Tortoise QuickTake 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.

Hello and welcome to the Tortoise Credit Strategies weekly podcast. I'm Greg Haendel, one of the Senior Portfolio Managers on the investment team at Tortoise Credit Strategies.

In the late 1600's it was said that Sir Isaac Newton was taking tea under an apple tree one sunny afternoon when an apple dislodged itself and landed on his head. It dawned on Newton that what goes up must come down, and this formed the basis of his Universal Law of Gravity. In relation to the financial markets today, we appear to still have some momentum to continue to "go up" or improve although this has also been accompanied by some market complacency regarding Newton's law of gravity (i.e. what goes up continues to go up?). Further, we must also keep in mind that post-financial crisis regulation and financial innovation could cause the velocity of the movement down, whenever it happens, to be fast and furious. In today's podcast we will briefly touch on the continued positive U.S. economic growth indicators, followed by a brief examination of market complacency and how bond market liquidity has changed post the financial crisis and what that could mean.

In general, U.S. economic data continues to point toward further improvement, despite some hurricane- related distortions. Both the ISM and non-ISM manufacturing surveys for the September period showed significant strength while the September auto sales numbers rebounded to a new post-crisis high. In addition, August trade balance and factory orders both improved modestly thereby providing some upside potential to Q3 real GDP estimates while the final read on August durable goods orders were also revised higher. The week culminated on the economics front with a mixed employment report showing some hurricane related distortions. While non-farm payroll data was significantly weaker, largely due to the hurricane, the cumulative revision to the prior two months also showed some weakness. However, the strong unemployment rate, reported at 4.2% and the lowest since 2001, combined with the firming in the labor force participation rate and the stronger than expected improvement in average hourly earnings more than offset the distorted non-farm payroll data.

The continued improvement in U.S. and global economic data combined with stronger global risk markets has created some complacency within the markets. Market volatility and market complacency can be measured in many different ways, with the VIX Index being one widely followed measure. The VIX is an index that is published by the Chicago Board of Trade and measures the volatility of index options on the S&P 500. The lower the index the less volatility and more general market complacency whereas the higher the index, the more volatility and "fear" within the market. In normal market conditions the index level hovers between 10 and 30 with a few notable breaks higher, including hitting 80 in 2008. On the flip side, prior to 2017, the VIX had closed below 10 on only 9 occasions dating back to 1990 while the index has now closed below 10 on 29 plus occasions so far in 2017 alone. Has something materially changed in the market to warrant this historically low level of volatility or high level of complacency? Maybe it is a result of the abnormally large amount of Central Bank stimulus in our markets or maybe something else. While we are not calling for an imminent increase in volatility, as markets tend to go further than anyone predicts, we are mindful of this historically high level of market complacency and the pending reversal of the Central Bank stimulus.

Post the financial crisis, financial regulation has increased, the size of many sectors within fixed income have grown precipitously and flows into the fixed income asset class have been robust. Financial market regulation has made it much more difficult for market makers to be a buyer of last resort using their balance sheet. In fact, according to Deutsche Bank, dealer inventories of corporate bonds have fallen from a peak at over $250 billion in 2007 to less than $25 billion today. At the same time, the size of the corporate bond market has grown from a little over $2 trillion in 2007 to roughly $6 trillion today. Further, according to Deutsche Bank, U.S. treasury dealer trading volumes have dropped to 1/3 of what they were prior to the financial crisis while they have dropped by 50% or more in the high yield and investment grade corporate bond markets.

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When many investors head to the exit at the same time, whether that is to rebalance risk or fund redemptions, bonds spreads and prices will likely encounter rapid air pockets down given the vast size of the bond market today versus the skinny market making abilities of broker dealers. We have only seen this tested post financial crisis in events like the "taper tantrum" in 2013 and the energy sell-off in late 2015 early 2016, resulting in markets moving faster and further than many would expect and well beyond what fundamentals would warrant. This lack of liquidity will not necessarily create a crisis although it could magnify an existing crisis.

Growth in financially innovative products, like exchange-traded funds (ETFs) and exchange traded products (ETPs) post the financial crisis has been remarkable. The global AUM of exchange-traded products has grown from around $800 billion in 2008 to over $4 trillion today. While ETFs offer some attractive attributes such as low costs, transparency, liquidity and potential index replication, they could also exacerbate the liquidity gap and the velocity of the price movements during periods of heavy redemptions. In periods of balanced flows, the daily volumes for larger ETFs can reflect shares in those ETFs changing hands with no new shares created or dissolved thereby eliminating the need for an underlying transaction. However, in a time of heavy one-way redemptions, ETF managers are forced to indiscriminately sell the underlying securities. When this occurs in less liquid assets classes such as high yield bonds it has the potential to vastly compound the selloff as well as diminish the effectiveness of the ETF replication strategy.

Strong economic and earnings related forces could continue the upward momentum against potential gravitational inflection points on the horizon such as Central Bank balance sheet tapering and more hawkish Central Bank policy. However, the financial markets appear to be getting a little too complacent that this momentum will continue indefinitely. While it is nearly impossible to time the point of inflection perfectly, once this inflection occurs, the velocity of the gravitational pull downward on asset prices will likely be faster than past corrections due to structural changes outlined within the markets. We believe that relatively smaller asset managers will have an advantage over larger managers during these corrections given their ability to be more nimble in thinner liquidity environments.

Thank you for listening to the Tortoise Credit Strategies podcast and hopefully you will join us for next week's edition.

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.

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