Tortoise QuickTake Podcast

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

Hello and welcome to the Tortoise Credit Strategies weekly podcast. I'm Greg Haendel, one of the Senior Portfolio Managers on the investment team at Tortoise Credit Strategies.

We have many famous scientists and experiments looking back in history, from Galileo testing theories on gravity to Isaac Newton separating light into its component colors to more recently Ben Bernanke and Janet Yellen experimenting with quantitative easing (QE as we will refer to it) and the size of the Federal Reserve or Fed's balance sheet. Each of these folks conducted an experiment and had a theory yet didn't truly know how everything would turn out until after the experiment was complete. Today our financial markets remain in the middle of what some have called "the greatest monetary policy experiment of all time." Many economists and market participants have argued about how large of an effect QE and the resulting ballooning of the Fed balance sheet have had on the economy and the financial markets. If you agree that this QE has had an effect on the financial markets, then how does the reversal of "the greatest monetary policy experiment of all time" effect the financial markets?

First a brief review of the Fed decision from Wednesday, June 14th. As largely telegraphed to the markets, the Fed raised the Fed Funds target rate by 25 basis points to a range of 1% to 1.25% while reaffirming its expectations for ongoing rate hikes this year and onwards into 2018 and 2019 despite recently weaker than anticipated inflation data. The minimal change to the Fed's forward rate expectations, slightly higher GDP growth estimates, lower projected unemployment rate and most importantly the transitory verbiage describing the recent weakness in inflationary data was a modestly hawkish surprise to the financial markets. This in turn caused short maturity interest rates to rise substantially more than longer maturity interest rates. Additionally the Fed provided an outline for their plan regarding the tools, pace and timing for reducing the size of their balance sheet which we will discuss in more detail shortly.

Getting back to "the greatest monetary policy experiment of all time," in order to understand the theory behind QE and the Fed's purchases of securities in the market, I suggest reading former Fed Chairman Ben Bernanke's Nov. 4, 2010 Washington Post op ed piece entitled "What the Fed Did and Why." In essence the experiment, which equates to a Fed balance sheet expansion of approximately $3.7 trillion dollars through the purchasing of U.S. Treasuries and agency mortgage backed securities or MBS, was intended to work through the portfolio balance channel. This is where the Fed purchases would lower Treasury and mortgage interest rates thereby easing financial conditions and making it easier for individuals and companies to borrow, all things equal. In addition, these actions were intended to incentivize investors to diversify their portfolio outside of U.S. Treasuries and agency MBS given the shrinking free float of those assets as well as the less compelling valuations versus other assets such as corporate bonds and even equities. In theory this should push corporate spreads tighter and U.S. equity prices higher, all else equal, which boosts consumer wealth and increases confidence, which can theoretically also spur spending which in a virtuous cycle further supports an economic expansion.

There is a great amount of debate regarding quantitatively how much the $3.7 trillion in QE affects various asset classes. While it is nearly impossible to single out the effects of QE from other market influences, some estimates include 100 basis points or 1% lower 10-year U.S. Treasury rates as a result of nearly $2 trillion of U.S. Treasury securities added to the Fed's balance sheet and 25 basis points or more in tighter mortgage spreads from the $1.8 trillion of MBS added to the Fed's balance sheet. In corporate credit and equities the effects on valuations are much more difficult to quantify given they are part of the second derivative effect of QE.

Essentially investors have crowded into asset classes like corporate credit and equities given yield and return hurdles were no long attainable in U.S. Treasuries and agency MBS. Outside of the unquantifiable spread tightening in corporate credit, we have also seen an increase in opportunistic issuance from companies looking to take advantage of low interest rates and attractive credit spreads. As a partial result, the size of the U.S. credit markets has doubled since 2007.

The reversal of QE will have to be very slow, measured and well telegraphed in order to minimize what could be an inevitable market impact. Currently the Fed reinvests all of its maturities and principal paydowns equating to approximately $25-$33 billion per month or $300-$400 billion per year for each US. Treasuries and agency MBS held on its balance sheet. As the Fed recently outlined, this potential balance sheet reduction could begin this year, however, it will start off slowly with a maximum monthly reduction in reinvestments of $10 billion between U.S. Treasury and agency MBS combined. This pace of tapering will then pick up quarterly by $10 billion combined each month culminating in a monthly reduction in reinvestment of $50 billion combined between Treasuries and agency MBS twelve months hence. At that point, the Fed could either begin selling the remainder of its intended portfolio reduction or much more likely, continue to let the portfolio slowly shrink over several years from strictly maturities and principal paydowns.

How the reversal of the experiment may play out is an issue of great angst and concern amongst some market participants. As the market digests the timing and implications of this new balance sheet reinvestment policy, we believe agency MBS spreads could drift wider and U.S. Treasury yields may drift higher given that financial markets typically price in the expected end game despite that being months or even years away. As the market implied probability for balance sheet reduction increases, so should U.S. Treasury term premiums and agency MBS spreads. Further, simple supply and demand analysis means, all things equal, there will be an enormous buyer, the Fed, slowly stepping back from the market while the potential supply of U.S. Treasury and agency MBS available to non-government holders increases.

Over time, months or maybe longer, as valuations improve in U.S. treasuries and agency MBS, those same investors that originally moved into corporate bonds or other more attractive yielding assets may reverse their initial trade and sell corporate bonds to buy U.S. Treasuries or agency MBS given the improved relative valuation. This in turn could weaken technicals in the corporate bond markets and lead to modestly wider credit spreads, all things equal.

While the situation just described may take several years to play out, once the financial markets anticipate future actions with a reasonably high probability, they tend to price in that future action into today's valuation. As such, this is one of the various factors contributing to our duration positioning that is shorter than that of the index, our underweight to agency MBS, and our modest risk reduction within corporate bonds, although we do remain constructive on credit fundamentals.

Thank you for listening to the Tortoise Credit Strategies podcast and hopefully you will join us for next week's edition.

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@tortoiseinvest.com.