Tortoise QuickTake Credit Podcast

Dec. 4, 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.

Jeff Brothers: Welcome to the Tortoise Credit weekly podcast, I'm Jeff Brothers, senior portfolio manager for Tortoise. Last week the stock market rose by 2.3% on just two words from Federal Reserve Chairman Jay Powell. In this week's podcast, we wanted to share our thoughts on whether Powell's comment that rates are now "just below" neutral indicates a turning point for monetary policy or a misunderstanding and overreaction from the market.

In October, we did a podcast discussing how the hawkish comments from Chairman Powell contributed to the sharp rise in U.S. interest rates. In his October 3rd comments, Powell 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." Fast forward to last week and now the Chairman says, "interest rates remain just below the broad range of estimates of the level that would be neutral for the economy." How did policy shift from a "long way" from the neutral rate to now "just below" in one month?

Let's begin with the view that perhaps the markets overreacted or misinterpreted Powell's comments. The first reason to believe that Powell was misunderstood was his upbeat assessment of the U.S. economy and inflation. In the speech, he mentions the 49-year low of 3.7% for the unemployment rate, inflation near the 2% target, and an economy growing at an above trend rate of 3%. This economic outlook is consistent with past comments and would not seem to warrant a change from the current gradual rate hike path. Another source of confusion may be the concept of the neutral rate of Fed Funds. Unfortunately, the neutral rate for Fed Funds, where GDP is growing at trend and inflation is stable is a moving target. As the economy grows above or below trend, the neutral rate gradually shifts higher or lower. The Fed's long-term estimate of the neutral rate from their dot plot ranges between 2.5% to 3.5%. As a result, whether we are a "long way" away or "just below" the neutral rate depends on a where the neutral rate might actually be. Lastly, the markets have been guilty in the past of overanalyzing and parsing every word from Fed commentary. In the Greenspan era, it became an art form to decipher the often intentionally lengthy, vague and ambiguous Fed statements. The more recent Fed, however, has prioritized a clear and transparent communication strategy, so we do not believe the "just below neutral" comment is only a matter of semantics.

We side with the perspective that Powell's speech and the "just below" comment in particular, are an intentional signal of a shift away from the gradual, one hike per quarter policy. Despite Powell's positive economic outlook, there is no question that global growth has hit a soft patch. Growth in China is slowing faster than expected and both the German and Japanese economies contracted last quarter. U.S. growth is still solid, but is expected to slow next year as the tailwinds from the tax cut diminish. In addition, the Fed has probably noted the weakness in the more interest rate sensitive sectors of the economy, such as housing, autos, and business fixed investment. Financial conditions have also been tightening with the rate hikes, the stock market decline, the strength of the dollar and the widening of U.S. credit spreads. The lack of inflation pressures also give the Fed cover to take a pause in the rate hike cycle. If anything inflation appears to be rolling over after reaching the Fed's 2% target in July, core PCE inflation has fallen to 1.80%. Powell also noted in his speech the fact that the economic effects from past hikes are uncertain and could take a year or more to be fully realized. Given the approaching neutral rate and the deceleration in growth and inflation, it makes sense to us the Fed would signal the option of potentially pausing in the rate hike cycle.

We believe the Powell speech signals the Fed is now data dependent, not on a preset course of quarterly rate hikes, and most importantly, this time they really mean it.

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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