Macro

- Recent data out of the euro area indicate a partial V-shaped recovery. While PMI readings in the euro area fell more sharply than those in the U.S., their subsequent rebound has been stronger. For example, the euro area flash manufacturing PMI for June rose 15.6 points in June vs. 9.8 in the U.S., leaving both measures at nearly equivalent levels. Labor regulations have also supported a euro area unemployment rate (7.3% in April) that has been about half of that in the U.S. (14.7% in April).

- While historically strong social safety nets and automatic stabilizers—e.g. direct payments to households rather than indirect methods, such as a reduction in tax rates with reduced income levels—may support euro area growth beyond the initial rebound, its medium-term growth challenges, including traditionally fractured fiscal policies, shouldn’t be underestimated. One additional source of future headwinds could be the surge in euro area government debt—an increase of more than 20 percentage points to around 105% of GDP—amid the various responses to the virus.

- The IMF released its latest World Economic Outlook last week, and its -5.2% forecast for real GDP growth in 2020 is slightly firmer than our forecast of -5.4%. However, there are some sizable regional differences between the forecasts. For example, the IMF’s developed market GDP forecast of -8.5% is notably weaker than our DM estimate of -6.6%. That is somewhat countered by the IMF’s estimate for real GDP growth of +1.0% in China compared to our forecast of -4.4%.

- Given the ambiguity of what shape of an economic recovery may indicate about actual U.S. GDP growth, we created five shape scenarios with average annual growth estimates for 2020 and 2021. A “strong-U” scenario culminates in an estimate for real GDP growth of -6.2% and +6.0%, respectively, while the estimates shift to -7.0% and +2.7% in the ‘weak-U” case. The “V” scenario projects growth of -5.2% and +7.2% in 2020 and 2021, respectively, and the “L” case indicates growth of -8.1% in 2020 and +1.9% in 2021. The “W” scenario carries growth of -8.0% in 2020 and -1.6% in 2021.

Rates

- We believe the long tail of the virus and its effects will continue to support a bull-flattening rally among developed market rate curves as long end valuations remain relatively attractive. While the U.S. Treasuries market could encounter some volatility from the upcoming June payroll report, a backup in long-term rates could present a buying opportunity.

- At the very front of the U.S. curve, bill issuance may recede from recent levels as the Treasury’s cash balance sits near an all-time high with tax receipts still forthcoming in July.

- U.S. MBS underperformed rates over the last two weeks as the bull flattening in rates negatively affected the upper portions of the MBS coupon stack. The market-cap weighted Treasury OAS widened 8 bps to 93 bps and the LIBOR OAS widened 7 bps to 94 bps as higher coupons cheapened. We saw little in the way of convexity-related flows as yields fell, and non-Japan accounts in Asia maintained steady buying. Domestic asset managers have added MBS into cheaper levels in preparation for month-end rebalancing needs, while some banks were better sellers of MBS pools to lock in gains before quarter-end. We expect banks to be more active in Q3 in the wake of the Fed’s recently released stress test results.

Corporates

- U.S. IG spreads widened by 7 bps to +153 bps last week amid concerns about increasing COVID-19 cases. Performance was consistent with the broader tone as banks and utilities outperformed, while energy, autos, and BBB-rated retailers underperformed as spreads widened by about 25 bps. The front end of the curve widened by about 4 bps and the long end moved 8 bps wider.

- Last week’s $18B in issuance brought the MTD and YTD issuance to $150B and $56B, respectively. The latter is about two times the pace at the same time last year and about 3.5 times faster on a net level. We believe several issuers have used proceeds to repay bank credit lines that they may have tapped during the worst of the market volatility in March.

- The pace of issuance is expected to cool somewhat in the second half of the year. About $70-$100B is expected to price in July with maturities of about $56B. The technical picture should improve in the coming months with gross issuance of $360-$500B through the end of the year counted by about $380B in maturities.

- The Fed bought $1.7B in corporates last week, bringing its total corporate purchases to $8.7B. Of the top 10 issuers set for Fed purchases, five are auto manufacturers and four are foreign auto companies (BMW, VW, Daimler, and Toyota) with U.S. operations. BB-rated Ford is also among the top 10.

- European IG spreads widened by 5 bps to +158 bps last week. The European primary market stalled slightly last week as $380B in issuance brought the MTD and YTD issuance to $180B and $116M last week, hard currency sovereign spreads widened by 6 bps with higher yields generally underperforming. The top performers were Angola, Belize, Sri Lanka, Zambia, and Tajikistan. Single-B rated Angola struck a three-year debt moratorium with China that significantly improved its liquidity profile, and its 10-year bonds rallied from about 40 cents on the dollar to about 90 cents on the dollar. Zambia’s debt rally on anticipation of a similar agreement with China, Belarus, Dominican Republic, Lebanon, and South Africa were laggards. Lebanon lagged as bailout plans from the IMF appear less likely in the near term.

- Emerging market central banks continued to ease policy rates last week as the Philippine central bank cut rates by 50 bps, Mexico cut its benchmark rate by 50 bps to a four-year low of 5.0%, and, in a surprise move from one of the more hawkish central banks, the Hungarian central bank unexpectedly cut rates for the first time since 2016 and signalled it might cut further. Given the aggressive monetary action being taken by EM central banks—we now see a terminal policy rate in Mexico of 2.5%—we are continuing to add duration in local rates.

EMERGING MARKETS DEBT

- Emerging market debt was relatively muted last week and held up relatively well in the face of increased COVID-19 cases in the U.S. and postponed state re-openings. EM corporates gained +0.18%, hard currency sovereigns gained +0.10%, hedged local rates gained +0.10%, and EMFX declined -0.21%.

- Credit continues to benefit from higher commodity prices (e.g. oil and copper) and positive fund flows. While overall emerging market bond flows were -$116M last week, hard currency and blend strategies saw flows of +$498M and +$124M, respectively.

- Hard currency sovereign spreads widened by 6 bps with higher-yielding bonds generally underperforming. The top performers were Angola, Belize, Sri Lanka, Zambia, and Tajikistan. Single-B rated Angola struck a three-year debt moratorium with China that significantly improved its liquidity profile, and its 10-year bonds rallied from about 40 cents on the dollar to about 90 cents on the dollar. Zambia’s debt rally on anticipation of a similar agreement with China, Belarus, Dominican Republic, Lebanon, and South Africa were laggards. Lebanon lagged as bailout plans from the IMF appear less likely in the near term.

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EM currencies lost ground against the dollar last week, and Latin American currencies underperformed largely due to the impact of COVID-19. Looking forward, we expect Latin American currencies to continue underperforming and Euro area and Asian currencies to outperform.

**HIGH YIELD**

- U.S. high yield bonds returned -1.25% last week as a combination of renewed virus fears and another week of heavy new issuance weighed on the market. Spreads widened by +39 bps last week to 641 bps. This compares to a recent tight of 550 bps on June 5 and a crisis wide of 1,087 bps on March 23.
- Against the backdrop of a spike in U.S. infections, COVID-impacted sectors underperformed, with airlines (-6.49%), aerospace (-3.45%), and gaming (-3.53%) declining the most. More defensive sectors, such as food & drug retail (-0.08%), consumer products (-0.34%), and cable (-0.50%), outperformed.
- By quality, BB-rated bonds (-1.01%) outperformed both B-rated bonds (-1.34%) and CCC-rated bonds (-2.16%) as risk sentiment weakened. Despite their relative outperformance, BB-rated bonds cheapened further against European BB-rated bonds and European BB-rated loans as the market appears to be differentiating based on virus, trade, and election concerns.
- In terms of supply, the primary calendar remained heavy last week with $13B in new issuance, bringing month-to-date issuance to a record $56B. Meanwhile, high yield bond funds reported $1.1B in outflows last week, contributing to a somewhat weaker technical backdrop for the asset class.
- Default, restructuring, and distressed exchange activity has been elevated. Chesapeake Energy, Chuck E. Cheese, and GNC filed for bankruptcy, Briggs & Stratton missed a coupon payment, and Party City, Diamond Sports, and AMC Theaters undertook a distressed exchange.
- U.S. leveraged loans were also lower, returning -0.75%. Discount margins widened by 18 bps to 596 bps, with BB-rated loan spreads ending the week 24 bps wider at 361 bps and B-rated loan spreads ending the week 23 bps wider at 575 bps.
- Bank loan funds reported another small weekly outflow, bringing year-to-date outflows to $17B. On the other side of the demand equation, four CLOs priced, bringing year-to-date CLO issuance to $33B.
- In terms of supply, four new loan deals priced last week for a total of $10.5B. Month-to-date issuance totals $27B, which is the second largest monthly total this year and more than the 2019 monthly average. Although ongoing outflows and heavy new issuance may contribute to a weak technical backdrop over the near term, we expect issuance to slow in the coming weeks, which may help to underpin prices going forward.
- European high yield and leveraged loans declined as investors grappled with a resurgence in COVID-19 cases in the U.S. and Germany. European high yield returned -0.41% while spreads widened by +14 bps, and loans posted a total return of -0.32% as the discount margin widened by 14 bps to +603 bps. European high yield has held up better than U.S. high yield due, in part, to having a higher percentage of BB-rated bonds and fewer virus-impacted sectors.

**SECURITIZED PRODUCTS**

- U.S. conduit CMBS spreads were unchanged last week as one new issue deal priced. The new issue deal priced 5 bps wider than the initial talk and a few loans were taken out due to cshshare race exposure. Only three or four conduit new issue deals remain 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 senior CLO spreads were unchanged last week despite some softness in mezzanine tranches. Primary spreads continued to tighten in AAA-rated issues. 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 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+165/220/275/425/800 bps for AAA/AA/A/BBB/BBs, respectively. Primary issuance saw a lot of demand last week 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 Europe and the U.S., while we remain cautious about junior mezzanine tranches given our views around impairments.
- ABS spread convergence continued last week on light trading as non-benchmark sectors, second tier issuers, and subordinate securities all outperformed. Specifically, subordinate classes in unsecured consumer loan and rental car ABS improved. YTD new issuance stands at $79B vs. $119B at this time last year. As we gain a clearer view of the health of originators and collateral performance, including underlying loan transition out of forbearance buckets, we maintain a preference for high-quality ABS issuers/securities.
source(s): PGIM Fixed Income unless otherwise indicated. As of June 2020.

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