MACRO

While the June payroll report in the U.S. was again stronger than expected, we see some lingering areas of concern within the global labor market. For example, the number of permanent job losses in the U.S. rose by another 588K to 2.9M in June. In addition, some large companies in virus-sensitive industries are set to implement restructuring plans over the next year—last week Airbus said it planned on a reduction of 15,000 jobs within a year, while Boeing said in April that it would cut 16,000 jobs. These pending payroll reductions may become another factor that likely maintains the policy accommodation from the Federal Reserve and other major central banks for the foreseeable future.

On the positive side, the virus situation resulted in 18.1M temporary job losses in the U.S. and 7.5M of those have already been restored. Of particular surprise, payrolls in the accommodation & food industry declined by 49% from February to April, and the industry has recovered 44% of those jobs (as a percent of lost jobs) from April to June.

We believe the Federal Reserve could introduce goals-based forward guidance, as opposed to time-based guidance, possibly in September as other recently-introduced programs are set to expire (but could be extended). We continue to believe that the explicit forward guidance would bolster the Fed’s credibility and would be preferable to a yield curve control program, which may be difficult to extract from without notable market disruption.

As the U.S. presidential election approaches, speculation is mounting about how a Biden administration might adjust corporate tax rates. We believe an adjustment from 21% to possibly 26-28% (lower than the campaign’s stated target of 28%) wouldn’t derail the corporate markets and would still meet some political goals. One rule-of-thumb is that every percentage point change in the corporate tax rate affects corporate earnings by 1.5 percentage points. In another scenario, any hike in the U.S. corporate tax rate could be delayed given the precarious economic conditions.

In terms of the timing around our recovery scenarios, our “V” case could see an implied U.S. GDP level that would return to Q4 2019 levels by Q1 2021, while, in the strong “U” case, growth wouldn’t return to Q4 2019 levels until Q3 2021. Our weak “U,” “L,” and “W” scenarios would not see implied growth return to Q4 levels through 2021.

RATES

Although the equity rally resumed on additional signs of recovering global growth, the market appears to be growing accustomed to the low-rate environment as the U.S. and German 10-year yields remained at 0.68% and -0.43%, respectively, during the rally. The U.S. yield appears biased to stay in the bottom of the 50-100 bps range over the near to intermediate term. Over the next year to two years, we believe the 10-year yield could remain below 1.0%.

We also expect the bull-flattening trend to resume following some upcoming issuance at the back of the U.S. curve.

MBS performance was mixed last week as lower coupon spreads tightened, while 30-year 4.0% issues and higher continued to drift wider. The market-cap weighted Treasury OAS widened by 1 bp to 34 bps, and the LIBOR OAS widened 2 bps to 35 bps, repeating last week’s cheapening in higher coupons. Buying activity was brisk in the early part of the week as month-end brought decent rebalancing activity, but the Street still seemed to be a little fuller on MBS than it wanted.

CORPORATES

U.S. IG spreads tightened by 9 bps last week to +144 bps. For reference, spreads started the year at +93 bps, reached the wides of +375 bps during the March selloff, and ended March at +270 bps. It’s possible that spreads could continue to grind tighter to a range of 105-100 bps by the end of the year.

Issuance was relatively slow during the holiday shortened week with $16B printing during the four days. Estimates call for $20-$25B to price this week and $85-$100B to print in July. In terms of the expectations for improving technicals in the second half of the year, the U.S. primary market has already printed $1.2T and recent estimates place full-year issuance at $1.4-$1.8T.

The Fed’s corporate purchases are the other end of the stable technicals, and its corporate holdings increased to $10B after it added another $1.3B last week.

European IG spreads tightened by 7 bps last week to +151 bps with high-beta names and financials outperforming. Issuance of €18B found a more receptive tone than the prior week as healthier concessions of 10-30 bps supported the new deals.

EMERGING MARKETS DEBT

The emerging market debt sector was largely positive last week as investors weighed an improving economic backdrop against an accelerating virus threat. Hard currency sovereigns gained +0.86%, EM FX gained +0.41%, EM corporates gained +0.14%, and hedged local rates declined -0.02%.

Hard currency sovereign spreads tightened by 14 bps, with higher-beta, oil-sensitive countries, such as Angola, outperforming as risk appetite improved and oil moved up 3-4%. At +461 bps, spreads on the index have now retraced 60% of their March widening, with spreads on the high-grade portion the index having now retraced 74% of their March widening.

Negotiations between Argentina and its bondholders continued as the government presented a proposal with improved terms that some bondholders found acceptable. However, two main creditor groups rejected the proposal based on both valuation and insufficient legal protections associated with the expected exchange bonds.

In Colombia, the central bank cut rates by 25 bps, which was less than the market expected, to 2.5%. However, since the terminal rate sits in a range of 2.00% to 2.25%, the less-than-expected rate cut did not prompt a selloff in local rates.

A weaker U.S. dollar benefited higher-beta currencies, such as the Argentina peso and South African rand. In EMFX, we are keeping a relative-value focus and currently favor Asia and European currencies over Latin American currencies.
### The Mixed Labor-Market Picture

**July 6, 2020**

#### HIGH YIELD

- U.S. high yield bonds returned +0.46% during the holiday-shortened week despite heavy new issuance, large outflows, and renewed virus concerns. Higher-quality bonds outperformed, with BB-rated bonds returning +0.67%. By comparison, B-rated bonds and CCC-rated bonds returned +0.34% and -0.20%, respectively.

- High yield bond funds posted an outflow of $5.6B last week, which was one of the five largest weekly outflows on record. This included $2.25B of outflows from ETFs on Monday, which was the largest ever single-day outflow.

- In terms of supply, the new issue calendar was relatively muted, with five news deals pricing for a total of $2.6B in proceeds. New issuance for the month of June was just shy of $58B, representing the highest monthly total on record. Year-to-date issuance now totals $233B, representing a 74% increase over the same period last year.

- Defaults remained a focus as oil and gas firm California Resources missed an interest payment on its bank loans and bonds. Following the news, the loans traded down to 60 cents and the bonds were trading below 10 cents on the dollar.

- In Q2, defaults totaled $82B across both bonds and loans—a quarterly record. Year to date, defaults have primarily been driven by energy (27%) and retail (10%). On an annualized basis, defaults in Q1 and Q2 totaled 5% and 15%, respectively, and we anticipate a default rate of 10% over the next 12 months, which somewhat tempers our short-term outlook.

- U.S. leveraged loans returned -0.29% despite a rise in U.S. equity prices. An active new issue calendar, muted CLO formation, and another weekly outflow from loan funds contributed to the weakened technical backdrop.

- Looking forward, the visible new issue calendar appears relatively light, which may help to underpin loan prices over the near term. We continue to anticipate that rising default rates, particularly for low B-rated issuers, will be the biggest risk to the asset class over the next four to six quarters.

- European high yield and loans returned +0.29% and -0.07%, respectively, in a relatively quiet week for new issuance. Loans suffered from a lack of bids for corona-affected industries, with travel, transport, and leisure giving back some of their recent gains.

- We continue to assume lower overall defaults in Europe than in the U.S. and we anticipate that this, combined with a general lack of new issuance, may drive some further spread tightening in the coming months.

#### SECURITIZED PRODUCTS

- U.S. Conduit CMBS spreads were 3 bps tighter last week on limited supply. Only three or four conduit new issue deals are in the pipeline for summer. We expect new issue origination will be limited for the rest of the year as dealers are just slowly restarting new originations. We continue to favor senior, well-enhanced CMBS tranches as the Covid-19 impact on CRE fundamentals remains to be seen.

- Secondary market senior CLO spreads were unchanged last week despite some softness in mezzanine tranches. Primary spreads continued tighter across the capital structure. 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 as we are currently being marketed over 100 deals across both markets. U.S. CLO primary spreads for higher quality portfolios ended at about ~3L+165/220/275/415/750 bps for AAA/AA/A/BBB/BBs, respectively. Primary issuance saw a lot of demand as the market aggressively pursues what it perceives to be high-quality, more liquid portfolios. We continue to favor senior CLO tranches in the long term in both Europe and the U.S. while we remain cautious about junior mezzanine tranches given our views around impairments.

- ABS spreads were unchanged last week on light activity. ABS new issue supply will be low for another week with YTD volume standing at $80 billion, one-third lower than last year at this time. We expect continued low supply to be supportive of spreads. Tiering is emerging among recently issued refinance private student loan shelves. Examples of senior trading levels are Sofi +120 bps, Navient +130s, Elfi +140s, and Commonbond +150s. We are constructive at these levels.
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