Tortoise QuickTake Credit Podcast

Tortoise

June 25, 2019

Welcome to the Tortoise QuickTake podcast. Thank you for joining us. Today, Tortoise provide a timely update on trending topics in the market.

Jeff Brothers: Welcome to the Tortoise Credit weekly podcast. I am Jeff Brothers, Senior Portfolio Manager for Tortoise. Last week the Federal Reserve delivered everything but a rate cut. The statement was dovish, with as shift from being "patient" to ready to "act as appropriate;" the dot plot of Fed rate projections took a dramatic shift downward; and Chairman Powell's press conference completed the dovish message with a willingness to confront the growing uncertainties. In today's podcast, we will attempt to answer the four big questions following last week's Federal Reserve meeting.

The first big question – What is next for Fed policy?

After laying the groundwork in the June meeting, the Fed now looks set to cut rates in July. The big question is whether they reduce by 25 or 50 basis points. A 25 basis point cut would be consistent with the cautious nature of the Fed. When asked why the Fed did not cut in June, Powell indicated the desire to see more data, which would include any progress on trade negotiations, second quarter GDP, and June's employment report. This approach, however, relies on reacting to backward looking data and risks falling further behind the curve. Another approach, which we think is more likely, is a bolder 50 basis point cut. Here, the Fed would use a risk management approach or as Powell put it in the press conference, "an ounce of prevention is worth a pound of cure." If the data remains weak, the Fed is well served by cutting more aggressively and if the economy surprises to the upside and inflation finally moves higher, then the Fed can always take back the insurance cut.

Question two – Why is there pressure to cut rates if the Fed's economic outlook is stable?

In the statement, the Fed describes a "favorable picture" for the economy with solid growth, a strong job market and a pickup in household spending. In the Summary of Economic Projections, they left their GDP forecast unchanged at 2.1% in 2019 and modestly increased 2020 to 2.0%. Chairman Powell said despite the positive outlook, the Fed was mindful of the ongoing crosscurrents, including trade developments and concerns about global growth. We believe the more urgent reason to cut rates is the complete lack of price pressures and the risk of deflation in the next downturn. Despite using every tool in their toolbox, the Fed has been unable to anchor inflation anywhere near their 2% target. The Fed's core PCE inflation target is currently running at 1.6% and has only been above the 2% target for six months over the past ten years.

The third big question - Is the Fed losing its independence?

Trump has tweeted a steady stream of criticism about Fed policy and last week the administration was exploring the legality of possibly demoting Powell from the Chairmanship. Former Fed Vice-Chair Stanley Fischer last week warned that Trump's pressure threatened the independence of the Federal Reserve. In the press conference, Chairman Powell was again asked about political considerations and the Fed's independence and he reiterated that he fully intended to complete his four-year term and the Fed's mission of serving both the economy and the country. It is hard to believe, however, that the Fed is not feeling the heat from President Trump's tweets, but perhaps the bigger bully facing the Fed is the bond market. With 10-year Treasury rates rallying 125 basis points from the November high and market expectations for three rate cuts in 2019, the markets are exerting heavy pressure on the Fed to deliver.

The last question – Will rate cuts really help the economy?

This is the toughest long-term question to answer. The Fed aggressively used their limited set of tools to fight the last downturn. Now with the funds rate at only 2.5% rather than 5.25% prior to the financial crisis, there is less ammunition to fight the next slowdown. In addition, the Fed's tools have had little impact on inflation and it would seem unwise to continue doing the same thing and expect a different outcome. The economy does not currently suffer from pent-up demand to borrow or any real tightness in credit availability that lower rates would cure. Finally, the Fed must be studying the lessons from

Japan and Europe where even negative interest rates have failed to turn the tide of disappointing growth and weak inflation. Judging by the rally in the stock market, the prospect of easier policy does clearly spur the animal spirits. At this point in the market cycle, it remains to be seen whether the asset inflation will ease financial conditions and ultimately lift the economy or risk creating another asset bubble.

To conclude, the Federal Reserve answered the question of their dovish intent by sending a strong signal to cut rates. Now the markets will have to wait for the answer to the magnitude and effectiveness of the rate cuts.

Thank you for listening, we will talk to you again next week.

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@tortoiseadvisors.com.