PGIM FIXED INCOME

March 26, 2020

CIO Update

The following summary is based on a market update provided by Mike Lillard, Head of PGIM Fixed Income and Chief Investment Officer, on March 26,2020. Click here to listen to the webinar.

Introduction

- The economic, market, and social environment through the first three weeks of March has been historically unprecedented.
- While several strategies have underperformed through the height of the market volatility, we continue to manage portfolios with a long-term perspective—a philosophy that has never been more important than it is today.
- As we look across our portfolios, we're holding many bonds that are trading at very attractive levels and that we continue to feel good about. Investment opportunities have also surfaced in the primary markets as issuers look to access the market during the recently improved conditions.

Global Economic Fallout

- The extent of the economic fallout from the virus likely follows the sequence of its global spread. For example, China was the first country to significantly curtail activity in the first quarter, and now, a V-shaped recovery appears to be taking hold as economic activity in the country appears to be running at about 75-90%.
    - When considering the extent of the contraction in China in Q1, Singapore has been one of the first countries in Asia to report preliminary Q1 growth—based on activity in January and February—and it reported a 10% contraction, and a similar contraction could occur in China. This would contribute to a significant divot in global GDP in the first quarter.
    - Although China is now recovering, the second quarter could see an economic contraction of a similar level as responses to the virus affect economies throughout the rest of the world. In the U.S., the extent of the sudden economic stop was reflected by Thursday's release of weekly jobless claims, which skyrocketed to a record high of 3.3 million after a previous reading of 282,000.

"Time X"

- The overriding economic question is when the shuttered economies will restart. We call the period from shutdown to restart "Time X," and in this scenario, the duration of Time X determines the severity and longevity of the economic fallout.
    - For example, if Time X lasts three to six months, defaults across the leveraged finance sector could range from 10-15% without explicit government support for the respective industries. This scenario would also see swathes of the BBB-rated segment of the investment grade market downgraded to high yield, which is what we already saw with the downgrade of Ford Motor Company into high yield.
- However, if Time X is two to three weeks, then the economic damage will be considerably less. We believe there is a solid possibility that this shorter timeframe for Time X comes to fruition.
- What drives Time X?
    - The curves of confirmed cases of COVID-19: the sooner these start to flatten, the shorter span of Time X.
    - There is also the possibility that effective treatments for COVID-19 are established and become more widely used. This could significantly ease the strain on healthcare systems globally.
    - Broader testing in the most affected regions will slow the spread by limiting contact and establishing more effective quarantines.
    - Consideration will also need to be paid to the implications of social distancing—does it work, do people abide by it, and what are the longer-term social costs of implementing such measures?
    - Time X could also be varied across regions of particular countries. For example, in the U.S., Florida and Texas, where there have been relatively few cases—could restart quicker than New York or New Jersey.

Market Conditions

- The degree of the recent market strain rivals that of the collapse of Long-Term Capital Management in 1998 and the Global Financial Crisis of 2008/2009. It remains uncertain how long the extreme market swings may last.
- At the height of the market volatility last week, liquidity was highly strained with bid/ask spreads that were five to 10 times wider than they were prior to the crisis. Trade sizes were smaller as well.
    - A couple factors have contributed to the reduced market liquidity. Most broker/dealers are operating in business continuity mode with salespeople and traders working from home or in backup facilities, which strains the connectivity between counterparties.
    - The risk management protocol for most broker/dealers centers on a value-at-risk (VaR) protocol—unlike our risk framework—which has limited their ability to disintermediate and take risk from counterparties.
- The near-constant rollout of fiscal and monetary responses—along with questions about their effectiveness and longevity—has also contributed to the market uncertainty.
- The broad central bank actions as well as the implemented and pending fiscal measures have recently improved market conditions.
    - For example, prior to the recent turbulence, the VIX was trading at 15, and it spiked to 82 during the height of the volatility before moderating to 61 on Thursday.
- The major central banks have demonstrated that they are all-in regarding their economic and market support. To borrow a term from former ECB President Mario Draghi, central banks are doing “whatever it takes,” and the Federal Reserve’s daily purchases of $75 billion in Treasuries and $50 billion of mortgage-backed securities underscores that determination.
    - This extends to the ECB’s loosened guidelines on asset purchases as well as the Fed’s initial foray into indirect purchases of corporate bonds.
- However, the combined effects of these steps will take some time to achieve their intended objectives.

Market Sectors

- In terms of U.S. interest rates, although we had a long-term overweight on duration, we’ve turned more tactical given the yield of 85 bps on the U.S. 10-year yield. The deeply negative spreads on 30-year interest-rate swaps also appear attractive from a short perspective (i.e. wider swap spreads).
- Furthermore, we do not believe the Fed will take its policy rate into negative territory given the negative effects on the banking and money market sectors.
- In terms of credit spreads, spreads on many high-quality assets—ranging from investment grade corporates, emerging market debt, and securitized assets—have widened by about three times relative to their levels prior to the market volatility. These are particularly attractive levels for assets with strong credit profiles.
- When we think about the recent performance of the credit sectors relative to equities, long-term U.S. corporate debt has posted an excess return of -26% year-to-date, while U.S. high yield has posted an excess return of -21%. This has lagged the rebound on the S&P 500, which is about 20% lower on the year.
    - Yet, the monetary and fiscal measures we’ve seen thus far are more targeted toward credit—i.e. aimed at preventing large scale job losses and defaults—rather than lifting equity prices. Therefore, accurate security selection across the credit sectors continues to point to highly attractive opportunities relative to equities, and we are increasing risk as we maintain a long-term perspective that is focused on an eventual recovery and beyond.

Source(s) of data (unless otherwise noted): PGIM Fixed Income as of March 2020.

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