Bond Blog

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PGIM FIXED INCOME

SUPPLY CHAIN STRAIN: THE INVESTMENT IMPLICATIONS

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Our three-part series exploring constraints in the manufacturing, labor, and commodities markets indicates the tightness experienced in these supply chains is likely to subside in 2022. Our more benign inflation outlook points to some compelling fixed income opportunities as we think many market participants are mistaken about extrapolating today's inflation prospects and supply chain gridlock.

Developed Market Rates: More Moderate Inflation Pricing

In the U.S., TIPS-implied inflation breakevens recently rose to the highest level in years while the 10-year nominal yield edged toward its pre-pandemic level (Figure 1), as investors priced in accelerating inflation and the consequent hawkish pivot by the Federal Reserve. Looking ahead, we expect growth and inflation to moderate, which should push yields lower as tighter monetary policy and secular factors, such as aging demographics, lead to a more gradual path of economic growth and inflation. As such, we think there is value in the long end of the Treasury curve, with breakevens leading the decline in yields. We particularly find value in the 20-year sector as it has been undervalued for technical reasons. Meanwhile, German yields are likely to follow a more muted path given a looser labor market and a more dovish European Central Bank.

FIGURE 1: U.S. 10-YEAR BREAKEVEN INFLATION REMAINS WELL ABOVE PRE-PANDEMIC LEVELS (DEC 2019 = 100)

Source: PGIM Fixed Income and Bloomberg. Data as of February 2, 2022.

Emerging Markets' Head Start

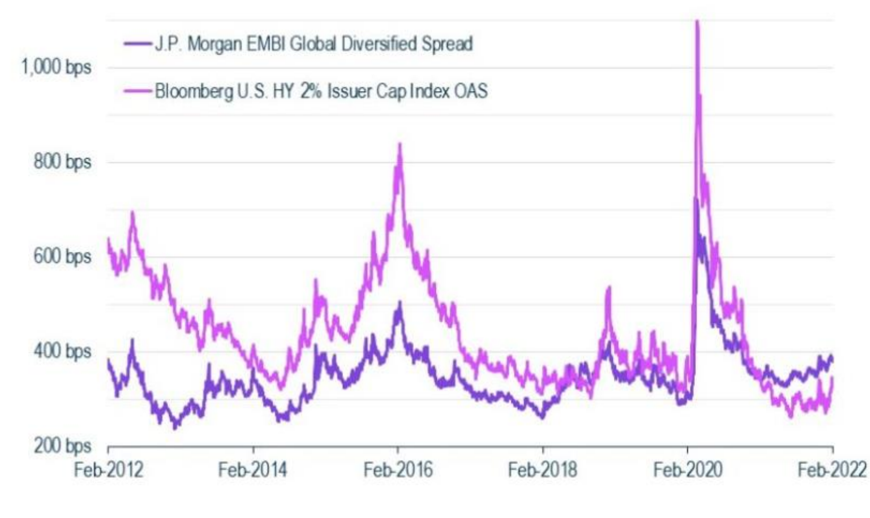
Emerging market sovereign bond markets priced in inflation earlier and more aggressively as soaring energy and food prices weighed heavily on their consumption baskets. As a result, EM yields rose substantially as central banks were forced to tighten monetary policy. But, in 2022, we think the aggressive hiking paths priced in many EM curves will likely moderate as cyclical commodity prices ease. With EM sovereign yields for the benchmark JPM-GBI local debt index trading in the vicinity of 6%, sovereign local debt offers highly interesting value propositions (Figure 2) from the perspective of carry and capital appreciation.

FIGURE 2: EM LOCAL YIELDS SOARED AS COMMODITIES-DRIVEN INFLATION FORCED CENTRAL BANKS TO RAISE RATES

Source: PGIM Fixed Income and Bloomberg. Data as of February 2, 2022.

EM hard currency debt also offers value as weak economic growth, tighter global financial conditions, and domestic factors led to wider spreads. Indeed, spreads in the broad hard currency market currently trade wider than U.S. corporate high yield spreads, which is an unusual occurrence (Figure 3). Lower global inflation and less supply chain disruption should temper the risk of tighter financial conditions while helping to unlock value in EM sovereign spreads.

FIGURE 3: EM HC SOVEREIGN SPREADS WIDENED IN 2021 AND TRADE WELL WIDE OF U.S. HY SPREADS



Source: PGIM Fixed Income and Bloomberg. Data as of February 2, 2022.

Spread Products: Limited Beta Plays, but Intriguing Alpha and Relative-Value Opportunities

A shift toward a lower and more rangebound environment for rates should translate into a less directional environment for spread products. Although such an environment is less conducive to beta plays, ample alpha opportunities should remain, especially if inflation moderates as we expect.

For example, in Europe, we expect GDP growth to surpass the U.S. in 2022 (4.3% vs. 3.6%, respectively), but with the benefit of moderate inflation due to the relative slack in the labour market and a milder consumption boom than the one that occurred in the U.S. As such, we think the policy environment in Europe will be more supportive of risky assets.

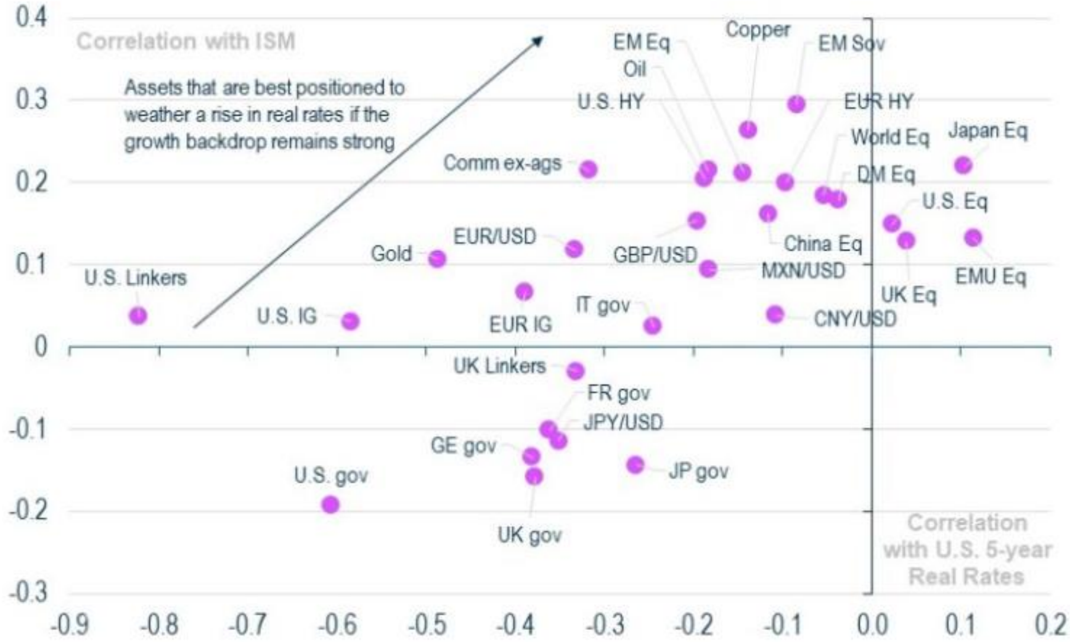
At present, the respective high-yield credit markets do not reflect the differences in the relative macro fundamentals. Indeed, European high yield spreads trade at multi-year wides relative to U.S. spreads (Figure 4), presenting active investors with an attractive set of relative-value opportunities.

FIGURE 4: EUROPEAN HY SPREADS TRADE CHEAP RELATIVE TO U.S. HY

Source: PGIM Fixed Income and Bloomberg. Data as of February 2, 2022.

Taking a step back, both European and U.S. high yield offer value relative to their respective investment-grade markets. High yield sectors are typically less sensitive to the volatility in U.S. real rates and tend to benefit more from a sustained economic recovery (Figure 5).

FIGURE 5: WHEN COMPARED TO THE IG MARKET, U.S. AND EUROPEAN HY APPEAR LESS SENSITIVE TO U.S. REAL RATES AND MORE SENSITIVE TO ECONOMIC ACTIVITY



Source: PGIM Fixed Income and Bloomberg. Data as of Jan 14, 2022.

High inflation and mounting economic uncertainties have certainly captured the attention of many investors. Yet, our careful quantitative research shows a much more benign inflation outlook than most investors anticipate. This divergence in views on the most important economic question of 2022 will likely produce sizable market opportunities for fixed income investors in the months and quarters ahead.

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