

WEEKLY VIEW FROM PGIM FIXED INCOME DESK

Breadth of Recovery Takes Shape with Q2 Now in Focus

March 29, 2021

MACRO

- As a global economic recovery remains all but a foregone conclusion, we believe the extent of the rebound will be exceptionally strong. Propelled by the vaccine, continued macro stimulus, and a resurgent consumer, global GDP is poised to jump by more than 6% this year. China, India, and the United States will likely lead this rebound, but growth in the euro area and the United Kingdom should gradually pick up as the year progresses. Latin America, in contrast, is expected to lag.
- Although there's little arguing that the global economy will experience a robust recovery as the year progresses, the debate has now shifted to two other related issues—what are the risks for inflation and what are the prospects for growth in 2022? On the former, while we see some scenarios in which inflation could rise, we continue to believe that, after a temporary boost this year, inflation will revert to low levels. And generally speaking, we believe that the performance of inflation following the pandemic is likely to resemble its pre-pandemic performance.
- On the latter, while the risk of a harder-than-anticipated landing is one that bears watching, we continue to expect that economic growth will continue steadily next year, even after the impact of exceptional fiscal stimulus begins to dissipate, households have drawdown pent-up savings, and the upfront surge associated with re-opening the economy has played through.
- Throughout the developed markets (DM), we expect that vigorous monetary support will continue as central banks fight to push inflation back toward their targets. In line with this objective, the Fed seems to be getting some traction in its efforts to lift inflation expectations, which have now risen a bit above 2%, to levels that prevailed several years ago. However, the situation in the euro area appears more acute. Inflation expectations have risen from their pandemic lows, but they remain well below the ECB's 2% target.
- The emerging markets (EM) outlook for further monetary stimulus is more nuanced. Policy is still broadly accommodative, but select central banks (e.g., Turkey, Brazil, and Russia) have recently hiked rates, while the PBOC is gradually tightening liquidity conditions. It remains an open question as to how long the EM central banks will be able to keep their feet on the accelerator, and off the brake, in the face of a likely powerful global recovery. The path of inflation in DM is likely to remain subdued—but that's not as clear for the emerging markets. And markets may pressure for rate hikes to preempt such risks. This raises the possibility of sustained policy divergence between EM and DM central banks.

RATES

- The U.S. Treasury curve bull flattened last week, showing signs of stabilization for the first time in several weeks as higher yields appeared attractive against the global risk backdrop. Treasury auctions were generally well supported and two-year and five-year notes came near their respective pre-auction levels. There appeared to be continued indigestion around seven-year auctions, which tailed about 3 bps, before trading well on the follow. Elsewhere, Canadian and UK rates markets outperformed the U.S., bull flattening by an average of 6 bps amid continued COVID-related pressure.
- While it's possible that developed market rates sell off further from current levels, we believe that rates are ultimately poised to peak during the second quarter and will likely end the year below consensus forecasts. For reference, consensus expectations are calling for 10-year yields of 171 bps, 9 bps, and -18 bps in Treasuries, JGBs, and Bunds, respectively, by year end.
- Within MBS, although valuations do not appear particularly attractive, we believe Q2 demand technicals will dictate performance relative to rates in the near term. Heavy real buying locally, while gross origination has been falling below our expectations as mortgage rates have edged higher, may keep MBS spreads within a contained range for now. We don't expect the Fed to adjust its MBS purchases until material progress is seen on its dual mandate.

CORPORATES

- U.S. IG spreads drifted wider last week amid concerns that a surge in economic growth could spur inflation. New issue supply remained robust, totaling \$40B and included an unexpected new issue from Oracle. The \$15B, multi-tranche offering prompted downgrades from the rating agencies. New issue performance remained lackluster despite a slight increase in new issue concessions. Dealers are calling for about \$25B of supply this week.
- Looking ahead, we have a modestly positive outlook on the U.S. IG market given the relative tightness of spreads and a more balanced credit outlook. And although we believe spreads will trade in a relatively tight range over the next three to six months, we believe spread compression, particularly within BBBs and off-the-run issues, will continue given strong underlying economic fundamentals.
- The European IG market carried a softer tone last week as risk appetite waned amid a resurgence of virus case counts and vaccine-related stress. The airlines sector was the notable underperformer as the market continues to reassess the sector's outlook given the uncertain timeframe for an economic reopening. Primary market activity was once again the major focus as €15B priced, bringing the month-to-date total to just over €55B. In contrast to the prior week, supply was skewed towards non-bank issuers.
- New issue performance was mixed, as deals that priced with concessions and green bonds performed the best. We expect new issue volumes to slow this week, which should help ease some of the pressure in the secondary market. Entering the second quarter, we believe spreads will be reasonably range bound, but believe there is still room for spread compression within BBBs, which creates the potential for very moderate index tightening.

EMERGING MARKETS DEBT

- EM hard currency (+0.14%) and corporate (+0.12%) assets posted positive returns last week, while local currency (-0.35%) and EMFX (-1.33%) lagged. Emerging Market stocks and currencies weakened on the back of an uptick in coronavirus cases and concerns around rising interest rates.
- EM bond fund flows were positive, totaling \$1.37B. Hard currency funds saw inflows of \$414M, compared to inflows of \$630M into local currency funds, and \$328M into blend funds. This brings year-to-date flows into EM bond funds to \$18.72B, with hard currency, local currency, and blend strategies accounting for \$5.18B, \$9.33B, and \$4.21B, respectively.
- Within hard currency, the top performers were Suriname, Sri Lanka, Jamaica, Venezuela, and Paraguay; while the underperformers were Turkey, Argentina, Ghana, Mozambique, and Ecuador. Within local rates, Indonesia, Thailand, Hungary, Malaysia, and Romania were outperformers, while Turkey, Mexico, South Africa, Brazil, and Colombia lagged. Quarter-to-date, the EM local index yield has risen by 80 bps to 5.02%, impacted by both the bear steepening in the U.S. yield curve as well as from rate hikes by select EM central banks.

- In EMFX, currencies that performed better last week were the Argentine peso, Philippine peso, Indonesian rupiah, Indian rupee, and Korean won; with the bottom performers being the Turkish lira, Russian ruble, Brazilian real, Colombian peso, and South African rand. EMFX has returned -2.51% so far in Q1.
- Looking forward, we're maintaining our highest conviction for EM hard currency sovereigns and corporates as we expect them to continue to benefit from ongoing DM policy accommodation. EM higher-quality spread curves are attractive, along with front-end, lower-rated sovereign issuers that have limited financing needs or have funding access from multi-laterals. Within corporates, we continue to favor the BBs with 5-7 year maturities.

HIGH YIELD

- U.S. high yield spreads tightened by -14 bps last week, to 353 bps, and have now tightened by -33 bps so far in Q1. Through late March, the U.S. high yield market has posted excess returns of +210 bps versus Treasuries and +252 bps versus swaps. Although average yields have risen 8 bps so far this quarter, this modest change masks the intra-quarter volatility that drove a 62 bps rise in yields between mid-February and mid-March. With yields 8 bps higher and spreads 33 bps tighter so far in 2021, the U.S. high yield market has absorbed roughly 80% of this year's rate move.
- High yield has returned +0.6% in Q1, seemingly caught in a tug-of-war between higher growth and higher rates, which has caused lower-quality credits to move higher alongside equities and higher-quality names to drift lower with Treasuries. CCC-rated credits have been the clear outperformer, returning +4.8% so far in Q1, outpacing BBs (-0.6%) by 540 bps. This recoups nearly all of the 2020 underperformance when CCCs trailed BBs by 576 bps.
- High yield sector performance has been mixed so far in Q1. Many of the higher-beta/COVID-impacted sectors that should benefit the most from strong growth and further reopening of the economy outperformed (airlines +4.5%, energy +3.2%, retail, +2.0%, aerospace +1.9%, media +1.5%). Meanwhile, higher quality, more defensive sectors that are more sensitive to rates lagged (utilities -1.6%, cable -1.2%, food & drug retail -0.9%, telecom -0.7%, homebuilders -0.3%).
- The high yield primary market remained active as issuers continue to take advantage of the low yield environment to refinance at lower interest rates and push out maturities. For the quarter, the market has so far priced 228 deals for \$151B in proceeds, the majority of which has been used to refinance debt. Meanwhile, flows into high yield mutual funds turned negative in Q1, totaling -\$10.3B, which unwinds about one-quarter of 2020's inflows.
- U.S. leveraged loans also gained last week as continued inflows into bank loan mutual funds and ongoing CLO formation provided a strong technical backdrop. Loans have now returned +1.98% this quarter, with B-rated loans outperforming BB-rated loans. Inflows into mutual funds remain robust, totaling approximately \$11B in Q1 as investors continue to seek out floating rate assets as a potential hedge against rising rates. We currently favor the higher-quality BB segment of the market, which has not recovered in valuation as much as the higher-coupon B issuers but recognize that higher-coupon B issuers could outperform if volatility does not pick up.
- In Europe, high yield bonds returned +0.18% last week and have now returned +1.4% so far in Q1. Spreads tightened by -2 bps last week, to 325 bps, as investors remained focused on new issuance. About €4.5B of bonds priced during the week, out of which €3.6B was new money. Meanwhile, ESG-related supply continues to grow, with both Novelis and Hapag-Lloyd issuing their debut ESG bonds. Loans returned -0.07% last week, which brings the year-to-date return to 1.82%.

SECURITIZED PRODUCTS

- U.S. conduit AAA CMBS spreads were unchanged last week. One CMBS conduit priced at wider levels than the initial talks due to macro rate volatility. The commercial real estate (CRE) refinance market continues to reopen and now includes some high-quality hotel and retail properties. Supply is expected to increase throughout the year with vaccine rollouts. We expect COVID to continue to weigh on CRE fundamentals in the hospitality, retail, and office sectors as we remain constructive on senior, well-enhanced CMBS tranches.
- CLO primary spreads continued to soften across the capital structure last week. While bonds continued to price at relatively tighter spreads, we continue to see some investor unwillingness to lift offer levels. While large anchor investors remain active in trying to source bonds, supply continues to impact spreads. In the short/medium term, we continue to believe supply will curtail further spread compression. We continue to expect robust issuance volumes in the U.S. and Europe this year as we are currently being marketed over 160 deals across both markets. U.S. CLO primary spreads for higher quality portfolios ended the week at about ~3mL+110/160/200/330/685 bps for AAA/AA/A/BBB/BB, respectively. Longer term, we continue to favor senior CLO tranches in both European and US CLOs and we remain cautious about legacy junior mezzanine tranches given our views around higher impairments given lower recovery rates.
- ABS spreads were unchanged to slightly wider last week. We believe primary market volume will remain light through the end of March, with year-to-date new issuance at \$59B, which is on pace with 2019. We'd note 2020 is not a good basis for issuance comparisons due to the primary market shut down during the early months of COVID. We continue to see some dealers looking to reduce aged inventory, which could cause additional near-term softening of spreads. Longer term, we expect ABS spreads to remain supported given our expectations for flat/negative net new issuance in 2021.

MUNICIPAL BONDS

- Tax-exempt municipal bonds continued to benefit from strong technicals last week. Muni/Treasury ratios largely tightened, with the 5-, 10-, and 30-year portions of the AAA-rated muni curve ending the week at 58.5% (down from 64.6% the prior week), 66.9% (down from 67.2%), and 73.5% (up from 73.4%).
- Year-to-date, municipal bond funds have now seen net inflows of \$31.1B. Year-to-date gross supply totals \$106B (12% higher year-over-year), including \$32B of taxable issuance (6.5% higher year-over-year).
- Despite solid outperformance in Q1 and relatively rich valuations versus historical averages for tax-exempt municipal bonds, positive technicals should provide a supportive backdrop heading into Q2. Additionally, passage of the \$1.9T American Rescue Plan is broadly supportive of municipal credits, with state and local governments set to receive \$350B. We expect lower-rated investment grade to continue to outperform higher-quality credits as investors seek additional yield.

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

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