WEEKLY VIEW FROM THE DESK

Rebounding economic activity; A diversity of recovery times

PGIM FIXED INCOME

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MACRO

- Although economic activity remains well below pre-COVID levels and we continue to project U.S. growth of -5.0% in 2020, recent U.S. economic data provides at least some level of comfort that risk markets have not become too far removed from underlying fundamentals. Retail sales have seen a sharp recovery from Q1 lows, while durable goods orders have continued to rebound. More importantly, the buildup in inventories usually seen during recessions has not materialized, which should help support production going forward.
- While the recent spike in coronavirus cases has dominated headlines, less attention has been paid to the sharp decline in COVID-related deaths in recent months. While deaths in the 0-24 year category remain near zero, deaths among those aged 55 and older have dropped sharply since April's peak as hospitals have grown more proficient in dealing with the illness, which may impact risk behavior going forward.
- Although the final European Council agreement on the €750B recovery plan initially appeared less favorable than originally proposed, key elements of support remained intact. While the final plan reduced total grants in favor of loans, the Recovery and Resilience Facility, which is aimed at supporting countries hard hit by the virus, was increased and the total earmarked for grants was upsized from €310B to €312.5B.
- Looking forward, we expect to see a diversity of recovery times across economies. While we expect the U.S. and Germany to recover to pre-pandemic levels of GDP by the end of 2022, other economies could take far longer. Following the global financial crisis, it took the U.S. 11 quarters to return to prior levels of growth. Meanwhile, Italy never recovered to pre-crisis levels and the U.K. never recovered its trendline growth.
- Though relatively small, China's bond market is catching up to other developed markets and is a growing component of EM indices. From a relative value perspective, China real yields appear attractive to other developed market real yields and are less volatile than the broader EM indices. While China's onshore bond market is currently dominated by domestic commercial banks, we expect accessibility and index inclusion to drive increased foreign participation.

RATES

- Despite the recent rally in U.S. 30-year Treasuries and bull flattening, we believe it's reasonable to expect further flattening of the 10-30 year part of the curve. When looking at prior instances when the Fed cut rates to zero (e.g. 2003-2004 & 2011-2015), it is typical to see the curve flatten significantly. Comparing the current curve to those past instances, it appears that there is room to flatten even further—particularly if the Fed introduces forward guidance and the U.S. economic recovery remains weak.
- We continue to see trading opportunities across real interest rate complexes. In the U.S, we continue to favor the 20-25 year part of the curve. Australia's new 30-year bond appears attractive given the steep term structure and a central bank committed to yield curve control. We continue to favor short positioning in 10-year UK linkers and long positioning in U.S. five-year and 10-year TIPS.
- U.S. MBS was relatively flat last week. The Treasury OAS closed flat at 30 bps and the LIBOR OAS widened to 31 bps. Buying supported the market early, but flattened out by week's end on supply. Domestic banks continue to add in pool form, while REITs continue to add lower 30-year coupons on widening.Convexity accounts remained quiet.

CORPORATES

- U.S. IG spreads tightened by 5 bps last week to +131 bps. Energy continued to outperform, with spreads tightenining by 10-20 bps following Chevron's recently announced acquisition of Noble Energy. Metals & Mining was another outperformer, with spreads tightening by 10-15 bps as the weaker dollar remained supportive of the sector.
- The market continued to benefit from strong tehnicals. Investor inflows of $7B equaled total weekly issuance, while the Fed's purchases continue to anchor demand. Supply totaled $7B last week, with Bank of America's $5B print comprising the bulk of that issuance. Issuance of $20-$25B is expected this week and $50-$75B in August, significantly lower than in prior months.
- On the fundamental side, 26% of the S&P 500 has now reported Q2 financial results, with 71% topping revenue estimates and 81% beating earnings estimates.
- In Europe, the agreement on the EU recovery fund was well received. The primary market, however, was extremely quiet with only a handful of new issues pricing last week and we expect new issuance to remain muted until September. In the absence of new supply, European IG spreads tightened by 10 bps to +125 bps. The banking and automotive industries both outperformed.
- Of the European corporates that have reported or pre-announced Q2 earnings, most have beaten expectations, in particular on the margins, although the numbers are sharply down sequentially. However, visibility through the second half of 2020 remains limited given the uncertain near-term economic outlook.

EMERGING MARKETS DEBT

- Emerging Markets saw another volatile week, but trended higher as renewed optimism around a vaccine was tempered somewhat by concerns about rising tensions between the U.S. and China. EM hard currency gained 1.29%, EM corporates gained 0.84%, hedged local rates gained 0.49%, and EMFX gained 0.82%. Hard currency spreads tightened by 12 bps, with lower-quality credits outperforming. Corporate spreads tightened by 10 bps as Q2 earnings are coming in better than expected.
- Fund flows were again positive, driven primarily by flows of $1.1B into hard currency funds. Local currency funds and blend funds saw $-120M and $283M of flows, respectively. This brings year-to-date flows to -$35.1B, with hard currency, local currency, and blend strategies seeing -$5.2B, -$26.7B, and -$3.2B of flows, respectively.
- Argentina outperformed after its largest creditor groups came together to submit a new restructuring proposal. Argentina's five-year and 10-year bond spreads tightened by 382 bps and 343 bps, respectively, as the market has grown more optimistic that a deal is imminent.
- The U.S. dollar continued its trend lower over the past week, heading for its worst month since 2018. With the coronavirus continuing to plague the U.S. and real rates currently negative, many investors have exited their positions in the safe-haven currency and are now taking short bets.

- We continue to be long (but selective) duration, with Russia and Mexico remaining key positions. We also find value in South Africa given the attractiveness of its yield curve.

HIGH YIELD

- U.S. high yield returned +1.52% last week amid solid earnings, positive vaccine new, and landmark stimulus coming out of Europe. Technicals remained favorable as weekly inflows of $3.5B were the strongest since early June and new issuance of $4.9B was the lowest weekly total since April.
- BB-rated bonds were again an outperformer, returning +1.6%. By comparison, Bs and CCCs returned +1.4% and +1.5%, respectively. Investment grade corporate spreads continue to move the goal posts for high-quality high yield as the BB/BBB differential has tightened by 80 bps this month to 205 bps.
- Looking across geographies, U.S. BB and B-rated bonds outperformed against similarly-rated EM and European bonds last week. For example, the spread differential between U.S. BB-rated bonds and European BB-rated bonds tightened to 43 bps last week from 55 bps the week before.
- All sectors were positive but skewed more favorably towards cyclical and virus impacted sectors. Airlines (+3%), aerospace (+2.8%), gaming (+2.3%) and autos (+2.0%) outperformed last week and are among the top performing industries so far this month. While airline data is weakening versus expectations, liquidity profiles remain stable over the near term. Aerospace benefitted from some positive news from Bombardier on its cash burn, which caused the company's bonds to trade up 7-12 points across maturities.
- U.S. leveraged loans rose +0.71% last week driven by strong technicals. While outflows from loan mutual funds continued, new CLO formation remained elevated and new issuance was relatively muted. Last week, eight new CLOs priced for a total of $3.45B, with another four to six deals expected this week.
- In Europe, high yield bonds and loans returned +0.93% and +0.35% last week as the agreement on the €750B recovery fund boosted sentiment and technicals remained supportive. Unlike the U.S., the European loan market has not benefitted from an uptick in CLO formation, with only two European CLOs pricing over the past week.

SECURITIZED PRODUCTS

- U.S. conduit CMBS spreads were unchanged last week. Two U.S. conduit deals priced with solid demand, especially for the mezzanine bonds. Two more new-issue conduits are left for the rest of the summer and we expect both secondary supply and new issue origination will be limited over the near term. We continue to favor senior, well-enhanced CMBS tranches as the Covid-19 impact on CRE fundamentals remains to be seen.
- CLO secondary spreads moved marginally tighter across the capital structure. Shorter tenor and/or bonds with higher quality underlying pools remained well bid. Some asset managers began aggressively bidding bonds in the primary and secondary markets, causing some spread tightening, but we continue to expect a high amount of near-term issuance to put a floor on spreads. We continue to see bifurcation in primary versus secondary market spreads, especially in mezzanine bonds, as portfolio quality and credit enhancement are vastly different. We expect robust primary issuance volumes in the U.S. and Europe given the large number of deals being marketed across both regions. US CLO primary spreads ended at about ~3L+160/210/275/420/800 for AAA/AA/A/BBB/BBs, respectively. We continue to favor senior CLO tranches in the long term in both Europe and the U.S. and remain cautious about junior mezzanine tranches given our views around impairments and respective valuations.
- ABS spreads were tighter last week as strong demand in new issuance continued. $5B in deals were placed with most issues pricing tighter than initial guidance. YTD new issuance is $95B, 30% lower than last year at this time. We expect continued low supply to be supportive of spreads.

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