Bradford & Marzec

Now part of **Tortoise Credit Strategies**

Global economic summary & outlook

December 2016

Global economic summary & outlook

International

Following the U.S. Presidential election and policy directive hints from the new administration, global market indicators point to an acceleration of U.S. economic growth. This has applied upward pressure to global interest rates. In addition to potential Federal Reserve action at the December meeting, investors appear to expect that many of President-elect Trump's policies will promote economic growth. For now analysts lack policy specifics, so bond markets could react negatively as the Trump administration releases additional details, even if actual inflation appears muted.

As we noted in November, signs of an economic pickup outside of the U.S. currently remain mixed, but could be improved by accelerating U.S. growth. The Organisation for Economic Co-operation and Development (OECD) forecasts that global GDP will increase 3.1% in 2017, a +0.1% improvement from the previous forecast. However, we note that the U.S. dollar strengthened against many major currencies since the election of Donald Trump. A stronger U.S. dollar inhibits the ability of central banks around the world to spur economic growth by further reducing interest rates. Additionally, a strengthening U.S. dollar usually weakens commodity prices. However, commodity prices generally increased in recent weeks, despite a stronger U.S. dollar. If this trend continues, it should provide a double boost for commodity dependent economies which constitute approximately 15% of world GDP.

Signs of an economic pickup outside of the U.S. currently remain mixed.

Major fiscal spending in China, Japan and the UK evidence the growing appeal of fiscal stimulus. EU finance ministers recently discussed fiscal spending programs to support economic growth in the ailing eurozone. The European economy remains on uncertain footing and represents a potential source of risk to global growth. Anti-EU sentiment voiced by the failure of the recent referendum vote in Italy could be amplified by upcoming elections in France, Germany and The Netherlands. Spread widening between French and German 10-year bond yields reflects uncertainty regarding the future of the EU.

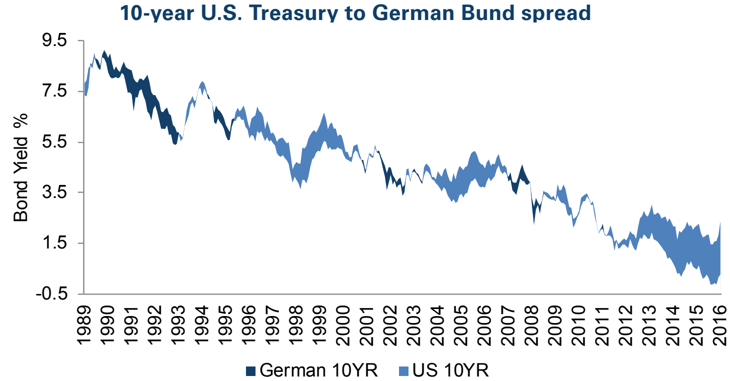
The U.S. dollar strengthened against many major currencies since the election of Donald Trump.

Recent break-even levels on U.S. Treasury Inflation Protected Securities (TIPS) indicate an increase in general inflation expectations. Rising commodity prices and some wage data further confirm upward pressure on prices. However, we note that both the Japanese and European central banks continue to struggle to raise domestic inflation rates to meet stated targets, and that global manufacturing capacity utilization remains very low.

Europe — summary

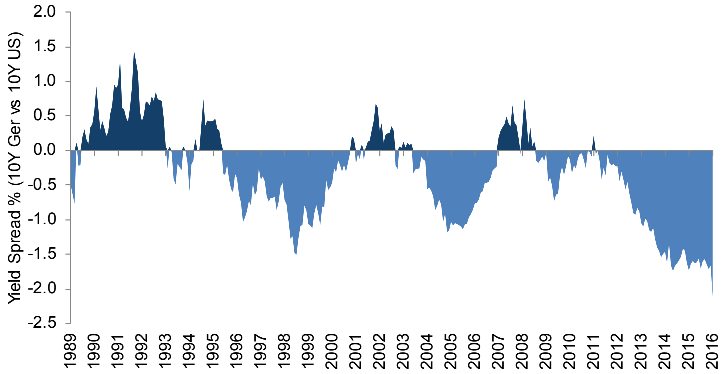
- On December 5, 2016, 59% of Italian voters rejected a constitutional referendum that would have weakened the power of the country's senate. The referendum's failure provides momentum to anti-EU forces. Voter turnout exceeded estimates by 10% and the number of voters rejecting the referendum exceeded estimates by 5%, indicating a higher than expected level of frustration with the EU. As expected, Italian Prime Minister Matteo Renzi tendered his resignation shortly after the vote on December 7, 2016. On the same day, Moody's downgraded the country's outlook to negative but retained its Baa2 long-term issuer rating. Investor concern now focuses on an eventual Italian general election likely to take place in 2018. If an anti-EU party gains control of the Italian government, the country could begin considering the possibility of withdrawing from the EU. In the meantime, a new coalition government in Italy will operate with a limited mandate while managing a banking system weakened by non-performing loans estimated at €350 billion. Funds continue to flow out of the Italian banking system as investors and depositors increasingly fear that a 'bail in' will occur similar to that experienced in Cyprus.
- The European economy remains sluggish. Eurostat reported that GDP in the 19-country euro area region grew 0.4% sequentially on a seasonally-adjusted basis in the third quarter of 2016. In addition, industrial production declined 0.8% sequentially on a seasonally-adjusted basis in September 2016. Despite the slow overall growth, eurozone unemployment declined to 9.8% (seasonally adjusted) in October 2016, the lowest rate recorded in the euro area since July 2009. EU finance ministers met to discuss the possibility of utilizing traditional fiscal stimulus. Some analysts believe that fiscal stimulus could total up to 5% of EU GDP, up from previous estimates of 1%.
- Post Brexit, the UK economy continues to surprise to the upside with UK house prices rising 1.4% sequentially in October 2016, according to the Halifax House Price Index. Industrial production also rose 0.6% in September, complementing strong service sector readings. The UK Office for National Statistics reported that its Consumer Price Index increased in October 2016 by a surprisingly weak +0.9% on a year-over-year basis. The debate over Brexit continues, and the process now awaits a decision by the UK's Supreme Court which will determine in January 2017 whether or not the accord requires parliamentary approval before Article 50 can be invoked. UK Prime Minister Theresa May maintains that March 2017 remains the deadline for invoking Article 50, and the EU has targeted October 2018 as the actual Brexit date.
- Given the recent increase in U.S. 10-year Treasury yields, some spreads to European sovereign bonds have reached record negative levels. The spread between German Bunds and U.S. Treasury notes represent the most notable such negative spread (see the following two charts.)

10-year U.S. Treasury to German Bund spread



As of: 11/30/2016. Source: Bloomberg

Yield Spread of 10-year U.S. Treasury to German Bund spread



As of: 11/30/2016. Source: Bloomberg

- Lars Rohde, Chairman of the Board of Governors of Danmarks Nationalbanken (Denmark's central bank) said that interest rates in Europe would "stay ultra-low well into the future."

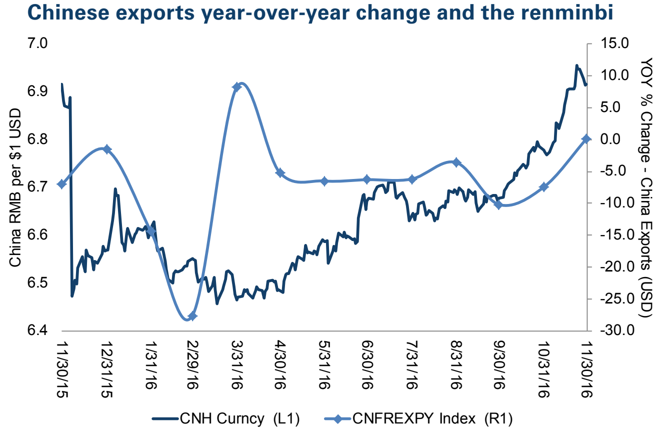
Europe — outlook

- The European Union faces an uncertain future as several elections could change the tone of European politics and threaten the cohesion of the Union itself. France, Germany and the Netherlands will certainly hold leadership elections and elections in both Italy and Spain appear increasingly possible. Given the recent embarrassing bi-election defeat for the ruling UK Conservative Party in November 2016, it now appears unlikely that the UK will go to the polls prior to 2020. If a pan-European political swing occurs, the final outcome will likely reject austerity politics, promote fiscal stimulus and possibly the departure of additional member countries or the dissolution of the entire European Union. Ultimately, under this scenario, European economic growth will likely accelerate, but not before major change occurs on the political front. The extent of future political change in Europe could be heavily influenced by the success of President-elect Trump's U.S. economic policies, as well as that of a post Brexit UK. Recognizing populist pressure for change, the European Commission issued a November communication entitled 'Towards a Positive Euro Area Fiscal Stance' confirming support for fiscal stimulus.

Rest of the world (ex-Europe and U.S.) — summary

- Unusually despite a depreciating currency against the US dollar, Chinese exports continue to decline (see chart below). In October 2016, Chinese exports declined 7.3% and imports declined 1.4%. In November 2016, China's Manufacturing Purchasing Managers Index rose slightly to 51.7, versus 51.2 in the preceding month. China's economic growth likely doesn't yet fully reflect the effects of fiscal stimulus implemented in early 2016.

Chinese exports year-over-year change and the renminbi



As of: 11/30/2016. Source: Bloomberg

- Economists working at Banco de Mexico, the country's central bank, reduced their 2017 GDP growth forecast from 2.20% to 1.72%, and increased their inflation forecast to 4.01%.
- The Brazilian government warned that further U.S. dollar strength will increase Brazil's inflation rate. This undesirable outcome would likely restrict the ability of Banco Central do Brasil (Brazil's central bank) to further cut interest rates. This development demonstrates that further U.S. dollar strength hampers worldwide economic growth.
- Australian GDP in the third quarter declined sequentially at a seasonally adjusted rate of 0.5%. A non-recurring public sector asset transfer accounted for most of the weakness in GDP growth. The Reserve Bank of Australia, the country's central bank, left interest rates unchanged.
- The Bank of Canada left rates unchanged, but sounded a cautionary tone regarding its global outlook. It's noteworthy that, as the largest trading partner to the U.S., Canadian exports continue to disappoint, but should improve as U.S. growth accelerates. Canada has increased fiscal stimulus through infrastructure spending but has yet to experience results. Despite a weaker currency, the central bank remains comfortable with core inflation of approximately 2%. Economists expect Canadian GDP growth to accelerate to 2.5% in 2017

Rest of the world (ex-Europe and U.S.) — outlook

- We continue to closely monitor economic data for signs of a global pickup in growth. For now, indications of economic growth remain tentative but could become more prevalent if U.S. GDP growth accelerates in 2017. Sustained price increases in some commodities, as well as higher shipping activity, support the view that demand is picking up around the world. Manufacturing capacity remains plentiful, which should somewhat contain inflationary forces, for now. Regardless, if economic growth takes hold, fixed income markets will likely react ahead of fundamentals.

Domestic

Nearly a month has passed since the election of Donald Trump and financial markets continue to react to newsflow regarding potential policies, cabinet appointments and other related developments. Taken in aggregate, it appears that investors anticipate significant fiscal stimulus out of the new administration, causing bond markets to sell off and equity markets to rally. The Trump administration will likely focus fiscal stimulus efforts in three main areas: 1) tax reform; 2) regulatory reform; and 3) direct government and private sector investment. We generally agree with the market's current assessment that the Trump administration will promote policies that bias near-term growth expectations higher.

Bonds sold-off dramatically in the weeks following the U.S. Presidential election, as evidenced by yield increases in U.S. Treasury 10-year and 2-year notes of approximately 55 bps and 30 bps, respectively. Unsurprisingly, interest rate volatility increased in the post-election period as a result of elevated uncertainty regarding both fiscal and monetary policy going forward.

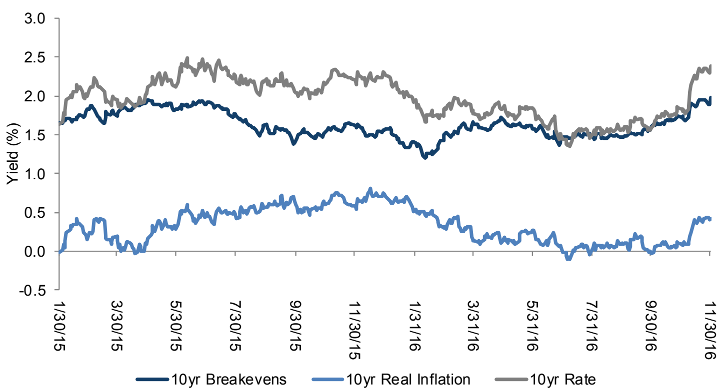
We believe that the prospect of stronger than previously anticipated growth in the coming quarters will bias interest rates higher. Consequently, we recently reduced the duration of our portfolios and continue to monitor developments with the intent of further adjusting portfolio positioning as events unfold.

The possibility of significant policy changes that might be implemented by the new Trump administration somewhat diminish the importance of recent economic releases. Nevertheless, recent data generally reflect better than expected economic conditions and suggest reasonable, if not exceptional, GDP growth to finish the year.

United States — summary

- As mentioned, bond markets sold off dramatically following the election, and markets appear to be pricing in nearly every form of stimulus that the Republican-controlled legislative and executive branches might possibly introduce.
- In November, the U.S. Treasury component of the Bloomberg Barclays Aggregate Index plunged the most since January 2009, posting a -2.67% total return.
- The U.S. 10-year Treasury yield increased from 1.85% at the close of business on November 8 to 2.38% on November 30. Interestingly, it appears that an increase in inflation expectations and an increase in real rates contributed equally to the recent Treasury yield move (see chart below.)

Components of the 10-year U.S. Treasury yield



As of: 11/30/2016. Source: Bloomberg

- We believe the recent increase in U.S. Treasury yields reflect investor expectations that increased fiscal stimulus will provide a boost to real GDP growth, increase returns on invested capital, and eventually pressure real interest rates higher, as well as increasing inflation. Higher real rates and increased inflation should make it easier for the U.S. Federal Reserve to raise its federal funds target rate.
- At November month end, the Federal Reserve Bank of Atlanta's GDPNow model forecast and the New York Federal Reserve Bank's Nowcast report forecast fourth quarter 2016 U.S. GDP growth at +2.4% and +2.6%, respectively.
- Given the +3.2% U.S. GDP growth reported for the third quarter, and assuming a +2.5% growth rate for the fourth quarter (i.e., the average of the two fed forecasts), we estimate second half 2016 GDP growth at a healthy post-crisis rate of approximately +2.85%.

United States — outlook

- President-elect Trump will likely steer governmental policies in a very different direction than the current administration; consequently, forecasting U.S. economic performance became more difficult following the election. That Republicans retain control of both the House of Representatives and Senate adds to the probability that the Trump administration will impart meaningful changes to governmental policies. As a result, backward-looking indicators such as employment surveys and measures of inflation will lose some of their value, as fiscal policies introduce new considerations to economic modelling and market forecasting.

- We will monitor the new administration's policy announcements and key administrative nominations to determine their potential effect on future U.S. GDP growth and market trends.

- We have identified tax reform, regulatory reform, and public and private investment as the three most probable levers of fiscal policy that the Trump administration may use to spur economic growth and, as a consequence, the trend of interest rates.

  - Tax reform, both corporate and personal, appears to rank high on the new administration's priority list. A more efficient corporate tax code could reinvigorate business investment, which has recently followed a weak trend.

  - With regard to regulatory reform, we observe that the Trump administration has already stated an interest in scrutinizing the Dodd-Frank Wall Street Reform and Consumer Protection Act, and the Patient Protection and Affordable Care Act. We also anticipate scrutiny of some of the more onerous regulations mandated by the Environmental Protection Agency. Specifics matter and details remain scant; nevertheless, we believe it is reasonable to expect that, on balance, regulatory reform introduced by the Trump administration will support economic growth.

  - On the subject of public and private investment, the Trump administration has proposed spending $1 trillion on infrastructure projects. Again, specifics matter, and while it's simply too soon to expect any details, we believe that public and private investment programs and investment incentives could significantly boost U.S. economic growth.

- We believe actual policy implementation may take longer than expected. But until proven otherwise, we anticipate that investors will assume that many Trump administration initiatives will succeed and that markets will reflect stronger economic growth assumptions and higher interest rates going forward.

- We believe the Trump administration's pro-growth attitude will likely foster a higher interest rate environment making shorter durations more appealing.

- Upward pressure on interest rates fostered by accelerated economic growth in the U.S. could be tempered by the current lack of inflation worldwide and prevailing low rates globally.

Disclaimers