Tortoise
Credit Strategies

Global economic summary & outlook

Second quarter 2017

Global economic summary & outlook

International

Hard data (i.e., that based on quantifiable statistics, rather than human perception) continues to confirm evidence of a global economic recovery. Increasingly, the data shows that after years of sub-par growth, economies outside of the U.S. are beginning advance at more normalized rates. Confirmation of economic growth has caused central banks around the world to begin to shift stimulus away from monetary policy. As a result, bond markets have reacted by pressuring short-term interest rates higher.

International economic growth is not unexpected, as it follows years of monetary easing outside of the U.S. and has included interest rate cuts as well as direct quantitative easing. However, a large proportion of European bonds continue to offer negative yields. At its last meeting, the European Central Bank (ECB) openly discussed ending its highly effective corporate and sovereign bond buying programs. Many investors expect that once the ECB withdraws its purchase programs, yield curves across Europe will, at a minimum, return to positive territory.

Negative yielding European sovereigns

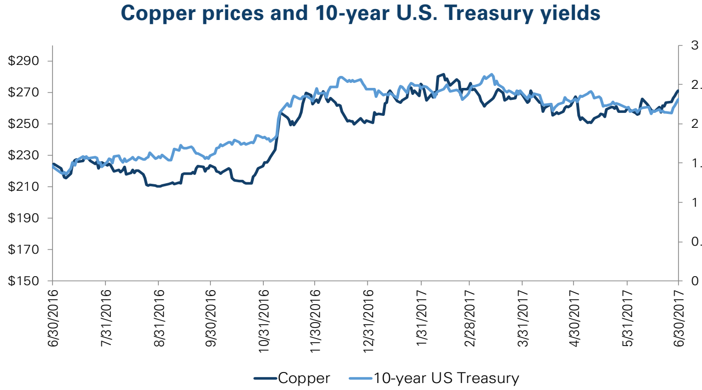
	Maturities with negative yields	Minimum yield (1 month)
Germany	6 years and shorter	-0.90%
France	5 years and shorter	-0.61%
Italy	2 years and shorter	-0.38%
Spain	4 years and shorter	-0.43%
Belgium	5 years and shorter	-0.65%
Portugal	2 years and shorter	-0.25%

As of 7/21/17. Source: Bloomberg

After a brief period of weakness, commodity prices have rebounded from recent lows. Specifically, copper, which remains a good indicator of global economic activity, and iron ore have generally moved higher. Interestingly, over the last fourteen months, copper prices have correlated closely with 10-year U.S. Treasury bond yields. If this correlation holds, and the global recovery accelerates pushing copper prices higher, U.S. interest rates could be pressured higher in tandem.

Hard data continues to confirm evidence of a global economic recovery.

Copper prices and 10-year U.S. Treasury yields



As of 6/30/2017. Source: Bloomberg

We believe copper prices could continue to rise, as excess inventories from earlier in the year have been absorbed, and the global recovery increases demand. Also, developing economies such as China could increase copper usage, as economic activity moves away from infrastructure spending and towards manufacturing.

Recent European economic data exceeded many investor's expectations.

Europe — summary

Recent European economic data exceeded many investor's expectations. Soft data (i.e., that based on human perception and expectations) indicates that business confidence is rising quickly after eight years of austerity. Purchasing Managers Index (PMI) data clearly show that businesses managers increasingly feel more confident. Consumer confidence in Europe reached its highest level since 2007. The Markit Eurozone Composite PMI registered a healthy 56.3 (anything above 50 implies growth), and has risen steadily since it reached 50 in June 2013.

- Eurostat's euro area Index of Industrial Production grew 4.0% on a year-over-year basis in May 2017, following a revised growth rate for April 2017 of 1.2%. Eurozone inflation is also returning, albeit at a very moderate rate of 1.3%.
- In May 2017, German exports, one of the brighter economic indicators in Europe, rose a strong 14.1% on a year-over-year basis and 9.4% sequentially since May.
- In an effort to stimulate the lagging French economy, President Emmanuel Macron, elected in May 2017, and his newly formed majority government, are considering tax cuts and labor reforms. The policies may represent the beginning of a shift in sentiment within the eurozone toward more business-friendly policies, although the initial tax cuts are aimed at the wealthy. This is especially noteworthy, as the French economy has been one of the least successful in Europe since the 2008 credit crisis. France and Germany are also working to harmonize corporate taxes between the two countries.
- The start of Brexit negotiations between the EU and the UK have not been harmonious, and some analysts fear that talks could break down altogether. Sterling has nevertheless remained stable, but remains well below the pre-Brexit level. In a sign of support, many countries, including the U.S. and Australia, have offered to sign trade agreements with the UK, post-Brexit. Meanwhile, EU officials appear emboldened by the recent French presidential election, which many interpret as a vote of confidence in the EU. Despite aggressive rhetoric from EU officials regarding the Brexit negotiations, we believe that investors should recall that economic imbalances between the negotiating parties remain strongly in favor of the UK, and the EU economy would suffer more if a mutually agreeable Brexit agreement isn't reached.
- Recent data clearly reflect a recovering European economy. Countries inside and outside of the eurozone are beginning to experience a return of more normalized growth and inflation rates, following eight years of austerity. As a sign of renewed confidence, European peripheral spreads to German bunds narrowed substantially, indicating increased confidence in what remains of the EU.

Europe — outlook

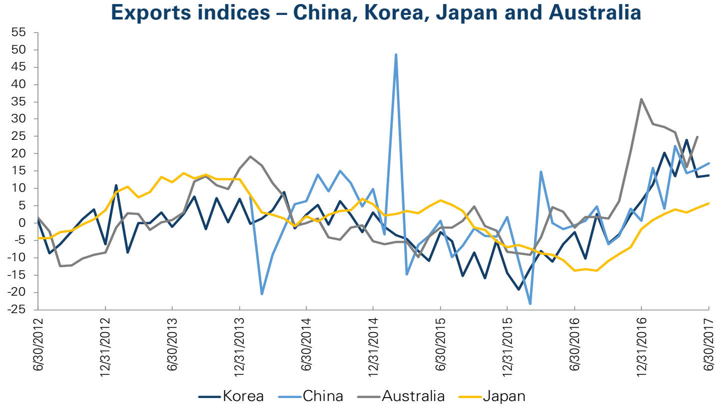
Although Italy and Germany have yet to hold critical elections, the EU breathed a collective sigh of relief following the May 2017 election of Emmanuel Macron as president of France. The focus now returns to the ECB and the proposed withdrawal of its quantitative easing program. In time, this will push short-term European interest rates higher. However, as the ECB withdraws its asset purchasing program, it will be critical that governments replace monetary stimulus with fiscal programs.

We maintain a mixed outlook on the UK economy, due to the uncertainty of Brexit. Theresa May, who lost political capital in the last election, now has a significantly weaker hand with which to negotiate an agreement. As a result, we believe the Bank of England is unlikely to raise interest rates soon.

Asia – summary

- The Australian economy continues to improve, and we believe that the Reserve Bank of Australia will likely raise interest rates in the near future. The Westpac-Melbourne Institute Consumer Sentiment Index for Australia consumer confidence rose 0.4% to 96.6 in July 2017.
- In a boost to liquid natural gas (LNG), Korea announced an intended move to 27% LNG power generation in 2030 versus 19% today. The shift will be made at the expense of coal and nuclear energy.
- Chinese GDP grew 11.8% in the first quarter of 2017 and we believe the full-year result could attain a double-digit percentage growth rate. Recently, Chinese authorities acted to restrict economic growth, which continues unabated. In May 2017, exports grew 11.2%, with the largest increase, (i.e. of 14.6%), going to Europe. Similarly, imports increased 17.2%. Despite this growth, inflation has been declining, especially as measured by the Chinese National Bureau of Statistics' Producer Price Index.
- Korea, Japan and Australia also recently reported strong export trends.

Exports indices – China, Korea, Japan and Australia



As of 6/30/17. Source: Bloomberg.
Please note that Chinese data became available in January 2014 and Australian data is as of 5/31/2017.

Asia – outlook

Except for China, where the government is already working to restrain growth, we believe that economic activity throughout Asia will continue to increase.

Despite its demographic challenges, even Japan is beginning to experience an acceleration of economic growth, albeit limited. Consequently, we do not anticipate a significant increase in Japanese interest rates and expect the Bank of Japan to continue purchasing bonds.

Rest of the world (ex-Europe, U.S. and Asia) – summary

- The Brazilian economy is finally emerging from recession and analysts expect 2017 GDP growth of 1.25%. In addition, inflation declined significantly to between 3.0% and 3.5%, allowing the Banco Central do Brasil to aggressively cut interest rates. On May 30, 2017, in its last policy action, the Brazilian central bank cut its SELIC rate by 100bps. The former President Lula was jailed for ten years on corruption charges, boosting confidence in the currency and political establishment, despite the recent scandals.
- The Bank of Canada raised short-term interest rates by 0.25% to 0.75%, as economic growth accelerated. Much of the strength has been in the housing market.
- Analysts also expect the Russian economy to emerge from recession and generate GDP growth of 1.3% in 2017.

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

Although lagging Asia and Europe, the outlook is improving in many of the world's challenged economies, most notably Brazil and Russia. In a pattern that has often been repeated globally, analysts welcomed the decline in Brazilian inflation. The absence of any real inflation threat among the major economies reflects the enormous capacities built up over the last ten years. As the global economic recovery accelerates, this excess will be absorbed, and most commodity prices should increase. Oil prices could remain low, however, due to the potential effect of increased U.S. oil exports.

Domestic

We currently believe that the U.S economy has found a Goldilocks sweet spot…not too hard, and not too soft. We view U.S. GDP growth as trending steadily at a rate of approximately 2% per annum, and the economy appears to be generating healthy job growth and very little inflation.

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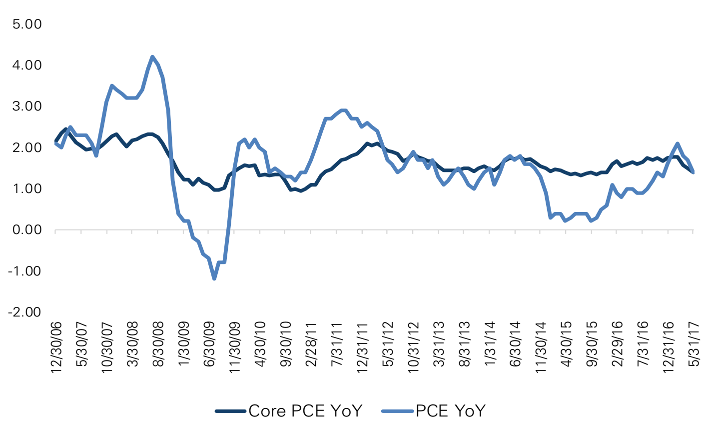
The Federal Reserve's dual mandate targeting maximum sustainable employment and stable prices, appears to be very close at hand. As a result, the discussion of normalizing interest rates to prevent overheating of the economy has moved to the forefront of policy debate. We believe that it is too early to be concerned about an overheating economy generating unwanted inflation. The Personal Consumption Expenditures (PCE) Excluding Food & Energy, which recently fell to 1.4% on a year-over-year basis, has tracked below the Federal Reserve's 2% target for over five years. Conversely, we also are not overly concerned the economy is encountering headwinds that could create a recessionary environment. We view U.S. economic growth as being supported by an improving domestic business environment and resurgent global growth.

We expect future monetary policy debate in the U.S. to hinge on prioritization of the Federal Reserve's dual mandate. It is a fact that the Federal Reserve has missed its stated inflation target to the downside for almost the entirety of the post-crisis recovery. Consequently, it appears that the Federal Reserve is more concerned that tight labor market conditions will spur higher wage growth, thus promoting higher inflation. With three rate increases now on the books, bringing the target rate to a stated range of 1.0% to 1.25%, the Federal Reserve may shift its focus from averting tight labor markets toward steering clear of weaker-than-desired inflation.

United States — summary

- We view the main domestic economic themes of the second quarter of 2017 as weakness in certain economic data and a commensurate decline in interest rates.
- Retail spending, as measured by auto sales, and traditional brick-and-mortar retail, underwhelmed the most during the second quarter. Housing also disappointed investors, as the rate of new home sales and home starts trended softer than expectations. We remain somewhat concerned that weak retail, auto, and home sales data point broadly to potentially softer consumer spending. We will monitor these data series closely over the coming months.
- On June 29, 2017, The U.S. Bureau of Economic Analysis revised upward its third estimate of first quarter 2017 GDP growth to 1.4% from an initially reported rate of 0.7%. Curiously, much of the improvement was due to an upward revision of personal consumption expenditures.
- Inflation disappointed to the downside during the second quarter of 2017. Both Personal Consumption Expenditures (PCE) Excluding Food & Energy and the Consumer Price Index for All Urban Consumers Less Food & Energy retreated from their January 2017 highs. The Federal Reserve acknowledged this weakness, but continues to characterize it as "transitory" and due to one-off effects.

PCE inflation rate



As of 5/31/2017. Source: Bloomberg

- After a surprisingly weak non-farm payroll employment number to end the first quarter (+50,000 in the month of March 2017), non-farm payrolls rebounded during the second quarter. The three-month moving average of non-farm payrolls for the second quarter of 2017 rose to 194,667 per month.

United States — outlook

- We continue to expect a pick-up in real GDP growth during the second half of 2017 .
- Stronger growth should move both real yields and inflation expectations modestly higher, supporting our 3.0% year end forecast for 10-year U.S. Treasury yields.
- Analysts now expect that the Federal Reserve will begin reducing the size of its balance sheet as soon as October 2017, by not reinvesting proceeds from maturing bond positions, rather than engaging in outright security sales. The Federal Reserve has stated that the monthly rate of portfolio run-off for its mortgage and Treasury securities will total $4 billion and $6 billion, respectively, and we do not anticipate significant market disruption as a result.

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- Based on statements made by members of the Federal Reserve Open Market Committee, it appears likely that the Federal Reserve will implement its next rate hike following its December 13, 2017 meeting. Based on that outlook, the Federal Reserve will have raised rates three times in 2017, in-line with its forecast. Of course, that outlook may change depending upon economic trends which develop over the next few months.
- Despite the highly partisan political environment that currently prevails in Washington D.C., we expect the U.S. will continue to exhibit modest economic growth in the near term. We base our outlook on a number of factors, including strong forward-looking surveys such as the National Federation of Independent Business Index of Small Business Optimism and the University of Michigan Index of Consumer Sentiment.