Tortoise QuickTake Credit Podcast

Tortoise

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

Welcome to this week's Tortoise credit podcast. I'm John Heitkemper, portfolio manager for high yield bonds and leveraged loans at Tortoise.

The 4th of July is a fun and much-anticipated holiday in the community where I live, a day filled from morning until night with a 5K fun run, swimming and barbecues, a parade, and of course, fireworks. But much of the anticipation around town last week, particularly in the 'tween crowd that includes my older daughter, was not for any of these activities, but instead for the release of Season 3 of Netflix's Stranger Things. I'll admit, there might have been some binge watching at our house, but rest assured, no spoilers on this podcast. But just so we're all on the same page here, the quick summary for the uninitiated listener is that the plot centers on a group of kids in 1980s Indiana who battle some very bad creatures from an alternative universe called "the upside down."

Before this podcast turns into a TV review, let's switch gears to financial markets, as Friday's reaction to the monthly labor report suggested that good news might actually be interpreted as bad news, as if we're experiencing our own Wall Street version of "the upside down." The report indicated that the U.S. labor market remains healthy overall, as the economy added 224,000 jobs in June, significantly more than the 160,000 expected by economists, and up from just 72,000 in May. Over the first half of the year, monthly job gains are averaging about 170,000, which while down from ~210,000 in the last half of 2018, is still respectable and indicative of an expanding economy. The unemployment rate did tick up from 3.6%, a 50-year low, to 3.7% in June, but this came as a result of a higher labor force participation rate, also a healthy signal. If there's any reason to knock the report, it's on wage gains, which have been stubbornly muted during this cycle. In June, average hourly earnings increased 3.1% year-over-year, below market expectations.

In response to the better-than-expected data release, U.S. equity markets sold off from record highs and Treasury yields backed up about 10 basis points, with the 2-year climbing from 1.76% to 1.87% as of yesterday, July 8th. In this upside down financial world, the markets viewed Friday's strong report unfavorably, as it cast doubt on a series of Federal Reserve rate cuts priced into the market. Going into the Friday jobs report, Fed futures had a 25 basis point cut fully priced in for the July meeting and about a 25% chance of a larger 50 basis point cut. Futures also showed expectations for three cuts in total by the end of 2019. With lingering trade uncertainties, slowing earnings growth and weaker global economic data all posing as dark gray clouds on the horizon, investors had been hanging their proverbial hats on easier monetary policy in the U.S. And in recent speeches, Fed Board Chair Jay Powell had said little to dissuade the market from believing that rate cuts are in the cards.

Although the Fed's July meeting is still three weeks away, the window is closing for Powell and his colleagues to guide the markets as to their updated thinking. This week's semi-annual testimony before Congress will be key for Powell in communicating both the timing and number of rate cuts to expect. Despite Friday's labor report, the market is still pricing in a near certain 25 basis point cut in July with another one or two cuts before the end of the year. Powell should certainly let markets know this week if futures are out of sync with the FOMC's own position on policy easing at coming meetings.

We still think the case is strong for a 25 basis point cut at the July meeting. First, global economic growth is slowing, and the outlook is particularly uncertain given the ongoing trade dispute between the U.S. and China. Global manufacturing PMI (purchasing manager index) data declined to contractionary levels in June for the first time since 2016, giving credence to the risk that as long as trade tensions remain unresolved, headwinds exist for the U.S. economy, particularly for trade-heavy

industries like the manufacturing sector. The FOMC is likely to be more focused on these forward-looking risks than June's labor data, which are both backward looking and historically very volatile on a month-to-month basis.

Secondly, today's starting point for potential easing gives the FOMC less room to maneuver. With its policy rate just above 2%, the U.S. central bank does not want to wait to see cracks in the U.S. labor market before cutting. Powell indicated in his "an ounce of prevention is worth a pound of cure" statement that a mini-easing cycle – of say two or three insurance cuts – is a better strategy than waiting to respond to actual signs of weakness, which could necessitate cutting aggressively to the zero bound. Once those bullets are used, it's back to quantitative easing. We think the FOMC would prefer to try to head off that scenario by firing a few rounds upfront.

Lastly, there's still the issue of inflation. Or more specifically, a lack of inflation. Despite a historically low unemployment rate, the Fed has yet to generate sustained inflation in line with its 2% target. With 10-year breakeven rates hovering around 1.7%, the bond market appears to be losing confidence in the Fed's ability to reach its own inflation target. Policy makers would desperately like to re-anchor expectations around 2%, which would presumably support longer-dated Treasury rates and help re-steepen the yield curve. If the FOMC were to sit on its hands in coming meetings, waiting for more troublesome data to emerge, they risk the recessionary consequences of a prolonged curve inversion.

Powell, like many of the preceding Fed Chairmen, has experienced a few stumbles in communicating with financial markets, and in this week's testimony, we expect that he'll be walking an especially fine line in previewing the FOMC's July meeting. Even more so than usual, investors are keenly focused on the Fed's next move, so this seems like the one time when a spoiler is warranted.

Thanks for listening, and please tune in for future Tortoise credit podcasts.

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.