Tortoise
Essential assets and income

Global credit economic summary & outlook

Fourth quarter 2017

Tortoise

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Domestic

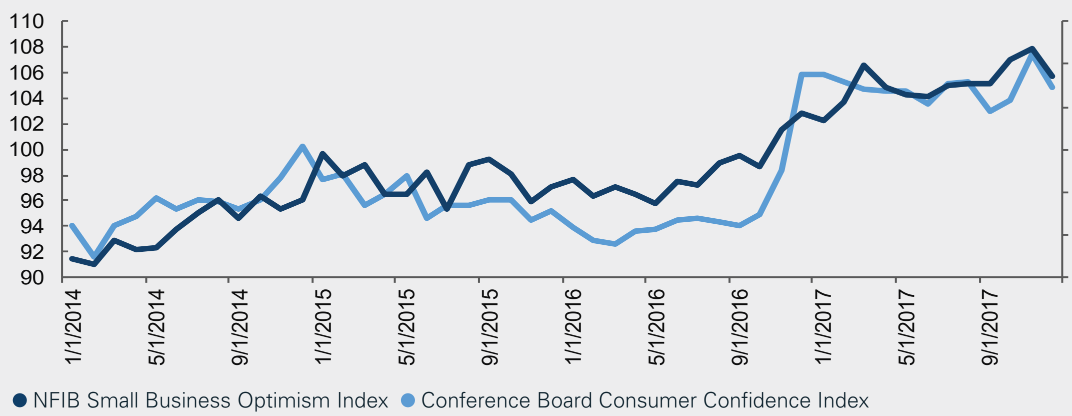
Summary

Domestic economic growth continued to improve during the last quarter of 2017, and inflation remained largely absent. U.S. GDP grew 2.6%, according to the "advanced" estimate released by the U.S. Bureau of Economic Analysis, falling short of the 3.0% analyst consensus estimate tracked by Bloomberg. Nevertheless, underlying consumer spending and business investment components appeared supportive of a favorable economic environment. Based on the advanced fourth quarter estimate, GDP growth will total 2.5% in 2017 versus 1.8% in 2016. Inflation, as measured by the PCE Price Index, has barely budged and was last reported as 1.7% over the last twelve months.

Importantly, healthy consumer and business spending activity support a robust economic outlook. Strong employment growth suggests consumers will continue to contribute to the favorable trend. Wage growth has remained anemic but consumers remain active. Business spending growth rebounded strongly from a weak 2016 and now stands at 4.5% year-over-year.

Given the continued elevated levels of both consumer and business confidence surveys (see below), we anticipate that economic growth will accelerate into 2018.

Business and consumer confidence indices

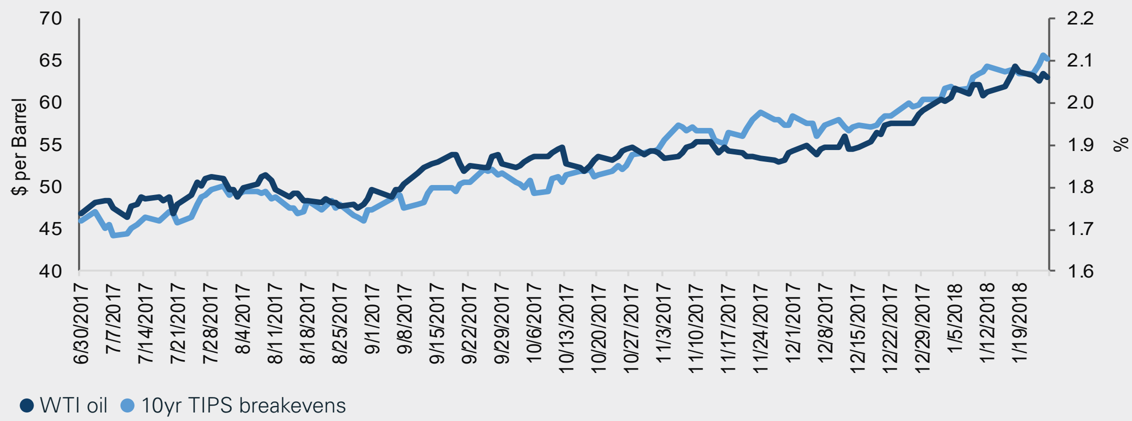


As of 1/25/2018. Source: Bloomberg

Inflation remains well below the Federal Open Market Committee's (FOMC) stated target of 2%. Nevertheless, the FOMC continued to increase the federal funds discount rate. We note that 2017 represents the first post-crisis year in which the FOMC executed policy as it had forecast. At the December 2016 FOMC meeting, the consensus expectation communicated by Federal Reserve officials called for three rate hikes in 2017 and the beginning of balance sheet tapering. Actual policy actions precisely matched that guidance.

Expectations for inflation increased 10-15 basis points (bps) since November 2017, as measured by the 10-year TIPS breakevens. Some might attribute this increase in expectations to passage of the Tax Cuts and Jobs Act of 2017, however, we believe the increase in commodity prices, specifically oil, likely represents the main driver of higher inflation expectations. Regardless, TIPS outperformed Treasuries and we believe that relative relationship will continue. Any improvement in realized core inflation would provide added benefit to TIPS positions.

10-year TIPS breakeven versus WTI oil price



As of 1/25/2018. Source: Bloomberg

Outlook

We currently forecast 3.1% U.S. GDP growth in 2018. Core inflation will likely remain subdued, but trend with an upward bias. We believe that employment growth will continue at a healthy rate and that non-farm payrolls will increase approximately 150,000 per month. This economic backdrop should provide an environment that allows the FOMC to continue on its rate hike path, which expects three rate increases this year per its December 2017 Summary of Economic Projections.

When her term as its chair expires on February 3, 2018, Janet Yellen will leave the Board of Governors of the Federal Reserve. Ms. Yellen, educated as an economist, spent most of her career in academia and with the Federal Reserve. Her replacement, Jay Powell, educated as an attorney, worked as a lawyer, investment banker, private equity investor, and held various positions within the U.S. Treasury. Their contrasting backgrounds may change the Federal Reserve's outlook on the economy and policy actions going forward. That said, we think it unlikely that Powell deviates significantly from the current path of expectation during his first year as chair. If policy differences arise, they will likely occur in 2019 and beyond.

International

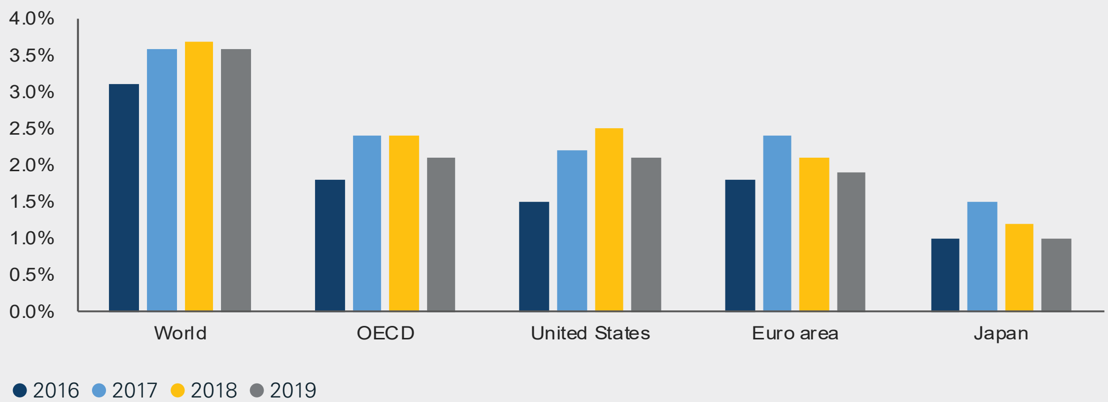
Summary

The implementation of the Tax Cuts and Jobs Act of 2017 provides additional support to a global recovery already underway. In response, organizations such as the International Monetary Fund (IMF) and the Organization for Economic Co-operation and Development (OECD) upgraded their estimates of worldwide GDP growth to approximately 3.5-4.0% through 2018. A range of other factors also contribute to the favorable worldwide economic outlook, including healthy trends emanating from emerging markets accounting for half of worldwide growth, multiple interest rate cuts by central banks around the world, and sizeable quantitative easing programs in the U.S., UK, Japan and Europe. Investor confidence is supported by record stock market levels driven by higher earnings estimates resulting directly from the Tax Cuts and Jobs Act.

The global economic recovery results in part from multiple central bank quantitative easing programs, a period of record low global interest rates and significant fiscal stimulus in many large developed countries. Given the momentum currently experienced worldwide, we believe that this recovery will continue for the extended foreseeable future, despite a mature U.S. economic cycle. Interestingly, the IMF predicts growth of only 2.7% for the U.S. economy in 2018, a surprisingly low rate given that the last three quarters of U.S. growth have totaled 3.1%, 3.2% and 2.6%. This suggests the IMF's forecast of U.S. GDP growth is somewhat understated.

World interest rates are slowly moving higher as the recovery accelerates, and a combination of tighter monetary policy and higher commodity prices forewarn of potential inflationary pressures. A handful of large central banks, including the UK, Canada and the U.S., have begun to increase rates as economic data confirms the economic recovery. As of yet, however, inflation is so far largely absent in the economic data. This is partly because global industrial capacity is plentiful and wage inflation has been modest.

Real GDP growth



As of November 2017. Source: OECD

Outlook

The momentum behind the global recovery ensures that it likely has some way to go. Lagging economies, such as those in Brazil and Russia, are emerging from recession and will likely benefit from higher commodity prices. We believe commodity prices will continue to rise in response to accelerating world trade, but could be subject to volatility. As a result, despite rich valuations, we continue to favor growth-dependent fixed income sectors. Although subdued, global inflation also appears set to rise as excess global manufacturing capacity is absorbed. Wage inflation could also build as fiscal stimulus begins to benefit larger economies such as the U.S. and Europe.

Factors which could affect the recovery include a potential slowdown of the Chinese economy due to demographic pressures, and an overly aggressive Federal Reserve. A sharp rise in U.S. short-term interest rates has the potential to invert the yield curve, pushing the economy into recession.

Currencies and commodities

The U.S. dollar may continue to weaken, driven by weak technicals and fears of a growing U.S. trade deficit and import tariffs. Mixed policy signals by the Trump administration have also clouded the outlook. A weaker dollar boosts growth expectations for U.S. export orientated companies.

Commodity prices firmed in reaction to increasing global demand. We expect this trend to continue, but not without volatility. For example, China produces more than 50% of the world's steel and may introduce production quotas for part of 2018, which could temporarily push prices higher. Rising commodity prices should benefit emerging market economies, which have generally lagged the recovery in the developed world.

Credit Spotlight

The debate over the U.S. dollar and the effect on commodities

This year's World Economic Forum in Davos was highlighted by a spirited debate about the U.S. dollar. U.S. Treasury Secretary Steve Mnuchin argued that a weak dollar is good for America's trade prospects, leading some to conclude that talking down the currency might be a weapon in potential trade wars stoked by the Trump Administration. However, President Trump contradicted his Treasury chief by claiming that he is, in fact, in favor of a strong dollar. Then, European Central Bank President Mario Draghi jumped in, suggesting that Mnuchin had broken G-20 agreements against pushing for competitive devaluations. Trump's return fire did not sway currency traders, however, and the dollar ended the week ended January 26 lower, bringing the year-to-date decline on the Bloomberg Dollar Spot Index to 3.5%. Since the beginning of 2017, the dollar index is down about 11.7%.

Of course, one significant corollary to a weaker U.S. dollar is the recent strength in commodities. Oil, as measured by WTI, has rallied nearly 10% this year and gained nearly 50% from its 2017 low on June 21. Copper and gold have also posted impressive 21% and 9% advances since mid-year 2017. In addition to the weaker dollar, this commodity run is underpinned by synchronized global growth, better-than-expected economic results in China, and hopes for a U.S. infrastructure spending bill.

With underlying commodity prices firming by the day, the fundamental backdrop for high yield commodity industries appears favorable and improving. After experiencing an extensive default cycle in the 2015-2016 period, when cumulative defaults in Energy and Metals & Mining totaled 18.4% and 24.7%, respectively, those sectors have rallied so far in 2018. As a matter of fact, a number of benchmark credits could receive upgrades that would return them to investment grade. This trend continues of a theme that was in place for much of the second half of 2017, when oil and other commodity prices started climbing. The key question is whether the recent run is the beginning of a new cyclical rally or just a temporary reach for yield.

Sector analysis

U.S. interest rates

During the fourth quarter of 2017, the yield curve continued to flatten. The short end of the yield curve moved the most, as the U.S. Treasury 2-year note ended the quarter to yield 1.88%, a 31 bps increase. The increase on the short end resulted mainly from the Federal Reserve's push to increase short rates. For the year 2017, the 2-year note began the year at 1.18% and ended at 1.88%, a 70 bps increase. The U.S. Treasury 10-year note yield increased slightly during the fourth quarter of 2017 from 2.37% to 2.40%, a 3 bps increase. For the year, the 10-year note yield decreased slightly from 2.44% to 2.405%. Additionally, the U.S. Treasury 30-year bond ended the year yielding 2.74%, a decrease of 33 bps. These changes account for the flattening trend during the year.

As long as the economy continues to improve, we believe the Federal Reserve will continue on a plan to raise short-term rates three times during 2018. As such, the yield curve should continue to flatten with the short end leading the way.

Securitized products

In the fourth quarter of 2017, the securitized products sectors registered solid performance, as MBS, CMBS, and ABS outperformed U.S. Treasuries by 25, 77, and 24 bps, respectively. The sectors benefited from strong investor demand for yield and a favorable overall economic trend. The securitized sectors are approaching historically rich valuations, which makes us more selective and defensive in our strategy. We remain underweight mortgages, neutral CMBS, and overweight ABS. We still find ABS attractive as a high-quality, short-maturity asset class to add incremental yield over U.S. Treasuries.

Investment grade credit

Investment grade credit performed well in the fourth quarter of 2017, outperforming U.S. Treasuries by 89 bps, with long duration and BBB rated credit leading the outperformance. We remain modestly underweight investment grade credit, due primarily to rich valuations and moderating technicals, offset by improving top-line fundamentals. Valuations remain stretched and reside near the past three cyclical credit spread tights dating back to 1997, adjusting for changes over time to the Bloomberg Barclays U.S. Aggregate Bond Index. Investment grade credit market demand technicals remain relatively strong, supported by both domestic and foreign investors, although foreign buying has decelerated in a trend that could continue. New issue supply remains high and we expect it to increase versus 2018 as a result of increased M&A activity, despite the positive effects of tax repatriation. Further, we expect overall cross-asset-class supply to materially increase in the second half of 2018, due to the tapering of Federal Reserve quantitative easing. Topline fundamentals continue to improve, largely a result of improving economic growth and favorable corporate tax reform. However, we believe that much of the earnings benefit from the aforementioned factors will accrue primarily to equity holders, and credit metrics will remain stretched.

High yield

The high yield market, as measured by the Bloomberg Barclays U.S. High Yield Index, returned a tepid 47 bps in the fourth quarter, finishing 2017 with a return of 7.50%. Lower quality credit outperformed in the quarter, as it did for the year, with CCCs posting an annual return of 10.38% (BBs 7.32% and Bs 6.49%). Spreads (OAS) tightened 4 bps in the fourth quarter and contracted 66 bps during the year, ending 2017 at 343 bps. With the strong start to 2018, spreads have reached new post-crisis lows, and valuations continue to fully reflect a solid economic backdrop. A benign default environment and positive earnings and leverage trends illustrate that fundamentals remain supportive in most high yield sectors.

Leveraged loans

Leveraged loans outperformed high yield bonds during the fourth quarter, posting a 1.17% total return as measured by the Credit Suisse Leveraged Loan Index. The full year 2017 return of 4.25% lagged the high yield market, however, as repricing activity hit an all-time peak. CLO creation continues to offset waning retail interest in the loan asset class, although additional Federal Reserve rate hikes could increase demand for floating rate investments. Rising LIBOR has pushed the yield on loans above the high yield market, a phenomenon that underpins our preference for loans over high yield bonds.

Non-dollar

We maintain a mixed outlook on non-dollar bonds. From a yield perspective, U.S. Treasuries have become more attractive as overseas spreads continued to narrow on a relative basis. Some markets have exhibited significant narrowing against U.S. Treasuries and spread differentials have tightened to record levels.

Our outlook for the U.S. dollar is negative in the near term, offsetting the attraction of higher U.S. Treasury yields. Although the potential for currency gains on non-dollar positions remains favorable, we believe non-U.S. dollar bonds currently exhibit little relative value advantage. If U.S. rates rise dramatically, some stable yielding foreign sovereign markets could offer investible opportunities.