Tortoise
Credit Strategies

Portfolio strategy summary & outlook

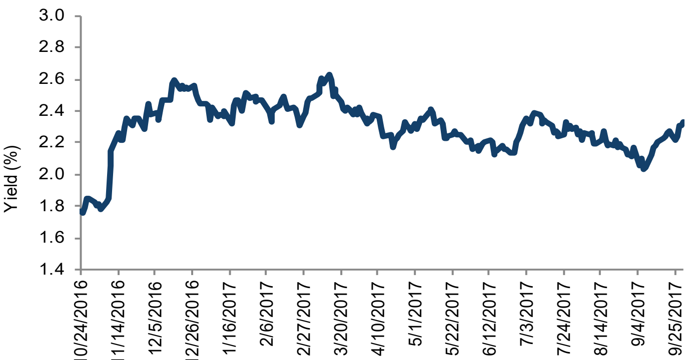
Third quarter 2017

U.S. interest rates

Summary

During the third quarter, interest rates took a wild ride to nowhere. U.S. Treasury 10-year note yields started the third quarter at 2.31% and closed the period virtually unchanged at 2.34%. That said, 10-year yields varied widely as they reached a low point in the quarter of 2.04% on September 7, 2017.

U.S. Treasury 10-year generic note



As of 9/29/2017. Source: Bloomberg

We attribute the initial drop in yields during the quarter to three factors. First, inflation measures came in below expectations. Second, uncertainty increased regarding President Trump's ability to advance fiscal policy initiatives, as a result of repeated failures by Republicans to roll back the Affordable Care Act. Third, saber rattling between the U.S. and North Korea triggered a flight to quality bid to the market. Subsequently, a firm core CPI print for the month of August and a coordinated effort by FOMC members to increase expectations of a December 2017 rate hike helped move yields back to 2.34% on September 29, 2017.

The yield curve shifted very little during the third quarter. Consequently, the 0.38% third quarter total return for the U.S. Treasury component of the Bloomberg Barclays U.S. Aggregate Bond Index (the Index) resulted primarily from coupon income.

Outlook

We anticipate that the U.S. Federal Reserve's withdrawal of monetary accommodation will move forward at a cautious pace. The Federal Reserve has maintained a consistently transparent attitude with investors regarding its effort to set monetary policy expectations. Therefore, we do not expect monetary policy moves in the coming quarters to significantly disrupt financial markets.

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We continue to favor positioning portfolios somewhat short of benchmarks on the expectation that interest rates will likely rise in the coming months. In addition, our view regarding Treasury Inflation Protected Securities (TIPS) has improved based upon our belief that investors have become too complacent regarding inflation expectations.

Securitized products

Summary

In the third quarter, the securitized products sectors posted strong performance as MBS, CMBS and ABS all outperformed U.S. Treasuries. The outperformance resulted from continued investor demand for yield and stable fundamentals. We recently increased our mortgage sector target allocation from 15% to 20%. Nevertheless, our target remains underweight versus the Index weight of 28%. Mortgage valuations remain rich, but appear to provide better relative value versus competing asset classes such as investment grade credit. We maintained our target allocation to CMBS and ABS at 3% and 10%, respectively.

Agency MBS: 20% versus 28% in the Index

Performance

- Mortgages performed well in the third quarter, and provided 47bps of excess return versus U.S. Treasuries, driven by stable interest rates, low refinancing risk and improved relative value.

Fundamentals: neutral

- The market appears well prepared for the beginning of the Federal Reserve's upcoming balance sheet normalization.
- While currently at record lows, we believe volatility could increase due to monetary policy uncertainty and as interest rates approach the higher end of the recent range.

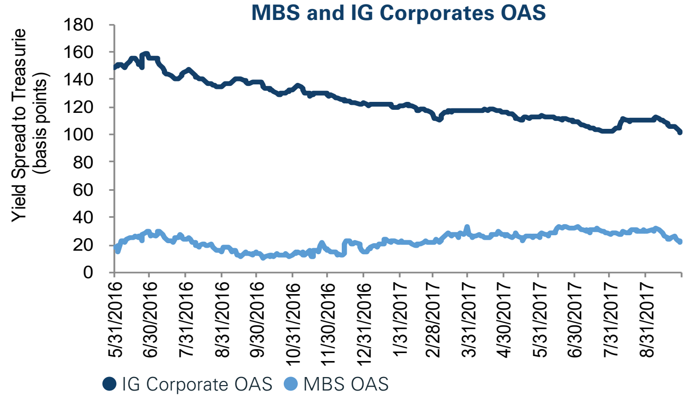
Technicals: neutral

- Supply and demand in the mortgage market appear well balanced.
- Year-to-date supply has been heavier than expected, but easily absorbed by strong demand from domestic banks and overseas investors.

Valuations: negative

- MBS valuations reside at the richest level in several years and, viewed in isolation, mortgages don't provide a compelling yield spread versus U.S. Treasuries. However, given the dramatic improvement in corporate yield spreads over the past year (see chart), we believe agency mortgage holdings provide portfolios with some relative positioning advantage.

Bloomberg Barclays U.S. Aggregate Bond Index – MBS and IG Corporates OAS



As of 9/29/2017. Source: Bloomberg

Outlook: negative

- We increased our target allocation based on better relative value versus investment grade credit, but remain underweight versus the Index.
- We focus on higher-coupon 30-year MBS, 20-year MBS and select non-agency RMBS.
- Federal Reserve balance sheet reductions could become more daunting by the first quarter of 2018, when the size of scheduled maturities approaches $12 billion per month.
- Refinancing risk appears muted, as only a small portion of homeowners seem poised to benefit from lower-rate loans.

CMBS: 3% allocation versus 2% in the Index

Performance

- CMBS produced strong performance, generating 34bps of excess returns versus U.S. Treasuries. Valuations are improving, helped by limited supply.

Fundamentals: neutral

- Overall, the fundamentals for commercial real estate remain favorable, but pockets of stress exist in some asset types and regions.
- Hurricane damage has not significantly impacted the broad market, but deal level analysis is critical.
- Retail properties remain under pressure from internet sales and store closings.

Technicals: neutral

- Limited supply and modest demand create an even balance in the market.

Valuations: negative

- Current valuation levels appear historically rich and leave little room for error.

Outlook: neutral

- We view CMBS less favorably, based mainly on rich valuations. Selective opportunities exist, but they require thorough bottom-up analysis.
- We favor subordinate, seasoned conduit securities and select single-asset subordinate tranches.

Asset-backed securities (ABS): 10% versus 1% in the Index

Performance

- ABS ranked as the top-performing securitized products sector in the third quarter, as it generated 56bps of excess return versus comparable U.S. Treasuries.

Fundamentals: positive

- The fundamentals for consumer finance remained favorable and supported by strong labor markets, rising consumer net worth and improved consumer balance sheets.
- We observed some weakness in subprime auto fundamentals, but acknowledge that agents design the structured investment vehicles to survive crisis level stress.

Technicals: positive

- Technicals remain positive with modest supply and strong demand for short-maturity, high-quality ABS.

Valuations: neutral

- Valuations appear fair on an historical basis and versus competing asset classes.

Outlook: positive

- We remain positive and overweight, as the sector should benefit from 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 moved our outlook on investment grade credit to a modest underweight, due primarily to rich valuations and moderating technicals, offset by improving top-line fundamentals. Valuations remain stretched and are nearing the past three cyclical tights dating back to 1997, adjusting for Index changes over time. Investment grade credit market technicals remain strong, supported by both domestic and foreign investors. However, foreign buying has slowed due to increased hedging costs and some compression in global yield differentials. Further, new issue supply remains high, and overall cross-asset-class supply is expected to materially increase in 2018 due to Federal Reserve quantitative easing (QE) tapering. Top-line fundamentals continue to improve alongside global economic growth and a stabilization in commodity prices, although credit metrics remain stretched. Additionally, pro-growth and pro-business policies supported by the Trump administration could extend the business cycle and add to the favorable fundamentals.

Performance

- The Bloomberg Barclays U.S. Credit Index (the Credit Index) returned 1.35% in the third quarter and 5.08% year-to-date.
- Excess return to similar-maturity Treasuries totaled 89bps in the third quarter and 2.41% year-to-date.
- The best-performing credit industries in the third quarter, on an excess return basis, comprised energy exploration & production, metals & mining, refining and sovereigns. The worst-performing industries during the quarter included cable & satellite, lodging, supermarkets and supranationals.

Fundamentals: improving

- As economic growth continues to improve and commodity headwinds become tailwinds, corporate revenues and EBITDA should continue to improve.
- Gross leverage remains high and interest coverage remains low, however, both are modestly improving as EBITDA growth outpaces debt growth. 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 Republican-majority 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, immigration restrictions and wage pressures could reduce profitability for some companies and industries.
- The timing and extent of fiscal and tax policy enhancements remain in question.

Technicals: remain strong, but signs of deceleration

- Accommodative European and Japanese central bank policy and low global yields continue to force foreign investors into U.S. dollar-denominated assets (crowding-in).
- Foreign investor hedging costs have increased while interest rate differentials among many developed countries versus the U.S. have modestly contracted.
- Investment grade credit mutual funds reported strong inflows totaling $191 billion year-to-date in 2017, versus $131 billion for all of 2016.
- Higher interest rates should attract increased domestic institutional buyers (insurance companies and pension funds).
- Gross new issuance declined 1.9% year-to-date versus the first three quarters of 2016, and could decline further for all of 2017 versus 2016.
- Favorable corporate tax reform, if enacted, and particularly changes to rules regarding foreign cash repatriation, could reduce new issue supply going forward.
- Increased hawkish central bank rhetoric and decelerating QE from both the U.S. Federal Reserve and the European Central Bank (ECB), due to improving global growth prospects, threaten the crowding-in demand that has driven positive technicals for non-government related securities.
- Analysts expect net investment grade supply (i.e., in this case defined as corporates, Treasuries and MBS supply, plus the effect of Federal Reserve tapering) to increase by $500 billion in 2018.

Valuation: rich

- Corporate spreads retraced more than 98% of spread widening between the summer of 2014 tights and the February 2016 wides. Spreads currently reside 114bps tighter than the 2016 wides, 2bps wide of the summer 2014 tights and 13bps wide of 2006 pre-crisis levels.
- When adjusting for the longer duration and lower credit rating of the Corporate Index (a subset of the Credit Index) today versus historically, corporate spreads reside within 10bps of the February 1997 cyclical spread tights, on top of the June 2014 tights and through the February 2007 tights.
- The Corporate Index effective yield of 3.16% remains attractive for many non-U.S. investors versus corporate yields in their home countries and currencies, although the gap is slowly narrowing.
- Credit Index spreads now reside 55bps tight of the 25-year average (roughly three quarters of a standard deviation rich); while BBB-rated issue spreads appear 76bps tight of the 25-year average (two thirds of a standard deviation rich).
- BB-rated credit spreads measure more than one standard deviation rich to BBB-rated credit over a two-year and ten-year basis, while BBB-rated credit resides 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, improved global growth, less exposure to shareholder activism and decent relative valuation make banking attractive.
- Higher interest rates, foreign cash repatriation, less exposure to shareholder activism and potentially reduced regulation should be positive for life insurance.

Industrials: neutral

- Shareholder activism, M&A risk and political risk remain prevalent. We see improvement within various commodity-related industries.
- 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 companies stand to benefit from a large fiscal stimulus infrastructure package and post-hurricane rebuilding.
- Telecommunications and cable companies remain challenged by technological change, fierce price competition and high debt levels.

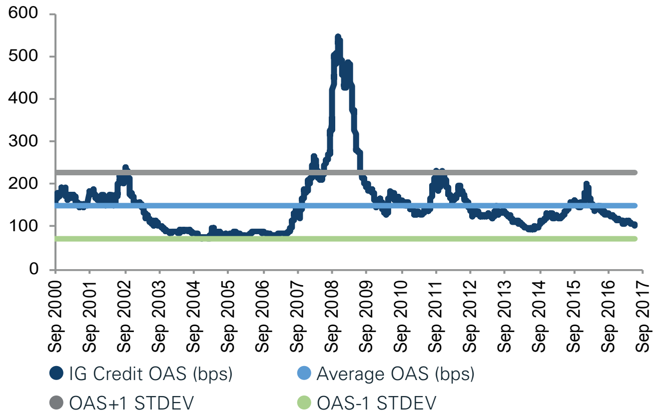
Outlook

We expect investment grade credit to offer modest performance (excess return) in the near term, driven primarily by coupon carry and issuer and industry selection, as strong, yet decelerating technicals and improving fundamentals offset stretched valuations. Looking forward, our largest sources of concern remain overly hawkish central bank policies, a deceleration in global QE (including tapering by the Federal Reserve), gridlock in Washington, D.C., geopolitical risk, and a slowdown in global growth. As such, we advocate a modest underweight target allocation to investment grade credit and a shift toward higher quality and less cyclical industries as a precursor to a reversal in credit sentiment.

Overweight: Airline Enhanced Equipment Trust Certificates (EETCs), banks, building materials, healthcare, insurance, pipelines, REITs, technology, post-event risk issuers

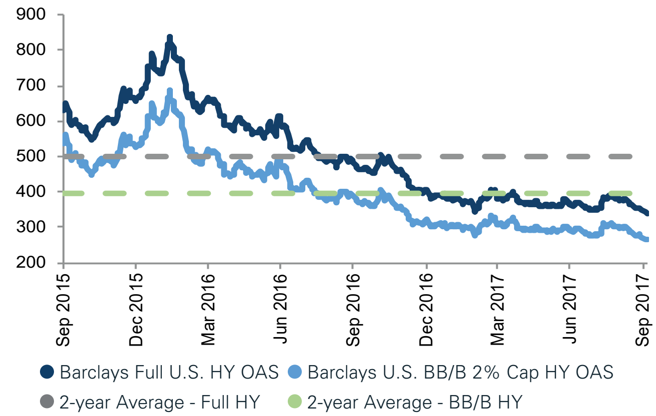
Underweight: Autos, consumer products, diversified manufacturing, pharmaceuticals, railroads, restaurants & retailers, sovereigns, utilities

Investment grade credit spreads



As of 9/29/2017. Source: Bloomberg

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



As of 9/30/2017. Source: Barclays

High yield

Summary

The U.S. high yield market posted a solid 2.0% total return in the third quarter, bringing year-to-date gains to 7%, as measured by the Bloomberg Barclays U.S. High Yield Index (the High Yield Index). With oil prices rallying over 10% during the quarter, the high yield energy sector posted a nearly 5% gain, partially erasing otherwise lackluster performance this year for the high yield market's largest industry by market weight. Corporate credit fundamentals remain supportive, with both earnings and leverage improvements continuing in the third quarter. While credit fundamentals remain on an improving path, the credit cycle feels extended to us as well as many investors.

The U.S. high yield market posted solid 2.0% total return in the third quarter of 2017, bringing year-to-date gains to 7%.

Performance

- The High Yield Index return was the third 2% plus quarterly gain this year. High yield spreads continued their march lower in the quarter, tightening 17bps to 347bps; year-to-date tightening now totals 62bps. Overall spreads now reside just 3bps wide of the multi-year low reached in mid-March 2017. During the third quarter of 2017, CCCs posted a 2.5% total return and ranked as the best-performing quality class, followed by BBs and Bs which returned 2.0% and 1.7%, respectively.
- Top-performing industries during the third quarter included energy and transportation, while supermarkets and wireline telecom were the notable underperformers and the only sectors to post negative returns.

Fundamentals: positive

- The high yield default rate continued to decline in the third quarter, falling another 43bps to 1.07%; only $2.7 billion of securities defaulted in the period, the lowest amount since 4Q13. Year-to-date default activity of $10.3 billion remains low and down substantially from $46.2 billion in the same period of 2016. On a year-to-date basis, the upgrade-to-downgrade ratio totaled 1.29:1 (dollar-volume basis), indicating an improving credit quality trend.
- Aggregate high yield issuer credit metrics exhibited incremental improvement based on earnings for the second quarter (i.e., the latest quarterly period for which results are available). EBITDA jumped 11% year-over-year, led by a recovery in the commodities sectors (5.5% ex-commodities), while leverage (i.e., total debt-to-EBITDA) declined for the fourth consecutive quarter to 4.38x (versus a post-crisis high of 4.57x in the second quarter of 2016).

Technicals: neutral

- High yield retail funds continued to experience outflows in the third quarter, although the pace slowed from earlier in the year. Investors withdrew $585 million in the quarter, down from $2.3 billion and $8.2 billion in the second and first quarters, respectively. Year-to-date outflows now total $11.1 billion and compare with a $10.2 billion inflow experienced during the same period last year.
- Despite a slowdown at the end of the summer, new issuance picked up in the third quarter of 2017, as issuers responded to a high yield market eager to put cash to work. New deal volume totaled nearly $80 billion in the third quarter, up from $77 billion in the second quarter and, on a year-to-date basis, new issuance increased 9% year-over-year to $255.6 billion. Refinancings continue to represent a majority of the deal flow (i.e., 62% in the current year-to-date period, versus 58% last year).

Valuation: negative

- High yield spreads continued to grind tighter during the third quarter, and slowed only temporarily by macro risk-off headlines in early August. The High Yield Index yield-to-worst tightened 17bps during the quarter (all spread tightening) to 5.45%, down from 5.62% and 6.12% at the end of June 2017 and December 2016, respectively. Yields reached a recent low of 5.36% on August 1, 2017, the lowest level since September 2014.
- We continue to view valuations as stretched in a historical context. At 341bps (High Yield Index as of October 6, 2017), spreads reside well below long-term averages and just 18bps above the post-crisis low. Furthermore, when compared to other credit sectors – namely investment grade and leveraged loans – high yield spreads appear tight relative to long-term historical relationships.

Outlook

High yield bonds offer the most attractive yield of all major world-wide fixed income asset classes. However, yields are compressed and appear to fully reflect a benign economic and fundamental backdrop. The market seems 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 Bs over BBs and remain in favor of rotating into floating rate loans where possible.

Overweight: Airlines, banking, chemicals, homebuilding/building products, media-cable, metals & mining, pipelines

Underweight: Aerospace & defense, retailers & restaurants, pharmaceuticals, technology, telecom

Leveraged loans

Summary

Leveraged loans posted its best return of the year in the third quarter, as repricing activity finally slowed from a torrid pace in the first half of the year. Loan prices ended the quarter modestly higher, as a more robust than expected CLO market offset retail fund outflows. Loan valuations still appear relatively attractive on a historical basis versus the high yield market, and additional Federal Reserve rate hikes could increase demand for floating rate investments.

Leveraged loans posted its best return of the year in the third quarter of 2017.

Performance

- The Credit Suisse Institutional Leveraged Loan Index (CSILLI) returned 1.12% for the third quarter, the largest quarterly gain thus far in 2017, as average loan prices gained 14bps to close the period at $99.64. Although repricing activity slowed during the quarter, returns remain constrained by the still limited quantity of loans trading above par (currently, approximately 66% of the market, up from approximately 50% at the end of June 2017).
- Lower-quality loans, which tend to be less call-constrained, continued to outperform during the third quarter of 2017, as CCCs, Bs and BBs returned 1.6%, 1.2%, and 1.1%, respectively. The energy sector led gainers, while consumer durables, retail, food & drug and telecommunications all lagged with negative returns for the quarter.

Leveraged loan spreads

As of 9/30/2017. Source: Credit Suisse

Fundamentals: positive

- The leveraged loan default rate declined a modest 11bps to 1.31% in the third quarter, slightly above the four-year low of 1.27% reached in March 2017. As of September 30, 2017, the distressed ratio (loans trading below $80) stood at 3.57%, up somewhat from 3.30% at the end of the second quarter of 2017.
- Loan issuer credit metrics held steady in the second quarter of 2017 (the latest earnings data currently available). According to Morgan Stanley, average total leverage remained at 4.56x, modestly below the cyclical peak of 4.89x reached in the first quarter of 2016. A potential concern going forward is the continued increase of leverage on new loan transactions, which exceeded 4.0x in the second quarter of 2017, up from 3.8x in the first quarter of 2017 and 3.9x in 2016.

Technicals: neutral

- During the third quarter, retail leveraged loan funds experienced their first outflows in over a year, as investors appear convinced that higher rates are not a risk, despite the Federal Reserve's forward dot plot showing multiple hikes for 2018. Following inflows totaling $17.5 billion in the first half of 2017, mutual funds experienced outflows of $251 million in the third quarter. Offsetting the retail outflows, new CLO issuance remained healthy during the third quarter at just over $30 billion, bringing year-to-date deal flow to $82.5 billion (versus $73.3 billion in 2016).
- Slowing loan repricing activity led to diminished new issue volumes in the loan market during the third quarter. Loan issuance volume totaled $155 billion in the third quarter of 2017, down from $246 billion in the second quarter and $331 billion (the highest quarterly total on record) in the first quarter. Year-to-date issuance of $723 billion already ranks as the highest annual total on record, beating the prior record ($670 billion in 2013)

by a significant margin with a full quarter still to go. Together, repricings and refinancings represented approximately 64% of third quarter new issue volume, down from 75% in the first half of 2017.

Valuation: negative

- The average yield, assuming a three-year par takeout (i.e., the three-year discount margin), for the CSILLI declined 2bps to 5.60% in the third quarter of 2017, as rising LIBOR continues to partially offset tighter spreads (driven in part by repricings). At the end of September 2017, the average CSILLI three-year discount margin reached 376bps, just shy of July's 369bps (the tightest level post-crisis and the lowest since October 2007). Three-month LIBOR, the benchmark rate from which loan coupons are calculated, rose another 3bps during the quarter and 33bps YTD to 1.33%, comfortably above the common 1.00% "floor" used in calculating most loan rates.
- With continued spread tightening in the high yield market, the relative value of loans versus high yield bonds has improved markedly. At the end of the third quarter of 2017, the average high yield spread was just 26bps wide of the comparable loan spread (as represented by the Credit Suisse High Yield Index versus the CSILLI). This difference contracted from 80bps at year-end 2016, and is well inside the ten-year average of 164bps. 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 nearly two-thirds 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, which we expect. Although retail flows have reversed from the strong trend earlier in the year, CLO demand remains steady. Furthermore, relative to the high yield market, loan valuations remain attractive and we continue to look to rotate into floating rate loans where possible.

Overweight: : Chemicals, consumer products, media & telecommunications

Underweight: Food & beverage, retail & restaurants

Non-dollar

Our view regarding non-dollar strategies remains mostly unchanged in the past quarter. Developed-market sovereign bonds continue to provide limited value compared to U.S. Treasuries, due to very low yields outside of the U.S.

Opportunity also remains in some emerging markets, as a trend of global growth and commodity price recovery continues. However, these markets offer limited yield opportunities.

We believe that U.S. rates will move higher as the Trump administration's policies take effect. As that occurs, select foreign-hedged yields could offer a haven from a rising U.S. Treasury yield curve.

Benchmark performance as of 9/30/2017

Total return	YTD
Bloomberg Barclays U.S. Aggregate	3.14%
Bloomberg Barclays U.S. Treasury	2.26%
Bloomberg Barclays U.S. TIPS	1.72%
Bloomberg Barclays U.S. Credit	5.08%
Bloomberg Barclays U.S. ABS	1.56%
Bloomberg Barclays U.S. MBS	2.32%
Bloomberg Barclays U.S. CMBS	2.99%
Bloomberg Barclays U.S. Corporate High Yield Index	7.00%
Citigroup BB/B ex-split B/CCC Index	6.03%
Credit Suisse Institutional Leveraged Loan Index	3.03%
Citigroup Non-USD World Government Bond (50% hedged)	4.74%
Yield	**Sept. 30**
U.S. 10-Year Treasury yield	2.34%

Disclaimers