Tortoise QuickTake Podcast

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Welcome to the Tortoise QuickTake podcast. Thank you for joining us. Today, senior members of Tortoise provides a timely update on trending topics in the market.

I'm Graham Allen, Senior Portfolio Manager for Tortoise Credit Strategies. Welcome to the first Tortoise credit podcast. We hope it will be the first of many. The Tortoise credit team has a long history of managing fixed-income portfolios through many economic and financial cycles. Today I'd like to cover a brief overview of the global economy along with the U.S. economy and then focus and review how we see this impacting the U.S. interest rate markets along with global bond markets. As part of that analysis we will review where we see current value in the mainstream fixed income markets.

So, to begin with, let's look at what's going on around the world. There is growing evidence of a coordinated pickup in global economic activity. Continents such as Europe are clearly seeing signs of growth. Elsewhere, data from China continues to show a slight acceleration in GDP growth from the present level of 6.5%.

One of the best pieces of economic evidence we are seeing to confirm a pickup is global purchasing managers and leading indicator surveys. Although this is soft data, we are seeing China, the UK, most of the Eurozone and even Japan, seeing an acceleration in business confidence. Indeed, further evidence of this has been the strength in equity markets around the world which is showing some limited signs of slowing.

Generally speaking, following years of sluggish growth, investors are beginning to expect inflation pressures to pick up as confidence in business activity grows. As a result we have seen bond markets react with a general rise in the level of interest rates around the world, but this has been contained by continuing central bank buying.

That said, signs of any increase in inflation have been muted, probably reflecting a lot of slack in global capacity, and generally stable oil prices. It's a good example of where hard data has yet to reflect market sentiment. There is still a lot of slack in the global system.

Here in the U.S., despite signs of a pickup in confidence, we have recently experienced a soft patch in the data. Here are some examples:

- Loans to banks have stabilized and have stopped growing for now
- Rail, trucking, and airline activity is stable and not accelerating sharply
- Lower import data, which improved the trade balance in March
- And weaker auto sales along with unusual decline in used car prices

Despite the softer data, there are few signs of an end to the credit cycle and forecasters predicting an imminent U.S. recession are very scarce. Indeed much of that can probably be attributed to the Trump administration's ambitious pro-growth policies that are yet to be enacted, as well as strong employment data recently. However for the time being, fixed income markets are reluctant to move higher and spreads tighten further without more specifics and certainty.

In reviewing the fixed income markets, I'm going to flip the order around and begin with the U.S.

The question for the fixed income investors in the U.S. right now are two-fold. Firstly, will a pick-up in the U.S. economy lead to a rise in U.S. inflation and ultimately to higher interest rates? The issue is especially pertinent given that for the last 30 years, long-term interest rates have generally been declining and people are now asking, quite correctly, has this decline come to an end? Is the end of the famous bond bull market over?

Secondly, should I be buying higher yielding non-government bonds in an effort to pick up yield when valuations are so rich? Like the equity markets, bond spreads have narrowed against U.S. Treasuries in anticipation of a pickup in growth and an extension to the already long- in-the-tooth U.S. credit cycle. In a growth scenario corporate credit quality should improve justifying narrower spreads. In a low inflation, low interest rate environment, there is a desperate hunger for yield in the marketplace. For the most part this demand has been met by record corporate bond issuance, which has been well absorbed by the U.S. credit markets to-date.

Our view is that the U.S. economy will gradually accelerate throughout 2017, notwithstanding recent soft data. We do not anticipate any significant spike in default rates. We believe markets are presently in a wait and see mode, ahead of specifics of the new administration's economic policies and whether that legislation can be passed. Most notable among those policies could be a new infrastructure bill, personal and corporate tax cuts and finally a healthcare overhaul bill. All of them at present would have a stimulative effect to varying degrees on the U.S. economy, if passed.

Under this scenario we believe corporate credit spreads although rich, could eventually go tighter as and when U.S. policies become confirmed, and done in a timely manner.

Some perspective on where we are with Corporate spreads versus U.S. Treasuries: As of the end of March of this year, investment grade bond corporate spreads stood at +118 basis points to equivalent U.S. Treasuries, and about + 383 in the case of high yield bond. Of course there are significant differences in industry sector spreads within these asset classes. As a whole and as sector rotational mangers we exploit these inconsistencies.

In the last ten years, corporate credit spreads have reached two notable inflection points, 2007 and 2014. Given our outlook we believe that going forward spreads can at least reach the level of 2014 given that the economic outlook today looks significantly better than back then. This would apply to both the investment grade and high yield markets.

With regard to our view on interest rates, we believe that given the global growth outlook there is the possibility that, with more fiscal stimulus interest rates will ultimately move higher, although the propensity for that is much higher in some overseas markets than the U.S., so we see limited value in those overseas interest rate markets for now.

As I said before, there is considerable slack in the U.S. economy which needs to be absorbed before inflation moves higher. However, markets will act ahead of fundamental shifts and we anticipate that as the specifics of U.S. monetary and fiscal policy become clearer, longer term U.S. interest rates could move higher. One important factor to note is that from a technical perspective we still are in the long-term bond bull market which is often quoted. We would need to see the U.S. Treasury 10-year bond yield move above 3% in the near term to confirm that the bond bull market has come to an end.

In closing, we continue to feel positive on the U.S. economy and feel as specifics of U.S. policy become known the credit cycle will continue. Thank you very much for your time and we hope you have found this helpful.

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.