WEEKLY VIEW FROM THE DESK

Rising DM Debt and Disinflation; Fear Remains in Risk Assets

PGIM FIXED INCOME

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MACRO

- The surge in fiscal spending programs globally has heightened inflation concerns among some observers. Yet, our decadal observations of nine developed market countries since the 1980s indicates that rising government debt (% of GDP) is more closely associated with declining rates of inflation, rather than rising rates of inflation. For example, an increase in DM government debt of 10% of GDP is associated with a 0.25 percentage point decline in the rate of inflation. We find less of a relationship in similar observations across emerging market economies.
- While PMIs across the U.S., Europe, China, and Japan have rebounded solidly since the worst of the lockdown effects, it remains to be seen whether a sustainable expansion is underway in the manufacturing sector as the readings in the U.S., Europe, and China remain around the 50 threshold between expansion and contraction. Japan's manufacturing PMI remains in contraction below 50 amid its concentration in auto manufacturing.
- A key near-term challenge for the euro area to achieve sustainable growth going forward will be the gradual removal of short-term working programs, which could possibly result in an increase in the unemployment rate from about 8% to 10% by the end of the year, which is similar to the level that we expect in the U.S. as well. The potential effects on consumer confidence could continue the disparity of growth in the region—the flash reading on Germany's Q2 real GDP showed a contraction of 10% compared to Spain's contraction of more than 18%—and possibly slow the rate of recovery in Q3 and Q4.
- In considering whether the rally in risk assets may have additional room, we've evaluated the relationship between realized and implied volatility on the S&P 500 Index. Over the past year, realized volatility has averaged 34.5, lifted by the March surge. Meanwhile, realized volatility over the past month and week averaged 13.8 and 10.9, respectively. However, implied volatility on the VIX is at 25 and is at 30 on a couple of VIX futures contracts. Thus, there still appears to be some volatility concerns across risk assets, possibly indicating room for additional gains should those fears subside over time.

RATES

- We continue to believe that the bull-flattening trend may continue in the U.S. Treasuries market, yet we believe that the curve could bear steepen in the short term, thus we've adjusted to a neutral stance at the back of the U.S. curve. Similarly, we believe the U.S. long bond may underperform swaps, thus leading to potential tightening in 30-year interest-rate swap spreads.
- Conversely, we remain bullish on the Australian Treasuries curve, particularly given the strong performance of its on-the-run 30-year issue and amid a steep risk premium of 21.2 bps.
- Further to some opportunities across real interest-rate complexes, we believe five-year U.S. TIPS could decline further from -1.25% to -1.50%, and we're maintaining long positioning in U.S. 10-year TIPS (-1.00%) and short positioning in UK 10-year real rates (-2.89%).
- U.S. MBS performed solidly last week as buying outstripped supply. The Treasury OAS tightened by 7 bps to 23 bps while the LIBOR OAS tightened by 2 bps to 29 bps. The Fed revealed a new purchase schedule of $61.8B over the two-week period beginning July 28th, reflecting increased paydowns on its portfolio. Operations were also changed to three per day (from two) and now solicit offers on all sectors each day (as opposed to cycling thru different sectors).

CORPORATES

- U.S. IG spreads tightened by 2 bps to 133 bps last week, and spreads finished July 17 bps tighter on the month. Of the $21B in supply, $11B came from AT&T's $11B deal with proceeds slated to tender for front-end issues and extend its maturity profile, which has become an increasingly common transaction within the IG market. AT&T's offering was said to price with concessions of 15 bps, and it will likely need notable concessions going forward considering it's carrying $160B in debt.
- Southwest Airlines may be considered to be the strongest airline with its BBB credit ratings, and it brought five-year and seven-year issues last week that priced at about 350 bps over comparable Treasuries. It appears that Southwest has a decent probability to retain its investment-grade credit rating going forward.
- Dealers are calling for $30-35B to price this week and $60-70B to price in August (up from prior forecasts of $50B). Google was one of the 10 deals that emerged Monday as it raised $10B in a multi-tranche offering with a five-year issue that priced with a 0.45% coupon. The order book on Google's deal was said to be more than three times covered.
- The Fed's corporate activity continued to wane last week as it only bought $150M in corporates. In contrast, the ECB has been averaging about $900M in weekly purchases as part of its CSPP facility and $19B over the last four weeks as part of its PEPP facility.
- European credit outperformed equity with the OAS of the Bloomberg Barclays Euro Aggregate Corporate Index 1 bp wider last week to +128, leaving the index 21bps tighter in July and 35 bps wider on the year. Similar to equities, financial credits underperformed with Spanish banks hit particularly hard.

EMERGING MARKETS DEBT

- Emerging market hard currency assets gained last week as investor optimism driven by a weaker U.S. dollar and an accommodative stance from the U.S. Fed was somewhat tempered by data out of the U.S. and Mexico showing record economic slowdowns. High grade outperformed high yield, with increased differentiation among lower-quality credits.
- EM hard currency gained +0.72%, EM corporates gained +0.51%, hedged local rates gained +0.08%, and EMFX gained +0.28%. Hard currency and corporate spreads tightened by 7 bps and 4 bps, respectively.
- Total flows into EM bond funds were muted at $184M. Hard currency, local currency, and blend strategies saw $30M, -$15M, and $169M of flows, respectively. Year to date, hard currency, local currency, and blend strategies have seen -$5.2B, -$25.7B, and -$3.0B of flows, respectively, for a total of -$33.9B. Last week also saw -$1.0B in flows from emerging market dedicated equity funds.

- Turkey unperformed across the board last week as concerns over depleting reserves and a weaker Lira spilled into the credit markets. Argentina also lagged as progress towards restructuring the country's debt appeared to stall. However, the country subsequently reached a $65B agreement with creditors, essentially resolving its third default since 2000. Economy Minister Martin Guzman added that he will also seek a new program with the IMF.
- South Africa unperformed after the approval of a $4.3B emergency loan from the IMF, which stands as the largest disbursement to any country yet for COVID-19 related help. Russia underperformed as a selloff in the ruble and an uptick in U.S./Russia tensions may provide a headwind for further yield compression. While some EM central banks appear to be closing in on an end to their cutting cycle, the overall backdrop of low core rates, a recently weakened U.S. dollar, and steep curves generally remain supportive of local rates.

HIGH YIELD

- U.S. high yield returned +0.88% last week amid better-than-expected earnings and dovish comments from the Fed. High yield bond mutual funds posted $2.7B in inflows, with the bulk coming on Thursday and Friday following the conclusion of the Fed's two-day meeting. Technicals remained favorable as new issuance in July totaled a more modest $26B (down from $55B in June).
- BB-rated bonds were again an outperformer, returning +0.96%. By comparison, Bs and CCCs returned +0.75% and +0.87%, respectively. All but two sectors were positive, with retail (+1.80%), autos (+1.67%), and metals & mining (+1.47%) outperforming. Airlines (-0.67%) and media (-0.10%) underperformed.
- On the fundamental side, Q2 corporate earnings are by-and-large coming in better than anticipated, with the majority of high yield companies beating estimates and posting better-than-expected cash flow numbers. For the most part, management teams appear to have done a good job managing expenses and may be more conservative going forward, which could benefit high yield bondholders in the coming quarters.
- Following a pickup in new issuance to $7.1B last week, supply is expected to increase again this week as earnings season ends and blackout periods expire. However, we expect supply to taper off again during the last three weeks of August.
- U.S. leveraged loans declined -0.05% last week as new CLO formation slowed from the prior week's elevated levels. Triple-C rated loans outperformed, led by some off-the-run, idiosyncratic situations. While modest outflows from loan mutual funds continued, their effect on technicals remained muted as retail assets currently comprise only a small percentage of the market.
- In Europe, high yield bonds were slightly wider last week as the number of virus cases picked up and COVID-19 impacted sectors underperformed. High yield bonds returned -0.21% and spreads widened by +12 bps. Loans returned +0.01%, bringing the year-to-date total return to -2.80%.

SECURITIZED PRODUCTS

- U.S. conduit CMBS spreads were unchanged last week. Two more new issue conduits are expected for August. We expect both secondary supply and new issue origination to be limited in the near future. With weaker economic data, there is increased discussion from policymakers to establish a facility to help CRE/CMBS borrowers. We continue to favor senior, well-enhanced CMBS tranches as the COVID-19 impact on CRE fundamentals remains to be seen.
- CLO secondary spreads continued to marginally tighten following strong demand as primary spreads remained relatively unchanged. Shorter tenor and/or bonds with higher quality underlying pools remained well bid. Some asset managers were aggressively bidding bonds in the primary and secondary market, causing some spread tightening. 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 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+160/210/275/420/800 bps for AAA/AA/A/BBB/BBs, respectively. 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 and respective valuations.
- ABS spreads were tighter last week. Strong demand continued for new issuance and duration caught a bid in secondary. YTD new issuance is $97B versus $137B at this time last year. We expect continued low YTD supply versus beginning of year expectations to be supportive of spreads.

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

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