

# WEEKLY VIEW FROM THE DESK

## Inflation Forecasts in Focus with Central Banks Lined Up

March 15, 2021

### MACRO

- Given the more gradual pace of vaccine rollouts in Europe, combined with some pauses in the AstraZeneca/Oxford vaccine introduction, the ECB assumes more stringent containment efforts through the first half of 2021, thus more forecasters are seeing broadly similar growth in 2021 and 2022. For our part, we see real GDP growth of 5.1% this year and a moderation to 3.5% in 2022. Europe is also expected to see an inflation "mirage" in 2021 as higher oil prices may lift headline inflation to the cusp of the ECB's target of below, but close to, 2% before a precipitous decline by the end of the year towards 1.0%. Therefore, euro area inflation will likely remain well below the ECB's target into 2023.
- While real U.S. GDP growth is set to lead the developed market economies in 2021 (6.4% vs. the DM average of 5.4%), a significant question looms as to how much momentum the economy will carry into 2022. For example, a survey of sell side real GDP forecasts estimates that U.S. growth will peak in Q2 2021 at 9.6% amid the base effects from the spring of 2020 before sequentially declining thereafter to an average of 1.7% by Q4 2022, which would be more consistent with the pre-virus growth pace.
- Similarly, the U.S. inflation picture continues to evolve as well. It's possible that monthly core PCE inflation could exceed 0.20% as the year progresses, which could place the 12-month reading in a range of 2.25-2.40% as the year concludes. However, we see the monthly pace then subsiding to 0.15%, which would bring the 12-month rate back down towards the 1.80% level in early 2022.
- One of the key items from this week's Fed decision will be the summary of economic projections. In all likelihood, the GDP and inflation forecasts from some of the participants will shift higher, which could complicate the consistency of Chair Powell's messaging during the press conference. In particular, the Fed previously stated that it aims for inflation moderately above 2% for "some time" under its flexible average inflation targeting regime, and reconciling higher inflation forecasts with the heretofore dovish rhetoric and the vagueness of the time horizon could become an increasingly challenging message to convey.

### RATES

- In general, we don't believe expectations for solid growth and optimism regarding long-term DM rates is mutually exclusive. For one comparison, we look at 2011 when the 10-year U.S. inflation breakeven rate jumped from zero to more than 2.0%, which marked the start of a decline in the 10-year nominal yield from 4.0% in early 2010 to about 1.50% by mid-2012. Even after that point, the 10-year breakeven spent a fair amount of time above 2.0%, yet the 10-year nominal yield never returned to the highs of 2010. Hence, our constructive view on long-term U.S. rates isn't necessarily based on deteriorating growth, rather it's based on inflation that consistently fails to meet the Fed's targets.
- The Fed's looming decision on whether it will extend the exclusion of Treasuries from the largest banks' supplemental leverage ratio (SLR) could lead to some short-term volatility in the market. A scenario without an extension or similar carveout could affect market liquidity, particularly given the Treasury's significant issuance needs. Some market movements may already be materializing as last week saw a \$64B decline in primary dealers' weekly positions, which was the largest decline since 2000.
- In terms of tactical positioning, we're short 5-year U.S. real rates and 10-year UK real rates amid a general over estimation on the inflation front, and we remain constructive on the long end of the U.S. nominal curve, which historically tends to peak once monetary policy exceeds its most accommodative stance.
- Demand technicals continue to help the U.S. MBS sector. The market-cap weighted Treasury OAS tightened to 3 bps (-2 bps) while the LIBOR OAS widened to 7 bps (+1). MBS excess returns remained flat at +26 bps March month-to-date. The dollar price of the benchmark MBS Index fell to \$105-03 and the Blackrock duration was now 4.6 years.

### CORPORATES

- Although the market showed some late-week stability, U.S. IG spreads ended the week wider by 2 bps to 98 bps as the continued backup in Treasury rates and robust issuance weighed on sentiment. The front-end of the U.S. IG curve underperformed, widening 5-7 bps amid increasing selling pressure as investors funded purchases in longer portions of the U.S. IG curve.
- Issuance exceeded expectations, totaling \$55B, and brings the month-to-date new issue supply total to \$120B (vs. initial forecasts of \$150B for the full month of March). Primary market activity was led by Verizon's highly anticipated, seven-tranche offering which, will be used to help [fund its purchases of 5G spectrum](#). The \$25B deal initially received almost \$120B of orders, with final order books of about \$100B after initial pricing was tightened.
- Deals earlier in the week struggled and priced with average concessions of 5-10 bps, suggesting that investors were waiting for the Verizon deal to come before participating in the primary market. The issuance pace is expected to normalize this week, with dealers calling for \$25-35B of supply, which supports our constructive short-term outlook.
- Despite some general heaviness to the European IG market, spreads ended the week unchanged at 89 bps. Primary market activity slowed last week with just €7B of supply, less than half the volume seen during the prior week. Issuance is expected to pickup over the next couple of weeks, which could bring the return of more meaningful new issue concessions. We'd note that primary market activity got off to a fast start on Monday.

### EMERGING MARKETS DEBT

- Emerging market hard currency assets posted modestly negative returns last week, while spreads tightened. EM hard currency returned -0.04%, EM corporates returned -0.33%, hedged local rates returned -0.28%, and EMFX returned +0.38%. EM hard currency spreads tightened by -6 bps to +356 bps, with the investment grade portion of the index tightening -7 bps to +153 bps and the high yield portion tightening by -6 bps to +609 bps.
- Emerging market bond fund flows were negative over the past week, totaling -\$3.15B. Hard currency funds saw outflows of \$2.4B, local currency funds saw outflows of \$799M, and blend funds saw an inflow of \$41M. This brings year-to-date total flows into EM bond funds to \$17.25B, with hard currency, local currency, and blend strategies accounting for \$4.76B, \$8.60B, and \$3.90B, respectively. Notably, EM equity funds continued to see strong inflows, totaling \$9.69B last week, as underlying global growth dynamics remain strong.
- Despite the rate selloff, hard currency sovereign spreads are only 4 bps wider year-to-date as performance on a country-by-country basis remains highly idiosyncratic. The top performers last week were Ecuador, Dominican Republic, Sri Lanka, Senegal, and Ukraine; while the underperformers were

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Argentina, Lebanon, Zambia, Honduras, and Paraguay. Despite higher-than-expected crop yields and a rally in agricultural prices, Argentina bonds were weaker as President Alberto Fernandez signaled his willingness to delay reaching a deal with the International Monetary Fund until after the mid-term elections.

- Within local rates, the index yield rose 6 bps last week to 4.87% and is now 66 bps higher for the year. EM local rates continue to trade in line with U.S. 10-year Treasuries with some additional selloff in countries, such as Brazil and Turkey, where inflation has surprised to the upside and central banks are expected to raise rates. With the exception of China, which last week released higher-than-expected credit growth, outflows from local bond markets have accelerated.
- EMFX rebounded last week, with cyclical, high-beta FX outperforming. Top performers were the South African rand, Mexican peso, Chilean peso, Colombian peso, and Brazilian real. As volatility in U.S. Treasury yields begins to ease and Treasury rates crest, we expect recent U.S. dollar strength to give way to some mild weakness.

### HIGH YIELD

- U.S. high yield returned -0.04% last week, seemingly caught in the tug of war between higher growth and higher rates. This has created bifurcation in the market, with lower quality moving higher alongside equities and higher quality drifting lower with Treasuries. Average yields were unchanged at 4.40%, while spreads tightened by 5 bps to +355 bps.
- By quality, CCCs returned +0.49% and BBs returned -0.26% last week. Year to date, CCCs have posted a return of +4.82%, outpacing BBs by 537 bps. This recoups all of the 2020 underperformance when CCCs trailed BBs by 576 bps. Higher-beta and more COVID-impacted sectors that will benefit from a further re-opening of the economy outperformed last week, with media (+0.45%), airlines (+0.43%), and aerospace (+0.32%) performing the best. More defensive, rate-sensitive sectors lagged, with utilities (-0.51%), food & beverage (-0.34%), and healthcare (-0.27%) underperforming.
- U.S. high yield mutual funds reported an outflow of \$2.9B, bringing year-to-date outflows to \$9.4B. Last week's primary activity remained robust with \$19B of issuance across 18 issuers. Most new issue rose modestly in secondary trading with a few notable exceptions. American Airlines' upsized \$10B multi-tranche deal (\$3.5B 5-year 5.50%/+468 bps, \$3B 8-year 5.75%/+441, and \$3.5B 7-year L+475 loan) backed by its loyalty program was the best performer, rising multiple points on the break.
- U.S. leveraged loans returned +0.07% last week as inflows into mutual funds continued and CLO formation remained strong. The primary market remained active as 20 issues priced for \$14.6B in proceeds, with dividend recapitalizations making up an increasing percentage of issuance as sponsors look to take advantage of strong loan demand to issue dividends to shareholders.
- In Europe, high yield bonds returned +0.26% as the ECB said it expects the asset purchases under the PEPP to be conducted at a significantly higher pace over the next quarter. BBs (+0.23%) underperformed Bs (+0.35%) and CCCs (+0.33%). The primary market was busier last week, with €1.65B of new supply. Loans returned +0.09%, which brings the year-to-date total return to +1.88%. Repricings remain a key trend as several issuers returned to the market last week to lower the spread on their existing facilities.

### SECURITIZED PRODUCTS

- U.S. conduit AAA CMBS spreads were 2 bps wider last week. The limited supply in the secondary and new issue market have kept cash spreads well behaved despite macro rate volatility. One conduit deal is going to price this week. The refinance market has continued to reopen for CRE, and some high-quality hotel and retail properties have also been able to refinance. Supply is expected to increase throughout the year with vaccine rollouts. Post COVID conditions should continue to weigh on CRE fundamentals in the hospitality, retail, and office sectors, and we remain constructive on senior, well-enhanced CMBS tranches.
- CLO primary spreads were softer throughout the capital structure last week with AAA bonds showing the most resilience. While many bonds continued to price at previous week levels, we began to see deals in the pre-marketing phase (deals pricing in next 2-weeks) widen out as the supply glut has started to impact spreads. While we continue to see large anchor investors (Global CIO offices and asset managers) looking to source bonds, supply is starting to impact spreads. In the short term, we continue to believe supply will curtail further spread compression. U.S. CLO primary spreads for higher quality portfolios ended the week at about ~3L+107/155/190/300/665 for AAA/AA/A/BBB/BB, respectively for 5-year reinvestment period deals. We continue to favor senior CLO tranches in the long term in both European and US CLOs while we remain cautious about legacy junior mezzanine.
- In ABS, spreads were unchanged for senior securities from top tier issuers, while tightening for subordinate securities and second tier issuers. New issuance remained heavy, but well absorbed, as most deals priced at/through initial guidance. Another Chase prime auto deal is being marketed this week. Total new issue volume is \$53B. We expect spreads to remain well supported due to our continued expectation for negative net new issuance in 2021.

### MUNICIPAL BONDS

- Both tax-exempt and taxable municipal bonds benefited from strong technicals last week. Muni/Treasury ratios tightened across the curve, with the 5-, 10-, and 30-year portions of the AAA-rated muni curve ending the week at 51.1% (down from 60.0% the prior week), 62.7% (down from 70.7%), and 69.3% (down from 76.4%). Year to date, the high-grade index has returned -0.24% and the high yield index has returned +1.93%.
- Municipal bond funds saw net inflows of \$1.1B, more than reversing the prior week's \$605mm outflow. Long term, high yield, and intermediate funds posted inflows of \$663M, \$430M, and \$167M, respectively. Year-to-date inflows now total \$29.3B. Year-to-date issuance totals \$83B, including \$27B of taxable issuance. Meanwhile, this week's calendar is estimated at over \$11B, including \$2B in taxable muni issuance.
- Following passage of the \$1.9T American Rescue Plan, Moody's Investors Service changed the outlook on state and local governments to stable from negative and upgraded Chicago Board of Education's rating to Ba3 from B1. The plan included \$350B for states, locals, territories, as well as additional funds for various muni sectors.

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

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