WEEKLY VIEW FROM THE DESK

PGIM FIXED INCOME

August 10, 2020

MACRO

- While the debate around the next U.S. fiscal package continues, we believe the executive orders implemented over the weekend put a floor under the potential economic damage that the lapse in fiscal measures, e.g. the $600 weekly supplemental unemployment payments, would cause. Going forward, we see U.S. real GDP coming in -5% in 2020, about +4% in 2021, and slightly higher than +2% in 2022. One of the wild cards we're monitoring as part of these estimates is business investment, which has been conspicuously lacking during the initial phase of the recovery.
- In assessing the effect of COVID-19 across Latin America, our scorecard is segmented into the countries' starting conditions (1/3 weight), handing of the pandemic (1/6 weight on total cases per 100k and 1/6 weight on total tests per 100k), and policy responses (1/3 weight). The weighted rank of those criteria place Paraguay, El Salvador, and Chile as the countries that are the best positioned to weather the effects of the pandemic and Jamaica, Panama, and Ecuador as those countries that are the worst positioned to weather the effects of the virus. That said, beyond the pending restructurings in Argentina and Ecuador, we believe it is unlikely that other countries in the region will also need to restructure their external debt.
- We see the recent weakness in the U.S. dollar as possibly the start of a bear market for the dollar, particularly as we view it in a long-term context of other strengthening developed market currencies, such as the Swiss franc, the yen, the deutsche mark, and the euro. The currency trends can be relatively long-lasting as periods of appreciation in these currencies since 1970 have lasted about 10 years, while periods of depreciation have been about half as long.
- In terms of a broad view on risk assets, we see a scenario where credit spreads are fundamentally supported if issuers stay friendly to bondholders while they remain in survival mode, the recent increase in liquidity is enough to bridge credits to the other side of the virus, most job losses during the pandemic prove to be temporary, and sovereign investors wait out deteriorating credit profiles and growth prospects. Alternatively, the dominating trend across risk assets going forward could be a monetization effect where the vast amounts of money that have been pumped into the system continue to boost asset prices and suppress volatility until the next risk-off event surfaces.

RATES

- We remain neutral across the U.S. Treasury curve as the market braces for a deluge of supply from the Treasury's upcoming $112B refunding that will continue to shift from bills to longer-dated coupons as the Treasury extends its weighted-average maturity from about 60 months.
- With annualized gross issuance set to exceed $4T by November 2020, the increased financing needs in the U.S. may indicate a supply of coupons swings from -$450B (factoring in the Fed's $2.2T of purchases this year) to a positive net supply of coupons of up to $2.4T in 2021 (factors in zero Fed purchases in 2021).
- Elsewhere, we continue to favor off-the-run Treasuries behind the recently issued 20-year bond, 30-year Australian bonds amid a steep term premium of 20 bps, short positioning in UK real rates, and long positioning in 5-year and 10-year U.S. TIPS.
- Mortgages had another solid week as buying continued to outstrip supply, and the Treasury OAS tightened by 6 bps to 17 bps (tightest since 2016) while the LIBOR OAS tightened by 8 bps to 16 bps. In a sign of the ongoing demand, the Fed's daily purchase operations reached the lowest offered ratios since March, implying fewer mortgages available for sale. For example, Friday's 30-year conventional operation offered just $3.965B vs. Fed buying $2.793B (1.42x coverage and well below typical ratios of 2.5x to 3x). Furthermore, estimates on the Fed's retained portfolio suggest $110B of MBS will be needed over the next month, whereas gross monthly supply has been about $190B.

CORPORATES

- U.S. IG spreads tightened by 7 bps to +126 bps last week as Q2 results and corporate cash-burn rates are generally coming in better than expected. In addition, it appears the rating agencies have essentially stepped to the sidelines given the notable improvement in corporate liquidity conditions. Spreads are about 75% back to their pre-virus levels.
- Issuance increased to $35B and continued apace on Monday with another 10 deals emerging and another 10 expected on Tuesday. Estimates indicate up to $40B could price this week, and supply should taper off later in the month. Up to $75B is expected to price in August.
- Although the Fed bought just $119M last week, it's challenging to buy at the front end of the market (where the Fed's purchases have been concentrated), and we continue to favor the BBB segment of the market and some of the higher-beta credits.
- European IG spreads tightened by 5 bps to +123 bps last week as conditions grew increasingly quiet. Given the relatively quiet market, we believe further tightening is likely the path of least resistance for spreads going forward. For comparison, the ECB indicated it bought €8B of corporate bonds in July via its CSPP and PEPP initiatives, which was a decrease from the €11B average in April, May, and June.

EMERGING MARKETS DEBT

- Emerging Markets hard currency and local currency assets saw another strong week on the back of positive vaccine developments and optimism surrounding a U.S. stimulus deal. The rally in EM currencies paused even as the U.S. dollar held close to its lowest level in two years as intensifying U.S.-China tensions outweighed an otherwise positive backdrop.
- EM hard currency gained +1.32%, EM corporates gained +0.76%, hedged local rates declined -0.04%, and EMFX declined -0.41%. Hard currency and corporate spreads tightened by -19 bps and -12 bps, respectively. For hard currency, it was the sharpest week of tightening since early June.
- Total flows into EM bond funds remained positive at $450mm. Hard currency, local currency, and blend strategies saw $232mm, $64mm, and $153mm of flows, respectively. Year to date, hard currency, local currency, and blend strategies have seen $5.0B, $25.6B, and -$2.9B of flows, respectively, for a total of -$33.5B. Last week also saw -$2.7B in flows from emerging market dedicated equity funds.
- Turkey continued to underperform on concerns over its current account deficit and depleting reserves, while the Lira declined to an all-time low against the U.S. dollar. Argentina outperformed as the country reached a restructuring deal that will lead to a better recovery than originally anticipated. Argentina's current bond prices imply a 12% exit yield. We believe Argentina's bonds are likely to continue to trade in the 11-12% range over the near term but could potentially rally further if the government shows further progress toward macro stabilization.

- Within local rates, we continue to see a pickup in core inflation in certain countries, leading to a slightly more cautious stance around duration risk. Within EMFX, higher-beta currencies, such as the Brazilian real and South African rand, underperformed. We continue to favor the Asian and euro-sensitive currencies over high-beta currencies given the potential for a further pickup in growth and room for further stimulus.

HIGH YIELD

- U.S. high yield returned +0.58% last week as inflows, positive vaccine news, and fiscal aid hopes outweighed near-record new supply. Year-to-date returns for the asset class are now positive at +0.35%. Recall that the asset class was down by approximately 20% during the depths of the market selloff in March.
- Technicals remained favorable as high yield bond mutual funds reported $4.4B in inflows—the eighth largest weekly inflow on record. High yield bond funds have now posted $60.5B in inflows since late March.
- By quality, CCC-rated bonds outperformed, returning +0.69%. By comparison, BBs and Bs returned +0.65% and +0.42%, respectively. Year to date, however, CCC-rated bonds remain an underperformer, returning -10.63%. By comparison, BBs and Bs have returned +4.22% and -1.56%, respectively. All sectors posted positive returns last week, with airlines (+5.04%), gaming (+1.34%), and chemicals (+1.12%) the top performers.
- The first week of August saw the fourth largest weekly new issuance volume on record as $20B priced across 28 deals. Last week's supply was skewed toward higher-quality credits, with the majority of issuance coming from BB-rated issuers. Despite the heavy new issue volume, performance was strong, with most deals trading up more than a point on the break and all but one issue trading above par. Another 10 deals for $5B in proceeds have already been announced this week.
- U.S. leveraged loans returned +0.40% as new CLO formation contributed to a favorable technical backdrop, particularly for performing B-rated loans. An uptick in the number of issuers turning to the high yield bond market to refinance existing loans in recent weeks has also contributed to the strong supply/demand dynamic.
- In Europe, high yield bonds and loans returned +0.58% and +0.23%, respectively, as no new deals priced in the high yield market and just two add-ons priced in the loan market. Year to date, high yield and loans have returned -2.71% and -2.57%, respectively.

SECURITIZED PRODUCTS

- U.S. Conduit CMBS spreads were 5bps tighter last week due to persistent secondary demand with little supply. A few new issue SASB (Single Propety/Single Borrower) deals have been well oversubscribed – a sign that investors still have strong appetite for high quality CRE risk. Two more new issue Conduit deals are expected this week. We expect both secondary supply and new issue origination to be limited in the near future. We continue to favor senior, well-enhanced CMBS tranches as the Covid-19 impact on CRE fundamentals remains to be seen.
- CLO spreads in the primary and secondary markets were unchanged this week on lighter volume. Shorter tenor and/or bonds with higher quality underlying pools remained well bid. We continue to expect 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 US and Europe as we are currently being marketed over 100 deals across both markets. US CLO primary spreads for higher quality portfolios ended at about ~3L+160/210/275/420/800 for AAA/AA/A/BBB/BB, respectively. We continue to favor senior CLO tranches in the long term in both European and US CLOs while we remain cautious about legacy junior mezzanine tranches in particular given our views around impairments and respective valuations.
- ABS spreads tightened last week as technicals remain strong. Notably, $540mm of a 5yr Avis rental car senior was placed at +175bps (from LM200s initial guidance). YTD new issuance is $103 billion versus $143 billion at this time last year . ABS technicals are expected to remain strong. Fundamentals, particularly in consumer sectors, carry increased uncertainty and are dependent upon the duration/impact of Covid-19. Extension/forbearance programs have helped collateral performance to date. As we continue to monitor issuer shelves and collateral performance, we maintain a preference for "top-of-the-capital structure" securities and/or bonds from strong origination programs.

Source(s) of data (unless otherwise noted): PGIM Fixed Income, as of 08/3/2020.

2020-5078