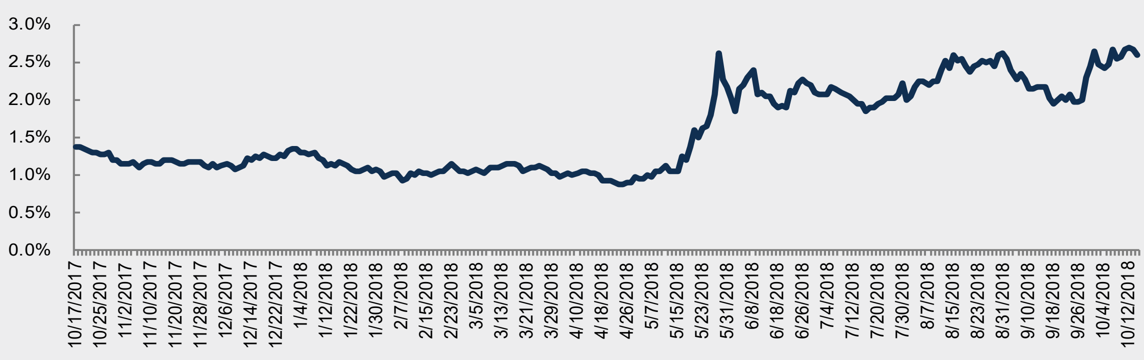
International

Summary

The global economy is growing at a rate of approximately 3.6% annually, led mostly by the U.S. and the developed world. Recently, the IMF slightly downgraded its outlook for 2019 worldwide GDP growth to 2.7%. The economic recovery appears uneven, especially in emerging markets where the effects of severe currency weakness is causing major dislocations. Forward GDP estimates in many emerging market countries are declining as central banks have been forced to raise interest rates to defend their currencies. Emerging market currency deterioration is exacerbated by a general shortage of U.S. dollars caused by the withdrawal of quantitative easing by the Federal Reserve, U.S. corporate cash repatriation and the effects of tariffs on trade flows. We don't believe this emerging market weakness will significantly dampen the global economic recovery in the near future.

In Europe, economic growth has been modest due primarily to two factors. Currently, the Italian government's recent budget deficit proposal which violates EU limits and ongoing efforts to affect Brexit figure prominently and, depending on how events unfold, either could ultimately cause significant market volatility. Concern regarding Italy's budget pushed Italian yields higher (see chart), potentially creating problems for its beleaguered banks. However, anti-EU sentiment is giving rise to demands for more fiscal stimulus across the continent that ultimately will be supportive of higher European economic growth. Brexit negotiations continue, without any apparent resolution. Given the March 29, 2019 Brexit implementation deadline, many believe a plan needs to be finalized by the end of 2018 to allow both houses of Parliament to ratify the plan.

Italian/German 10-year note yield spread



As of 10/16/2018. Source: Bloomberg

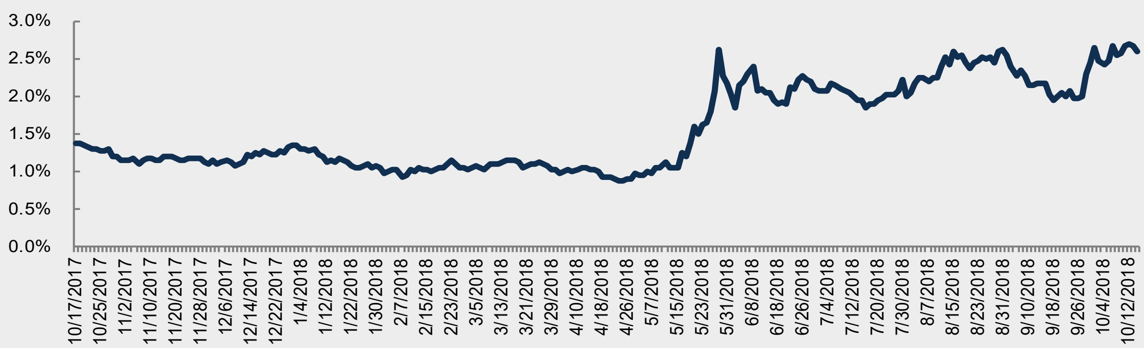
Deliberate policy moves by Chinese authorities to stimulate their country's economy prior to trade talks with the U.S. are beginning to yield results. Despite this, Chinese economic data presents a mixed signal, as the reflation push appears offset by slowing exports, affected by ongoing U.S. trade tariffs. Total Chinese energy consumption has remained steady.

Outlook

Momentum in the developed world's economies appears sufficient to overcome weakness in emerging markets for now. Any trade and tariff settlement between China and the U.S. will likely remain elusive for the foreseeable future, but is offset by the new trade agreements between the U.S. and Mexico and Canada. In any event, analysts estimate that recent tariffs could reduce 2019 U.S. GDP by approximately 0.25%. We anticipate worldwide GDP growth to be healthy in 2019, supported by strong U.S. growth.

Emerging markets are set to experience economic headwinds as they absorb the effects of currency devaluations. These include slower growth, higher interest rates and a spike in inflation. For example, Turkey most recently reported that inflation jumped from 15% pre-crisis to 24% due to weakness in the Turkish lira and higher interest rates. Looking ahead to 2019, a lack of an agreement on Brexit and continued friction between the EU and Italy will likely cause market volatility.

Turkey inflation (CPI, percent year-over-year change)



As of 10/16/2018. Source: Bloomberg

Currencies and commodities

A global shortage of U.S. dollars, which will worsen if threatened tariffs are actually implemented, is likely to support the U.S. dollar going forward. This is becoming a problem for the U.S., as exports are becoming more expensive. This is especially the case with China, which has used its currency as a weapon in the trade war. Commodity prices have stabilized following a period of weakness; this has helped keep global inflation in check.

Sector analysis

U.S. interest rates

U.S. Treasury yields followed a relatively narrow range in the third quarter of 2018, with the ten-year rate trading between 2.80% and 3.10%, and ending the period at 3.06%. Yields at the short end of the curve increased the most, as Treasury supply was concentrated on the short end of the curve and the Federal Reserve continues to raise short-term interest rates. In fact, the 2-year Treasury yield rose to 2.82%, an increase of 27 basis points. The increase in short-end rates was the most significant driver of yield curve flattening. Measuring the spread between the 2-year and 10-year Treasury yields, the curve flattened 19 basis points. The spread between the 2-year Treasury and the 30-year Treasury decreased by almost 10 basis points. We maintain the view that the Federal Reserve will raise rates one more time in 2018 and the 10-year yield will end the year at approximately 3.20%.

Securitized products

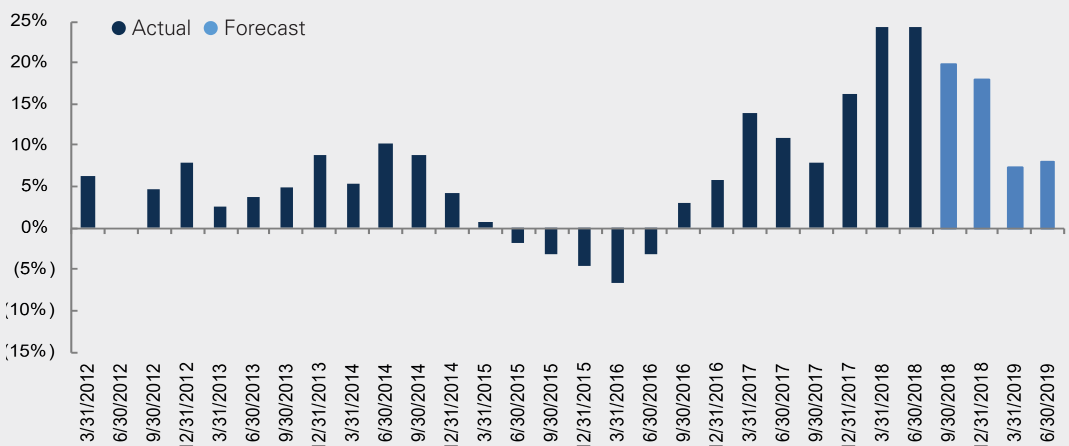
The securitized sectors modestly outperformed U.S. Treasuries in the third quarter of 2018, but were unable to keep pace with the strong rally in the credit markets. Within the securitized sectors, CMBS was the best performing category with an excess return versus U.S. Treasuries of 76 basis points, followed by ABS and MBS with 30 and 17 basis points of excess return, respectively. The sectors were helped by positive fundamentals, which continue to benefit from the strong U.S. economy and healthy labor markets. Supply and demand technicals have also been supportive and characterized by modest new issuance and strong investor demand for short-maturity, high-quality assets. Valuations remain the one area of concern, as many of the sectors have returned to tight pre-financial crisis spread levels and exhibit limited upside potential. ABS remains our favorite sector, based on strong consumer fundamentals and attractive short-maturity yields. We maintain our underweight allocation to agency MBS due to poor valuations and concerns regarding supply and demand imbalances. Within CMBS, we remain close to benchmark weight, but find select opportunities in seasoned deals, single A-rated bonds and single-asset properties.

Credit Spotlight

Corporate earnings remain strong despite earnings deceleration

Some investors lament that corporate earnings per share growth likely peaked in the first and second quarters of 2018 with year-over-year rates of 24.3% and 24.4%, respectively. However, that doesn't necessarily mean the corporate earnings engine is sputtering. The 2018 peak in earnings per share growth shouldn't surprise investors, as it largely results from the well-telegraphed effects of the November 2017 Tax Cuts and Jobs Act which reduced tax rates on businesses and individuals, and to a lesser extent record share buybacks. Indeed, while the rate of growth may slow, it appears that analysts continue to expect further improvement, albeit at a slower pace than the extraordinary rate achieved in the first and second quarters of 2018. Continuing earnings growth will help corporations manage the higher level of leverage built up over the past few years, although leverage management will also ultimately depend on dividend and share buyback and M&A policies, too. As we near the anniversary of the Tax Cuts and Jobs Act of 2017, current analyst estimates suggest corporate earnings per share will continue to grow in the first and second quarters of 2019 at rates of 7.4% and 8.1%, respectively (see chart). While earnings growth of 7-8% appears moderate rather than extraordinary, we point out that it's being generated on the higher base of earnings achieved in 2018. Consequently, we continue to view corporate earnings as being generally supportive of overall credit fundamentals. However, within investment grade credit, strong earnings haven't masked the higher existing debt leverage as well as the increased focus on returning cash to shareholders at the expense of debt holders.

S&P 500 share weighted year-over-year quarterly EPS growth



As of 10/17/2018. Source: Bloomberg

Investment grade credit

Investment grade credit rebounded during much of the third quarter, outperforming U.S. Treasuries by 157 basis points, and retracing almost half of the spread widening experienced since achieving the post financial crisis spread tights in late January 2018. Many of the performance laggards during the first half of 2018 led the rebound during the third quarter, with long maturity credit, BBB-rated credit and industries such as cable, telecommunications, banking (Tier1 capital), midstream energy and sovereign credit experiencing the most relative spread tightening.

We remain underweight investment grade credit due to relatively weak technicals, high debt leverage, a decelerating fundamental earnings outlook and stretched valuations, all partially offset by renewed domestic demand due to higher yield levels. Investment grade credit market demand technicals are mixed due to retail inflows over 75% less than 2017, and a substantial decline in foreign demand as a result of increased currency hedging costs. Renewed insurance company and pension fund demand is partially offsetting the decline in retail and foreign demand, as higher interest rates allow these yield-sensitive buyers to achieve their targets. The nearly flat U.S. Treasury yield curve has made short-maturity credit relatively attractive, consistent with the majority of retail credit inflows occurring in short duration products. New issue supply remains elevated and near the robust level experienced in 2017, as a result of increased M&A activity, despite the positive effects of tax repatriation.

Cross-asset-class supply materially increased in the second half of 2018, as a result of the tapering of Federal Reserve quantitative easing and increased U.S. deficit funding needs. Following significant strength in recent quarters, we expect corporate earnings fundamentals to decelerate due to challenging year-over-year comparisons as well as some margin pressure from increasing commodity prices and tariffs, partially offset by continued strong U.S. economic growth. Further, net credit leverage remains near a multi-decade high, as many companies have increased borrowings in order to finance M&A activity and equity share buybacks. As of September 28, 2018, valuations remained stretched on the Bloomberg-Barclays U.S. Credit Index, which then resided only 11 basis points wider year-to-date and 18 basis points wide of the post financial crisis tights achieved in late January 2018, yet roughly 100 basis points tighter than the early 2016 cyclical wide.

High yield

The U.S. high yield bond market, as measured by the Bloomberg-Barclays U.S. Corporate High Yield Index, shrugged off higher rates to post a solid total return of 2.40% in the third quarter of 2018. High yield bond spreads tightened nearly 50 basis points to end the quarter at +316 basis points, with a run even tighter in early October to +303 basis points, a new post-crisis low. In a theme that has held for most of 2018, CCCs outperformed during the third quarter, returning 2.73%, while higher-rated tiers lagged again (BBs and Bs both returned approximately 2.3%). For the second consecutive quarter, pharmaceuticals and supermarkets led sector performance, returning 4.48% and 4.02%, respectively, while lodging and retail trailed with returns of 0.91% and 0.07%, respectively. Technicals proved resilient as the post-Labor Day calendar underwhelmed expectations and retail outflows tapered. Fundamentals remain a bright spot, with positive leverage and EBITDA growth trends continuing in the second quarter of 2018 (most recent data).

Leveraged loans

Leveraged loans ended the third quarter on a strong note, with average prices finishing the period at their highest level in more than four years. During the quarter, loans, represented by Credit Suisse Leveraged Loan Index, returned 1.93%, pushing the year-to-date total return to 4.36%. As was the case in the high yield market, lower-rated loans outperformed during the third quarter, with split B / CCCs posting a 3.48% gain while Bs and BBs returned only 1.98% and 1.67%, respectively. On a sector basis, retail continued to outperform, posting a 3.44% return, while metals and mining lagged by returning 1.34% following a strong second quarter. Retail loan funds continue to experience inflows which, combined with firm CLO demand, underpin a strong technical backdrop to the market. Loan spreads, as measured by the three-year discount margin, tightened 19 basis points in the third quarter to +381 basis points, a new post-crisis tight. However, loan yields ended the quarter unchanged at 6.86%, as LIBOR climbed. Although underwriting standards have clearly deteriorated, we continue to view loans as attractive versus high yield bonds on a relative value basis.