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.

Hello. I'm Graham Allen, senior portfolio manager at Tortoise Credit.

As if the year-to-date performance of the S&P 500® Index of -0.70% isn't puzzling enough, an analysis of the change of earnings outlook in the last six-months quickly leaves one scratching one's head. Given this, let us look at some of the forces presently at play in the markets, which could be contributing to the present consolidation occurring in the bond and stock markets, despite a strong fundamental outlook.

Before examining any exogenous factors that could be clouding the outlook, let's first of all look at the positive side of the ledger.

At the equity market peak on January 26th, 2018, the forward PE multiple of the S&P 500® Index stood at approximately 18.2, which is at the high end of the historical range. Given this, a market correction was not surprising. What is not widely appreciated is the extent of the earnings outlook improvement that has occurred in the last six months which has not yet been reflected in equity prices. If one looks at the earnings expectations in October 2017, before passage of the tax package, it is clear there has been a significant upgrade. Expectations for 1Q 2018 earnings in October 2017 was +9.3%. Today, as first quarter results are being reported, earnings are coming in at a rate of +20.4%. For the full year 2018, the expectation has now risen to 21% versus +12.6% back in October. Since then, the S&P 500 has risen by just 3.1%. As a result, the forward multiple now looks a more reasonable 16.2 times.

Of course, bonds have also not performed well which could be weighing on equity market prices. As of May 1, 2018, the Bloomberg Barclays U.S. Aggregate Index has a negative return of 2.19%. Although it is very early in the year, a negative return on the Bloomberg Barclays U.S. Aggregate Index should be viewed in the context of its 32-year actual history. The 3-month YTD 2018 return of -2.19% is actually worse than 35 years of annual returns out of its 36-year history. This is relevant as it demonstrates that there are major secular shifts at play. For the record, the worst of those years for the Aggregate was 1994 when the total return was -2.92%.

It may be that the factors negatively affecting bond sentiment are bleeding through into the equity market outlook, but may not directly affect the improving fundamentals. This would argue that equities are becoming more attractively valued. An example would be evidence of higher inflation in the data, which would push bond yields higher. This will actually increase earnings but decrease real earnings, technically pushing equity prices and multiples higher in the long-run.

What are the main factors pushing bond total returns into negative return territory? First of all is the technical behavior of the ten-year US Treasury bond. The yield recent breached the 3% level for the first time since December 2013. While 3% is relevant, it has not been that long since the 10-year was at these levels. Perhaps more important is the fact that when one looks at a 30-year history of the 10-year yield, it seems to be breaking out from its 30-year downward trend. Given this, the markets will need a period to digest the reality of higher long-term yields. Fundamentally, U.S. yields are rising for a combination of reasons. The recent Price Consumption Expenditure (PCE) indicator, reportedly the most influential inflation measure, watched by the Federal Reserve, is close to the Fed's 2% target, being reported at +1.9% this week. The index has moved consistently higher since the August 2017 1.3% low. There is also evidence that some wage pressure is entering the system and industrial prices are rising. That said, more traditional inflation measures have yet to reach levels of concern, such as industrial capacity utilization.

Other factors obviously include the actions of the Fed in tightening monetary policy as well as neutralizing the Fed's recent QE program. Also, with the implementation of the tax cut and the recent passage of the omnibus budget bill, concerns are also rising for the U.S. budget deficit as well as the overall level of U.S. debt. For the time being, these concerns are likely premature as the beneficial effects of these factors have yet to be felt on tax receipts which could ultimately reverse any short–term deterioration. In addition, Treasury yields are now becoming extremely attractive when compared to other sovereign yields. Spreads between the U.S. and both Germany and the UK, are at 30-year wides, implying that U.S. Treasuries are relatively attractive, especially if the U.S. dollar appreciates.

Given these factors, the worst may be over for now in the bond markets.

While stocks adjust to the new environment and the uncertainty of the higher interest rate environment, there are still indications that the fundamentals will improve. Of concern has been the length of the present economic cycle, which is long-in-the-tooth by any measure. It is worth remembering that the 2009 recovery has proceeded at about half the average growth rate of previous recoveries, implying that the cycle could last for a while longer. Although many forecasters expect growth to peak in the second half of 2018, many do not predict a slowdown until late 2019. Capital expenditures are expected to accelerate in the second half of 2018 as the tax cuts and higher than expected 1Q profits boost investment spending. There is evidence that growth rates in other parts of the world, such as Europe, are moderating but it is too early to identify any secular change in trend.

In conclusion, equity market uncertainty is likely to continue for a while as the risk markets acclimatize to a higher interest rate environment. We maintain that as this occurs the underlying fundamentals will continue to improve. Ultimately, stock market performance is driven by earnings, which for the time being look encouraging. Although bond market fundamentals look less favorable, yields are becoming attractive, especially compared to the overseas markets. For example, the yield to worst on the Bloomberg Barclay's U.S. Corporate High Yield Index is 6.26%. With institutions being generally underweight U.S. fixed income, a rebalancing will occur at some juncture when yields become attractive, providing a healthy bid to the fixed income markets. We hope you find this podcast useful. Thank you.

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 S&P 500® Index is a market-value weighted index of equity securities.

The Bloomberg Barclays U.S. Aggregate Bond Index measures the investment-grade, U.S. dollar denominated, fixed-rate taxable bond market. The index includes treasuries, government-related and corporate securities, mortgage-backed securities (agency fixed-rate and hybrid adjustable rate mortgage pass-through securities), commercial mortgage-backed securities (agency and non-agency) and asset-backed securities. It is not possible to invest directly in an index.

The Bloomberg Barclays U.S. Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below. Bonds from issuers with an emerging markets country of risk, based on Barclays EM country definition, are excluded.

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