Tortoise℠
Credit Strategies

Global economic summary & outlook

February 2017

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International

It appears that political attitudes favoring fiscal policy stimulus over monetary policy continue to build. In addition, a coordinated economic recovery continues, putting mild upward pressure on world interest rates. The acceleration of growth is gradual, and signs of concerted central bank tightening are still not widespread. Rather, the pressure to cut interest rates in several emerging economies continues, as the strength of economic recovery in certain regions remains tentative. Reflecting this, energy and other commodity prices remain stable-to-higher.

The U.S. dollar peaked on January 3, 2017, following a period of strength in the wake of the U.S. Presidential election. While the U.S. dollar fell throughout the month of January 2017, further U.S. dollar strength versus the most recent peak, if it remains unchecked, could prove damaging to a world-wide economic recovery.

In the emerging markets, Brazil, Russia, Indonesia, India and China (the "BRIIC" countries) continue to experience varying rates of GDP growth. While GDP in India, Indonesia and China continues to grow at rates of between 5-7%, Brazil and Russia appear poised to emerge from recession in 2017.

We believe that investors may increasingly focus on political instability, particularly in Europe. Many elections pass with little trepidation from investors. Currently, however, upcoming general elections in France, Germany and Holland pose a potential threat to the European Union (EU) given the present political climate. Although a European economic recovery appears underway, and inflation is rising, the continent still struggles with the constriction imposed by fiscal austerity in prior periods. In addition, a lack of commitment to a unified Europe by the 28 member states appears at least partly to blame for the current situation. Finally, we believe that the EU's construct contains several inherent fundamental flaws. Consequently, we maintain a view that, almost twenty years since its founding, the EU continues to lack the necessary structure for a successful central government. Instead, the EU operates as a "loose Federation of States based on the unanimity rule."

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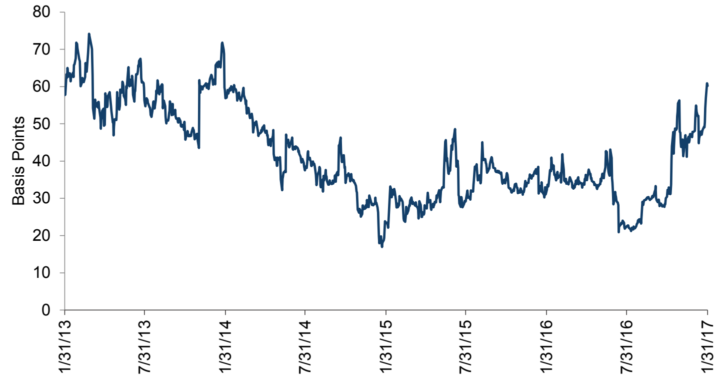
Globally, inflation is rising, albeit gradually. Japanese authorities appear more optimistic about reaching the Bank of Japan's 2% price stability target. Eurozone inflation increased 1.8% in the fourth quarter of 2016. Commodity prices generally exhibited strength in recent weeks, supported by growing global trade activity. Bond markets are beginning to react and yields have increased in anticipation of higher global growth and prices.

Europe — summary

- Eurozone inflation increased to +1.8% in the fourth quarter of 2016, while GDP grew at +0.5% and +0.6% in the eurozone and EU28, respectively. However, core inflation totaled a more modest 0.9% in January 2017, suggesting a potentially more benign inflationary environment.
- Germany reported a 2016 trade surplus of €266 billion, exacerbating the notion of an economic imbalance within the eurozone, and highlighting how much German industry benefits from a weak euro. The surplus is the largest of any country worldwide.
- In the French Presidential election, a financial scandal involving candidate Francois Fillon and his wife boosts the prospects of frontrunner Marine Le Pen. Although Le Pen is the favorite to win the first round, markets have discounted the likelihood that she will win the overall presidency in the second round run-off. A win for Le Pen may cause increased financial market volatility because her stated policies could signal the beginning of the end for the euro currency.
- The yield spread gap between French and German ten-year sovereign notes has widened, reflecting the growing uncertainty surrounding the French election.

France / Germany 10-year note yield spread

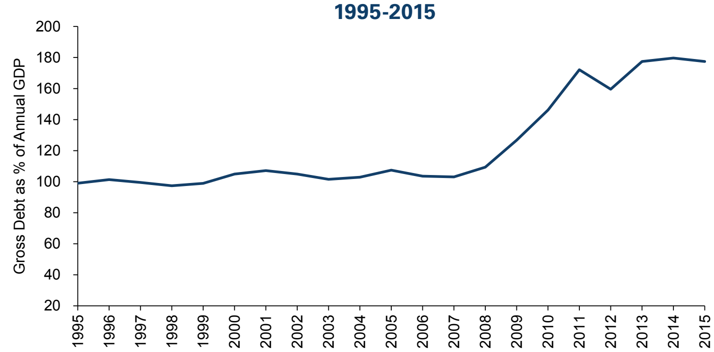


As of 1/31/2017. Source: Bloomberg

- Brexit remains on track following a Parliamentary vote allowing Prime Minister Theresa May to trigger Article 50 and start the two-year process to withdraw the UK from membership in the EU.
- Not surprisingly, Greece's debt problems re-emerged as the country faces significant debt maturities in 2017. Currently, the IMF believes that Greek GDP growth isn't sufficient to allow the country to continue to service its debts as scheduled. Consequently, the IMF argues that Greece's European partners (i.e., the other EU member countries) should provide "debt relief" (i.e., extend due dates and fix interest rates at their current low level). Greek Finance Minister Euclid Tsakalotos favors debt relief, because he believes it would eventually lead to the inclusion of Greek government debt in the ECB's buying program and support the refinancing of principal maturities in 2017. However, Germany and other EU members appear reticent to agree to significant additional concessions. Moreover, EU cooperation with Greece's debt appears contingent on continued IMF involvement. Greek nominal GDP has fallen by 31% since its peak, and the country's debt-to-GDP ratio remains near levels attained prior to its latest (third) bailout (i.e., €86 billion in funding provided in August 2015).

Greece debt-to-GDP ratio

1995-2015



As of 12/31/2015. Source: Eurostat

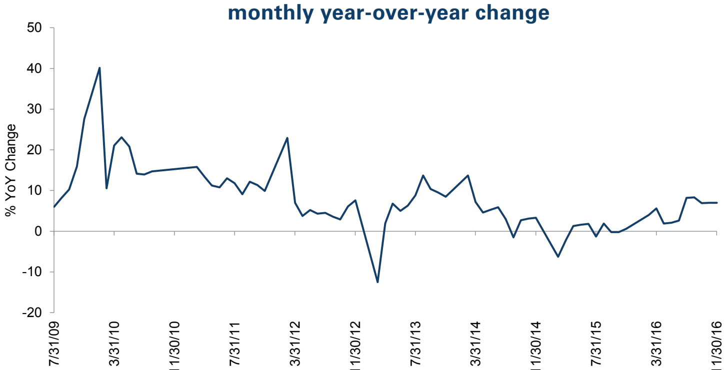
Europe — outlook

- In Europe, we believe in 2017 investors will focus on the possibility that anti-EU political parties could gain power. The issues with the most potential to threaten political stability include the French Presidential election, the continuing Greek financial crisis, and a possible Italian general election. In addition, the actual manner in which the UK enacts Article 50 and withdraws from EU could contribute to uncertainty.
- Economic fundamentals appear to be improving gradually. We expect this trend will continue into the foreseeable future, so long as the ECB maintains its bond buying program.

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

- Outside of Europe, economic trends appear mixed, but we continue to view global GDP growth as improving.
- China reported that its GDP grew at a rate of 6.7% in 2016; the rate of growth is consistent with the country's stated 6.5%-7% target range. Seemingly at odds with a general consensus that Chinese economic growth is decelerating, GDP growth increased to 6.8% on a year-over-year basis in the fourth quarter of 2016, versus 6.7% in the third quarter. The unusual trend, plus recent admissions that a Chinese province inflated GDP statistics between 2011 and 2014 forced the National Bureau of Statistics of China to affirm the 6.8% fourth quarter growth rate as "authentic" and "reliable." Total energy consumption, an indirect measure of economic activity, appears to be rising.

Chinese electricity consumption – monthly year-over-year change



As of 11/30/2016. Source: Bloomberg

- Inflation in Brazil reached a three-year low of +5.35%, giving Banco Central do Brasil more room to cut rates. We expect that Brazil will revert to positive GDP growth in 2017.
- In its latest meeting on February 7, 2017, the Reserve Bank of Australia left its "cash rate" (i.e., its market interest rate on overnight funds) unchanged at 1.50%. Inflation in Australia appears relatively modest, especially when adjusted to exclude recent gains in real estate prices. The Reserve Bank of Australia expects a gradual increase in inflation over the next two years.
- Headline employment data in Canada jumped surprisingly as the economy added 53,700 jobs in December 2016 and 48,300 jobs in January 2017. Nevertheless, the favorable jobs additions mask disappointing wage growth; wages grew 1.2% between January 2016 and January 2017, according to Statistics Canada. While still positive, GDP growth in Canada remains muted. Stable oil prices have benefitted the U.S.'s largest trading partner; as of November 2016, mining and oil & gas extraction comprised 8.1% of Canadian GDP.

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

- The global economic cycle most likely bottomed in the second quarter of 2016. We believe that global GDP will continue to accelerate with only a mild pickup in inflation, as slack in the system appears ample. On November 30, 2016, OPEC pledged to remove 1.2 million barrels per day from its production output. Oil and other commodity prices have remained firm in recent weeks. Rising demand and inflation should continue to put gradual upward pressure on global interest rates as these trends continue.

Domestic

In January 2017, investors witnessed the inauguration of Donald Trump as President of the United States, but gained little certainty regarding the new administration's policies. In addition, despite the issuance of eight executive orders through February 3, the new administration hasn't yet put into place any policy that appears significant to either the economy or financial markets. Consequently, while rhetoric appears clearly slanted towards a pro-growth theme, investors currently lack a specific fundamentals-based investment thesis supported by Trump administration policy initiatives.

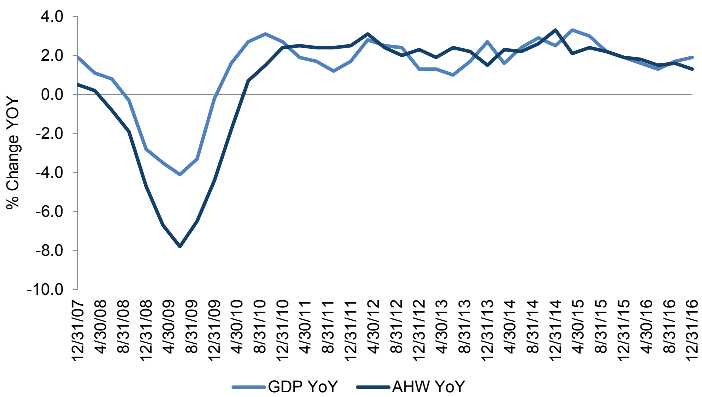
As we noted in a previous edition, most economic data looks backward and helps project trends and changes in momentum during times of consistent policy. Today, however, the outlook for governmental policy is anything but consistent with the past. As a result, we currently favor forward-looking surveys of business and consumer attitudes. Taken in aggregate, the majority of these indicators, both consumer and business, point toward optimism regarding business opportunities and stronger economic growth.

United States — summary

- On January 27, 2017, the U.S. Department of Commerce's Bureau of Economic Analysis (BEA) released its advance (i.e., initial) estimate regarding the national income and product accounts for the fourth quarter of 2016.
  - Real GDP grew at an annualized rate of 1.9% in the fourth quarter of 2016, versus 3.5% in the third quarter. The preliminary estimate of 1.9% fell short of the 2.2% expected by a Bloomberg survey of 85 economists.
  - Despite the slight miss in the headline GDP number, the underlying details were largely positive. Consumers again comprised the largest contributor to GDP growth, as personal consumption expenditures advanced at an annualized rate of 2.5%.
  - Gross private domestic investment increased 10.7% in the fourth quarter, versus a 3.0% increase in the third quarter. The increase in gross private domestic investment growth represents a pleasant surprise and the strongest growth in this GDP component since the second quarter of 2014.
  - On a disappointing note, a large drop in net exports of goods and services subtracted 1.7% from headline GDP growth in the fourth quarter of 2016. However, the negative trend represents a reversal of a one-time item that occurred in the preceding period. More specifically, net exports of goods and services increased 14.4% in the third quarter of 2016, as a result of an extraordinarily large surge in soybean shipments, mostly to China. The one-time surge reversed itself in the fourth quarter, contributing to a 6.9% decrease in net exports during the period. Both of these swings represent one-off events.

- The U.S. Department of Labor's Bureau of Labor Statistics releases aggregate hours worked indices on a monthly basis. Aggregate hours worked indices correlate highly with GDP growth (see chart). We observe that the percentage change in Total Private Aggregate Hours Worked decelerated in the past year and a half, likely due simply to decelerating employment growth (i.e., the BLS calculates aggregate hours worked by multiplying total employment by an estimate of average weekly hours worked). Currently, the aggregate hours worked series is trending below GDP growth. Either an increase in employment growth or productivity would contribute to a higher rate of growth in aggregate hours worked and maintain the historical correlation between the growth in U.S. GDP and aggregate hours worked.

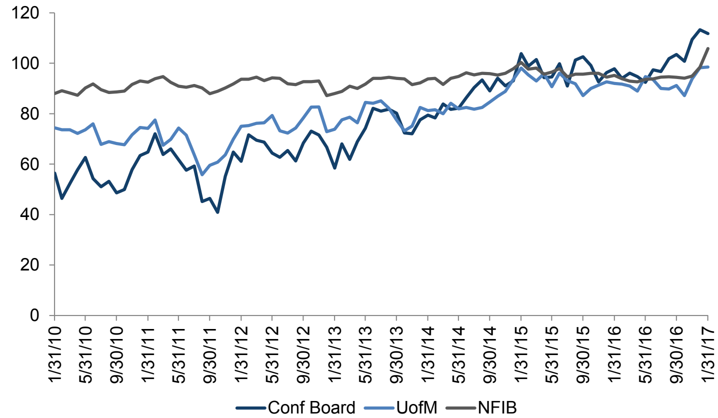
Growth in U.S. GDP and aggregate hours worked



As of 12/31/2016. Source: Bloomberg

- Forward-looking sentiment surveys continue to point toward elevated optimism from both consumers and businesses.
  - Consumer confidence, as represented by both the Conference Board Consumer Confidence Index and the University of Michigan Index of Consumer Sentiment generally increased between 2009 and 2015, held steady throughout most of 2016, and then jumped following the U.S. Presidential election (see chart).
  - The National Federation of Independent Business Index of Small Business Optimism held steady between 2009 and most of 2016, and then registered a sharp increase in December 2016 and January 2017 (see chart).

Consumer and business sentiment surveys



As of 1/31/2017. Source: Bloomberg

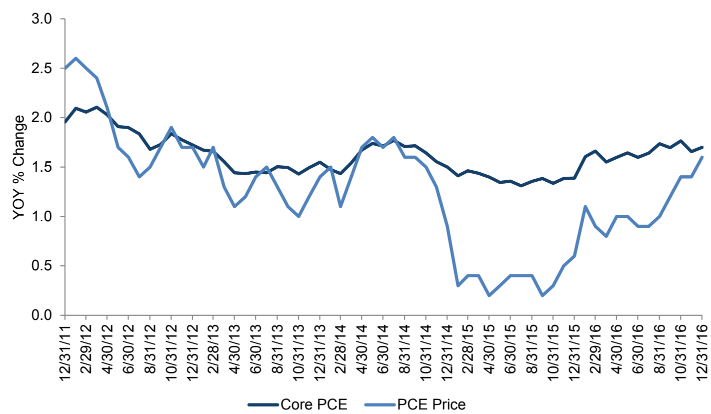
United States — outlook

- We observe continued strength in consumer spending, supported by healthy employment gains, as well as a reinvigorated business sector that anticipates pro-growth policies out of Washington, D.C. We believe that these factors will contribute to favorable U.S. GDP growth of approximately 3% in 2017 versus 1.9% in 2016.

- While the timing of events remains uncertain, we strongly believe that positive fiscal stimulus, in the form of both regulatory and tax reform, will spur the corporate sector to increase business investment. Increased business investment normally leads to increased worker productivity, and thus sets the groundwork for healthier wage gains.

- Inflation remains well contained as the core PCE deflator tracks sideways at approximately 1.7%

Core and headline inflation



As of 12/31/2016. Source: Bloomberg

- We expect stronger U.S. economic growth to lead to higher interest rates and as such favor shorter durations. We continue to monitor events and will modify our positioning as conditions warrant.