EMERGING MARKETS DEBT

Emerging market debt performance was muted last week as duration and idiosyncratic events largely drove performance. Longer duration debt generally underperformed, while Argentina and Ecuador both underperformed on the back of their respective restructuring proposals. EM corporates gained +0.45%, EMFX gained +0.22%, hedged local rates gained +0.21%, and hard currency sovereigns gained +0.10%. Hard currency sovereign spreads widened by +4 bps, while EM corporate spreads tightened by -4 bps.

Following the market holiday, fund flows were positive. Hard currency funds saw $1.5B of inflows, local currency funds saw -$63M of outflows, and blend strategies saw $159M of inflows. Year to date, bond fund flows total -$372.2B, with hard currency, local currency, and blend strategies seeing -$7.5B, -$26.3B, and -$3.5B of flows, respectively.

Ecuador outperformed following a preliminary agreement to restructure $17.4B in outstanding debt. Meanwhile, the Ad Hoc and Exchange bondholder groups in Argentina chose not to accept the country’s latest restructuring offer, with Economy Minister Martin Guzman following up that there will be no additional improvements to the proposal.

Malaysia’s central bank cut its benchmark rate by 25 bps to 1.75%, which is a record low amid warnings of downside risks. This marks the fourth consecutive rate cut issued by the Malaysian central bank and additional fiscal and monetary policy stimulus measures look likely.

For Professional Investors only. All investments involve risk, including possible loss of capital.
Our key long duration positions remain in Russia, Mexico, and China. Russia was one of the better performers last week as its central bank indicated that further rate cuts are likely. China rates underperformed amid reports that local investors continue to shed fixed income exposure in favor of equities. Our thesis on China rates remains intact as we don’t believe current rates are sustainable given that debt metrics have deteriorated markedly on the back of the country’s COVID-related stimulus measures.

We are currently seeing signs of a bottoming of inflation in a number of emerging market countries, particularly commodity-importing countries, which may pose a risk to duration positioning. However, we currently view this as more of a tail risk than our base case.

**HIGH YIELD**

- The U.S. high yield market rose +0.29% last week despite an increased number of virus infections and shutdowns. By quality, BB-rated bonds (+0.35%) outperformed both B-rated bonds (+0.28%) and CCC-rated bonds (+0.02%). Spreads tightened by 3 bps to +614 bps, which is still 254 bps wider than where they began 2020. Year to date, high yield bonds have produced excess returns of -942 bps versus Treasuries and -936 bps versus swaps.

- High yield bond funds reported inflows of $2.0B last week, recouping a portion of the prior week’s $5.6B outflow. Year-to-date inflows now stand at +$29.2B. In terms of issuance, 11 deals priced last week for $7.9B in proceeds—still active but down from an average of ~$10B in weekly new issuance during July.

- Charter Communications priced $1.5B in 10.5-year senior unsecured notes to yield 4.25%, or a spread of +363 bps. This is about 100 bps wider than where a similar issue from the BB-rated cable provider traded at the end of last year, yet it’s fundamentals likely remain relatively stable given the industry and the economic lockdowns.

- More generally, BB-rated bonds continue to appear cheap and we remain constructive on the segment. By one measure, the ratio of BB spreads to BBB spreads has risen to 2.5 times from just 1.5 times at the beginning of 2020. Conversely, the ratio of CCC spreads to BB spreads has tightened to 2.5 times from more than 5 times at the beginning of 2020.

- U.S. leveraged loans rose +0.35% last week, with performance relatively consistent across ratings categories. While outflows from loan mutual funds persisted, new CLO formation appears to be picking up, as the arbitrage has improved somewhat over the past few weeks.

- The pace of downgrades slowed last week, with no loans downgraded to CCC for the first time since the outbreak. Nevertheless, downgrades remain a focus, with 33% of loans in the index having been downgraded and 12.3% having been downgraded to CCC. The loan market remains bifurcated across quality, with prices on downgraded loans down by -16% year to date and prices on non-downgraded loans lower by just -2.2%.

- In Europe, high yield bonds and loans returned +0.14% and +0.22%, respectively, in a relatively quiet week for new issue.

- We continue to expect relatively low default rates in Europe relative to the U.S. In the European loan market, we expect default rates of 1-2% for the remainder of the year as LBO sponsors help offset business declines by contributing more equity and raising additional debt.

**SECURITIZED PRODUCTS**

- U.S. conduit CMBS spreads were 2 bps tighter last week due to limited supply. Only three or four conduit new issue deals are in the pipeline for the summer. One UK industrial portfolio will be in the market this week. 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 continues to unfold.

- CLO secondary spreads remained generally flat across the capital structure lighter volumes. At the top of the capital structure shorter tenor and higher quality bonds remained well bid, while higher beta bonds softened on the week. On average, senior spreads ended flat for the week. Primary spreads remained unchanged as a number of deals being announced stymied the recent tightening trend. The market began to take note of the number of deals being announced in the primary as a potential floor to further tightening in spreads in the near term. 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. 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. 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 tightened last week. While trading activity was light, significant investor interest was expressed in new issue deals set to price this week. YTD new issuance of $81B is about one-third lower than last year at this time. We expect continued low supply to support spreads.
Global Fiscal Waves and Steep Curves

July 13, 2020

Source(s): PGIM Fixed Income unless otherwise indicated. As of July 2020.

PGIM Fixed Income operates primarily through PGIM, Inc., a registered investment adviser under the U.S. Investment Advisers Act of 1940, as amended, and a Prudential Financial, Inc. (“PFI”) company. Registration as a registered investment adviser does not imply a certain level or skill or training. PGIM Fixed Income is headquartered in Newark, New Jersey and also includes the following businesses globally: (i) the public fixed income unit within PGIM Limited, located in London; (ii) PGIM Netherlands B.V. located in Amsterdam; (iii) PGIM Japan Co., Ltd. (“PGIM Japan”), located in Tokyo; (iv) the public fixed income unit within PGIM (Hong Kong) Ltd. located in Hong Kong; and (v) the public fixed income unit within PGIM (Singapore) Pte. Ltd., located in Singapore (“PGIM Singapore”). PFI of the United States is not affiliated in any manner with Prudential plc, incorporated in the United Kingdom or with Prudential Assurance Company, a subsidiary of M&G plc, incorporated in the United Kingdom. Prudential, PGIM, their respective logos, and the Rock symbol are service marks of PFI and its related entities, registered in many jurisdictions worldwide.

These materials are for informational or educational purposes only. The information is not intended as investment advice and is not a recommendation about managing or investing assets. In providing these materials, PGIM is not acting as your fiduciary. These materials represent the views, opinions and recommendations of the author(s) regarding the economic conditions, asset classes, securities, issuers or financial instruments referenced herein. Distribution of this information to any person other than the person to whom it was originally delivered and to such persons as was unauthorized and any reproduction of these materials, in whole or in part, or the divulgence of any of the contents hereof, without prior consent of PGIM Fixed Income is prohibited. Certain information contained herein has been obtained from sources that PGIM Fixed Income believes to be reliable as of the date presented; however, PGIM Fixed Income cannot guarantee the accuracy of such information, assure its completeness, or warrant such information will not be changed. The information contained herein is current as of the date of issuance (or such earlier date as referenced herein) and is subject to change without notice. PGIM Fixed Income has no obligation to update any or all of such information; nor do we make any express or implied warranties or representations as to the completeness or accuracy or accept responsibility for errors. All investments involve risk, including the possible loss of capital. These materials are not intended as an offer or solicitation with respect to the purchase or sale of any security or other financial instrument or any investment management services and should not be used as the basis for any investment decision. No risk management technique can guarantee the mitigation or elimination of risk in any market environment. Past performance is not a guarantee or a reliable indicator of future results and an investment could lose value. No liability whatsoever is accepted for any loss (whether direct, indirect, or consequential) that may arise from any use of the information contained in or derived from this report. PGIM Fixed Income and its affiliates may make investment decisions that are inconsistent with the recommendations or views expressed herein, including for proprietary accounts of PGIM Fixed Income or its affiliates.

The opinions and recommendations herein do not take into account individual client circumstances, objectives, or needs and are not intended as recommendations of particular securities, financial instruments or strategies to particular clients or prospects. No determination has been made regarding the suitability of any securities, financial instruments or strategies for particular clients or prospects. For any securities or financial instruments mentioned herein, the recipient(s) of this report must make its own independent decisions.

Conflicts of Interest: PGIM Fixed Income and its affiliates may have investment advisory or other business relationships with the issuers of securities referenced herein. PGIM Fixed Income and its affiliates, officers, directors and employees may from time to time have long or short positions in and buy or sell securities or financial instruments referenced herein. PGIM Fixed Income and its affiliates may develop and publish research that is independent of, and different than, the recommendations contained herein. PGIM Fixed Income’s personnel other than the author(s), such as sales, marketing and trading personnel, may provide oral or written market commentary or ideas to PGIM Fixed Income’s clients or prospects or proprietary investment ideas that differ from the views expressed herein. Additional information regarding actual and potential conflicts of interest is available in Part 2A of PGIM Fixed Income’s Form ADV.

In the European Economic Area (“EEA”), information is issued by PGIM Limited or PGIM Netherlands to persons who are professional clients as defined in Directive 2014/65/EU (MiFID II). PGIM Limited’s registered office: Grand Buildings, 1-3 Strand, Trafalgar Square, London, WC2N 5HR. PGIM Limited is authorised and regulated by the Financial Conduct Authority (“FCA”) of the United Kingdom (Firm Reference Number 193418). PGIM Netherlands B.V. is authorised by the Dutch Authority for the Financial Markets (Autoriteit Financiële Markten – AFM) as an alternative investment fund manager with MiFID top up service capabilities under registration number 15003620. PGIM Limited and PGIM Netherlands are authorized to provide services or operate with a passport in various jurisdictions in the EEA. In certain countries in Asia, information is presented by PGIM (Singapore) Pte. Ltd., a Singapore investment manager registered with and licensed by the Monetary Authority of Singapore. In Japan, information is presented by PGIM Japan Co., Ltd., registered investment adviser with the Japanese Financial Services Agency. In South Korea, information is presented by PGIM, Inc., which is licensed to provide discretionary investment management services directly to South Korean investors. In Hong Kong, information is provided by PGIM (Hong Kong) Limited, a regulated entity with the Securities & Futures Commission in Hong Kong to professional investors as defined in Section 1 of Part 1 of Schedule 1 (paragraph (a) to (i)) of the Securities and Futures Ordinance (Cap.571). In Australia, this information is presented by PGIM (Australia) Pty Ltd (“PGIM Australia”) for the general information of its “wholesale” customers (as defined in the Corporations Act 2001). PGIM Australia is a representative of PGIM Limited, which is exempt from the requirement to hold an Australian Financial Services License under the Australian Corporations Act 2001 in respect of financial services. PGIM Limited is exempt by virtue of its regulation by the FCA (Reg: 193418) under the laws of the United Kingdom and the application of ASIC Class Order 03/1099. The laws of the United Kingdom differ from Australian laws. In South Africa, PGIM, Inc. is an authorised financial services provider – FSP number 49012.

© 2020 PFI and its related entities.

2020-4499

For Professional Investors only. All investments involve risk, including possible loss of capital.