Tortoise℠
Credit Strategies

Global economic summary & outlook

April 2017

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International

In contrast to recently weaker economic data in the U.S., evidence suggests that a coordinated global recovery is underway. The cumulative effect of easier monetary conditions, as well as significant fiscal stimulus introduced in 2016, is having an impact on business confidence in many countries around the world. The shift is particularly notable in the eurozone and Japan, where earnings forecasts continue to be upgraded, albeit from depressed levels. Monetary easing also continues in many emerging markets such as Brazil, Mexico and India where interest rates remain stubbornly high.

Given the pickup in expectations regarding economic growth, global interest rates around the world including the U.S. have increased, even though 'hard' economic data (i.e., that based on non-qualitative counts and metrics) confirming an inflationary trend in prices remains limited. For the time being, the upward shift in rates has paused, as investors await evidence and specifics regarding U.S. policy and the outcome of important European elections. We believe upcoming European election results could significantly impact future eurozone policies.

Evidence suggests that a coordinated global recovery is underway.

Global PMI surveys, which mostly indicate a significant pickup in business confidence worldwide, currently contrast with less bullish measures of actual industrial output and other economic activity. Commodity prices, which have recovered from the lows of 2016, seem paused and awaiting 'hard' economic data that will corroborate the bullish sentiment implied by recent 'soft' data (i.e., qualitative measures of sentiment and other survey results). Similarly, while we believe that interest rates will move higher, we currently require corroborating 'hard' data to confirm the timing and rate of acceleration in growth. Additional information regarding the substance of the Trump administration's economic agenda continues to represent a significant unknown that restrains investors' ability to build a well-founded economic view.

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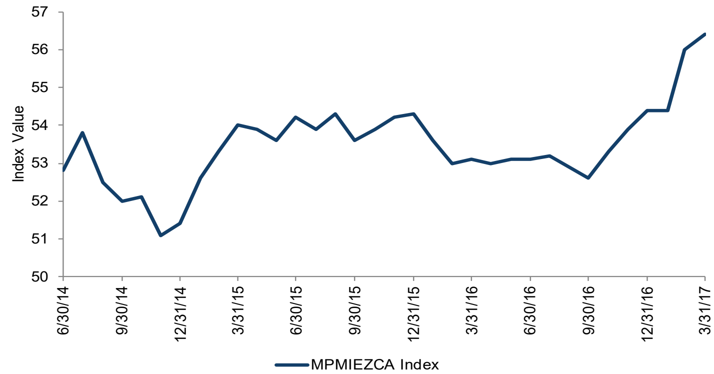
Europe — summary

- In Europe, economic growth and inflation are accelerating. European GDP growth in 2017 could reach as high as 2.0% and inflation could climb to 1.8%. In March, the European Commission's Eurozone Economic Sentiment Indicator maintained a level in excess of 107.0 for the fourth consecutive month; the index reached a recent low of 84.7 in October 2012 and hadn't exceeded 107.0 since April 2011. The current outlook represents a stark contrast to the recent past, when investors perceived deflation as a significant threat to the eurozone economy. Interest rates declined in recent weeks, however, as the ECB maintains its bond buying program for now. The Markit Eurozone Composite PMI suggests that euro area economic sentiment is improving.

Markit Eurozone Composite PMI



As of 3/31/2017. Source: Bloomberg

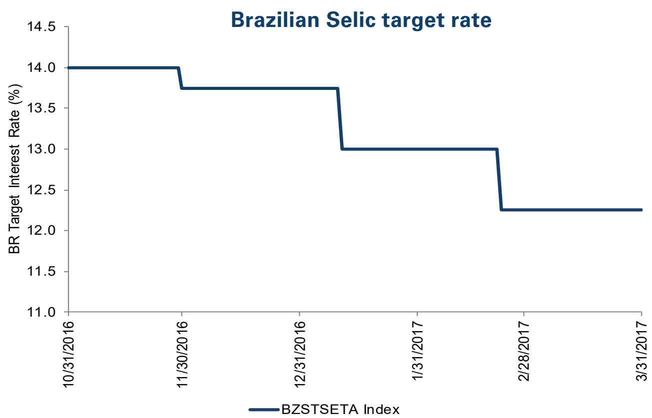
- The UK triggered Article 50, implying that Brexit is now likely irreversible. Investors currently appear focused on what form of negotiations will take place between the EU and the UK over the next two years. The fact that the UK runs a trade deficit of approximately €60 billion annually and that 46% of UK exports supply other EU countries argues against a 'hard' Brexit. However, slowing commercial loan growth and other signs suggest that the UK's economy may fall short of its solid performance in 2016.
- Although Geert Wilders' anti-euro Party for Freedom did not win the Dutch election, it added five seats in the Dutch Parliament, putting the party in second place overall with twenty seats. Many pundits view the result as a victory for supporters of a united Europe. Regardless, we continue to believe the anti-euro movement remains a potentially powerful disrupter of political stability throughout the region.
- The upcoming French election remains a focus of the market and very difficult to predict. Consequently, investors may consider future developments regardless of the election's outcome. For instance, France and Germany appear on a collision course from an economic perspective, and that conflict will require resolution at some point. The heart of the conflict is France's lack of economic competitiveness relative to that of Germany. For example, at 31%, the level of social spending as a percent of GDP in France ranks as the highest in the EU and the G7. None of the candidates running for office in France offer credible economic policies to combat this basic deficiency. Regardless of who wins the presidency in France, it appears that the EU will continue to struggle to reconcile the economic divergences between its member states. Consequently, the single-currency experiment may continue to face criticism and calls for its dissolution.
- German industrial production increased +2.2% in February, causing analysts to raise first quarter 2017 GDP growth forecasts to +2.0%.

Europe — outlook

- Given the pickup in European inflation and economic growth expectations, interest rates in Europe appear too low. This seems largely due to the ECB's continued intervention in the corporate and sovereign bond markets. Consider that the U.S. and Germany share similar 2017 growth and inflation expectations, and yet the 10-year U.S. Treasury yield remains approximately 200bps above the equivalent 10-year Bund yield. This apparent incongruity makes European bonds currently appear unattractive.

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

- China reported strong export and import data, supporting the view that economic growth is accelerating. Exports increased 16.6% in March and imports increased 20.3%. For 2017 as a whole, analysts expect Chinese GDP to grow 6.7%. However, many analysts expect GDP growth to peak by year end, due to the accumulating demographic challenges within the country.
- New Zealand exhibited further evidence of an increase in global business confidence, as the BNZ - BusinessNZ PMI reached 57.8 in March; any reading over 50 denotes growth.
- The Bank of Canada's April 2017 Monetary Policy Report predicts that the country's GDP will grow +2.6% in 2017. This resides at the high end of expectations, but nonetheless represents additional evidence of an increase in global economic activity. Canadian GDP grew +1.4% in 2016 and +2.6% in the fourth quarter 2016, suggesting that the rate of GDP growth is accelerating.
- Central banks continue to cut interest rates in an effort to boost economic growth. Argentina, Brazil and Mexico comprise the latest to aggressively cut interest rates. In most cases, lower inflation trends provide policy makers with latitude to further deploy monetary policy tools.
- The Brazilian economy contracted in 2016. Analysts currently forecast that Brazil's GDP will grow as much as +2.0% in the first quarter of 2017. On April 12, 2017, the Banco Central do Brasil cut its Selic target rate to 11.25%.



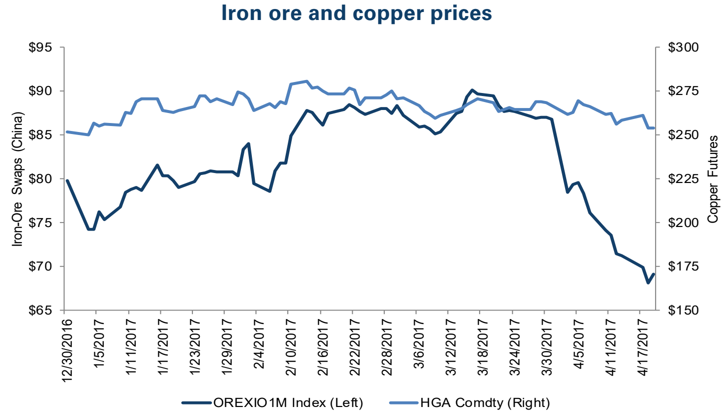
As of 3/31/2017. Source: Bloomberg

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

- 'Soft' economic data around the globe, especially PMI indices and leading indicators, continues to suggest that economic growth will increase in coming periods. The pickup is likely in response to the amount of fiscal and monetary stimulus introduced in 2016 and continued into 2017. Given the apparent delay in the passage of pro-growth policies in the U.S., it appears that growth in the first half of 2017 may accelerate faster overseas than domestically. This may hold especially true in Japan and Europe, where analysts revised earnings expectations upward at a faster rate than in the U.S. and most emerging market countries.
- Although inflation remains very benign around the world, we expect it to accelerate later in 2017.

Currencies and commodities

- While copper prices remained relatively stable, iron ore experienced a sharp downward correction. Forecasters predict that iron ore prices will fall even lower by the end of 2018.



As of 4/17/2017. Source: Bloomberg

Domestic

The markets are having trouble digesting President Trump's unconventional politics. As we have previously noted on a number of occasions, market expectations, business expectations, and consumer expectations (i.e., all 'soft' data) surged following the November 2016 U.S. presidential election. Many economists and analysts predict that these more favorable expectations will lead to increased investment and spending and thus, stronger economic growth. Increased investment and spending will register in 'hard' data and, ultimately, in the final measure of GDP growth. Investors continue to wait for this 'hard' data to materialize.

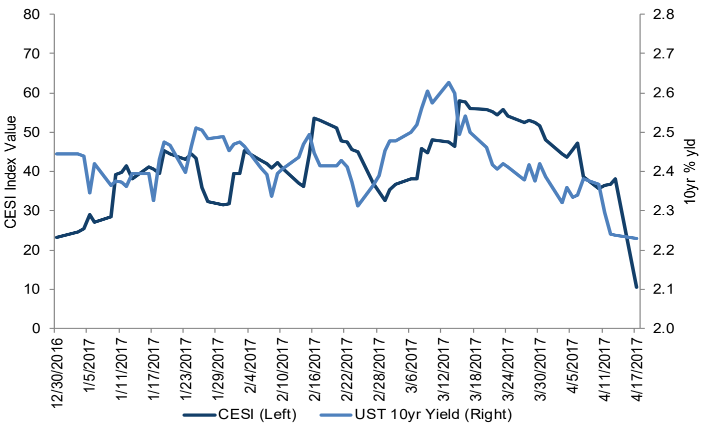
In the vacuum of significant 'hard' data indicating stronger growth, investors will likely scrutinize any bit of information regarding the progress of the Trump administration's policy initiatives. The recent failure by the Republicans to repeal and replace the Affordable Care Act (i.e., Obamacare) represents the Trump administration's first major setback, and it caused investors to reduce their expectations regarding fiscal stimulus and push back the expected timing of future economic growth. Priorities and timelines regarding specific legislation remain very much unclear and, as such, investors currently appear to be taking more of a wait-and-see approach.

At its meeting in March, and despite the uncertainty regarding fiscal policy in the coming quarters, the Federal Open Market Committee (FOMC) decided to raise the federal funds target rate by 25bps. We believe the continued strength in employment likely strengthened the FOMC's resolve to continue raising rates at a consistent pace. However, the move may also suggest that the committee remains comfortable looking past what will undoubtedly be weak U.S. GDP growth in the first quarter of 2017, as personal consumption expenditures decelerated significantly during the first quarter. Given that consumer spending underpinned economic growth in recent periods, it is important that this deceleration be temporary.

United States — summary

- After increasing prior to the March 2017 FOMC meeting, U.S. Treasury 10-year yields moved lower for the balance of the month, as economic data underwhelmed and policy uncertainty increased. Interest rates topped out at 2.63% on March 14, 2017, the day preceding the FOMC decision, and subsequently declined to end the month at 2.38%.
- The chart below clearly reflects the increase and subsequent reversal of the Citi Economic Surprise Index, as it coincided with the drop in interest rates following the March 2017 FOMC meeting.

Citi Economic Surprise Index and 10-year U.S. Treasury Yield



As of 4/17/2017. Source: Bloomberg

- Wage growth remains slow, despite continued strong non-farm payroll employment growth and a sub-5% U-3 unemployment rate. Specifically, growth in average hourly earnings of production and non-supervisory employees continues to decelerate, declining to +2.34% in February 2017 versus +2.65% in September 2016. For consumer spending to remain supportive of growth, we believe that wage growth needs to improve.

United States — outlook

- We continue to anticipate that the Trump administration's fiscal agenda will move forward, but not in as direct of a path as investors originally hoped. Ultimately, we believe the Trump administration will make progress on tax reform, resolution of the Affordable Care Act, a revision to The Dodd–Frank Wall Street Reform and Consumer Protection Act, and the creation of an infrastructure spending initiative. All of these policy efforts should stimulate economic growth and bias interest rates higher.
- The FOMC appears intent on moving the federal funds target rate higher throughout the year, with the majority of the members expecting two more rate hikes in 2017.
- Discussion recently increased regarding how the Federal Reserve should resolve its holdings of U.S. Treasuries and mortgage-backed securities. Some FOMC members believe that the Federal Reserve should begin winding down such holdings by year end. Bill Dudley, president of the Federal Reserve Bank of New York, has publicly expressed his preference to simultaneously utilize both rate hikes and balance sheet runoff as tools of monetary policy. If the FOMC adopts that view, it could pause the pace of interest hikes as it reduces the size of its balance sheet holdings. We believe it's a bit early to make that call, but also consider that the issue deserves close attention.
- We believe that U.S. GDP growth in the first quarter of 2017 will likely be the slowest of the year, and that fiscal policy clarity will fuel increased growth in the second half of the year. Increased U.S. economic growth will extend what is already a very long business cycle.
- Capacity constraints within the economy do not yet appear to be impacting inflation. Despite strong employment growth, wage growth remains very subdued, likely due to 1) the depressed labor participation rate (i.e., many people have simply stopped looking for work, even though they still desire long-term employment); and 2) the sustained large number of people who work part-time, but desire full-time positions. These underutilized workers effectively create excess slack in the labor pool, and inhibit wage growth. A low capacity utilization rate of 75.7% as of February 2017, versus levels that exceeded 80% prior to the 2008 recession, provides additional evidence of slack capacity in the economy.
- Global uncertainty will likely keep demand for U.S. Treasuries high, and yields low. We anticipate upside risk to the 10-year U.S. Treasury yield at approximately 3%.
- Inflation risks appear low, however, deflation risk seems to have fully dissipated. Nevertheless, questions remain regarding the resilience of economic growth in China and Europe and the high level of political uncertainty in Europe. These factors warrant close monitoring, as changes in economic growth patterns in or increased political instability in any major world economy could affect business activity in the U.S.
- We maintain our bias towards a short benchmark duration in order to insulate portfolios from rising interest rates.