PGIM India Mutual Fund

WEEKLY VIEW FROM PGIM FIXED INCOME DESK

The Base, Bull, and Bear Paths for the EA, China, and the Globe

April 19, 2021

MACRO

- Given the rate at which economic conditions are evolving, we recently rechecked the pulse of growth in Europe, China, and the global economy. Our base case for global growth sees an expansion of 6.3% in 2021, while the "Bull" path results in growth of 7.5% and the "Bear" path culminates in growth of 5.4% this year. Importantly, the scenarios eclipse the Q4 2019 level in each quarter of 2021. In 2022, our base case for global growth moderates to 4.1%.
- China has led the global economy out of the COVID-induced slump, and we anticipate growth of 9.0% in 2021, which is above the IMF's 8.4% estimate and below J.P. Morgan's projection of 9.5%. Our "Bull" path for China is 9.7% and our "Bear" path is 8.0% in 2021. However, our base case for the pace of growth is then nearly halved in 2022 to 4.7% with a "Bull" path of 5.8% and a "Bear" path of 3.5%.
- With vaccine deployment accelerating in the euro area, we believe the growth in the region continued to contract by -0.3% in Q1, which aligns with the strongest sell-side estimates. However, we believe there may be some upside risk to that forecast based on high-frequency indicators, such as purchasing manager indices and industrial production. Our base case for the euro area calls for growth of 5.4% in 2021 and 3.5% in 2022.
- We believe the ECB will continue to provide broad monetary support—coupled with advocacy for additional fiscal support—as the euro area economy recovers. Indeed, Executive Board member Fabio Panetta recently stated that "a truly prudent policy approach calls for leaning towards injecting too much stimulus rather than too little." While we believe the ECB will maintain its policy rates at this week's meeting, there may be an outside chance that it adjusts the Pandemic Emergency Purchase Programme to provide another impulse given the Programme's scheduled expiration in March 2022.
- In terms of what may drive the next gains across the broad fixed income complex, we're viewing the rotation from credit to duration from the perspective of margin for error. For example, with U.S. investment grade spreads ending at 89 bps last week, we believe there could be 5-15 bps from rolling down the spread curve. Conversely, a significant gap remains between forward and spot interest rates. For example, a 5-year 5-year interest-rate swap has risen from 75 bps late last year to 225 bps and has remained about 135 bps over a 5-year interest rate swap, which has risen from 30 bps to 90 bps over the same timeframe.

RATES

- While the rally in the 10-year U.S. Treasury note may have benefitted from some short covering last week, it's also notable that yields dropped amid an influx of supply and the report indicating a 9.8% surge in retail sales in March. Although we continue to see lower U.S. rates by the end of the year, the most tangible hurdle may be how rates react to the Fed's tapering process, rather than their reaction to an upside surprise in long-term inflation or growth.
- That being said, the Fed has continued to push back on speculation about potential QE tapering, but we believe it's messaging process—including at next week's meeting—will become increasingly challenging going forward. We continue to believe that the Fed may be on a trajectory to commence tapering by the end of the year.
- From a tactical perspective, we're maintaining long positioning at the 20-year portion of the curve vs. short positioning in long-futures contracts and the nominal long bond. We're also long 10-year futures vs. 2-year and 10-year nominal notes.
- U.S. mortgage spreads continued to drift along the rich end of the recent range amid outright buying and lighter-than-expected origination. The market-cap weighted Treasury OAS closed last week at 4 bps (-3), while the LIBOR OAS closed at 6 (+2). MBS MTD excess returns in April ended the week at +6 bps, holding in well despite the nearly 15 bps rally in rates. Activity has been centered predominantly around 30-year 2s and 2.5s as originators continue to focus on selling 2.5 and 2.0 issues while relative value players add. Convexity accounts have adding back previously sold duration. Domestic bank demand has been strong, focused on 30-year 2.5% and 2.0% issues.

CORPORATES

- Although U.S. IG spreads experienced some orderly widening spurred by a deluge of money center bank supply, the index OAS ended the week unchanged at 89 bps. Sector performance was led by energy and utilities while banks, telecom, and technology lagged. We'd note that COVID-sensitive sectors have also held up well.
- Last week's issuance of about $50B exceeded expectations on a surge in financial supply. In terms of sizing, JPMorgan priced the largest bank deal ever, at $13B, on Thursday (which we regard as being driven by regulatory requirements), only to be topped by Bank of America's $15B deal on Friday (which we regard as being driven by a desire to expand its capital markets footprint). Goldman also priced a $6B offering and Morgan Stanley was in the market on Monday with a $6-$7B deal. Deals priced at sizeable concessions (of around 50 bps), which we viewed as an opportunity to tactically increase our allocations to money center banks. We're considering the likelihood that concessions of this size continue or decline closer to the 30 bps range.
- A bulk of the market is due to release earnings over the next two weeks, and a meaningful pickup in new issue supply will likely follow. While we generally view U.S. IG technicals as favorable, it's possible that the uptick in primary supply could cause some indigestion, particularly as investors compare money center bank valuations to absolute level of industrial spreads.
- European IG spreads tightened by 1 bp, but the trading tone was divergent across sectors. For example, tobacco credits remain in ample supply while rebounding COVID-sensitive sectors (i.e., airlines, hotels) and high-beta sectors remain in very strong demand. Primary market activity was limited, totaling only €2.6B. Issuance is expected to remain light this week. In anticipation of last week's supply surge, we tactically reduced our reverse-yankee bank exposure in order to make room for the impending supply of U.S. money center bank paper, where permitted.

EMERGING MARKETS DEBT

- Emerging market hard and local currency assets posted positive returns last week, while EM currencies had their best week for the year as lower Treasury yields and relief over the severity of U.S. sanctions on Russia supported risk appetite. EM hard currency returned +1.44%, EM corporates returned +0.25%, hedged local rates returned +0.39%, and EMFX returned +0.80%. EM hard currency spreads tightened -10 bps to 339 bps, with the high yield portion of the index tightening -25 bps to 580 bps.
- Emerging market bond fund flows were again positive, totaling +$1.55B. Hard currency funds saw inflows of $1.04B, local currency funds saw inflows of $430M, and blend funds saw an inflow of $75M. This brings year-to-date total flows into EM bond funds to $21.25B, with hard currency, local currency, and blend strategies accounting for $7.42B, $9.01B, and $4.77B, respectively. EM equity funds saw $5.06B of inflows last week.

- In hard currency sovereigns, high yield outperformance was led by the single-B sector. Nigeria and Angola tightened on the back of higher oil prices. Ecuador bonds continued to rally after a more market-friendly candidate won the presidential election two weekends ago. Underperformers last week were Lebanon, Suriname, Romania, India, and Slovakia. We remain constructive on hard currency sovereigns, but remain mindful that U.S. rate uncertainty may result in volatility over the short term.
- EM corporates lagged last week as China Huarong Asset Management's bonds declined after unexpectedly missing a deadline to release its 2020 financial results. The bonds subsequently reversed some of their declines after the banking regulator said the manager had ample liquidity.
- In EM local rates, the benchmark index yield tracked Treasuries, declining 6 bps to 4.85%. Higher beta markets performed well, driven largely by the lower U.S. dollar. High yielding names such as South Africa, Turkey, and Brazil, tightened by as much as 25-40 bps, while Russia outperformed as new U.S. sanctions are expected to have minimal impact on markets.
- In EMFX, cyclical and commodity currencies outperformed as a decline in U.S. real yields boosted performance. Our base case has been for the U.S. dollar to weaken in Q2 as growth in the rest of the world begins to converge with U.S. growth, and it appears that narrative is beginning to gain traction.

HIGH YIELD

- U.S. high yield returned +0.23% last week as flows remained positive and the rally in Treasuries provided a boost to the market. Spreads tightened by 2 bps to +322 bps. Month to date, high yield has now returned +0.95%.
- By quality, BBs outperformed, with spreads tightening by 3 bps to 231 bps. Meanwhile, Bs widened by 2 bps to 357 bps and CCCs were unchanged at 638 bps. Month to date, BBs have returned +1.08%. By comparison, Bs and CCCs have returned +0.81% and +0.78%, respectively. This reverses the trend of recent CCC outperformance during which CCCs have outperformed in seven of the past eight months.
- By industry, energy, utilities, and airlines were notable outperformers last week on the back of stronger commodities and a better rate backdrop. Telecom, healthcare, and aerospace were the only high yield sectors in negative territory, albeit only modestly.
- U.S. high yield mutual funds reported a fourth consecutive weekly inflow. At $601M, last week's inflow trims year-to-date outflows to $6.0B. For context, net inflows totaled $45B in 2020. Primary activity remained busy with $12B in issuance, which brings month-to-date primary issuance to $33.3B. The calendar was led by the $4B United Airlines secured deal, which was part of a $9B package to refinance existing debt and bolster liquidity. Demand for the UAL deal was robust as the issuer priced a five-year and eight-year tranche 75 bps tight of initial talk at 4.375% and 4.635%, respectively, both of which traded up 3.5 points on the break.
- U.S. leveraged loans returned +0.05% last week as the market focused primarily on the heavy new issue calendar. As part of its financing package, United Airlines issued an upsized $5B term loan priced at LIBOR+375 with a 0.75% LIBOR floor and a 99.5 OID. Similar to the concurrent bond offering, demand for UAL's term loan was strong, which allowed the issuer to upsize the facility by $1.5B and flex pricing down during syndication.
- U.S. loan mutual funds posted another $1B inflow last week, which brings year-to-date inflows to nearly $12B. The streak of 14 consecutive weekly inflows ranks among the strongest starts to a year on record.
- In Europe, high yield bonds returned +0.16%. By quality, BBs, Bs, and CCCs returned +0.12%, +0.15%, and +0.62%, respectively. Spreads tightened by -9 bps to 302 bps as the market is trading inside the pre-COVID February 2020 level and is now back to 2018 levels. Primary activity was again busy, with €4B of issuance across six deals. Loans returned +0.11% last week, which brings the YTD return to +2.06%. In the loan market, UPC repriced its U.S. and euro tranches, lowering the discount margin by 50 bps.

SECURITIZED PRODUCTS

- U.S. conduit AAA CMBS spreads were unchanged last week. Although new issues priced slightly wider than initial talk, secondary demand remained strong. Two conduit deal announcements are expected this week. The commercial real estate refinance market continues to reopen and now includes some high-quality hotel and retail properties. Supply is expected to increase throughout the year as vaccine rollouts continue. We expect COVID to continue to weigh on CRE fundamentals in the hospitality, retail, and office sectors, and we remain constructive on senior, well-enhanced tranches.
- Primary CLO spreads were flat to slightly firmer at the top of the capital structure with junior mezzanine tranches generally unchanged. While we continue to see large anchor investors looking to source bonds, supply continues to negatively impact spreads and limit compression. We continue to expect robust issuance volumes as we are currently being marketed over 170 deals across the U.S. and Europe. U.S. CLO primary spreads for higher quality portfolios ended the week at about ~3mL+113/170/225/335/690 bps for AAA/AA/A/BBB/BB, respectively. Long term, we continue to favor senior CLO tranches and remain cautious about legacy junior mezzanine tranches.
- ABS spreads were unchanged to tighter last week as $7B in new issuance was well absorbed. This year's issuance now totals $72B, which is on pace with 2019's pace of $74B through mid-April. Secondary spread clearing has met some resistance, but continues to clear around year-to-date tights. We expect ABS spreads to remain well supported due to our expectation for flat/negative net new issuance in 2021.

MUNICIPAL BONDS

- Tax-exempt municipal bonds benefited from strong demand coupled with manageable supply last week. The 5 , 10-, and 30-year portions of the AAA-rated muni curve ended the week at 43.3% (down from 54.3% the prior week), 58.7% (down from 62.0%), and 68.3% (down from 70.3%). Year to date, the high grade index has returned +0.58%, and the high yield index has returned +3.61%.
- Municipal bond funds saw net inflows of $2.3B last week, which brings year-to-date inflows to $38B. Year-to-date gross supply now totals $133B, including $41B of taxable issuance. This week's calendar is estimated at $11B, including $2B in taxable muni issuance.
- Puerto Rico's Financial Oversight and Management Board reached a tentative agreement with bond insurers Assured Guaranty and National Public Finance Guarantee Corp. over how to restructure highway and convention center debt. This would strengthen a separate agreement to restructure $18.8B in PR GO and PBA debt as the bond insurers' participation in that agreement relies on the resolution of highway and convention center debt.

Source(s) of data (unless otherwise noted): PGIM Fixed Income as of April 2021

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