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 weekly Tortoise credit podcast. I'm Greg Haendel, Senior Portfolio Manager at Tortoise. When I took my first economics class in college, I can still picture the introductory text book we used, entitled *Stiglitz Economics*, which not so coincidentally was also authored by a great alumni from my college, Nobel Laureate Joseph Stiglitz. One of the first lessons we learned from Stiglitz's book was the basics of supply and demand curves and how we can find market equilibrium when supply equals demand. As I continued down the path toward becoming an economics major, I learned many more complex and intricate economic theories although often many lessons and case studies could be simplified by just returning to the basics of supply and demand. Similarly, in today's fixed income markets there are many complex factors affecting the level and directionality of interest rates and credit spreads, although today I believe a lot of this can be simplified and explained, at least partially, by looking at some of the overarching supply and demand technical factors across fixed income.

Let's start the discussion with the supply side of the equation. The biggest proverbial elephant in the room is the reduction in the size of the Federal Reserve's balance sheet by not reinvesting maturities or principal payments from their enormous portfolio of U.S. Treasury and agency mortgage-backed securities. At its recent peak last year, the Fed's balance sheet was nearly $4.5 trillion, up from less than $1 trillion immediately prior to the financial crisis. By the end of October 2018, the Fed's balance sheet had already shrunk to $4.14 trillion and has been telegraphed to continue to shrink by approximately $50 billion per month for the foreseeable future ($30 billion treasuries and $20 billion agency mortgages). As Jeff Brothers outlined in his podcast last week, this is a large supply headwind for the agency mortgage market and part of the reason for his defensive positioning in the sector. However, this increased mortgage and treasury supply as a result of the Fed balance sheet unwind, also means there is approximately $50 billion more each month of high credit quality assets (U.S. treasuries and agency mortgages) competing for a fixed, or potentially shrinking as I will outline shortly, amount of investment dollars buying these assets. Adding additional fuel to the fire on the treasury supply side of the equation, is the increase in net U.S. treasury issuance required to fund our growing budget deficit. Net treasury issuance is expected to end 2018 up roughly 50% versus 2017 and 2019 is expected to increase almost 20% versus 2018 according to some estimates.

Additional supply considerations come from investment grade credit, high yield credit and leveraged loan new issuance supply. Within investment grade credit, new issue supply in 2018 is tracking modestly lower (down 5-10%) than the all-time record pace seen in 2017, whereas high yield issuance is tracking down 30% and leverage loan issuance is up 20% (net of repricings). The near record pace of new issuance supply in investment grade credit combined with the increase in the high credit quality alternatives previously discussed has kept the supply side of the equation challenging in investment grade credit while the reduction in high yield bond supply has greatly helped to offset retail demand challenges and high levels of loan supply have been met with robust demand.

On the demand side of the equation, we can simplistically separate this into retail demand, institutional demand (pensions, insurance companies, money managers) and overseas foreign demand. Retail demand inflows into investment grade fixed income assets are 70% lower than that of 2017 although short duration retail demand remains near the robust pace experienced in 2017. High yield retail demand flows are actually outflows of roughly $30 billion year to date while leveraged loans have experienced robust inflows year to date. These retail demand flows are not surprising given they tend to chase returns and have significant sensitivity to rising interest rates. Institutional demand can be harder to gauge, however, we believe it has modestly improved for pensions given their better funded status, improved for insurance companies given they tend to benefit from higher rates, and modestly deteriorated for money managers. However, CLO new issuance year to date is near a record pace, thereby causing significant institutional demand for leveraged loans. The other elephant in the room, which tends to have an outsized impact on investment grade credit, treasury and agency mortgage demand is the foreign buyer, which by some estimates can constitute 1/3rd or more of all high quality fixed income demand. Foreign demand is estimated to be down 25% versus 2017 and is largely a result of extremely high hedging costs (due to divergent global short term interest rates as well as some year-end effect). These hedging costs, in turn, make many or our high quality fixed income assets unattractive on a currency-hedged basis for many foreigner investors.

On a backward looking basis, many of these supply and demand factors can help explain a lot of the recent relative performance amongst fixed income assets. On a forward-looking basis, near term we expect many of the technical supply and demand influences to continue down the same path with the largest drivers being the increased supply of high quality assets due to the Fed balance sheet unwind and mixed foreign demand due to expensive currency hedging costs. Longer term, higher interest rates in the U.S. should improve the relative attractiveness of fixed income assets for both the retail investor as well as many institutional investors thereby helping to put supply and demand largely back into equilibrium. We are also speaking in generalities given there are various pockets currently within fixed income, such as short duration and leveraged loans which exhibit very favorable supply and demand influences. Lastly, despite the contribution to relative performance from the various technical supply and demand factors, we believe fundamentals as well as valuations should dominate relative performance over the longer term.

Thank you for listening, we'll 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.