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Fixed Income Market Outlook

March 21, 2019—Mike Lillard, head of PGIM Fixed Income and chief investment officer, and Mike Collins, managing director and senior portfolio manager, recently shared their views on the current economic environment and their market outlook for the near term, as well as their positioning and strategies resulting from these views. Read more about their thoughts on global growth, expectations for the Fed Funds rate, and potential opportunities in the fixed income marketplace.

Global economy

- Short Run
  - PGIM Fixed Income's forecast for global economic growth continues to be positive, although growth is likely past peak momentum. The Firm's forecast for 2019 global GDP growth is 3.5%, which is down from 2018's forecast of 3.7%.
  - Growth is starting to slow in the U.S. due to the lagged effects of the Fed's balance sheet reduction and tighter monetary policy. However, PGIM FI does not expect a recession to occur in 2019, with a forecast of 2.5% GDP growth.
  - PGIM FI expects 1.2% growth in the euro area, which has continued to slow, particularly in large economies such as Germany. Despite Brexit uncertainty, growth in the U.K. is forecasted to increase slightly higher in 2019. In China, PGIM FI is expecting 2019 GDP growth of 6.3% which is contingent on a view that China will continue to stimulate their economy in 2019.
- Long Run
  - PGIM FI's long-run views for the U.S. economy are less encouraging. The U.S. federal deficit as a percentage of GDP is now at 4% moving towards 5%, largely driven by the aging population and increasing entitlement spending. In the long run, this is going to be a strong headwind for U.S. growth and will keep rates lower.

U.S. Rates

- At its March meeting, the Federal Reserve did not raise the Fed Funds target rate range and stated that they will be patient as it determines what future adjustments will need to be made.
- Rather than the median projection of two rate hikes in 2019, the Fed's dots show that many members believe there will be no change this year.
- The Fed also stated that they are going to taper their quantitative tightening program and are targeting that to be done by the end of September. PGIM FI no longer feels there is a risk that the Fed will hike rates to a level that triggers a recession in the U.S.
- PGIM FI believes the U.S. 10-year Treasury yield at 2.5% is biased to go lower and a large part of that view is based on where rates are relative to other countries.

Fixed Income Markets: Key Positioning for the Coming Quarter

- Duration and curve positioning:
  - In the first quarter of 2019, the front-end of the yield curve inverted due to the market pricing in rate cuts over the next few years.
  - PGIM FI is currently overweight the 5- to 10-year part of the curve because when the Fed stops hiking, that part of the curve typically performs the best.
- Credit:
  - PGIM FI's base case is a benign environment for credit spreads, where lower rates beget tighter spreads and exacerbate the reach for yield.
  - With the Fed on hold and growth slowing down, spreads have moved in a lot and PGIM FI is cautious on some of the credit sectors. PGIM FI is rotating out of and being defensive in investment grade and high yield industrial corporate bonds, while focusing on sectors that are in the early to middle stages of the business cycle, such as U.S. and certain global money center banks.
  - The Firm continues to favor high-quality (mostly AAA-rated) structured products, such as collateralized mortgage-backed securities (CMBS) and collateralized loan obligations (CLO). Additionally, PGIM FI continue to hold a significant underweight to agency mortgage-backed securities (MBS) for multiple reasons, including tight spread levels and the ongoing roll-off from the Fed's balance sheet.