Tortoise[SM]
Credit Strategies

Portfolio strategy summary & outlook

Second quarter 2017

U.S. interest rates

Summary

The flattening of the yield curve represents the most notable rates move during the second quarter of 2017. Throughout the period, public commentary by hawkish members of the Federal Open Market Committee caused a significant sell-off in the front end (short maturities) of the yield curve, as investors priced in a higher degree of certainty regarding future federal funds rate hikes. Two-year yields increased 13bps, while 10-year rates fell 8bps. These moves brought the yield spread between 2-year and 10-year U.S. Treasury notes down to 92bps, from 113bps on March 31, 2017. The flattening added to a trend that began in March of this year (see chart, below). During the second quarter, the flattening of the yield curve pivoted around four-year maturities.

Yield spread between 2-year and 10-year U.S. Treasuries

As of 6/30/2017. Source: Bloomberg

The U.S. Treasury component of the Bloomberg Barclays U.S. Aggregate Bond Index (the Index) returned 1.19% during the second quarter, as the drop in longer-maturity rates more than offset the negative impact of rising short-term rates.

Also noteworthy during the quarter was the fall in interest rate volatility. The Merrill Lynch Option Volatility Index (the MOVE Index) dropped 18%, from 61 at the beginning of the quarter, to a low of 50 on June, 26 2017, before closing the quarter at 55. June 26 marked a low point for the MOVE Index since the pre-taper tantrum period in May 2013.

Outlook

We believe that quantitative easing (QE) and other actions by the European Central Bank (ECB), the Bank of Japan and the U.S. Federal Reserve may have created a sense of complacency among some investors. The Federal Reserve recently announced its intent to begin curtailing its practice of reinvesting principal maturities of its investment portfolio. In March 2017, the ECB reduced its monthly rate of open market securities purchases to €60 billion from €80 billion, and analysts increasingly believe that the ECB will further reduce its pace of intervention in 2018. A significant withdrawal of central bank purchases could affect markets, surprise complacent investors, and possibly lead to unintended consequences. Consequently, we have reduced our portfolio exposure to interest rates by lowing target durations to 90% of the benchmark.

The Federal Reserve recently announced its intent to begin curtailing its practice of reinvesting principal maturities of its investment portfolio.

Securitized products

Summary

Both ABS and CMBS performed well during the second quarter, generating 32bps and 34bps, respectively, in excess return versus U.S. Treasuries. The agency MBS sector lagged with a -4bps excess return, as mortgages struggled with rich valuations and uncertainty surrounding the upcoming Federal Reserve balance sheet reduction. We remain underweight the MBS sector with a 15% allocation versus 28% in the Index. ABS remains our top pick, with a target allocation of 10%, based on strong consumer finance fundamentals and attractive yields for a short-maturity, high-quality asset.

Mortgages struggled with rich valuations and uncertainty surrounding the upcoming Federal Reserve balance sheet reduction.

Agency MBS: Underweight 15% versus 28% in the Bloomberg Barclays U.S. Aggregate Bond Index

Performance

- Agency MBS generated -4bps of excess return versus U.S. Treasuries, making it the worst-performing sector in the second quarter 2017.

Fundamentals: negative

- Refinancing risk appears muted with a small universe of mortgages in the refinance universe.
- While currently at record lows, we believe volatility could increase due to monetary policy uncertainty and global economies tracking at an important inflection point.
- The timing of the Federal Reserve's potential balance sheet reduction adds uncertainty to the fundamental landscape.
- Government-sponsored enterprise (GSE) reform remains on the backburner in Washington, D.C., but could trigger concern regarding the housing market in 2018.

Technicals: negative

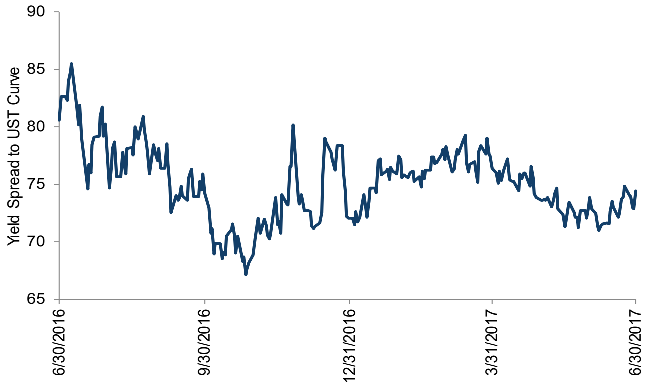
- Supply and demand technicals for MBS appear slightly negative, primarily due to higher-than-expected net supply. Supply could exceed $300 billion in 2017, which would rank as the largest net addition to the agency mortgage market since 2009.
- Demand has been mixed with some signs that overseas buyers are returning to the market.

Valuations: negative

- Valuations remain unattractive and leave little upside potential.
- The sector is vulnerable to Federal Reserve reinvestment uncertainty and a break-out in the interest rate range.

- Agency MBS should benefit from a safe haven status, given its high quality and strong liquidity.

Agency MBS current coupon spread to U.S. Treasuries



As of 6/30/2017. Source: Bloomberg

Outlook

- We recommend an underweight based on poor valuations and elevated policy risk.
- We focus on higher-coupon 30-year MBS, 20-year MBS and select non-agency RMBS.

CMBS: 4% target allocation versus 2% Index weight

Performance

- CMBS returned 34bps of excess return versus U.S. Treasuries in the second quarter of 2017.
- Lower-rated A and BBB- bonds performed best in the second quarter.

Fundamentals: neutral

- Overall, the fundamentals for commercial real estate remain favorable, but pockets of stress exist in some asset types and regions.
- Strong labor markets and an extension of the business cycle support the longer-term health of commercial properties.
- Retail malls, selective multifamily markets and Houston office are areas that currently require close scrutiny.

Technicals: neutral

- Supply is expected to be heavy in the third quarter of 2017, but remains modest for the entire year 2017.
- Net supply is expected to total $70 billion for 2017.

Valuations: negative

- In our opinion, valuations appear poor and near recent tight levels across the ratings spectrum.
- Relative value versus credit markets has improved, given the recent strong credit performance.

Outlook

- We favor a defensive and selective positioning within the CMBS sector, as valuations appear stretched and the best fundamental news is probably behind us.
- We like subordinate seasoned conduit securities and select single-asset subordinate tranches.

Asset-backed securities (ABS): Overweight 10% versus 0.5% in the Index

Performance

- ABS generated slow and steady performance in the second quarter of 2017, producing 32bps of excess return versus U.S. Treasuries.

Fundamentals: positive

- The fundamentals for consumer finance remain favorable and supported by strong labor markets, rising consumer net worth and improved consumer balance sheets.
- We are closely following developments within the auto sector, and in particular, the recent increase in subprime auto delinquencies and losses.

Technicals: positive

- The technical environment for ABS appears positive with modest supply easily absorbed by strong investor demand for short-maturity, high-quality assets.
- Supply in 2017 should modestly exceed the $200 billion level achieved in 2016.

Valuations: neutral

- Valuations appear fair on a historical basis, but look attractive versus similarly rated short-maturity alternatives.

Outlook

- We remain positive and overweight, as the sector should benefit from its high quality and short maturity.
- We like prime and subprime auto ABS subordinate classes, due to attractive valuations and strong structural support. We also favor timeshare and whole business ABS.

Investment grade credit

Summary

We remain with a marketweight outlook on investment grade credit, due to modestly improving fundamentals combined with continued strong technicals, offset by rich valuations. Fundamentals continue to improve alongside global economic growth and stabilization in commodity prices. In addition, pro-growth and pro-business policies supported by the Trump administration could further extend the business cycle and add to the favorable fundamentals. However, the timing and scope of Trump administration policy initiatives remain in question. Technicals continue to be very robust, due to solid demand from domestic and foreign buyers. However, new issue supply remains high and numerous global central banks have turned hawkish and telegraphed plans to decelerate or remove QE programs, which could negatively affect technicals. Valuations remain stretched when compared to prior cyclical tights; however, yields remain attractive to many non-U.S. investors. Stretched valuations, gridlock on Capitol Hill, geopolitical risk, overly hawkish central bank policies, a deceleration in global QE, and any reversal in the recently supportive trend of global growth remain our largest concerns.

Performance

- The Bloomberg Barclays U.S. Credit Index (the Credit Index) returned 2.35% in the second quarter of 2017 and 3.68% year-to-date.
- Excess return to similar-maturity Treasuries totaled 0.99% in the second quarter and 1.48% year-to-date.
- The best-performing credit industries in the second quarter, on an excess return basis, were cable/satellite, oil refining and life insurance. The worst-performing industries during the quarter were supermarkets, oilfield services, and oil exploration and production.

Fundamentals: improving

- As economic growth improves and commodity headwinds subside, corporate revenues and EBITDA will continue to improve.
- Gross leverage remains high and continued to increase year-over-year, while interest coverage continued to deteriorate, but remains manageable. M&A and shareholder-friendly policies remain the primary drivers of increased leverage, although the pace of increase has been slowing.
- President Trump and a majority Republican Congress could achieve decreased regulation, favorable corporate tax reform, foreign cash repatriation, increased fiscal spending and reduced Capitol Hill gridlock, which should help corporate profitability.
- Protectionist policies, such as border adjustment taxes, if enacted, immigration restrictions and wage pressures could reduce profitability for some companies and industries.
- The timing and extent of fiscal policy enhancements remain in question.

Technicals: remain strong, but deceleration is probable

- Accommodative European and Japanese central bank policy and low global yields continue to force foreign investors into U.S. dollar-denominated assets (crowding-in).
- Mutual fund inflows were strong at $123 billion year-to-date versus $131 billion for all of 2016.
- Higher interest rates should attract increased domestic institutional buyers (insurance companies and pension funds), while increasing premium rates required by the Pension Benefit Guarantee Corporation should also support pension fund buying.
- Gross new issuance declined 0.9% year-to-date versus the first half of 2016, and is expected to decline further for all of 2017 versus 2016.
- Increased hawkish central bank rhetoric and decelerating QE from both the U.S. Federal Reserve and the ECB, due to improving global growth prospects, threaten the crowding-in demand that has driven positive technicals for non-government related securities.
- Surveys on investor positioning show a modest overweight; while surveys on investor sentiment toward credit spreads have moderately improved, yet remain materially below recent highs achieved following the U.S. presidential election.

Valuation: rich

- Corporate spreads retraced more than 90% of spread widening between the summer of 2014 tights and the February 2016 wides. They currently reside 106bps tighter than the 2016 wides, 9bps wide of the summer 2014 tights, and 21bps wide of 2006 pre-crisis levels.
- When adjusting for the longer duration, lower credit rating and higher dollar price of the Corporate Index (a subset of the Credit Index) today versus historically, corporate spreads are within 10bps of the February 1997, February 2007 and June 2014 past cycle spread tights.

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- The Corporate Index effective yield of 3.19% remains attractive for many non-U.S. investors versus corporate yields in their country and currency, although the gap is slowly narrowing.
- Credit Index spreads now reside 45bps tight of the 25-year average (two-thirds of a standard deviation rich); while BBB-rated issue spreads were 67bps tight of the 25-year average (two-thirds of a standard deviation rich).
- BB-rated credit is slightly more than one standard deviation rich to BBB-rated credit over a two-year and ten-year basis, while BBB-rated credit is more than one standard deviation rich to A-rated credit over a two-year basis and one-half of a standard deviation rich over a ten-year basis.

Financials: positive

- Strong asset quality, improved profitability from higher interest rates, robust capital levels, lower exposure to shareholder activism and strong relative valuation make banking attractive. European political risk makes euro area banks less attractive.

- Higher interest rates, foreign cash repatriation, lower exposure to shareholder activism and potentially reduced regulation should be positive for insurance.

Industrials: neutral

- Shareholder activism, M&A risk and political risk remain prevalent. We see improvement within some commodity-related industries, while companies with foreign manufacturing face potentially higher tariffs.
- Energy pipelines continue to benefit from attractive valuations, strong asset values and potentially reduced regulation.
- Technology and pharmaceutical companies continue to pursue large M&A deals and share repurchases, although both industries stand to benefit significantly from a potential foreign cash repatriation deal.
- Brick and mortar retail remains challenged, due to e-commerce competition. Building materials stands to benefit from a large fiscal stimulus infrastructure package.
- Industry and issuer selection is of the utmost importance.

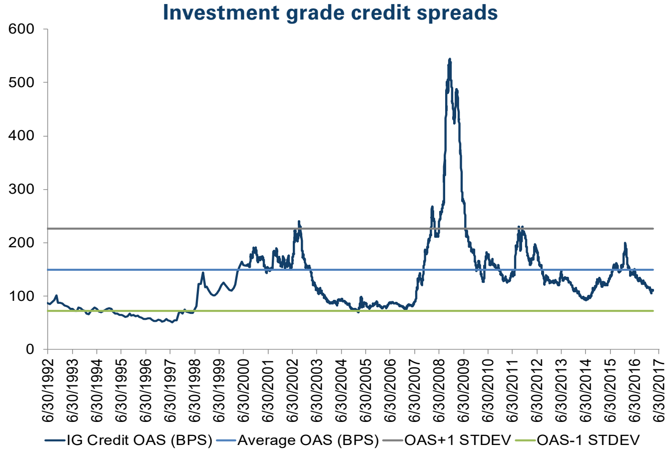
Outlook

We expect investment grade credit to continue to offer reasonable performance (excess return) in the near term, due to strong technicals and improving fundamentals as a result of an improving growth outlook and potentially positive governmental fiscal policies. We continue to maintain a marketweight outlook while we shift our portfolio to higher-quality ratings and less cyclical industries as a precursor to a reversal in credit sentiment. We continue to focus broadly on industry and issuer selection.

Overweight: Banks, Insurance, Pipelines, Airline Enhanced Equipment Trust Certificates (EETCs), Aerospace & Defense, REITs, Healthcare, Building Materials, post-event risk issuers

Underweight: Restaurants & Retailers, Autos, Railroads, Consumer Products, Metals & Mining, Pharmaceuticals, Technology, Utilities, Sovereigns, Emerging Markets

Investment grade credit spreads



As of 6/30/2017. Source: Bloomberg

High yield

Summary

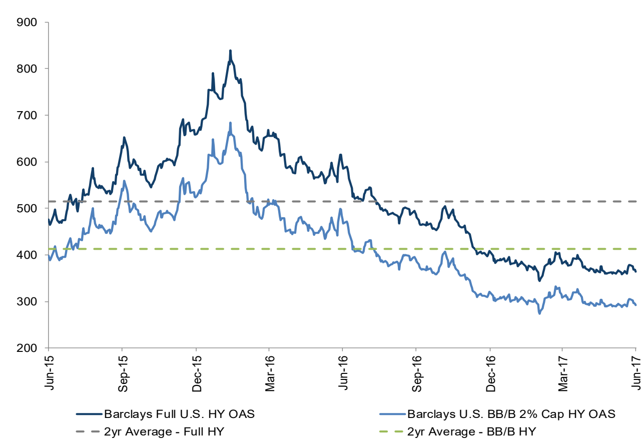
The U.S. high yield market posted solid returns in the second quarter of 2017, bringing year-to-date gains to nearly 5%, as measured by the Bloomberg Barclays U.S. High Yield Index (the High Yield Index). Following several quarters of large gains from lower-quality bonds, BBs made a good showing in the period as U.S. Treasury rates rallied for much of the quarter. With oil prices falling to the low-$40 range in June, the energy sector experienced some volatility that, as of now, has yet to spill over to the broader high yield market. Although the technical picture is not quite as rosy as it was for much of last year, corporate earnings in the first quarter of 2017 demonstrated that credit fundamentals remain on an improving path, even though the credit cycle feels extended to many investors.

The U.S. high yield market posted another solid set of returns in the second quarter of 2017.

Performance

- The High Yield Index tightened another 19bps during the second quarter of 2017 (45bps year-to-date), resulting in a solid total return of 2.17% for the quarter. Spreads ended the period at 364bps (on an OAS basis), about 20bps wide of the multi-year low of 344bps reached in mid-March 2017. Reversing the recent trend, higher-quality bonds outperformed in the second quarter, with BBs returning 2.71%, Bs 1.72%, and CCCs 1.85%.
- Top-performing industries during the quarter included Pharmaceuticals (with a 5.56% total return), Banking (with a total return of 4.59%) and Chemicals (with a 4.06% total return), while Energy (down 1.16%) and Industrial Other (down 1.52%) were the notable underperformers and the only sectors to post negative returns.

Bloomberg Barclays U.S. High Yield Indices, yield (OAS)



As of 6/30/2017. Source: Barclays

Fundamentals: positive

- The high yield default rate declined another 40bps to 1.50% during the second quarter. Default activity remains low and down substantially from 2016 ($9.5 billion year-to-date versus $34.8 billion in the same period of 2016). On a year-to-date basis, the upgrade-to-downgrade ratio was 1.28:1 (dollar-volume basis), indicating an improving credit quality trend.
- Aggregate credit metrics for high yield issuers showed incremental improvement following the first quarter 2017 earnings season. After five quarters of negative growth, EBITDA came in flat on a year-over-year basis, as the drag from Energy waned. Ex-Energy, growth was relatively flat at 3% year-over-year, according to Morgan Stanley data. Total leverage (i.e., total debt-to-EBITDA) improved to 4.45x from a cyclical peak of 4.70x as of the fourth quarter of 2016, while net leverage improved to 3.88x from an all-time high of 4.14x in the first quarter of 2016.

Technicals: neutral

- Following a large $8.2 billion outflow during the first quarter of 2017, high yield retail funds continued to lose assets in the second quarter of 2017, as investors pulled another $1.3 billion. The year-to-date outflows have essentially reversed all of the $9.6 billion that came into the market during 2016 (most of which came in a post-election surge that reflected the hopes of pro-growth Trump policy changes).
- Gross new high yield issuance trailed off during the second quarter (following a relatively robust first quarter), helping the technical picture by offsetting negative fund flow trends. Year-to-date new issue volume of $175 billion is up 13% on a year-over-year basis, although refinancings represent 64% of this year's volume, up from 58% a year ago.

Valuation: negative

- Spreads remained relatively range bound during the second quarter of 2017, ending the period 19bps tighter at +364bps, as measured by the High Yield Index. The High Yield Index yield-to-worst tightened a similar amount to 5.62% from 5.84% at the end of the first quarter and 6.12% at year-end 2016. Yields reached a recent low of 5.42% in mid-June, the lowest level since August 2014, before widening back out at the end of June as oil prices and U.S. Treasury rates caused some volatility in credit markets.
- We continue to maintain that valuations appear somewhat stretched in a historical context. At 361bps (High Yield Index as of July 5, 2017), spreads are well below long-term averages and just 40bps above the post-crisis low. Furthermore, when compared to other credit sectors – namely investment grade and leveraged loans – high yield spreads appear tight in a long-term context.

Outlook

We remain guarded on high yield valuations, as they fully reflect a benign economic and fundamental backdrop. The market appears delicately balanced between still healthy corporate credit trends (positive earnings growth and slight leverage declines) and potential drivers of instability, including energy price volatility, a rancorous U.S. political environment and the reversal of the Federal Reserve's easy money policy. We expect technicals to remain uneven as sentiment shifts, which could lead to modest volatility in the high yield market, given current valuations. On a relative value basis, we continue to prefer single Bs over double BBs and remain in favor of rotating into floating rate loans where possible.

Overweight: Airlines, Banking, Chemicals, Homebuilding, Media-Cable, Pipelines & Distributors

Underweight: Aerospace & Defense, Retailers & Restaurants, Pharmaceuticals, Technology, Telecommunications

Leveraged loans

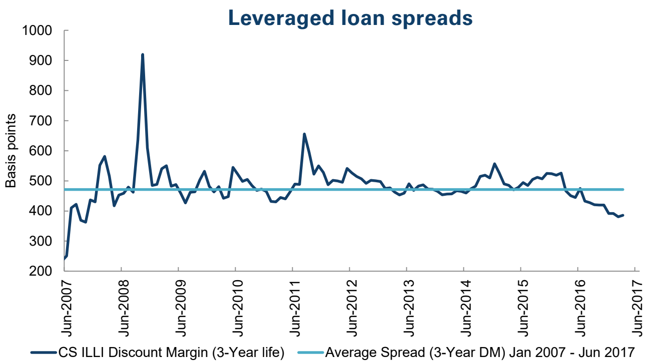
Summary

Strong loan market technicals held throughout much of the second quarter of 2017.

Although retail fund inflows slowed in recent weeks, strong loan market technicals held throughout much of the second quarter of 2017, providing support for another period of repricing activity. As was the case in the preceding quarter, second quarter loan market returns of 0.9% were constrained by falling spreads and call-constrained prices. Loan valuations still appear relatively attractive on a historical basis versus the high yield market, and additional Federal Reserve rate hikes could fuel more inflows to the loan market.

Performance

- The Credit Suisse Institutional Leveraged Loan Index (CSILLI) returned 0.89% in the second quarter, the smallest gain in six periods, as average loan prices declined 22bps to $99.50. Although repricing activity slowed somewhat by quarter end, returns were once again constrained by softness in loans trading above par. By the end of June, slightly over 50% of loans traded above par, down from nearly 70% last quarter.
- Lower-quality loans, which tend to be less call-constrained, continued to outperform during the second quarter, as CCCs returned 1.81%, Bs 1.12%, and BBs 0.44%. Consumer Durables, Healthcare, and Autos all posted sector-leading returns of approximately 1.3% during the quarter, while the Shipping (-1.13%) and Food & Drug (-0.69%) industries lagged during the period.



As of 6/30/2017. Source: Credit Suisse

Fundamentals: positive

- The leveraged loan default rate increased slightly (i.e., 15 bps) to 1.42% in the second quarter, slightly above the four-year low of 1.27% reached in March 2017. As of June 30, 2017, the distressed ratio (loans trading below $80) stood at just 3.30%, up slightly from 3.17% at March 31, 2017. Nothing on the immediate horizon suggests that defaults will accelerate meaningfully during the remainder of 2017.
- Loan issuer credit metrics exhibited continued improvement in the first quarter of 2017 (the latest earnings data currently available). According to Morgan Stanley data, average total leverage declined slightly during the first quarter of 2017 to 4.70x; the figure compares to a cyclical peak of 4.95x reached in the first quarter of 2016.

Technicals: positive

- With U.S. Treasury rates moving lower during most of the second quarter of 2017, the loan market experienced tapering demand from retail investors during the period. Following two quarters during which inflows exceeded $12 billion, mutual fund inflows totaled just $3.2 billion in the second quarter of 2017, with the last two weeks of June posting outflows. On the flip side, however, new CLO issuance picked up during the quarter, as over $35 billion priced, double the total pricing in the first quarter of 2017.
- Repricing activity drove loan issuance in the second quarter to $246 billion, the second highest quarterly total on record (trailing only the $331 billion reported in the first quarter of 2017). The year-to-date figure, $577 billion, already ranks as the second-highest annual new issuance total on record behind the $670 billion achieved in 2013. Together, repricings and refinancings totaled 75% of new issue volume in the first half of 2017, resulting in net new volume of $174 billion, still well ahead of last year's year-to-date pace of $78 billion.

Valuation: negative

- The average yield, assuming a three-year par takeout, for the CSILLI declined 5bps to 5.62% in the second quarter of 2017, as tighter spreads (driven in part by repricings) were offset by rising LIBOR. As of the end June, the average CSILLI three-year discount margin reached 387bps, just shy of February's 381bps (the tightest level post-crisis and the lowest since October 2007). LIBOR, the benchmark rate from which loan coupons are calculated, rose another 15bps during the quarter to 1.30%, comfortably above the common 1.00% "floor" used in calculating most loan rates.
- With the significant spread tightening in the high yield market since the U.S. presidential election, the relative value of loans versus high yield bonds has improved markedly. At 428bps as of June 30, 2017 (per the Credit Suisse High Yield Index), the average high yield spread is just 41bps wide of the comparable loan spread (as represented by the CSILLI). This difference contracted from 80bps at year-end 2016 and is well inside the ten-year average of 167bps. In mid-2014, this spread actually turned negative (i.e., high yield bond spreads were tighter than leveraged loan spreads, on average), so it is possible for high yield bond spreads to continue contracting, relative to loans.

Outlook

With more than half of the leveraged loan market still trading at or above par, we continue to believe that returns from the sector will be constrained going forward. However, both returns and retail flows could see gains if LIBOR continues to rise. Although flows have slowed from earlier in the year, CLO demand has increased recently, and supported a positive technical backdrop. Furthermore, relative to the high yield market, loan valuations appear attractive, and we continue to look to rotate into floating rate loans where possible.

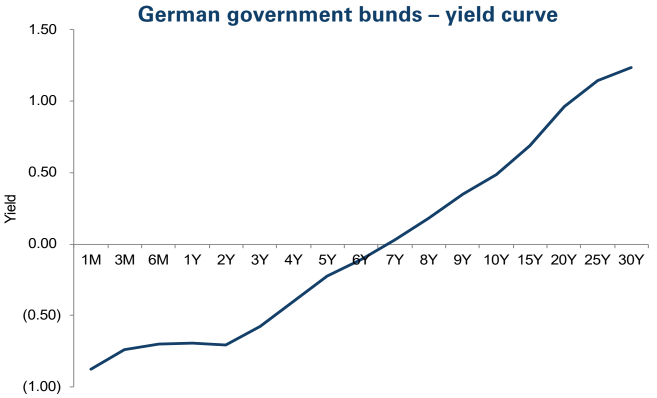
Overweight: Chemicals, Consumer Products, Media/ Telecommunications

Underweight: Food & Beverage, Gaming & Lodging, Retail & Restaurants

Non-dollar

Developed markets

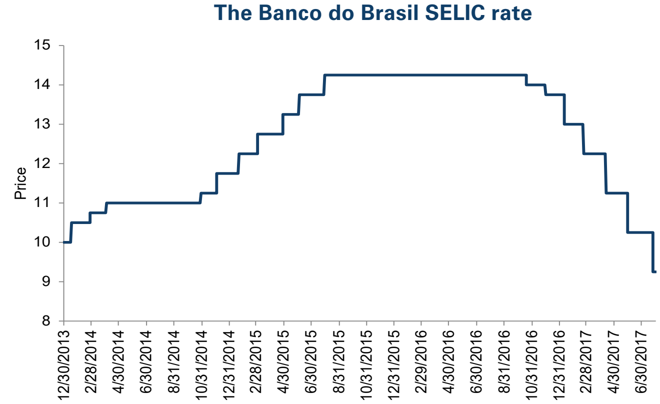
Developed-market sovereign bonds presently provide limited value compared to U.S. Treasuries, due to very low yields outside of the U.S. Notably, most European (excluding Greece) and Japanese sovereign bonds yield well below the equivalent-maturity U.S. Treasury. Furthermore, the ECB is now openly discussing withdrawing its bond buying programs in 2018; eventually, that will likely cause negative yields to reverse into positive territory. In other words, we believe short-term European yields are set to rise over the next eighteen months. In developed markets such as New Zealand and Australia, where long-term yields are higher than those in the U.S., we anticipate accelerating economic growth. Consequently, despite higher nominal yields, New Zealand and Australian sovereign bonds will likely underperform similar-maturity U.S. Treasuries on a total return basis. Therefore, from our perspective, we see little value in these markets.



As of 6/30/2017. Source: Bloomberg

Emerging markets focus – Brazil

We continue to see opportunity in some higher-value emerging markets. Specifically, Brazil's economic outlook has significantly improved, despite the country's political instability. Analysts expect Brazilian GDP growth of 1.0% to 1.5% in 2017, a significant improvement over the recessionary conditions that prevailed in 2016. As a result of the country's improving economic outlook, the Brazilian real has also appreciated against the U.S. dollar. We expect this trend to continue, provided that inflation remains low and growth continues. A significant decline in inflation has allowed the Banco do Brasil to aggressively cut short-term interest rates to support the economic recovery. Brazil will also likely benefit from a general global economic recovery. Political uncertainty may continue, but we do not expect that to disrupt the recent favorable trend.



As of 6/30/2017. Source: Bloomberg

Benchmark performance as of 6/30/2017

Total return	**YTD**
Bloomberg Barclays U.S. Aggregate	2.27%
Bloomberg Barclays U.S. Treasury	1.87%
Bloomberg Barclays U.S. TIPS	0.85%
Bloomberg Barclays U.S. Credit	3.68%
Bloomberg Barclays U.S. ABS	1.14%
Bloomberg Barclays U.S. MBS	1.35%
Bloomberg Barclays U.S. CMBS	2.18%
Bloomberg Barclays U.S. Corporate High Yield Index	4.93%
Citigroup BB/B ex-split B/CCC Index	4.15%
Credit Suisse Institutional Leveraged Loan Index	1.90%
Citigroup Non-USD World Government Bond (50% hedged)	3.05%
Yield	**June 30**
U.S. 10-Year Treasury yield	2.30%

Disclaimers