Tortoise QuickTake
Credit Podcast

Tortoise

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

Hi, I'm John Heitkemper, portfolio manager for high yield bonds and leveraged loans at Tortoise.

You would think that of all the days in the year, Father's Day would be the one where I could get my daughters to listen to me. Guess again. My hopes were dashed again this year, as my appeals were treated not with mere indifference but with the look of a Ronaldo or Messi when they don't get a call from a World Cup referee.

Like my daughters, it's not clear that financial markets were paying attention last week, in particular to central bank statements. Granted, there were many headline-grabbing distractions, including President Trump's meeting with North Korea's leader, more shots fired in the U.S.-China trade skirmish, and the aforementioned World Cup. While those events could certainly have important consequences, we wonder whether they overshadowed some small, but significant policy shifts from both the Fed and ECB.

Starting on this side of the Atlantic, the FOMC predictably voted last Wednesday to raise its Fed Funds target by 25 basis points to 1.75-2.00%. This move represented the second hike this year and the seventh since the Fed began normalizing monetary policy at the end of 2015. Chairman Powell, who took the reins from Janet Yellen back in February, appears to be settling in and starting to influence the tone of the Fed's message. Both the press release and Powell's testimony read more bullish on U.S. economic growth – driven by tax cut effects – and more confident that inflation is indeed firming up to the Fed's 2% goal. The FOMC members' GDP growth forecast for 2018 improved a tenth of a percent to 2.8%, with lower expected unemployment – 3.6% vs. 3.8% in their prior forecast – and faster inflation, 2.1% vs. 1.9%.

Noticeably, the FOMC statement chose not to highlight international risks such as trade policy or the Italian sovereign situation, and in his testimony, Powell suggested that the Fed wouldn't react to international events until they start to show up in U.S. economic data. For the dot-plot watchers out there, the median forecast is now calling for a total of four hikes in 2018, up from three, as well as an additional three hikes in 2019 and one more in 2020. Under this scenario, the Fed Funds would reach 3.4% in 2020, above the FOMC's own estimate of the neutral rate, the theoretical level of interest rates that coincides with steady-state unemployment.

Before we get tripped up by "FedSpeak" minutia, let's take a look at the big picture here. Powell's FOMC is increasingly confident that the U.S. economy is in good shape, unemployment is set to remain below the longer-run forecast and inflation is moving decidedly higher. As a result, FOMC participants now expect five more rate hikes before the end of next year.

Does this suggest that there is actually a risk that the FOMC hikes more than expected? Before you answer, let me just throw out one more FOMC change announced last week. Chairman Powell indicated that starting in 2019, he'll hold press conferences after every FOMC meeting, not just the quarterly meetings that include projection updates, as is the current protocol. On the face of it, more opportunity to communicate to financial markets certainly implies he'll have more flexibility to tighten more aggressively, should the need arise.

While most Wall Street economists called last week's FOMC meeting somewhat hawkish, financial markets reacted with a big "ho-hum." The 10-year Treasury barely budged, still hanging out just under 3%, while stocks lost less than a half of a percent (as measured by the S&P 500® . Furthermore, Fed Funds futures still imply that the market expects closer to just three hikes over the next 18 months, not five. The only perceptible reaction was a flattening of the 2s-10s curve, which narrowed to 35 basis points, a cyclical low. The FOMC will likely keep its eye on this figure, as a turn to the negative would imply to markets that rate hikes have gone too far.

One reason for a muted market reaction to the FOMC came on Thursday in the form of dovish guidance from the European Central Bank (ECB) as it starts to plan the reversal of its stimulus measures. With regard to quantitative easing, the ECB intends to slow its monthly purchases of European sovereign and corporate bonds from 30 billion euros currently to 15 billion at the end of September, and then all the way to zero at year-end. The market had largely priced this in already and took comfort from the statement indicating that ending QE is conditional upon incoming economic data. Additionally, and more importantly, ECB President Mario Draghi surprised by committing to hold rates steady – at their current negative level – through at least the summer of 2019. Thus, the ECB offset what was substantively a hawkish announcement on ending QE with a strongly dovish forward rate guidance.

So in the midst of a noisy headline week, the ECB's dovish language offset a somewhat hawkish Fed. Whether the market was listening amidst the distractions or just decided to sit on its hands, we'll never quite know. But our guess is that the FOMC's new outlook bears further monitoring; if we get to the end of 2018 with two more hikes under our belt and the Fed still targeting three more for 2019, financial markets are bound to start paying attention.

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

Narrator: 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.

The S&P 500® Index is a market-value weighted index of equity securities.

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