Tortoise
Credit Strategies

Global economic summary & outlook

Third quarter 2017

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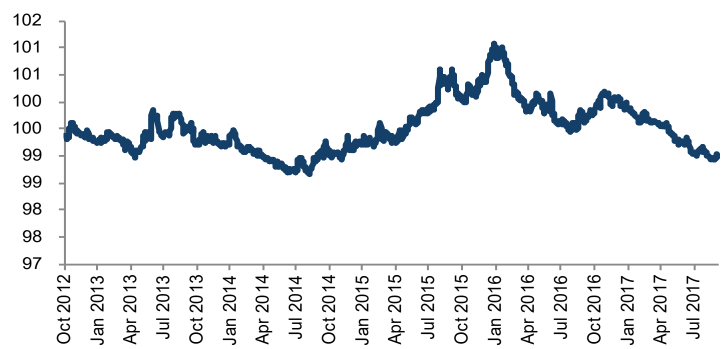
Domestic

The U.S. economy continued on a 'Goldilocks' trajectory over the past few months. Growth held steady, as evidenced by the Bureau of Economic Analysis's 3.0% preliminary estimate of U.S. GDP growth in the third quarter of 2017; the rate compares to 1.2% GDP growth in the first quarter of 2017 and 3.1% in the second quarter.

Inflation remains low, having actually fallen from higher levels earlier in the year. In August, the U.S. Bureau of Economic Analysis's Core PCE Price Index (i.e., excluding food and energy) dropped to a 1.29% year-over-year annualized rate. All the while, the employment situation continues to improve, as the U.S. seasonally adjusted unemployment rate (U-3) declined to 4.2% as of September 2017, its lowest level since February 2001. It certainly appears that the Federal Reserve, for the time being, has achieved the objectives of its dual mandate to maximize employment while controlling inflation.

Importantly, it appears that U.S. economic growth remains on solid footing. Both consumer and business confidence indicators reflect elevated levels for this point in the recovery cycle. These sentiment surveys continue to benefit from very easy financial market conditions, despite the Federal Open Market Committee's ("FOMC") recent increases in the federal funds rate. The Goldman Sachs Financial Conditions Index ("GS FCI") tracks U.S. Treasury yields, the federal funds rate, the trade-weighted dollar, the S&P 500 Index and investment grade credit spreads; a declining trend indicates an easing in financial conditions.

Goldman Sachs Financial Conditions Index

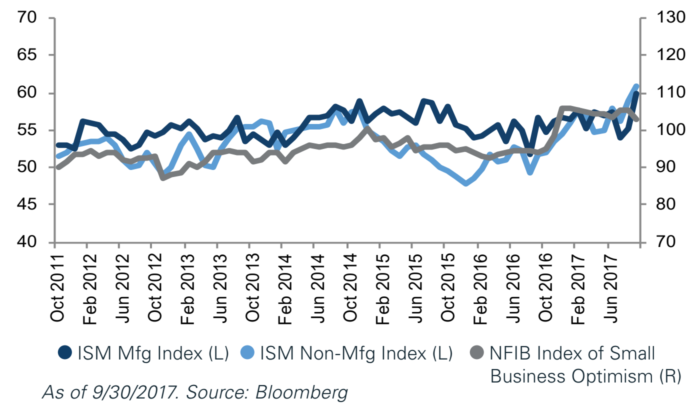


As of 9/29/17. Source: Bloomberg

The recent decline in the GS FCI largely reflects higher equity prices, tighter credit spreads and a lower trade-weighted dollar, offset somewhat by a higher federal funds rate. Some members of the FOMC, including Federal Reserve Bank of New York president William Dudley, maintain that further tightening of monetary policy remains warranted, given the recent easing of financial conditions as evidenced by the declining GS FCI. However, we note that many of the inputs to the GS FCI can reverse course rapidly, and most of them remain outside of the control of the Federal Reserve. Consequently, we believe focusing on financial conditions is potentially dangerous in that the Federal Reserve has little to no control over any of the GS FCI variables except short-term interest rates (i.e., through the federal funds rate).

A revival of business spending represents a particularly bright spot in the economy. We believe three of the most important business survey indices are the ISM Manufacturing Index, the ISM Non-Manufacturing Index and the NFIB Index of Small Business Optimism (see chart). All three of these point toward continued healthy growth from business investment.

Business Survey Indices



As of 9/30/2017. Source: Bloomberg

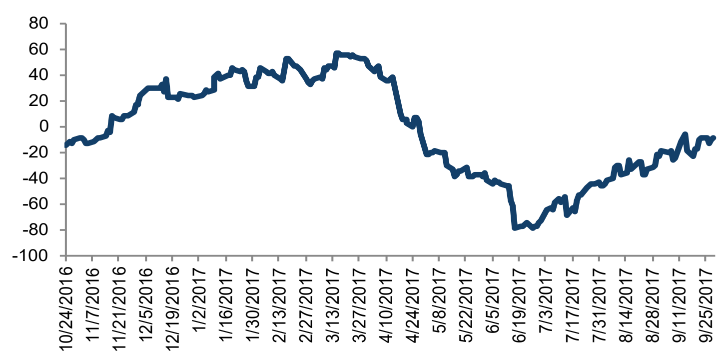
Persistently low inflation and its implications on economic growth represents a debatable issue. As previously noted, the Core PCE Index, the Federal Reserve's favored measure of inflation, dropped to 1.29% on a year-over-year basis for the month of August. We anticipate that inflation will remain well contained while moving somewhat higher as energy prices increase.

U.S. federal government fiscal policy and its implications for the economy remain unresolved, yet could represent an upside catalyst for growth. Regulatory roll back has progressed nicely, with more anticipated, as has been reflected in the strength of recent business surveys. However, tax reform expectations appear to be fading. Any progress on the passage of tax reform is likely to lend a strong boost to the business sector.

United States — summary

- During the third quarter of 2017, fixed-income investors focused on news emanating from Washington D.C. Fiscal policy appeared mired in politics and tweets. Despite progress on rolling back overly onerous regulations, health care and tax reform initiatives appear stalled. While we expect that health care reform would benefit the small business sector, it is likely, depending on details, that tax reform would more meaningfully benefit the broader economy.
- On balance, economic releases during the third quarter appeared stronger than investors anticipated. The Citi Economic Surprise Index increased from -72.60 on June 30, 2017, to -7.90 on September 29, 2017. The improvement in economic indicators coincided with improved conditions globally.

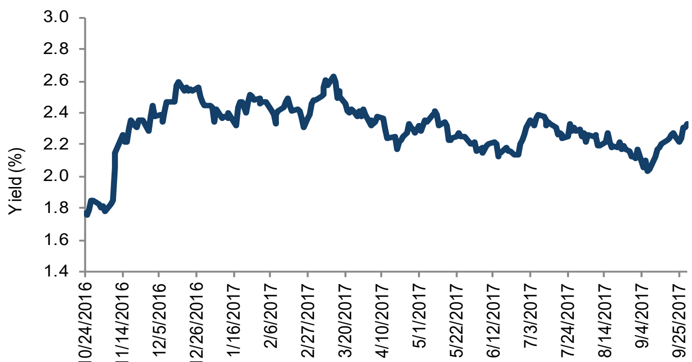
Citi Economic Surprise Index



As of 9/29/2017. Source: Bloomberg

- Political tumult in Washington D.C. significantly diminished expectations for meaningful tax reform. In early September, investors expressed their reduced expectations regarding tax reform by lowering the probability that the Federal Reserve would raise rates after its December 2017 meeting to a low of 20%. Longer-term rates followed suit and bottomed, as evidenced by the decline of U.S. Treasury 10-year yields to 2.04% on September 7, 2017. Federal Reserve officials appeared uncomfortable with investors' belief in a low likelihood of a rate increase, and began messaging on the subject of higher rates. Consequently, U.S. Treasury long-term yields reached 2.34% on September 29, 2017 (see chart). At the end of September, federal funds futures priced in a 70% probability that the Federal Reserve would hike rates in December.

U.S. Treasury 10-year generic note



As of 9/29/2017. Source: Bloomberg

- Finally, we note that the effect of hurricanes Harvey and Irma will distort economic statistics over the next few months. Initial unemployment claims (reported weekly) already reflect these effects, as claims spiked to 298,000 in the week ended September 1, 2017, versus 236,000 reported in the preceding week. We believe that investors should look past these distortions and focus on underlying trends.

United States — outlook

- With regard to monetary policy, we expect that, following the FOMC's meeting on December 13, 2017, the Federal Reserve will raise its federal funds target rate to a range of 1.25% to 1.50% from the current 1.00% to 1.25% range. This view is inline with market expectations and, consequently, we do not anticipate a significant market reaction to the policy action.
- Fiscal policy appears somewhat uncertain; however, we expect that Capitol Hill will achieve some progress on both individual and corporate tax reform. Overseas cash repatriation, in particular, deserves attention. On the margin, we believe that any meaningful fiscal policy action will likely contribute to an upside surprise insofar as economic growth is concerned.
- We believe that market inflation expectations have become too complacent. The prospect of higher-than-expected growth and/or higher commodity prices appears under appreciated. As a result, our view of Treasury Inflation Protected Securities (TIPS) has become more favorable.
- We continue to believe that a higher interest rate environment may evolve and we continue to favor duration positioning somewhat short of portfolio benchmarks.

International

The various forms of stimulus enacted by central banks and governments since the 2008 recession are finally influencing global growth in a positive manner. Following a lackluster 2016, data indicates that a concerted recovery is under way, and that growth in some regions of the world is accelerating. The International Monetary Fund recently upgraded its 2017 and 2018 global GDP growth forecasts to 3.6% and 3.7%, respectively. Our prediction is that global GDP growth will reach 3.5% in 2017.

We believe that global GDP growth could reach 3.5% in 2017

In recent years, four major central banks, the U.S. Federal Reserve, the European Central Bank (ECB), the Bank of England and the Bank of Japan, maintained significant quantitative easing programs. In addition, Japan and China introduced stimulus through fiscal spending and reduced bank capital reserve requirements. Since 2008, central banks worldwide introduced more than 600 interest rates cuts.

The European economic recovery appears driven by strong growth in Eastern Europe, buoyed by exports into expanding economies in core Europe. Japan finally appears to be emerging from recession, as evidenced by sequential real GDP growth of 0.6% (2.5% annualized) in the second quarter of 2017.

While economic recovery appears widespread, the rate of global growth in certain regions remains mixed. The mature state of the expansion cycle in China and the U.S. dampens the rate of economic acceleration in those regions. The UK, Australia and New Zealand face a mixed outlook and their respective central banks continue to debate a reversal of monetary policy; exports from these countries remain strong and reflect higher growth elsewhere. Analysts expect a reversal to positive 2017 GDP growth in Russia and Brazil, where economic conditions lagged in recent periods.

Globally, inflation remains very subdued, despite a general rise in commodity prices. We expect that commodity prices will continue to increase as global demand persists. Additionally, some global regions exhibit signs of wage price pressures. For now, however, inflation pressures remain low and don't threaten to drive bond yields higher. A significant number of fixed income instruments (mostly euro and yen denominated sovereign obligations, and very high quality corporates) continue to provide negative yields. Many analysts believe that most negative yields will revert into positive territory once the ECB ends its bond-buying program, projected for sometime in 2018. This could trigger a general rise in developed market sovereign yields.

Europe – summary

- The IHS Markit Eurozone Composite Purchasing Managers' Index rose to a recent high of 56.7 in September, indicating that growth and confidence remains strong in the single currency market. For the recovery to continue, fiscal stimulus will need to replace monetary stimulus, as the ECB pulls back from its quantitative easing (QE) program.
- German industrial production surged in August by 2.6% month-to-month, the sharpest increase in six years[1]. Encouragingly, strength registered across most sectors. In contrast, French industrial production declined -0.3% month-to-month in the same period[2].
- In the second quarter, GDP in most Eastern European economies grew at an annualized rate of between 3% and 6%.

- The German election result was disappointing for Chancellor Merkel, who returned to power with a diminished majority. Consequently, Ms. Merkel's Christian Democratic Union of Germany (CDU) party will govern as part of a 'Jamaican' coalition along with the Free Democratic Party (FDP) and Greens parties. This could result in a less aggressive pro-EU agenda going forward and a more pragmatic approach to Brexit.
- The Catalan independence referendum result showed that populism in Europe did not die with the French Presidential election. Despite heavy resistance from Spanish authorities, Catalonians voted overwhelmingly for independence from Spain. The event was mostly symbolic, and markets did not react negatively to the result, as Catalonia remains a long way from actually separating from Spain. Obviously, pro-EU authorities in Brussels remain vehemently opposed to the notion, especially on the heels of Brexit.
- Romania, which reported annualized GDP growth of 5.9% in the second quarter of 2017, ranks as the fastest-growing economy in Europe. The strength at least partially reflects a strong euro, which benefits exporting countries located outside of the common currency group. An active Romanian economy has led to labor shortages and rapid wage growth.
- While the UK faces the uncertainty of ongoing Brexit negotiations, its strong economy provides it with significant bargaining power. However, a challenge to Theresa May's leadership has weakened her influence with the European Commission. This uncertainty and weakened leadership has negatively affected business confidence.

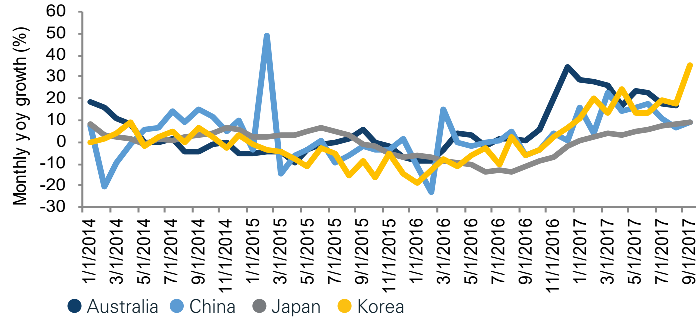
Europe – outlook

- Accelerating economic growth in eastern Europe continues to pull core Europe out of its slump. As growth recovers, the ECB will increasingly look to withdraw monetary stimulus. Additionally, as the ECB begins to telegraph its plan to investors, interest rates across the continent may be pressured higher, especially at the short end of the curve where negative rates exist today. We do not expect this to occur at least until 2018. Fundamentally, growth appears likely to accelerate in response to a continuing global economic recovery. However, a rising euro could negatively affect exports and dampen overall economic growth. The ECB has increasingly addressed the risk of a rising euro in its public statements.

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

- Citing rising credit levels, Standard & Poor's lowered China's sovereign rating by one notch to A+ from AA-. Analysts expect China's economic growth to slow in the second half of 2017 and for GDP growth for the entire year to reach 6.5%, a level considered by Chinese authorities as manageable.
- Japan's economy continues to surprise to the upside as it reported GDP growth in the second quarter of 2017. Although inflation remains subdued, wage pressures are rising due to shortages of labor in some industries. These trends fulfill government policy objectives.
- In September, Korean exports increased 35% over the previous year. Australian, Chinese, Japanese and Korean exports continue to increase (see chart). Increasing exports activity supports the notion of accelerating pan-Asian economic growth.

Export growth: Australia, China, Japan and Korea



As of 9/30/2017, except Australia (8/31/17). Source: Bloomberg

- Brazil's inflation rate continues to improve, allowing the Banco Central do Brasil to further cut interest rates and boost growth. Many analysts believe lower rates have supported consumer activity, and overall retail sales increased 3.6% in August. However, retail sales (excluding cars and construction) declined 0.5% in August 2017. Provided the Brazilian real remains stable, we anticipate additional rate cuts from the central bank, which should ultimately result in positive GDP growth for 2017.

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

- We expect the global recovery to continue. Export data in Asia appears particularly strong and implies healthy regional growth. In many areas, the recovery remains in an early stage and is likely to accelerate in 2018. Commodity prices, while somewhat increased, haven't yet influenced broader measures of inflation. Some instances of wage pressure appear, as labor shortages continue to develop. The recovery will occur at varying rates, with countries such as Brazil and Russia lagging the developed world. We anticipate the economic recovery will continue as the withdrawal of monetary stimulus outside of the U.S. is replaced with fiscal stimulus.

Currencies and commodities

- In September, the U.S. dollar stabilized against the world's major currencies, following a six-month period of weakness. The preceding decline benefitted U.S. exports. Commodity prices have risen in reaction to accelerating growth around the world, but the pace of price increases remains moderate. We anticipate this trend to continue.

[1]Source: Deutsche Bundesbank
[2]Source: INSEE

Disclaimers