Tortoise[SM]
Credit Strategies

Global economic summary & outlook

January 2017

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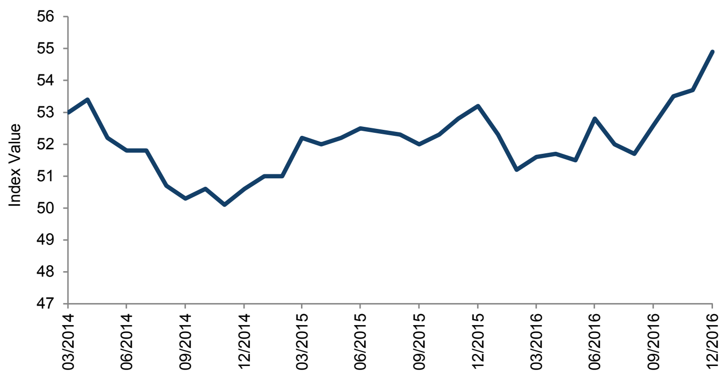
International

It appears that the widespread policy actions implemented outside of the U.S. in 2016 are finally having a positive effect on global growth; we expect this trend to continue throughout 2017. Notably, we observe an increase in the activity level of purchasing managers in the manufacturing industry, as measured by various purchasing manager indices (PMI). Regions exhibiting improved PMI trends include China, the UK and the eurozone itself (see chart, below). An increase in manufacturing activity in the U.S., as well as overseas, sets the stage for a broad reflationary recovery and a rise in inflation. However, it appears that considerable slack still exists in the system that may need to be absorbed before inflation pushes global bond yields significantly higher.

Markit Eurozone Manufacturing PMI



As of December 31, 2016. Source: Bloomberg

The various forms of stimulus implemented worldwide include lower interest rates, quantitative easing programs and, lastly, fiscal stimulus. Business activity in emerging market economies still lags the developed world; in some cases, higher commodity prices may help close the gap. The Brazillian and Russian economies continue to stand out as laggards, although improvement could become apparent soon. The potential for the Trump administration to influence a relaxation of sanctions against Russia could help boost economic growth in that country. Brazil will likely continue to struggle with stagflation and political uncertainty, but improved global demand could contribute to positive GDP growth in 2017.

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A better investment environment, higher U.S. interest rates, and the safe haven status enjoyed by the U.S. have recently influenced capital flows and contributed to a stronger U.S. dollar. The Trump administration's pro-business stance will likely sustain pressure on capital flows and continue to influence the U.S. dollar higher in 2017. China has sought to restrict capital outflows, at least partially in reaction to the strengthened U.S. dollar. Overall, U.S. dollar strength, partially driven by higher U.S. interest rates, remains a mixed blessing for many countries. Higher import prices exacerbate inflation and restrict the ability of central banks to cut interest rates. However, as we previously noted, some emerging economies benefit from improved demand for other export products in a strong U.S. dollar environment. An excessively strong dollar could ultimately require the attention of the U.S. Federal Reserve.

Europe — summary

- Widespread political change could occur throughout Europe in 2017. Germany, France and The Netherlands will each experience the uncertainty of a general election. Other countries, such as Spain and Italy may also hold leadership elections if circumstances dictate. More specifically, Spain will likely continue to grapple with the push for independence by Catalonia, its richest province by Gross Regional Product (GRP)[1]. Moreover, by the end of 2017, the fate of the euro could become known, one way or another. As such events unfold, market volatility could increase. Nevertheless, underlying economic growth could continue to support a favorable long-term trend in capital markets activity and the eurozone business climate. Increased fiscal stimulus appears as the likely clear outcome that would emanate from a change in eurozone politics.
- The UK continues to struggle with the terms of Brexit with much posturing on both sides of the issues. Nevertheless, a doomsday economic scenario has yet to evolve, and a weaker pound sterling has provided some incrementally beneficial economic trends, including increased 'retail tourism.' Manufacturing, as measured by the Markit/CIPS UK Manufacturing PMI, jumped to a 30-month high in December. We anticipate UK inflation and gilt yields will rise in the near term, reflecting an increase in GDP growth expectations. However, we note that the UK hasn't actually left the EU yet, so current optimism may be some two years premature.
- Elsewhere, European growth, and to a lesser extent inflation, are picking up. A consistent trend of inflation represents a significant milestone, because of the European Central Bank's (ECB) ongoing concern regarding a pan-European deflationary trend. A weaker euro and higher energy prices comprise the main factors pushing prices higher. Core CPI of +1.1% in December 2016 remains well short of the ECB's 2.0% target. If the recent inflationary trend continues, it may temper the ECB's negative interest rate policy. Consequently, we remain cautious regarding European bond market investments.
- Euro currency weakness has boosted exports and renewed hopes for European GDP growth, while a coincidental strength in the U.S. dollar furthered the effect. In addition, anti-euro comments by certain European politicians have also contributed to euro currency weakness. The euro will likely continue to weaken until investors receive clarity regarding certain European elections and the concomitant policies that could result.

Europe — outlook

- In Europe, politics will likely dominate news flow and investor sentiment. Against this backdrop, the eurozone economy should gradually accelerate, despite the structural deficiencies of the construct itself. A weaker euro currency and accelerating global GDP should benefit eurozone economic growth more than any domestic policy initiatives. We expect that any pickup in inflation will be gradual; nevertheless, European rates could push higher. Both the Italian banking system and the Greek economy will likely remain problematic until permanent solutions are found.

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

- China has changed the basket of currencies against which it assesses movement of the renminbi. The new basket slightly deemphasizes developed economies such as the U.S., Japan and Europe, in favor of a more global mix. The change is part of a multi-faceted effort to restrict the outflow of capital from the country. Chinese capital outflows have contributed significantly to higher asset prices around the world. Consequently, a successful result in this effort could have the unintended negative effect of lowering asset prices around the world. Meanwhile, Chinese economic growth has picked up in response to significant early 2016 stimulus, but is likely to slow again towards the end of 2017, as China faces demographic challenges.
- The Indian economy, previously one of the bright spots in the world economy with 2016 growth estimated to slightly exceed 7%, is decelerating quickly. The reason: a proposed ban on high-denomination cash notes, which could wipe out significant wealth.
- Weakness in the Mexican peso continues. Markets currently anticipate that the Trump administration will implement policies that will hurt the Mexican economy. In reality, the weaker currency is likely to benefit the Mexican economy and at least somewhat offset any policy that the Trump administration may implement. Mexican U.S. dollar-denominated bonds are beginning to look attractive versus U.S. equivalents.

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

- Although the U.S. economy will likely take the lead in any 2017 global recovery, other countries should also contribute. However, many developed economies increasingly face demographic challenges which could inhibit growth. Emerging markets don't share that dynamic and, therefore, could benefit from increased economic activity in certain developed countries and the competitive advantages provided by their recently depreciated currencies.

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- With regard to fixed income markets, global debt levels remain problematic, specifically in China, Japan and some European countries. According to the Institute of International Finance, word debt totals US $217 trillion, or 325% of world GDP[2]. European debt–to-GDP improved slightly over recent periods, despite lackluster economic growth. Nevertheless, certain countries continue to maintain debt at critical levels. If the political will to use traditional fiscal stimulus to boost economic growth gains momentum, sovereign debt could trend higher globally in the early stages. However, increased economic activity and higher government debt levels could ultimately put upward pressure on interest rates worldwide. It remains to be seen how some parts of the world will cope with high debt levels as interest rates rise. Given the slack capacity in many economies, any significant rate rise seems unlikely in the near term. Indeed, even the recent rise in the yield on U.S. ten-year Treasury notes appears contained within a long-term downtrend.

Domestic

Out with the old and in with the new, 2017 appears as if it will bring significant change to the economy and financial markets. The election of Donald Trump and the Republican control of both houses in Congress make it appear fairly certain that the baton of growth will transition from a basis built upon monetary policy and Federal Reserve intervention, to easier fiscal policies emanating out of Washington, DC. We agree with current market expectations that a transition to stimulative fiscal policies will shift domestic growth to a higher level.

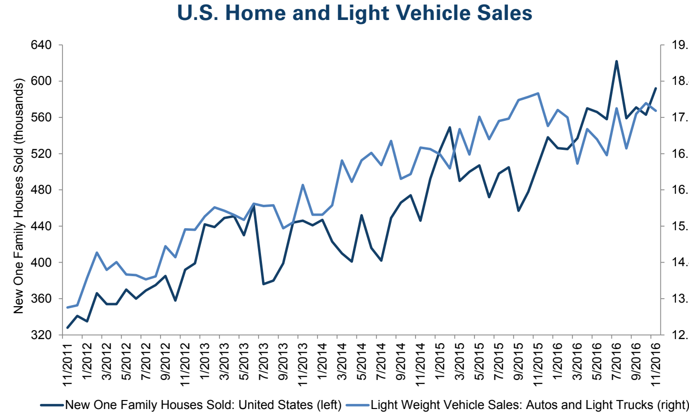
We believe U.S. economic trends could significantly improve, depending on how quickly and successfully the Trump administration is able to implement a new agenda. In December 2008, the U.S. Federal Reserve reduced its federal funds target rate to effectively zero percent. Since that time, the Fed has added multiple rounds of quantitative easing to its stimulus efforts. However, since the end of the recession in the second quarter 2009, and despite a highly accommodative Federal Reserve, the U.S. economy has registered a disappointing average real GDP growth rate of 2.1%. The prospect of new and significant fiscal stimulus provides some investors with hope that real GDP growth can accelerate into the 3-4% range.

Given the prospect of improved U.S. economic growth, the market has begun pricing in higher real interest rates and inflation expectations. We believe this trend has room to continue, and we anticipate that interest rates will be biased higher for the foreseeable future. As a result, we believe shortening durations, thus reducing sensitivity to interest rate increases, could be prudent. We continue to monitor the new administration's agenda and policy initiatives.

United States — summary

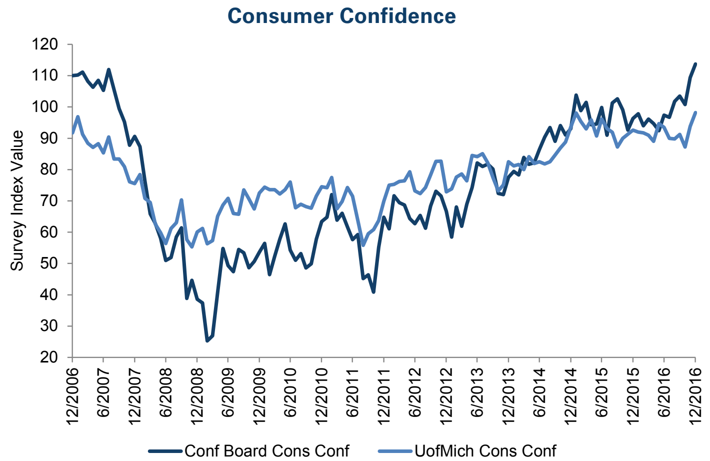
- It appears that the U.S. economy continued to advance in the fourth quarter of 2016, led by continued strength in consumer spending. The Atlanta Fed GDPNow forecast estimates that personal consumption expenditures will contribute 1.69% to real GDP in the fourth quarter of 2016. As of month end December 2016, the same GDPNow forecast estimates U.S. GDP growth of 2.5% in the fourth quarter of 2016.
- Large ticket purchases, specifically automobile and home purchases, reported in December exceeded consensus expectations. Vehicle sales of 17.75 million (SAAR) in November 2016 exceeded the 17.70 million (SAAR) consensus expectation. Meanwhile, both new and existing home sales also surprised to the upside versus consensus forecast (i.e., new home sales of 592,000 (SAAR) in November 2016 versus the 575,000 (SAAR) Bloomberg consensus estimate, and existing home sales of 5.61 million in November 2016 versus the 5.50 million (SAAR) Bloomberg consensus estimate).

U.S. Home and Light Vehicle Sales



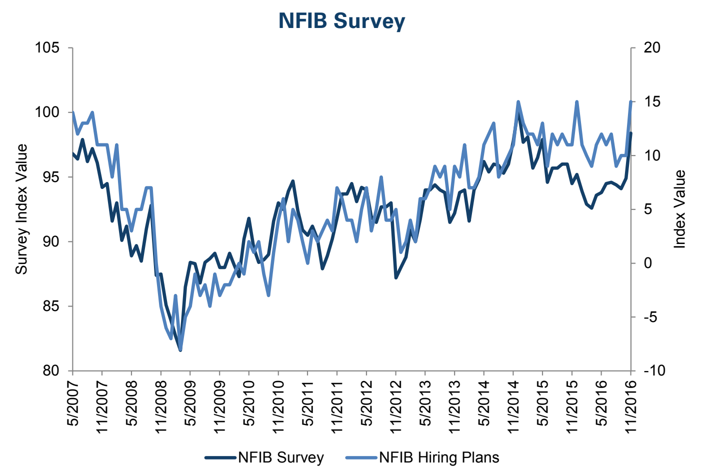
As of November 2016. Source: Federal Reserve Bank of St. Louis

- Given the magnitude of anticipated changes in U.S. fiscal policy, many of our backward-looking economic indicators will be less useful in forecasting the strength and momentum of certain trends. As a result, we are paying increased attention to sentiment surveys, both consumer and business, as indicators of future economic strength. Recent strength in consumer surveys increases our confidence that consumer spending will continue at a healthy pace.



As of December 31, 2016. Source: Bloomberg

- Business confidence also appears to be improving. The National Federation of Independent Business (NFIB) survey is approaching post-recession highs. The hiring plans component of the survey already attained a post-recession high. If business investment increases, the combined effect of these trends could drive GDP growth to a higher level.



As of December 31, 2016. Source: Bloomberg

United States — outlook

- Despite the elevated degree of uncertainty in both monetary and fiscal policy, we are confident that the prospects for economic growth are biased higher for 2017. Monetary policy remains accommodative and fiscal policy is poised to become potentially much more stimulative.

- The Trump administration has yet to clarify its priorities for the first 100 days following the inauguration, but it appears that markets expect a significant amount of pro-growth change to occur, especially with regard to regulatory and tax reform.

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- In the coming months, we believe that caution is warranted with regard to how much progress the Trump administration will be able to achieve. Markets appear to have priced in a strong expectation that the Trump administration will implement growth strategies quickly and successfully. The risk that actual results will trail expectations could reverse many post-election market trends. We continue to monitor news flow emanating from Washington D.C. and the Trump Tower in New York City, which could impact capital markets.

- We believe that U.S. real GDP growth advanced at an annualized rate of greater than 2.5% in the second half of 2016 (an official figure hasn't yet been released). The U.S. economy appears to be carrying forward a respectable amount of momentum into 2017 and we expect the momentum will continue to build throughout the year.

- We believe the anticipated strength in the U.S. economy will continue pressuring interest rates higher. Nevertheless, we expect that rates will likely be well ccontained as realized inflation moves closer to the Fed's 2% target, but does not run much further than that.

[1] Eurostat
[2] Institute of International Finance

Disclaimers