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Tortoise QuickTake Podcast

July 7, 2017

Welcome to the Tortoise QuickTake podcast. Thank you for joining us. Today, a senior member of Tortoise provides a timely update on trending topics in the market.

Good morning and welcome to the Tortoise Credit Podcast for 7th July 2017. I'm Graham Allen, Senior Portfolio Manager for Tortoise Credit in Los Angeles.

This morning we're going to discuss the recent rise in interest rates around the world, and explore some of the reasons why the fixed income markets have recently appeared to have changed their tone.

On or around June 26th 2017, 10-year sovereign bond yields began rising. Since that time we've seen an almost 30 basis point increase in the German 10-year Bund yield, A 6 basis point increase in the Japanese 10-year bond yield and a 24 basis point increase in the U.S. 10-year Treasury yield. In addition to that in Europe we have also seen short term rates rise at quite a significant rate, for example the 5- year German Bund has risen by 50 basis points since its 2017 low, twisting the yield curve, and moving it back towards a positive yield. The 5-year Bund presently only has a negative yield of approximately -7 basis points, a yield not seen since the beginning of 2016.

As German yields rise, most European government bond yields are also pressured higher. As a result of this, increasingly fewer European bonds will have negative yields. For example, at its lowest point, the first ten years of maturities of the German yield curve had a negative return; now only the first 6 years of the curve has a negative yield.

So let's review why interest rates may be rising and also whether this represents a secular change in direction for interest rates generally.

Probably the most identifiable reason for a shift in sentiment has been a change of tone by both the U.S. and European central banks, as laid out in recent meeting minutes by both institutions. It's been no secret that since 2008 the use of monetary stimulus has been the preferred form of financial policy stimulus enacted by Western governments. One of the reasons for this was the lack of fiscal flexibility caused by high government debt levels after the Great Recession of 2008.

Quantitative easing programs by the Bank of Japan, the European Central Bank and the Federal Reserve have all been mainstays of monetary policy for the past nine years. These programs have injected enormous levels of liquidity into many of the ailing Western economies after the Great Recession. Now that the global economic recovery continues to accelerate, many of the central banks are openly discussing ways to end these programs, and in some cases are increasingly uncomfortable with negative yields and direct purchases of sovereign bonds. The preference of central bankers now is to return interest rates to more normalized levels and to ultimately replace monetary stimulus with more conventional forms of fiscal stimulus. Importantly however, the impetus behind implementing any fiscal stimulus lies with politicians and not with bankers, and with the end of the quantitative easing, markets are expecting fiscal stimulus to replace the monetary stimulus to support the global recovery.

Indeed, fiscal stimulus has already occurred in significant quantities in countries such as Japan and China, but effectively remain in the pipeline in the U.S. and Europe. Of course, in the case of the U.S., specific fiscal stimulus is contingent upon the passage of the Trump administration's economic proposals through Congress. In Europe the expectation is that more fiscal stimulus will be introduced as overall debt-to-GDP levels fall and the European Union eases some of the deficit restrictions which have heretofore hampered governments' abilities to enact fiscal stimulus. Even the European commission realizes this and advocates for less austerity.

Recent statements from The Federal Reserve and the European Central Bank now seem to indicate that these programs have run their course and will come to an end. Central to those programs have been significant bond-buying programs by the central banks, so the expectation is that absent these purchases, interest rates may rise. Direct buying of government bonds is more prevalent in Europe. For a quantifiable effect of this buying, one need look no further than the interest rate differential between the U.S. 10-year Treasury bond and the 10-year German Bund which presently stands at roughly 180 basis points. This differential is not justified when U.S. growth expectations, inflation expectations and debt levels are not that different to Germany's. The implication therefore is that without ECB purchases, European yields will move significantly higher.

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Against this backdrop of anticipated policy change, there has been a groundswell of positive economic data around the world. This has comprised both soft and hard data. Business confidence surveys in Japan, China, Europe and the USA have been very strong. Examples of this would be the Japanese tankan survey which was surprisingly positive. This bodes well for the continuation of the global economic expansion.

Commodity prices have also rebounded from recent lows. Both iron ore and copper prices have recovered from recent weakness. Interestingly, there seems to be a very high correlation between the U.S. 10-year yield and copper prices going back for the past 15 months. Because copper is used in so many manufacturing processes it is seen as a good proxy for global economic expansion in general. If copper prices continued to rise the inference is that 10-year yield could follow.

When it comes to actual economic data there has also been generally positive reports. Growth in Europe and Japan is clearly accelerating, which is surprising in Japan given its demographic challenges. In China the concern is that the economy may be growing too fast once again, which is why short term rates there have also risen as Chinese authorities try and temper the growth rate. In contrast, the U.S. has experienced a general downgrade of expectations, with 2Q 2017 GDP growth likely to be in the 2 to 2.5% range.

So to conclude, a change in tone of policy from the major central banks, coupled with a generally positive economic environment, maybe the reason why bond markets are beginning to anticipate a higher interest rate environment. It is still early days but there does seem to be a hyper sensitivity to any news that could pressure future inflation, which for the moment remains subdued. It's too early to say if there are tectonic plates moving in the bond markets, but we are beginning to feel some tremors.

Thank you for listening. We hope you have found this podcast useful.

Thank you for joining us. And stay tuned for our next cast. Have topics you want covered or other feedback to share? Write us at info@tortoiseinvest.com.

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