Tortoise QuickTake
Credit Podcast

July 17, 2018

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. Tortoise QuickTake Podcast

Welcome to the Tortoise credit weekly podcast. I am Jeff Brothers, senior portfolio manager for Tortoise. The relentless flattening of U.S. Treasury yield curve has been receiving extensive media and market attention. The yield curve, as measured by the difference between 10-year and 2-year Treasury yields, has historical been a reliable predictor for economic recessions. A yield curve inversion, when long rates drop below short rates, has preceded a recession by on average twenty months and an inversion has accurately signaled the last seven recessions. The spread between long-term and short-term rates has narrowed to only 25 basis points, raising concerns that the yield curve could soon be indicating a recession. In today's podcast, we will focus on the slope of the yield curve and potential for an upcoming recession.

The shape of the yield curve is normally upward sloping as investors demand additional yield compensation for the uncertainty of moving to longer maturities. With the yield difference between 10-year and 2-year Treasuries moving from 260 basis points in 2014 down to only 25 basis points, the lowest level since 2007, these are not normal times. Short interest rates have moved higher with the strong economic performance and gradual rate hikes from the Federal Reserve. Longer maturity yields, however, have remained stubbornly low in the absence of any significant inflationary pressures. With the Federal Reserve expected to raise rates two more times this year and three times in 2019, we may soon be facing an inversion of the yield curve. Is the yield curve signaling the good times are about to end or is there something different in today's market environment?

One difference, perhaps affecting the yield curve is the supply and demand of U.S. Treasuries. Years of quantitative easing by the Federal Reserve, which focused on purchasing longer maturity Treasuries, has reduced the available supply and pushed down long rates. The Fed is now in the process of shrinking its balance sheet and reversing the quantitative easing, but is doing so at a very gradual pace. In addition, the growing budget deficit to fund the recent tax cuts should require increased Treasury supply, but has to-date focused on shorter maturities, putting upward pressure on the front end of the yield curve. On the demand side, pension funds, insurance companies and international investors have been strong buyers of long bonds keeping the long end of the yield curve well supported.

Another possible difference could be the market expectations for Fed rate hikes. When the yield curve inverts, it usually signals that the markets expect future economic weakness and that the next move from the Federal Reserve will be to ease policy to head off a recession. With the end of the business cycle approaching, long interest rates become attractive and demand shifts out the yield curve. Nothing in today's market indicates expectations for a rate cut in the near future. In fact, the market expectations match the Fed outlook for continued rate increases over the next two years.

Lastly, perhaps the flatter yield curve is a function of muted inflationary pressures rather than a signal for an upcoming slowdown. One unique aspect of the current recovery has been that despite improved economic growth and tight labor markets, inflation and wage increases have remained subdued. Without inflation pressures, investors have been comfortable moving to longer maturities and as a result flattened the yield curve.

It seems strange to be thinking of a recession when the U.S. economy according to Fed Chair Jay Powell is in "good shape." The economy is benefitting from robust labor markets, healthy consumer spending, and record corporate profitability. The second quarter could produce one of the better quarters for economic growth since the financial crisis with GDP expected around 4%. The current economic recovery, however, is long by historical standards and while we would like to think this time is different, we will be watching the yield curve closely for indications the good times may be over.

Thank you for listening, 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.

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