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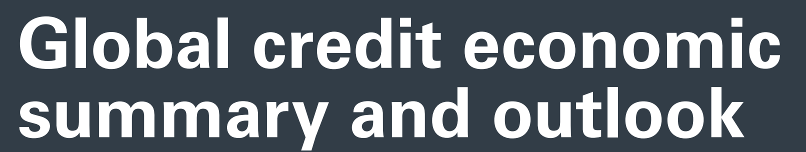


Fourth quarter 2018

![Tortoise logo] Tortoise℠

Global credit economic summary & outlook

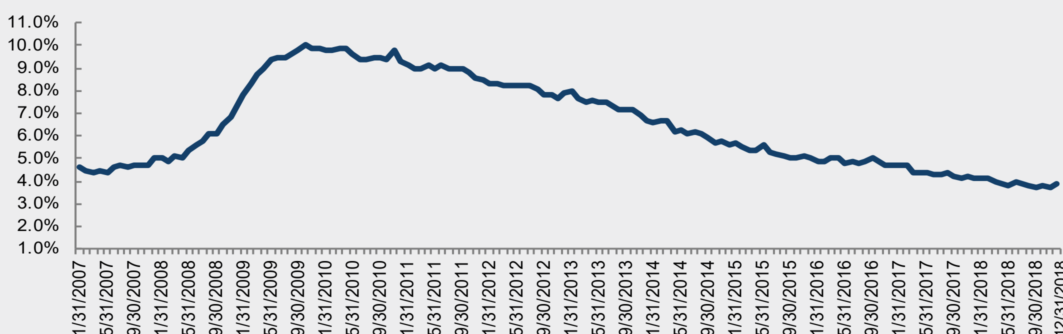
Domestic

Summary

Economic growth in the fourth quarter of 2018 should be quite healthy, although in all likelihood the rate will decelerate again from the previous period. To recap, GDP increased at a seasonally annualized rate of 2.2%, 4.2% and 3.4%, respectively, in the first, second and third quarters of 2018. Notably, on a year-over-year basis through the third quarter of 2018, GDP has increased nine consecutive quarters, the first time this has ever occurred. We believe the U.S. economy might currently reside at the peak rate of growth for this cycle. Based on initial estimates released by both the New York and Atlanta Federal Reserve Banks, we believe that fourth quarter GDP growth will come in at approximately 2.5%.

Meanwhile, inflation remains very subdued and is arguably rolling over to an even lower level, despite the fact that the U-3 unemployment rate continues to track below 4% (see chart). Indeed, the last reported measure of Core PCE inflation, the Federal Reserve's favored measure of inflation, fell to a year-over-year rate of 1.88% in November 2018 after peaking at 2.04% in July 2018. Headwinds to increasing inflation include restrained energy and commodity prices as well as slowing global economic growth, especially in China.

U-3 – Unemployment rate total in labor force, seasonally adjusted



As of 12/31/2018. Source: Bloomberg, U.S. Department of Labor Bureau of Labor Statistics

As expected, on December 19, 2018, against a backdrop of an economy experiencing potentially cyclical peak growth and a moderating inflationary environment, the Federal Reserve raised its benchmark federal funds rate target by 25 basis points to a range of 2.25% to 2.50%.

Importantly, in a post release press conference, Chairman Jerome Powell unnerved investors by implying that the Federal Reserve would institute two additional rate hikes in 2019 and continue to allow its significant mortgage and U.S. Treasury holdings to run-off in a manner referred to as being on "automatic pilot." This forward guidance was not well received by market participants as investors had been increasing their assessment of the probability of a recession in the near future. A flight to quality ensued, driving interest rates lower and the U.S. Treasury 10-year Note yield ended the year at 2.68%.

Federal Reserve board members noted the risk-off, flight-to-quality trade, and in the days following the December Federal Open Market Committee meeting many made public speeches and interviews walking back Chair Powell's statements. Markets now expect the FOMC to pause and reassess its base case of increasing the federal funds rate quarterly.

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Outlook

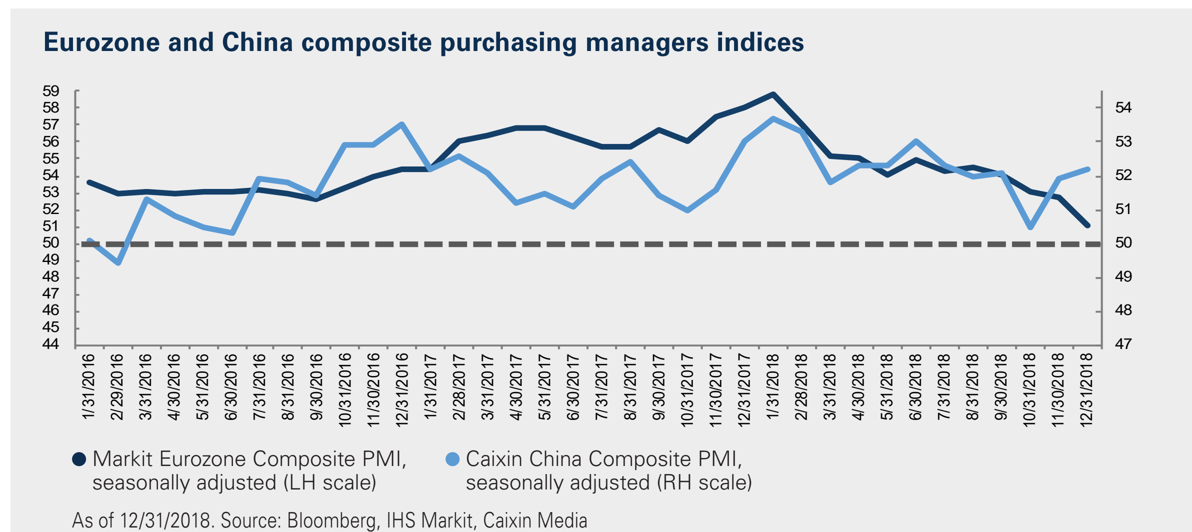
We expect that the U.S. economy will continue to expand in 2019, although growth will likely moderate versus 2018. Employment growth should remain strong, likely keeping downward pressure on the unemployment rate. Although wages may be biased upward, we believe inflation will remain well contained. Our current base case assumes that the Federal Reserve will raise the federal funds rate once in 2019, bringing the target to a range of 2.50% to 2.75%. We also believe that the yield curve will remain flat, and that the spread between two-year and ten-year U.S. Treasury Notes will not invert.

International

Summary

Market volatility continues as analysts reduce global economic growth expectations. Globally, investors remain concerned regarding growth in China and Europe as recent data, especially in China, reflect a noticeable slowdown in economic activity. However, neither yet appears to be in recession as composite PMI indices remain above 50 (see chart).

Eurozone and China composite purchasing managers indices



As of 12/31/2018. Source: Bloomberg, IHS Markit, Caixin Media

In Europe, the reasons for the economic slowdown differ materially from those affecting China. Notably, German manufacturing data, as well as recent import and export data, also point to a marked slowdown in business activity. In addition, the economy in France appears pressured by public unrest and yellow vest protests. However, in contrast, many eastern European countries continue to experience growth, led by Hungary.

While European economic data on balance appears more resilient, we note that Chinese governmental authorities possess relatively more power to introduce policies that could offset the slowdown. Indeed, China has already introduced pro-growth policies in recent weeks, including a lower reserve requirement ratio for major banks and wide ranging tax cuts. These policies result directly from the growing impact of U.S. trade tariffs.

Emerging markets have stabilized following significant currency weakness in 2018. A change of government in Brazil improved business optimism and bolstered the country's Bovespa Index. However, weakness in commodity prices represents a significant headwind for many emerging market and developing economies. In a January 2019 report titled "Global Economic Prospects – Darkening Skies", the World Bank acknowledged this factor as it downgraded its 2019 GDP growth outlook for emerging market and developing countries to 4.2% from a previously estimated rate of 4.7%.

Outlook

Regardless of the Chinese government's greater control over its economy and even if it resolves its trade dispute with the U.S., the country's economy will likely continue to slow in 2019 and possibly into 2020. In addition, while the announcement of a trade agreement may immediately calm financial markets, complete resolution of U.S. / China trade issues will likely take several years.

Italy will likely enter a mild recession during 2019 and France may succumb soon thereafter as it continues to experience public unrest and yellow vest protests. If these situations persist, European authorities may face a significant dilemma. From a monetary perspective, there appears little that the ECB can do to arrest the decline given that interest rates are already low, and it has previously forecasted the end of its bond buying program. From a fiscal perspective, those countries generally in need of fiscal economic stimulus face high debt levels and restrictive budget deficits.

On the European political front, the year 2019 will likely be volatile. The popularity of elected leaders is declining rapidly, heightening speculation that France's Macron and Germany's Merkel will not last to the end of their current terms. Mid-year European elections may also reflect a rise in anti-euro sentiment.

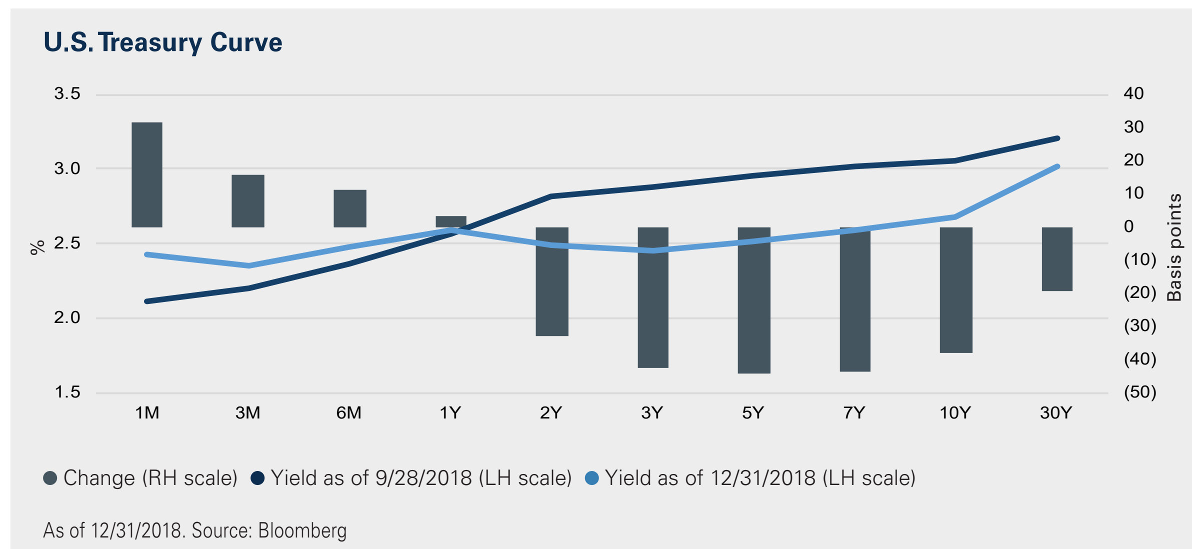
Currencies and commodities

The outlook for the U.S. dollar remains mixed with a bias for a strengthening. The U.S. economy continues to grow at a healthy pace and will likely continue to attract capital supporting the dollar. We anticipate weakness in the euro as a recession looks increasingly likely and political uncertainty increases. The lack of clarity surrounding Brexit will likely keep Sterling under pressure for the time being. Emerging market currencies appear unlikely to significantly weaken further against the U.S. dollar. The outlook for inflation remains benign for 2019, given the slowing outlook for worldwide economic growth and the prevailing weakness in commodity prices.

Sector analysis

U.S. interest rates

The U.S. Treasury curve flattened considerably during the fourth quarter of 2018 as the spread of the two-year and ten-year U.S. Treasury Notes declined five basis points to end the period at 20 basis points. The belly of the curve led the decline as yields on the five-year and seven-year U.S. Treasury Notes declined 44 basis points and 43 basis points, respectively.



As of 12/31/2018. Source: Bloomberg

Although the flattening trend continues, we have not seen the yield curve invert at the two-year to ten-year or five-year to ten-year ranges. In early 2019, rates declined further; nevertheless, we continue to believe we are in an increasing rate environment and the Federal Reserve will continue tightening monetary policy.

Securitized products

While the riskier fixed income sectors fared particularly poorly in the fourth quarter of 2018, even higher quality sectors such as securitized products experienced difficulty.

Notably, ABS ranked as the best performing sector for the quarter, and it ended the year 2018 as the only one that generated a positive excess return versus Treasuries. Positive consumer fundamentals driven by the strong labor market continue to support investments in ABS. In December, we began reducing our overweight to the sector, primarily in recognition of strong recent performance.

Despite favorable fundamentals, the CMBS sector was unable to shake its correlation to riskier assets and performed poorly in the fourth quarter. We continue to identify select opportunities in single-asset and seasoned CMBS deals.

We viewed agency MBS negatively throughout the year, but are starting to see light at the end of the tunnel. Valuations have improved and we believe demand for safe, liquid securities like agency MBS will emerge in the coming year. With robust expected new issuance and normalization of the Federal Reserve's balance sheet, we view supply and demand technicals for MBS as challenging. We are currently underweight the sector, but expect to increase our allocation in the first quarter of 2019.

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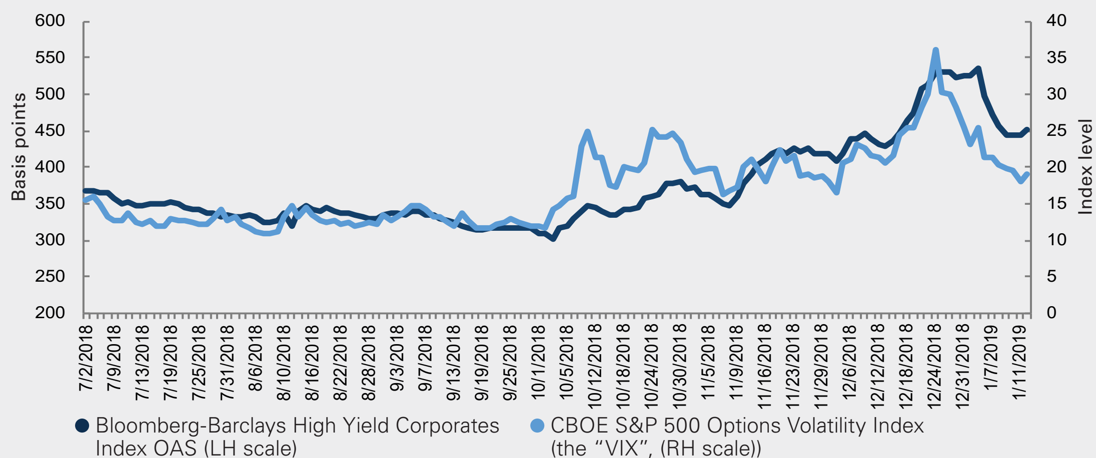
Credit Spotlight

The Anxiety of the Markets

Financial markets continue to react anxiously to a number of significant headline issues, including Federal Reserve policy and its communications with investors, an impending earnings growth slowdown, the U.S. government shutdown, tariffs and a potential trade war with China, slowing global economic growth, Brexit, and ongoing political theater in seemingly every corner of the globe. The markets hate uncertainty, and the only certainty today seems to be the endless list of potential variables to consider. Looking back over the last six months, investor anxiety and concern appear to have peaked in late December as measured by the VIX (see chart). Historically, periods of elevated uncertainty, volatility and investor capitulation have proved to be good environments to add to risk assets. While the VIX has retraced much of its widening from the peak in December, particularly as the Federal Reserve has walked back most of its hawkish rhetoric, it continues to reside well above levels set in the second half of 2018. Risk assets, including credit and high yield corporate bonds have followed the partial recovery in the VIX. For example, the Bloomberg-Barclays U.S. High Yield Corporate Index option adjusted spread (OAS) widened 234 basis points from its tight of 303 basis points in October to a wide of 537 basis points on January 3, 2019. Since then, similar to the VIX, high yield spreads have contracted significantly as at least some investor fear and anxiety has dissipated.

High Yield Corporate Bond spreads and the S&P 500 Options Volatility Index



As of 1/14/2019. Source: Bloomberg, Cboe Global Markets, Inc.

Going forward, we expect volatility will remain elevated given the continued uncertainty surrounding numerous headline issues that investors regard as critical top-down fundamental, political and economic determinants. Nevertheless, we believe the significant widening of corporate bond spreads in December created a tactical opportunity to add risk on the margin. Although markets have meaningfully retraced some of the sell-off that prevailed in the fourth quarter of 2018, we continue to expect corporate bond spreads to grind slightly tighter in the near term, albeit in a potentially volatile fashion.

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Investment grade credit

Investment grade credit struggled during the fourth quarter of 2018, underperforming U.S. Treasuries by 285 basis points, with 80% of the calendar year spread widening occurring during the period. The best performing industries and sub-segments of credit experiencing the least amount of spread widening in the quarter were non-corporate credit, apartment REITs, cable, consumer products, short-maturity credit, and higher credit quality issuers. The worst performers during the quarter included tobacco, independent energy, automobiles, gaming, refining, and cross-over rated credits.

We remain underweight in investment grade credit due to relatively weak technicals, high debt leverage, and a decelerating fundamental earnings outlook, all partially offset by improved valuations. Investment grade credit market demand technicals remain challenged due to poor retail flows as well as subdued foreign demand as a result of expensive currency hedging costs. Renewed institutional demand from insurance companies and pension funds may partially offset tepid retail and foreign demand as higher interest rates and wider credit spreads allow these yield-sensitive buyers to achieve their return targets. The nearly flat U.S. Treasury yield curve continues to make short-maturity credit relatively attractive, consistent with the majority of retail credit inflows occurring in short duration products. An expected modest decline in new issue supply should partially offset lower demand. However, the increased cross-asset-class supply resulting from the reduction in the size of the Federal Reserve's balance sheet and increased U.S. deficit funding may compete for the marginal investment dollar, potentially crowding out some demand.

We expect positive yet decelerating revenue and earnings growth, some margin pressure, and a continuation of corporate behavior returning cash to shareholders at the expense of the debt holder. Further, balance sheet leverage and corporate debt remain near cyclical peaks although this phenomenon is concentrated in a handful of industries and issuers as opposed to the entire investment grade credit market.

Valuations have significantly improved over the course of 2018 from the cyclical spread tights reached on February 1, 2018. However, investment grade corporate credit spreads are now only a couple basis points wide to the average spread level over the last eight and twenty-five year periods, although some industry and issuer valuations are substantially wider than average.

Given the rapid sell-off that occurred during the fourth quarter, we expect a tactical short-term improvement in credit spreads in early 2019, followed by continued volatility and wider spreads later in the year. We believe opportunities exist in some issuers and industries where valuations fully compensate for the perceived risks. In addition, we continue to see value in the short-maturity tenor due to improved technical demand.

High yield

The U.S. high yield bond market limped to the finish line in 2018, as the Bloomberg-Barclays U.S. Corporate High Yield Index posted a dismal return of -4.53% in the fourth quarter that resulted in a -2.08% return for the year. After hitting a new post-crisis low of +303 basis points in early October, high yield spreads gapped wider, ending the year at +526 basis points. Single Bs were the best performers for the year with a return of -1.31% as higher rates restrained BBs, which returned -2.41% and the fourth quarter risk-off trade crushed CCCs with a return of -3.84%. The fourth quarter 2018 slump hit cyclical industries hardest, particularly energy as it ended 2018 trailing all other sectors. Communications, consumer non-cyclical, and utilities were the only sectors posting positive returns for 2018.

While investors lost confidence in the cyclical story at the end of 2018, credit fundamentals remain a bright spot for high yield issuers, with positive leverage and EBITDA growth trends continuing in the third quarter of 2018 (most recent available data). Although earnings growth will likely slow in 2019, credit trends should remain solid. The high yield default rate remains benign, hovering around 2%, and we do not envision a meaningful move higher in 2019.

Technicals held up in 2018 until the fourth quarter, when approximately $20 billion of retail outflows overwhelmed a market that had benefitted from a very light new issue calendar. Notably, new issuance declined approximately 40% year-over-year in 2018 and not a single deal closed in the month of December. With issuers increasingly utilizing the loan market, we expect another tepid year of high yield bond issuance in 2019. Given the year-end timing of the recent sell-off, the high yield market appears positioned to perform well, if broader risk markets rally; however, we plan to remain somewhat cautious as the year – and the economic cycle – progresses.

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Leveraged loans

The leveraged loan market barely held on to positive gains and provided a total return of 1.14% in 2018, as the year ended on an extremely weak note returning -3.08% in the fourth quarter driven by a -2.29% return in December, the largest monthly loss by the Credit Suisse Leveraged Loan Index since 2011. After starting the quarter at their highest levels in more than four years, loan prices dropped nearly 4.5 points in the fourth quarter to an average of just above $94, the lowest level since August 2016. As was the case in the high yield market, lower-rated loans underperformed during the fourth quarter, and not a single sector posted a positive return. A massive exodus from retail loan funds exacerbated the general risk-off tone in the quarter, as December's $9.9 billion outflow ranked as the largest on record. A key question for loan market technicals in 2019 is the health of the CLO market, which experienced a record new issue year in 2018 but is likely to slow in 2019. During the fourth quarter, loan spreads, as measured by the three-year discount margin, widened 169 basis points to +550 basis points at year end, after beginning the quarter at +381 bps, a new post-crisis tight. The significant fourth quarter widening in loan spreads leaves valuations much more attractive than nearly any time over the last two years. Three-month Libor climbed another 40 basis points in the fourth quarter to 2.8%, moving overall loan yields over 8%, the highest level since 2009. Although underwriting standards clearly deteriorated in 2018, we continue to view loans as attractive versus high yield on a relative value basis.

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