Tortoise QuickTake
Credit Podcast

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Welcome to the Tortoise QuickTake podcast. Thank you for joining us. Today, a senior member of Tortoise provides 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. Unfortunately, for most folks it is that uncomfortable time of year once again when we all have to get our finances in order and file our federal and state taxes for the prior calendar year. In other words, for many people it is time to pay the proverbial piper for any fiscal imbalances from the prior year. In a similar fashion, we are quickly approaching "tax time" for the U.S. fixed income markets, as they will be forced to pay the proverbial piper and address the technical supply/demand imbalances that have built up over the past several years. In today's podcast, we will discuss some of these technical supply/demand imbalances together with their potential implications on parts of the fixed income markets.

Post the financial crisis, the Federal Reserve (The Fed) as well as several other global central banks began buying sovereign debt, agency mortgage-backed securities (MBS), and in the case of some foreign central banks, even corporate bonds in what is referred to today as quantitative easing (QE). For more detail on QE, please listen to or read our podcast dated June 19th, 2017. In the U.S., this QE equated to a Fed balance sheet expansion of approximately $3.7 trillion dollars and between the Fed, European Central Bank (ECB) and the Bank of Japan (BOJ), QE equated to an expansion of more than $11 trillion dollars combined on their balance sheet or almost 10% of the global investable universe according to some measures. Simply put, this created a large imbalance in the private sector between the supply of investable assets versus the buyer demand for these assets that now included several large global central banks with very deep pockets. In turn, in the U.S. this imbalance incentivized investors to diversify their portfolio outside of U.S. Treasuries and agency MBS given the shrinking free float of those assets due to Fed purchases as well as the less compelling valuations versus other assets such as corporate bonds and even equities. Some would refer to this phenomenon as the crowding out effect.

Today the U.S. and several global economies are on much better footing and hence some economies like the U.S. no longer require the same extent of extraordinary central bank policies such as QE. As such, the Fed has begun their measured process of shrinking the size of their bloated balance sheet by reducing the amount of reinvestment of maturing debt held on their balance sheet. While this process has started out slowly, the tapering of balance sheet purchases, sometimes called quantitative tightening (QT) has been telegraphed to increase to roughly $50 billion per month by the 4th quarter of 2018 or a run rate of approximately $600 billion per year. This is roughly the amount of U.S. Treasuries and agency MBS that will essentially flow back into the private sectors investable universe per year with the pace picking up significantly during the second half of 2018. At the same time, the ECB has already slowed the pace of expansion of their balance sheet while some estimate they will no longer expand the size of their balance sheet by the end of 2018.

Outside of the additional supply of investible securities as a result of QT, we have seen a sizable increase in net U.S. Treasury issuance to fund our growing deficit (as a result of the recent Trump tax plan). Some market strategists estimate the increased deficit funding will result in a 50% jump in US Treasury net issuance, equating to an increase of over $200 billion of U.S. Treasury net issuance in 2018 versus that of 2017. Given the large supply of U.S. Treasuries as a result of both QT and deficit funding, in conjunction with a continued rebound in U.S. and global growth, we do anticipate rising U.S. interest rates over the longer term. Further, given the increased supply of investable assets on a forward-looking basis (from QT and deficit funding), we are mindful of a potential reversal of the crowding out behavior previously discussed.
From the demand side of the equation, we believe that retail fixed income inflows, while still strong, will not keep pace with the record inflows experienced in 2017. Typically, retail flows in fixed income tend to improve based upon strong current performance, low interest rate volatility and strong equity markets (due to rebalancing), all of which have been challenged as of late. In fact, the pace of Q1 2018 inflows into investment grade mutual funds is 28% less than Q1 2017. We have also recently experienced a slowdown in buying from foreigners due largely to increasing foreign currency hedging costs as well as other compelling investment opportunities abroad, although the exact extent of the slowdown is tough to measure on a real time basis.

Despite this less than rosy supply and demand technical picture outlined, there are some pockets of significant investor demand when one dives deeper into the details, and near term technicals are modestly better due to a seasonal slowdown in corporate bond issuance. Given the increase in U.S. interest rates, long duration investors, such as life insurance companies as well as pension funds, both of which have grown assets recently, have an increased investment appetite for long maturity bonds. Along the lines of rising interest rates, there has also been an increased appetite for floating rate fixed income products, such as leveraged loans, which benefit in a rising interest rate environment. Lastly, given the flatter yield curve and substantially higher interest rates in shorter maturity bonds, there has also been a renewed appetite for money markets and short duration products despite the technical headwind caused by cash repatriation from the tax plan as discussed in prior podcasts.

The supply/demand technical balancing act is only one of several legs of the investment stool that we analyze within our fixed income investment process, with fundamentals, valuations, sentiment and positioning also being vital legs to that stool. However, when the technical picture shows signs of weakness and another component, such as valuations, looks less compelling, we become more cautious on the margin as we are today. This does not mean that there are not pockets of opportunity within the fixed income universe, it just means that active management through proper duration and curve positioning, sector and industry allocation and issuer selection are now more important than ever in our opinion when navigating this changing technical landscape.

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 info@tortoiseadvisors.com.

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