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.

I am Graham Allen, Senior Portfolio Manager at Tortoise Credit Strategies.

Welcome to the Tortoise Credit podcast for 1st August 2017.

Today we will discuss the state of the global economy and the implications that this has for U.S. and overseas interest rates.

Despite some recent concern and volatility caused by comments from the European Central Bank indicating an end to its quantitative easing program, longer-term fixed income yields have remained range bound. This has been in spite of the fact that we are clearly seeing an acceleration of global growth, albeit from relatively low levels in some continents. This would include Europe and Latin America. Given this, why have yields not reacted to what has clearly been a more positive economic environment, rising business confidence and record equity prices?

One of the worst economic environments that can be experienced is that of stagflation. This is where a country experiences very low growth but with high inflation, similar to the 1970s. The opposite environment that has evolved to-date therefore is quite favorable; that is healthy growth and low inflation. A situation that intuitively does not last as strong growth has ultimately led to rising prices in the past.

Although some countries are not yet growing at full potential, it would appear that the global recovery is well underway, with some of the larger economies experiencing very high growth rates already. Although some of the major elements have yet to metastasize, one of them being the replacement of monetary stimulus with fiscal stimulus, it would appear that the recovery is in the early stages for large parts of the global economy. Given this, it would be reasonable to expect a negative reaction from fixed income markets in anticipation of high inflation down the road. So far this reaction has been muted, and is probably connected to the fact that we have yet to see any real signs of global inflation. Although commodity prices have recovered from the 2015 lows, we have yet to see this translate into higher inflation reports in most parts of the world. In fact, generally speaking inflation is still trending lower. It shouldn't be forgotten however that inflation is a lagging indicator, so it is reasonable to ask that as growth accelerates will this translate into higher prices and by extension higher yields?

So let's start with a brief review of the state of this global recovery at present. Beginning in Europe it seems clear that the EU is emerging from a seven-year slowdown, with the latest report showing GDP growth in the Eurozone of over 2.0%. In countries such as Spain, GDP is presently growing at about 3% year on year. Core countries such as Germany and France are also seeing accelerating growth rates, although an economic competitiveness disparity between the two major European countries remains a problem. The economic pick-up is welcome given the seven years of austerity after the Great Recession. Indeed, it was only a matter of months ago when the continent was struggling with growth and the real fear was deflation. This caused the European Central Bank to increase its monetary stimulus pushing short-term interest rates to negative in many countries. It is also encouraging that beginning in late 2015, debt to GDP levels generally began to fall. This is important because it gives the individual governments the potential to increase fiscal stimulus going forward. If, as we expect, the ECB begins to pull back its monetary stimulus in the coming months it will be important that it is replaced by fiscal stimulus in order to maintain the momentum. So at present we are seeing limited signs of inflation, positive GDP growth rates and generally improving business and consumer confidence across the European Union.

The one exception to this would be the UK. Contentious BREXIT talks have created market uncertainty for now. A spike in inflation caused by weak sterling, and the lack of an agreement with the EU is creating market uncertainty. Despite the rhetoric, and political instability in the conservative party, the U.K. continues to have a strong bargaining hand. It is estimated that the annual trade deficit with the EU is approximately €60 billion. Furthermore, if the EU decides to play hardball with the U.K., there is a considerable European manufacturing base within the U.K. borders. Punitive trade tariffs therefore would damage European interests based in the U.K .and therefore remain unlikely. This is especially the case with Germany which has an estimated 370,000 employees in the U.K. alone. Given all of this it is therefore unlikely that the U.K. will experience a recession but rather experience lackluster growth of 2% while the negotiations take place.

Latin America is beginning to see growth after a similar period of stagnation as Europe. For 2017 as a whole the expectation is for approximately 1% GDP growth. This is forecast to rise to 2% in 2018. Brazil which has been in a deep recession is it also expected to experience positive growth of slightly above 1% for this year. This will be helped by further anticipated interest rate cuts from the Brazilian central bank. Short-term interest rates still remain around 9.25%.

Turning to Asia, China continues to grow above expectations. Second-quarter real GDP grew at 6.9% with nominal GDP for the first half growing above 11%. Perhaps one of the best ways to assess growth in Asia is to look at the export data for the four largest economies in the region; Japan, Korea China and Australia. The latest report from Japan shows a 4.0% increase, China 11.2 % increase, Korea a 13.7% increase and Australia 29.3% increase all from the previous year's level. When one examines the Chinese #data, being the largest exporter of the group by volume, it also reveals that the increase in exports to Europe was a healthy 14.6%. Conversely China also showed an increase of imports of 17.2%, strong by any measure. As a general indicator this is clearly a sign of a positive regional economic environment.

A major contributor to this has been a recovery in commodity and energy prices since the lows of 2015. There is no doubt that some emerging economies as well as some developed markets have all benefited from a higher commodity prices. This would include Brazil, Canada and Australia to name a few. So far these have not impacted headline inflation for the most part as global capacity remains plentiful. However, as the recovery accelerates and the slack in manufacturing is taken up, it is reasonable to expect that inflation could trend higher. Despite low employment in the U.S., we have yet to see this translate into significantly higher wages and therefore inflation. So the muted response from the fixed income markets is likely predicated upon two things;

First, a lack of inflation as reported in the data and secondly, healthy demand for fixed income instruments (translated as yield) from investors and central banks. If either one of these elements changes significantly, then we could expect a coordinated rise in global interest rates. Recent comments by the ECB discussing the potential that it could curtail its bond buying program did cause some temporary volatility in the global bond markets. Markets are sensitive to any pullback in the actual purchases of corporate and sovereign bonds by the ECB. Active buying has undoubtedly caused yields to be well below real market levels across the Eurozone. Ultimately, the unwinding of the central bank's balance sheet accumulated during the last six years will also impact bond yields negatively although this could be some years away in the case of Europe. In the case of the Fed open market purchases are limited but their balance sheet remains in place. Any sign that this was to be unwound could also have potentially negative impacts on U.S. fixed-income markets.

So for now, bond yields remain range-bound despite some clear signs of accelerating growth. Copper prices, a good indicator of economic activity in general have risen 30% since the recent low in May of this year. With accelerating growth commodities prices In general seem set to trend higher in the near future. Despite growing U.S. oil exports, oil prices have also drifted higher in response to concerns about Venezuelan supplies and growing global demand for energy. If these trends continue they will ultimately put upward pressure on inflation and global interest rates in general, especially if the Central banks absent themselves from the markets. Whether this signals the end of the bond bull market remains to be seen, as any recovery will be met with some powerful deflationary forces coming in the years ahead in the form of demographics and technological advancements. So for now we are enjoying the best of both worlds, that is, healthy growth and low inflation!

We hope you have found this podcast useful and informative. Thank you.

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.