Tortoise QuickTake Credit Podcast

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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.

Welcome to the Tortoise Credit weekly podcast. I am Jeff Brothers, Senior Portfolio Manager for Tortoise. One of my colleagues here at Tortoise described last Wednesday's bond market sell-off as "feeling like the dam was broke." In today's podcast, we will share our thoughts on the cause of last week's dramatic increase in U.S. interest rates.

The rates market took center stage last week as yields broke through their recent ranges and pushed significantly higher. Wednesday saw 10- and 30-year U.S. Treasury yields rise 12 basis points to 3.18% and 3.34% respectively. Single day sell-offs of this magnitude are rare in the bond market, the last one occurred in 2016 following the Trump election. The move eclipsed the previous high in May and exceeded the high in yields following the taper tantrum in 2013. With the recent trading range broken, rates continued to drift higher and the 10-year yields finished the week up 17 basis points to 3.23%, the highest level since 2011. The Treasury yield curve, which has been on a relentless flattening trend, also reversed course and ended the week 9 basis points steeper. Finally, real interest rates also crossed into new territory, as 10-year real rates breached 1.0% for the first time since 2009. Interestingly, the move higher in nominal rates was mostly the result of higher real rates, with inflation expectations only increasing marginally.

What finally caused the dam to give way? The move was really a combination of forces, starting with strong economic data released on Wednesday. The ADP employment report surprised with 230,000 new jobs added versus expectations for 184,000. The Non-Manufacturing ISM Index also exceeded expectations and rose to 61.6, a new cycle high. The subcomponents of the index also showed strength with the employment category reaching a 20-year high. With the sell-off in rates well underway, the markets awaited the Friday employment report, which produced more evidence of solid labor markets. Including previous month's revisions, the economy added 221,000 new jobs and the unemployment rate fell to a 3.7%, a sixty-year low. The only real disappointment was that wage growth slowed from 2.9% to 2.8%. The economic data certainly played a role in the rate selloff, but the stronger data trend has been in place for several months and although survey data like consumer confidence and the ISM index are hitting new highs, hard data like durable goods orders and retail sales have been more mixed.

Beyond the stronger economic data, the markets reacted to the uncertain outlook for Federal Reserve rate hikes and the neutral rate of funds. Commentary from Fed Chair Powell on Wednesday expressed confidence in the "extraordinary" U.S. economy and he said, "Interest rates are still accommodative, but we're gradually moving to a place where they'll be neutral." He went on to say, "We may go past neutral. But we're a long way from neutral at this point." Three takeaways from Powell's comments that troubled the bond markets. First, is monetary policy accommodative or not? The markets made a big deal about the term "accommodative" being dropped from the last Fed statement and now Powell suggests rates are still accommodative. Powell's comment that we are "a long way" from neutral also spooked the bond markets. The Fed dot plot shows the neutral rate at 3.0%, only three quarterly rate hikes away from today's 2.25% funds rates. Unfortunately, the neutral rate, where GDP is growing at trend and inflation is stable is a moving target. As the economy grows above trend, as it is now, the neutral rate gradually shifts higher. Lastly, the acknowledgement of potentially moving past neutral added to the hawkish tone and underscored a willingness by the Fed to continue raising rates.

We would highlight three additional factors that may have also played a part in the Treasury route. First, U.S. rates, as an investor safe haven, have benefited from the recent geopolitical uncertainties. Last week, two of these subsided, at least temporarily, with the signing of the new NAFTA agreement and positive news on the Italian fiscal situation. Next, from a technical perspective, Wednesday's move broke important support levels around 3.12% on the 10-year Treasury. With the long held trading range broken, the market quickly raced to the next support around 3.25%. Lastly, some market participants put increased hedging costs for foreign investors, which make U.S. fixed income investments less attractive, as a source of the sell-off. Foreign demand has been important to the fixed income markets, especially in credit, but we doubt hedging cost were a big driver in last week's Treasury sell-off, especially since both Japan and China have not been net buyers of U.S. Treasuries for the past several years.

From our perspective, last week's violent rate move was an accumulation of factors that ultimately broke the dam and pushed Treasury yields over the top.

Thank you for listening, and we will talk to you again 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@tortoiseadvisors.com.

The ISM Non-Manufacturing Index is an **index** based on surveys of more than 400 non-manufacturing firms' purchasing and supply executives, within 60 sectors across the nation, by the Institute of Supply Management (ISM).

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