Bradford & Marzec

Now part of **Tortoise Credit Strategies**

# Investment outlook & portfolio strategy

June 2016

## Global economic outlook summary

**International**

The risk of Brexit increased as polls for 'Leave' and 'Remain' were too close to call. We continue to think that the initial reaction to a leave vote will be a flight to quality, but that large injections of liquidity post vote by the Bank of England (BOE) and the European Central Bank (ECB) will ultimately underpin financial asset prices. Regardless of the outcome, anti-European Union (EU) parties in other countries will be emboldened to promote an overall anti-European project sentiment, undermining the long-term viability of the project. Growing uncertainty led to a significant rally in global bonds with the 10-year bond yield hovering at close to 0%.

**US economy**

For the third consecutive year, second quarter gross domestic product (GDP) growth appears to have rebounded from subpar first quarter performance. The increased pace of growth in 2Q16 was largely attributable to higher online spending by consumers and an increase in home sales and residential construction spending.

The pace of growth in employment gains has decelerated. However, it is not yet clear whether this reflects that the economy has achieved full employment or that employers are responding to tighter profit margins by trimming costs.

Inflation expectations remain very weak.

US GDP growth for 2016 is forecasted to be in the 1-2% range.

## Portfolio strategy

**US interest rates and TIPS summary**

Interest rates were little changed in May as the Treasury component of the Barclays Aggregate Index was flat for the month.

The yield curve resumed its flattening bias in May as 2-year notes were higher in yield by 9.5 basis points (bps), 5-year notes were higher in yield by 8 bps, and 10-year notes only sold off 1bp.

Interest rate volatility remained very low during the month of May.

With regard to duration, we remain neutrally positioned versus benchmarks.

**Securitized products**

We are still defensive with regard to securitized markets based on a combination of poor valuations and waning fundamentals. We reduced our Agency Mortgage-Backed Securities(MBS) target to 18% versus 28% in the Barclays Aggregate Index, as yield spreads approached historical tights and the sector was vulnerable to lower interest rates. In the Commercial Mortgage-Backed Securities (CMBS) markets, we continue to reduce allocations into strength due to historically rich valuations and as commercial real estate markets move into later stages of the cycle. We remain overweight and positive on the safe haven Asset-Backed Securities (ABS) sector with a target allocation of between 8-10%.

**Investment grade credit**

We maintain a stable outlook based on improving technicals and reasonable valuations offset by deteriorating fundamentals. Credit spreads significantly improved in recent weeks and appeared near fair value, yet all-in yields remained attractive to non-US buyers. Credit fundamentals and corporate profitability continued to deteriorate in some industries; we expect this trend to persist. Technicals are improving due to strong demand from non-US investors as a result of interest rate differentials and foreign central bank Quantitative Easing (QE). US and global growth concerns, a potential United Kingdom (UK) exit from the EU, Federal Reserve (Fed) policy uncertainty, the US Presidential election and depressed commodity prices may keep spread volatility high.

**High yield**

We remain constructive on high yield bonds, based on strong fundamentals in most industry sub-sectors, with the exception of Energy and Metals & Mining. High yield provides diversification benefits, given its low long-term historical correlation to interest rates. Following the strong rally this spring, the high yield market appears fairly valued.

**Leveraged loans**

The leveraged loan market posted another solid month in May, with returns nearly matching high yield for the first time since the risk rally began. The Credit Suisse Institutional Leveraged Loan Index returned 0.73% in May following gains in excess of 1% in April and May. Technicals continued to improve as retail loan funds experienced their first inflows in a year. While fundamentals remain broadly supportive, the Energy and Metals & Mining sectors remain severely challenged.

**Non-dollar**

The US dollar strengthened against most major currencies in May, reversing the trend from the previous few months, as the prospect of a summer rate hike by the Fed increased. The sharp rebound in oil continued off of February lows even while the dollar strengthened, as the likelihood of a global slowdown appeared to be overdone.

## Global (ex US) Economic Outlook & Summary

The risk of Brexit has increased as polls for 'Leave' and 'Remain' are too close to call. We continue to think that the initial reaction to a leave vote will be a flight to quality, but that large injections of liquidity post vote by the BOE and the ECB will ultimately underpin financial asset prices. Regardless of the outcome, anti-EU parties in other countries will be emboldened to promote an overall anti-European sentiment, undermining the long-term viability of the project. Growing uncertainty has led to a significant rally in global bonds with the 10-year Bond yield hovering at close to 0%.

**Europe - Brexit update**

In the event of a 'Leave' vote, it is important to understand the timing of likely subsequent events. In the case of the UK, it would quickly invoke Article 50 of the Treaty of Lisbon, which allows for a member to leave, and repeal the 1972 European Communities Act. The process of cutting ties could be completed by 2019. The pro-Brexit camp has proposed immediate legislation, restricting immigration, enacting tax cuts and restoring the power of the British courts. Market uncertainty will likely cause an initial flight to quality, although sovereign yields across Europe are already at extremely low levels. Despite the volatility, it is important to understand that the day after a Brexit vote, the expected changes in the trading relationships with the EU will take place over a number of years. Unquestionably, the central banks of Europe would act forcefully to supply liquidity to the markets to stabilize sentiment.

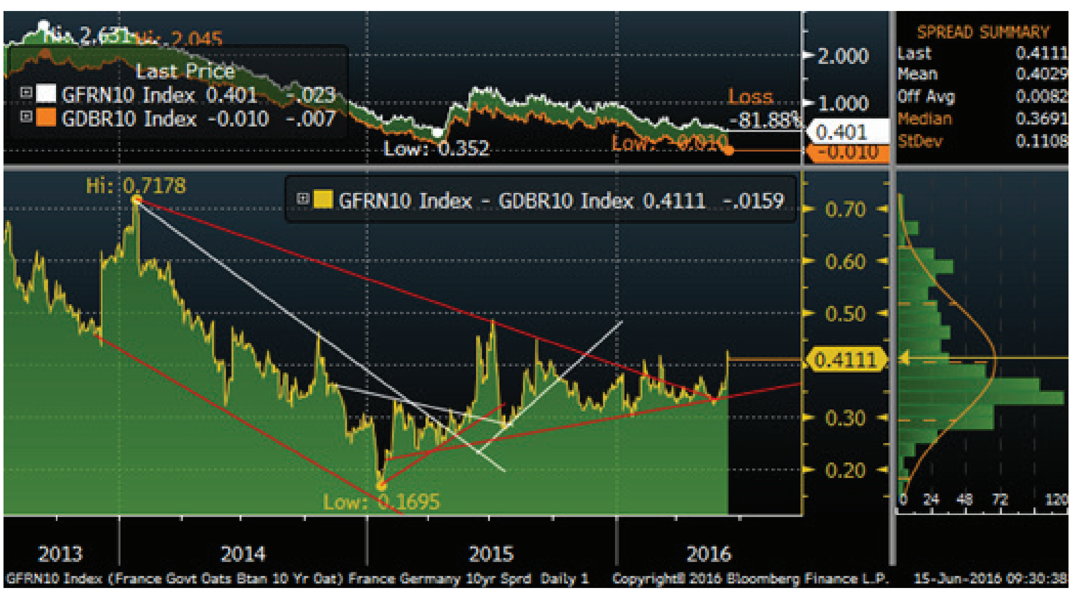
**Rest of Europe**

Of more concern would be the ramifications for the rest of Europe. A Brexit vote would likely empower anti-EU sentiment across Europe, particularly in France, Italy, Spain, Greece and the Netherlands, where follow-on referenda could occur. European sovereign spreads have begun to widen against the German Bund, which historically reached a zero yield. The present industrial disruption in France is symptomatic of the unwelcome changes imposed on countries in an effort to create conditions under which the Eurozone can function. In the words of Angela Merkel, France's competitive deficit with Germany has to be addressed.

We conclude that while a Brexit could cause a short-term shock to the market, the really negative effect on growth and sentiment could linger for years. Short-term central bank actions could provide opportunity on any meaningful sell off of risk, if Brexit occurs.

**Rest of the world**

- Central banks around the world (recently, Korea and Russia) continued to ease monetary policy, which we anticipate will help stimulate growth later in the year.
- Elsewhere, statements from the Reserve Bank of New Zealand as well as the Reserve Bank of Australia indicated that rate cuts are on hold due to an increase in economic growth.
- Despite healthier growth expectations in some parts of the world, the uncertain outlook regarding European growth has stalled a recovery in commodity prices. The price of copper, which is a good indicator of general economic activity, traded $7 above its January low of $197.
- The Chinese renminbi has continued a weakening trend, ostensibly controlled by the government, which began in April 2016.



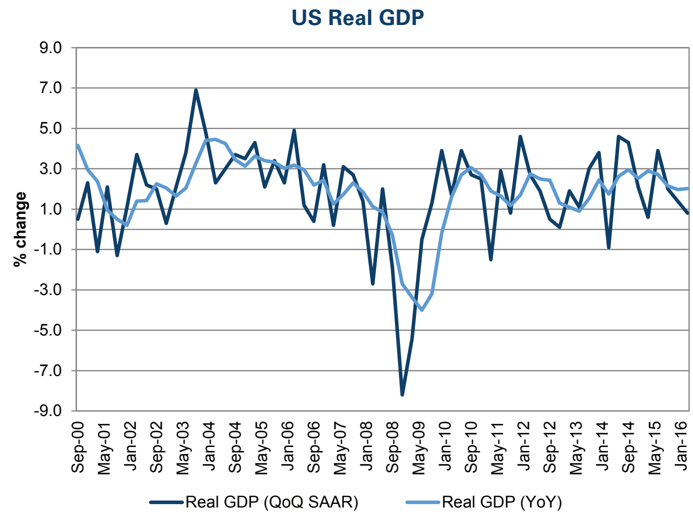

*Source: Bloomberg*

*Note: Statements expressed are our current opinions as of the date of publication and are subject to change without notice.*

## US economy

### Summary

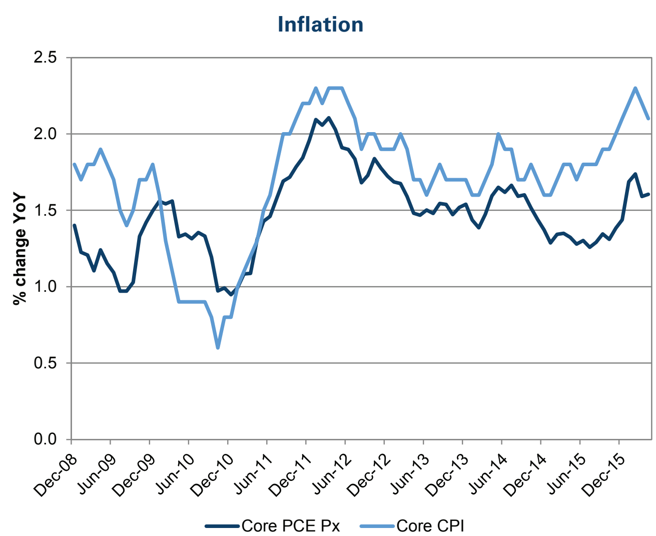
- The economy appears to be recovering from the subpar growth experienced in 1Q16.
- Much of the 2Q16 improvement occurred as a result of an increase in personal consumer spending, which was closely tied to a significant increase in online retail spending. Housing sales and residential construction spending have also improved significantly versus 1Q16.
- Somewhat worryingly, the rosy employment picture seems to be receding, as evidenced by the Labor Markets Conditions Index (LMCI), which aggregates 19 labor market indicators. The LMCI, which emphasizes the unemployment rate and private payrolls, declined to -4.8 in May.
- Commodity prices remained well-behaved throughout the month as the US dollar stabilized.
- Inflation expectations remain a concern of the Fed as their preferred measure of inflation, the core personal consumption expenditures (PCE) price index, remains well below their 2% target at 1.6%. The market's pricing of expected inflation is not confidence inspiring as inflation breakevens implied from the Treasury Inflation Protected Securities (TIPS) markets have begun to fall again.




*Source: Bloomberg*

### Outlook

- Market expectations for rate hikes from the Fed declined recently as a result of softer economic data. Currently, the market prices in a 50% probability that the Fed will increase the Fed Funds rate in 2016.
- After another slow first quarter this year, 2Q16 looked to rebound slightly as both the New York Fed and Atlanta Fed forecasts predict GDP growth of approximately 2.5%.
- Although the hiring rate and new job creation slowed recently, we do not anticipate a significant weakening of the employment situation. Consequently, we expect consumer spending to remain strong.
- We continue to forecast that GDP growth for the year will be in the 1-2% range.



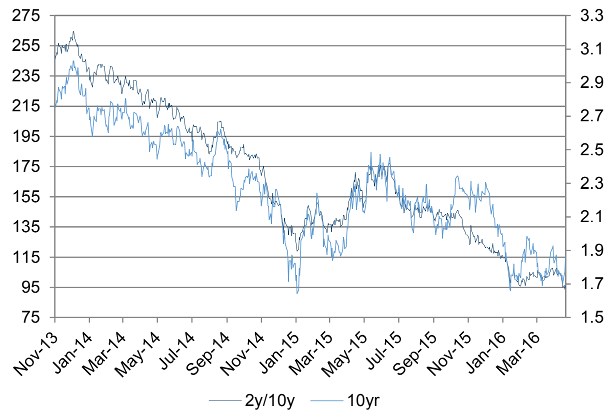

*Source: Bloomberg*

## Portfolio strategy - US interest rates & TIPS

### US interest rates: risk off, treasuries rally

- The yield curve resumed its flattening bias as 2-year notes were higher in yield by 9.5 bps, 5-year notes were higher by 8 bps, and 10-year yields only sold off 1bp. The 2-year/10-year curve ended the month at 96 bps.
- Interest rate volatility continued to fall as the 10-year note yield traded within a tight 18 bps range for the entire month of May.
- In May, "Fed speak" became increasingly hawkish in speeches given by Fed officials. It is likely that Fed representatives attempted to influence investor perception regarding the probability of a summertime rate hike, thus providing themselves with increased latitude to act without overly upsetting market trends.
- The net result of the Fed's hawkish messaging was threefold: 1) the probability of a rate hike increased from ~15% to ~55% (however, the increase was short lived); 2) the yield curve flattened; and 3) inflation expectations as measured by TIPS breakevens fell. The second and third consequences of the hawkish talk are not necessarily welcomed by the Fed.

**10-year yield and 2-year/10-year curve**

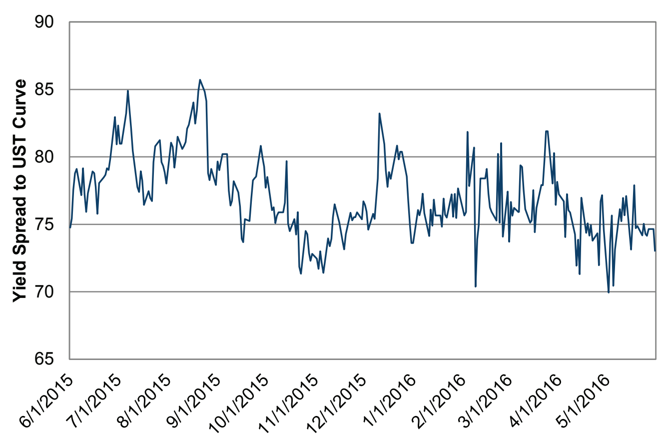



*Source: Bloomberg*

### Agency MBS: modest underweight, 18% versus 28% in the index

- Agency mortgages modestly outperformed US Treasuries by producing 17 bps of excess return in May.
- Valuations remained rich and have traded in a very narrow range over the past year.
- Mortgage pricing was vulnerable to a potential pick-up in historically low levels of interest rate volatility.
- We expect performance to remain very directional with interest rates; lower rates will bring underperformance and higher rates will lead to outperformance versus Treasuries.
- Valuations should be supported in the near term, given the very dovish commentary in recent Fed statements.
- We expect support for high quality mortgages from foreign investors faced with the prospect of negative interest rates.
- We still like 20-year agency securities and selective new issue non-agency bonds and are underweight both GNMA and 15-year MBS.

**Agency MBS current coupon spread to UST**




*Source: Bloomberg*

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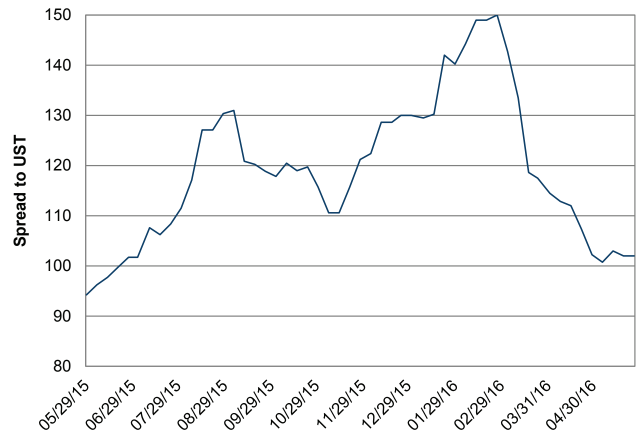
## Portfolio strategy - securitized products

**CMBS: lower target to 5%**

- CMBS performed well in May, providing an excess return over US Treasuries of 24 bps.
- Performance benefited from improved liquidity and a reduction of new issue supply. Our target remained at 5% versus the benchmark at 2%.
- In our view, valuations have moved back to rich levels and we have concerns regarding recent weak economic trends, Fed policy uncertainty, and the upcoming election.
- The fundamentals surrounding commercial real estate remained favorable, driven in large part by strong labor markets, but are approaching late cycle conditions in select markets.
- Supply estimates have been slashed from $75 billion to $50 billion for 2016. Net supply is approximately negative $25 billion year-to-date through May.
- We still prefer higher quality new issue senior bonds and subordinate agency and single-asset CMBS.

**CMBS new issue 10-year AAA to UST**

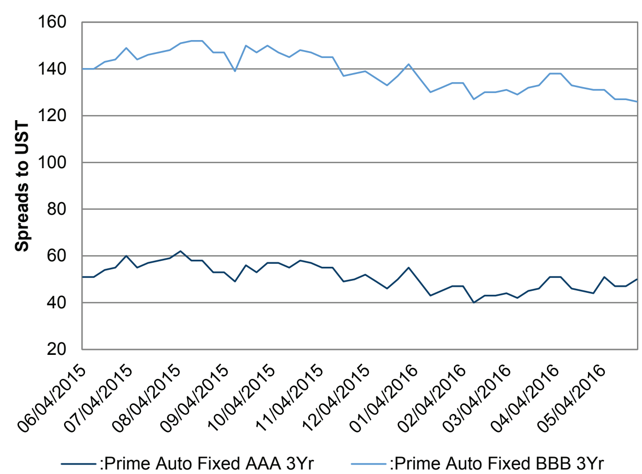



*Source: J.P. Morgan*

**ABS: favorable view on select market segments**

- The ABS sector outperformed US Treasuries in May by 19 bps. Markets have stabilized and new issuance has been met with strong investor demand.
- We are positive on the sector due to improving fundamentals and high quality assets. We target a portfolio allocation of 8-10%.
- The fundamentals for consumer finance were very favorable, supported by strong employment growth and elevated savings rates.
- Supply should be very manageable for the rest of the year with most new issuance coming in the prime and subprime auto market.
- We like prime and sub-prime auto ABS subordinate classes due to attractive valuations and strong structural support. We also favor timeshare and whole business ABS.

**Auto ABS Spread**




*Source: Barclays*

## Portfolio strategy - investment grade credit

Stable outlook based on improving technicals and reasonable valuation offset by deteriorating fundamentals.

**Performance**

- The Barclays Credit Index returned -0.04% in May and 5.14% year-to-date.
- Excess return to similar maturity Treasuries totaled -0.11% in May and 1.46% year-to-date.
- We expect macro sentiment, supply/demand technicals, foreign buying, and industry and issuer selection to drive returns in the intermediate term. Credit fundamentals and corporate profitability continue to deteriorate in some industries; we expect this trend to persist.
- Spread volatility is expected to be exaggerated due to diminished market liquidity.

**Fundamentals – deteriorating yet adverse incentives slowing**

- 1Q16 revenue growth of -9.5% year-over-year; excluding Energy and Metals & Mining -0.3%.[1]
- 1Q16 EBITDA growth of -8.7% year-over-year; excluding Energy and Metals & Mining -0.1%.[1]
- 1Q16 net leverage of 2.35x, up from 2.23x in 4Q15.[1]
- 1Q16 interest coverage of 10.4x, down from 10.94x in 4Q15.[1]
- We expect M&A and share buybacks to slow as government intervention is preventing some M&A and companies are being less rewarded by the equity market for share buybacks.
- We expect commodity-based industries to continue to struggle.
- Decelerating global growth and minimal productivity enhancements will pressure corporate earnings and US manufacturing, yet a reversal of dollar strength should help multinationals.

**Technicals – improving**

- Accommodative European and Japanese central bank policy, low global yields and a strong dollar are forcing foreign investors into USD assets: crowding in from overseas QE.
- 25% of global government bonds and 10% of European corporate bonds have negative yields.
- YTD mutual fund inflows of $50 billion.[1]
- Gross new issuance is up 9% year-over-year, but only 1% excluding ABIBB record issuance.
- We expect 2016 gross issuance to decline versus 2015 due to market volatility and an M&A slowdown
- We expect M&A funding pipeline to shrink and new M&A to slow amidst government intervention.

[1]J.P. Morgan

**Valuation – fair**

- Barclays US Credit Index spread was 141 bps at the end of May, 45 bps wide of the 2014 tights.
- Barclays US Credit Index was 6 bps tight of the 25-year average; BBBs was 6 bps tight of 25-year average.
- Effective yield of 3.04%, uninspiring, yet very attractive for many non-US investors.
- Spread as a percentage of all-in yield at 46%, versus 15% pre-crisis (2/28/2005).

**Financials – positive**

- Increased regulation, improved capital base and asset quality, less exposed to shareholder activism.
- Constrained earnings growth due to increased regulation and low interest rates.
- We believe the selloff in US banks in 1Q16 was overdone across the capital structure.

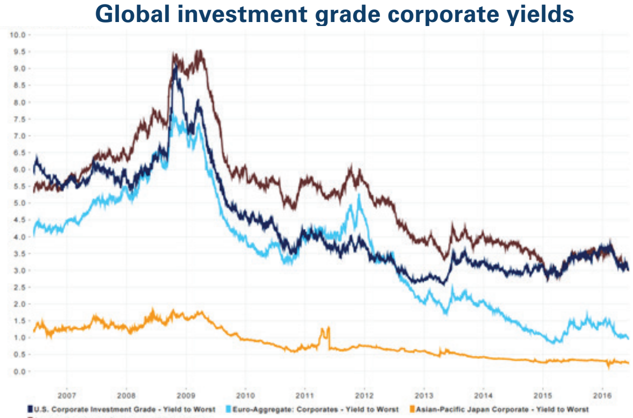
**Industrials – mixed**

- Shareholder activism in the form of share buybacks, higher dividends, and M&A activity should diminish.
- Industry and issuer selection of the utmost importance.
- Fundamental deterioration within Metals & Mining, and Energy (Exploration & Production and Oil Field Services).

**Overweight**: Banks/Financial, Food & Beverage, Supermarkets, Pipelines, Airline Enhanced Equipment Trust Certificates (EETCs), Media Non-Cable, Telecom, Technology, Building Materials, post event risk issuers, and BBB-rated credits

**Underweight**: Metals & Mining, Healthcare, Utilities, Defense, Pharmaceuticals, Chemicals, Insurance, Railroads, Sovereigns and Emerging Markets

**Global investment grade corporate yields**




*Source: Barclays*

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## Portfolio strategy – high yield

**Performance – high yield rally lost some steam in May**

- The Barclays (full-quality) High Yield Index produced a total return of 0.62% in May as the rally in risk assets slowed from its torrid pace in April (when the High Yield Index returned 3.92%).
- Lower-quality bonds continued to outperform the overall market in May, with the CCC-rated portion of the Barclays HY Index (+2.23%) outperforming BBs (+0.31%) and Bs (+0.22%). Through May, CCCs (+14.3%) remained well ahead of BBs (+6.9%) and Bs (+6.6%) on a total return basis.
- Most sectors in the Barclays HY Index posted a positive returns in May, led by Energy (+1.77%), Chemicals (+1.73%) and Media (+1.70%). Oil Field Services (-2.59%), Retail (-1.55%), and Pharmaceuticals (-1.11%) were the largest underperforming sectors during the month.

**Fundamentals – defaults continued in energy despite oil rally**

- Although default activity slowed in May, the last twelve months (LTM) default rate increased from 3.7% to 3.8%. May's $3.5 billion of high yield bond and loan defaults broke a streak of six straight months of $5 billion or more. Thus far in 2016, 35 companies have defaulted on a total of $41.9 billion of bonds and loans. Excluding commodity sectors (Energy and Metals & Mining), the default rate remained just 0.42% at the end of May.
- With the continued rally in May, the high yield distressed rate (bonds trading below 50% of par) fell again to 2.25% from 3.20% in April and 4.65% in March. Energy and Metals & Mining accounted for nearly 50% of the distressed universe, down from over 70% in March.
- The year-to-date upgrade-to-downgrade ratio stood at 0.40:1, indicating more downgrades to upgrades at the end of May. On a dollar-value basis, upgrades and downgrades were nearly even during the month with Charter's upgrade offsetting further downgrades in the Energy sector.

**Technicals – supply accelerated while flows turned negative**

- High yield mutual fund flows turned negative (-$2.4 billion) in May following three consecutive monthly inflows. Year-to-date, inflows totaled $9.6 billion versus $8.6 billion over the same period last year.
- New issue activity picked up again in May as 63 new bonds priced for a total of $42.3 billion, the highest monthly total since September 2014. Year-to-date issuance remained down 25% year-over-year.

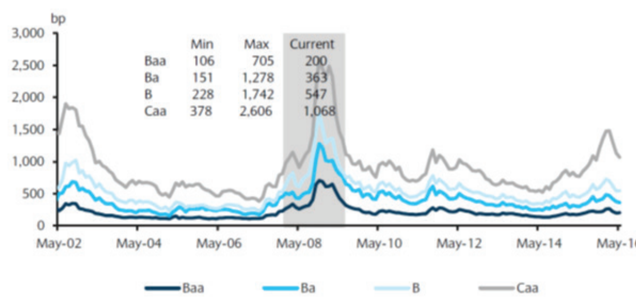
**Valuation – market appeared fairly valued post rally**

- High yield bond yields decreased 21 bps in May to 7.84% (7.24% ex-commodities). The average bond spread decreased 28 bps to 654 bps in May (595 bps ex-commodities).
- Against a global backdrop of low (or even negative) yields, the high yield market remained attractive even after an impressive bounce from February's low. If risk sentiment and commodity prices remain supportive, it's reasonable to expect a coupon-like return over the remainder of 2016.

**Overweight**: Airlines, Autos, Consumer Products and Media

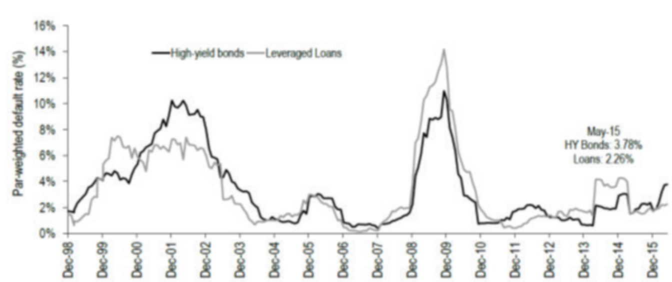
**Underweight**: Retailers, Healthcare, Energy and Metals & Mining

**High yield spreads by credity quality**




*Source: Barclays Research*

**LTM default rate**




*Source: JPMorgan*

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## Portfolio strategy – leveraged loans

**Performance – loan returns remained steady, positive**

- The Credit Suisse Institutional Leveraged Loan Index (CSILLI) posted a third straight gain in May (+0.7%) after strong results in April (+1.2%) and March (+1.8%). The year-to-date and trailing one-year returns stood at 3.5% and 2.6%, respectively. Lower-quality loans outperformed during the month as CCCs returned 1.6%, Bs 0.8%, and BBs 0.6%.
- The CSILLI average price gained another 0.12 points in May, and at 99.00, the average loan price is now up over two points from February and at the highest level since last July.

**Valuation – spreads compressed to tightest level in five years**

- The average nominal spread for loans increased 3 bps to 384 bps at month end, while the three-year discount margin (DM) tightened another 6 bps to 445 bps (-81 bps versus February), the lowest level in five years.
- The excess spread of high yield relative to loans tightened modestly to 206 bps, down from 311 bps at the end of January (the highest level in over six years).

**Fundamentals – few problems outside of commodities**

- The leveraged loan default rate increased to 2.0% in May, although the distressed ratio has declined meaningfully (led by Metals & Mining). Notably, however, certain non-commodity sectors have seen their distressed ratios increase of late. Default rates will likely continue to trend up in the near term, but fundamentals remain fairly supportive outside of the commodities sectors.
- For the second consecutive month, every sector in the CSILLI posted positive returns. Energy (+2.5%) and Metals & Mining (+2.3%) were the strongest industries during May, while the more stable Consumer Products and Food & Beverage sectors trailed for the month.

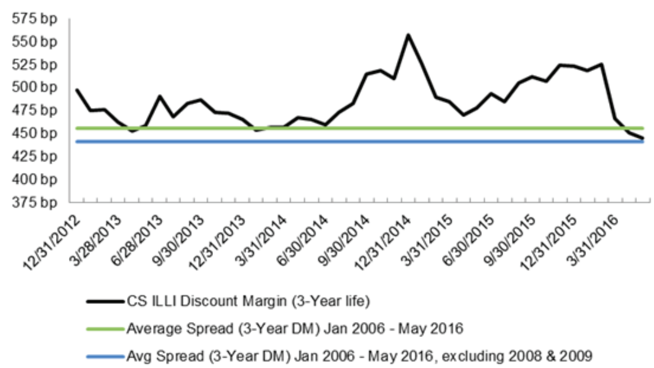
**Technicals – loan funds see first positive flows in a year**

- Retail loan funds reported an inflow of $277 million during May, the first monthly inflow since May of last year. On a year-to-date basis, loan funds have reported outflows of $6.0 billion through May as compared to a $4.9 billion outflow over the first five months of 2015.
- Collateralized Loan Obligation (CLO) activity slowed somewhat during May as 12 deals priced for $4.9 billion, down from the 14 new deals for a total of nearly $6 billion that were done in April. The year-to-date volume of $19.6 billion remained well below last year (-64% year-over-year).
- Against the supportive backdrop of retail fund inflows and steady CLO activity, loan new issuance spiked 65% from April to $32.9 billion in May. Following a very slow start to the year, May marked the fifth consecutive monthly new issue volume increase. Despite this, volume remained down over 40% from 2015. Through May, over half of new issue volume has been for acquisition financing.

**Overweight**: Chemicals, Consumer Products and Media & Telecom

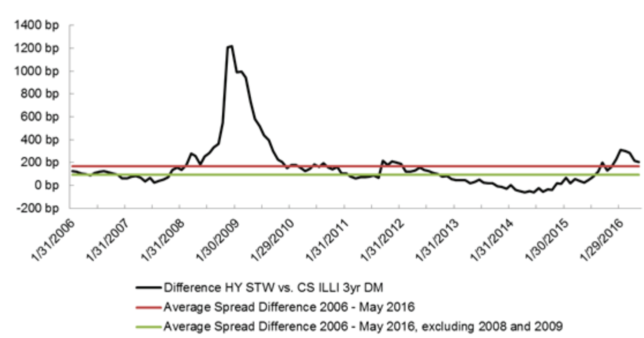
**Underweight**: Food & Beverage, Financials and Services

**Leveraged loan three-year discount margin**




*Source: Credit Suisse*

**Relative value between high yield bonds and leveraged loans**




*Source: Credit Suisse*

## Portfolio strategy – non-dollar

The US dollar strengthened in May against most major currencies, reversing the trend of the past few months.

### Europe

The euro pulled back slightly in May although it has followed a fairly tight range since opening the year at $1.09. The prospect of Brexit took center stage as Britain's vote on EU membership is set to take place on June 23rd. Polling currently shows those leaning toward Brexit are roughly equal to those in favor of staying.

**EUR/USD Spot**

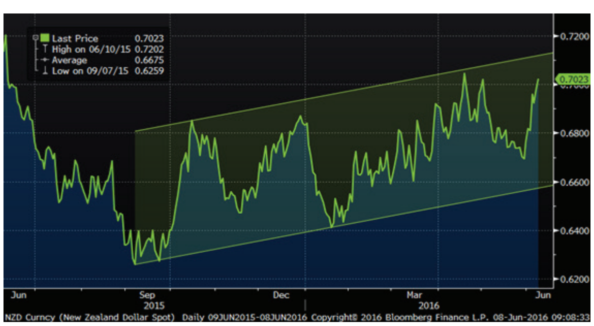

*Source: Bloomberg*

### Other

- Currencies around the globe weakened against the US dollar in May. This was a welcomed reprieve and may be short lived as we expect the dollar to weaken later in the year.
- In emerging markets, we continue to like Mexico, Brazil and Indonesia on an unhedged basis.
- In developed markets, we have added positions in Australia, New Zealand and Canada.
- Even as world economic growth forecasts are tapered, we believe emerging market currencies will continue to exhibit relative strength.
- We look for the dollar to take a short breather, then continue to weaken versus most major currencies as the pace of Fed tightening is scaled back.

### Australia, New Zealand and Canada

Spreads widened modestly in May, as currencies remained range-bound against the US dollar.




*Source: Bloomberg*

### Currency

Currencies in Australia, New Zealand and Canada completed a bottoming process in May and we began to see all three exhibit strength.

**CAD**

**AUD**

*Source: Bloomberg*

## Benchmark performance as of 5/31/2016

| Total return | MTD | YTD |
|---|---|---|
| Barclays US Aggregate | 0.03% | 3.45% |
| Barclays US Treasury | -0.00% | 3.09% |
| Barclays US TIPS | -0.71% | 4.08% |
| Barclays US Credit | -0.04% | 5.14% |
| Barclays US ABS | 0.09% | 1.70% |
| Barclays US MBS | 0.13% | 2.27% |
| Barclays US CMBS | 0.13% | 4.13% |
| Citigroup BB/B ex-split B/CCC Index | 0.25% | 6.54% |
| Credit Suisse Institutional Leveraged Loan Index | 0.73% | 3.47% |
| Citigroup Non-US$ World Government Bond (50% hedged) | -0.67% | 6.80% |
| **Yield** | **April 30** | **May 31** |
| US 10-Year Treasury yield | 1.83% | 1.84% |

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## Disclaimers