Tortoise QuickTake Podcast

August 8, 2017

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.

Welcome to the Tortoise Credit Strategies weekly podcast. I'm Jeff Brothers, Senior Portfolio Manager for Tortoise Credit. In today's podcast we will review the important events from the past week and discuss investment opportunities in the Treasury Inflation Protected Securities (TIPS) market.

The big news in what was a quiet week for the bond markets was the employment report on Friday. The labor markets continue to show strength with a better than expected 209,000 new jobs added in July, bringing the 3-month average to 195,000. Encouragingly, the labor market participation rate inched higher and the unemployment rate declined to 4.3%. Despite the strong job additions, labor market slack appears to still be limiting wage growth, which increased a modest 0.3% in July and 2.5% year over year. The jobs report was the one bright spot on the week as the balance of the economic news came in weaker than expected. Personal income and spending, auto sales, construction spending and the Chicago Purchasing Managers Index all disappointed. Interest rates closed the week at a 2.26% yield in the middle of the recent range between 2.12% and 2.38% on the 10-year U.S. Treasury note. The fixed income sectors modestly underperformed Treasuries on light new issue supply and slow summer trading volumes.

Next, we wanted to briefly discuss what we think is an attractive investment opportunity in the Treasury Inflation Protected Securities or TIPS market. TIPS are a unique fixed income asset class that provides investors with a real yield by protecting against changes in inflation. The inflation protection comes from the bond's principal amount adjusting up or down with changes in the CPI inflation rate. The Treasury first started issuing TIPS in 1997 and the market has since grown to $1.2 trillion with regular issuance of 5, 10, and 30-year maturity bonds. We have always utilized the asset class on a very opportunistic or tactical basis across our fixed income strategies and for a number of reasons think now is a good time to be adding TIPS to the portfolios.

First, from a fundamental perspective, we believe after four consecutive disappointing CPI reports and the failure to enact the Trump pro-growth fiscal policies, that inflation expectations have finally reached a bottom. The excess capacity in the U.S. and global economies following the financial crisis in 2008 has gradually been drawn down. With the global upswing in economic growth in Asia and Europe and a rebound in the U.S. economy following a very disappointing start to the year, we expect a further reduction in excess slack and increased price pressures in the second half of the year and into 2018. Wage pressures have also been non-existent despite the strong labor markets, leading many to question whether the link between the jobs market and inflation or the Phillips Curve is broken. Time will tell, but we believe the slack in the labor markets is also gradually being reduced and the tight labor markets and continued demand for employment will eventually lead to increased wage pressures which in turn should lift consumer prices.

Second, overall financial conditions have actually eased despite the shift in monetary policy and four rate hikes from the Federal Reserve. In fact, the Goldman Sachs Financial Conditions Index shows conditions near their "easiest" levels in nearly two years as the weakness in the U.S. dollar, higher stock prices, and a contraction in corporate yield spreads have more than offset the increases in short-term rates from the Fed. In addition, the recent Fed minutes could indicate a less hawkish policy stance as they highlight concerns over the recent weakness in inflation.

We also expect the recent upswing in commodity and energy prices to continue which could provide a potential tailwind for inflation and TIPS valuations. Commodities prices appear to have reached a near-term bottom and have recently been driven higher by improved global demand and the weakness in the U.S. dollar. Energy prices, which represent 7% of the CPI index, can have significant impact on the TIPS market.

Lastly, we believe TIPS represent good relative value versus conventional nominal U.S. Treasuries. A good gauge of relative value for the TIPS market is the breakeven inflation rate. The breakeven inflation rate is the difference between the yield on the nominal U.S. Treasury and the real yield on a similar maturity TIPS bond and also represents a market-based expectation for future inflation. Inflation expectations from the breakeven inflation rate on 10-year TIPS have recently drifted lower to 1.80% after reaching a peak of 2.08 % earlier in the year. We believe at a 1.80% breakeven inflation rate the market has fully discounted the recent weak inflation reports and the lack of follow through on the Trump policy agenda. And like buying an umbrella on a sunny day, we view TIPS as a cheap insurance policy for the rainy days ahead when inflation returns to the market.

Thank you for listening, we'll talk to you 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@tortoiseinvest.com.

The Chicago Purchasing Managers Index

Purchasing Managers' Indices (PMI) are economic indicators derived from monthly surveys of private sector companies. The two principal producers of PMIs are Markit Group, which conducts PMIs for over 30 countries worldwide, and the Institute for Supply Management (ISM), which conducts PMIs for the United States.

The Goldman Sachs Financial Conditions Index

Goldman Sachs Financial Conditions Index. The Goldman Sachs FCI is a weighted sum of a short-term bond yield, a long-term corporate. yield, the exchange rate, and a stock market variable (Dudley and Hatzius, 2000; Dudley, Hatzius and McKelvey, 2005).