WEEKLY VIEW FROM THE DESK

The Wave of Extending U.S. Maturities

August 17, 2020

PGIM FIXED INCOME

MACRO

- We see the U.S. economic recovery as unexpectedly taking more of a "V" shape as retail and new home sales have surpassed pre-virus levels, manufacturing has recovered about 60% of its pre-virus levels, auto sales have recovered about 50%, and employment has recovered about 42% since the lockdowns. Importantly, inventory levels were also drawn down during the quarantine periods—leaving inventory to sales ratios slightly below pre-virus levels—which should support production activity as the recovery progresses. Even if the recovery plateaus from here, estimates for Q3 GDP appear to be coalescing in the low to mid +20% range.
- Our proprietary, recession-forecasting models for the U.S. have diverged recently with the financial model (variables include 10-year Treasury yield minus Fed funds rate term premium, nonfinancial commercial paper spread, and the real S&P 500 index) implying an 11% probability of recession, while the macro model (variables include initial unemployment claims, real goods PCE, consumer confidence, housing permits, and average hourly earnings) implies a 100% chance of recession. A notable trough between the difference in model outputs (financial – macro models) has been a feature of each business cycle since 1970, and the difference has currently troughed at 89%. And except for January 2008, troughs in the differences between the models have signaled the end of the recession within three months. In 2008, the trough preceded the end of the recession by 13 months.
- Following the surge in July CPI, we continue to see mild inflationary conditions where the core PCE could end 2020 between 1.25%-1.50% and rise to 1.50% and 1.75% by the same point in 2021. Elsewhere on the inflation front, it's possible that this Wednesday's release of the minutes from the FOMC's June 28-29 meeting could contain some color regarding the Fed's revised inflation framework. When considering the ramifications of an average inflation targeting framework, we believe that, over an intermediate span of three to five years, the revised approach could reduce the risk of an overtightening in monetary policy, which is what we believe occurred in 2018.

RATES

- As we anticipated, last week's incoming Treasury supply resulted in yields at the back of the curve repricing higher, particularly with the latest 30-year auction that priced with a considerable tail. After the curve steepening, we believe the bull flattening trend may resume as more participants acknowledge the potential persistence of the global low-rate conditions.
- However, the recent influx of Treasury supply, which will likely persist and grow along with fiscal deficits for the foreseeable future, provides some nuances to our view as we believe interest-rate swaps at the back of the curve may outperform 30-year nominal bonds, thus leading to tighter swap spreads going forward. We believe the U.S. Treasury may be agnostic to the relationship between the yield on the long bond and the 30-year swap spread and will likely look to continue extending its weighted average maturity given the low rates across the curve.
- Last week, mortgage option adjusted spreads cheapened amid three developments: 1) late week supply as originators tried to beat the September 1st cutoff for the "adverse market fee" of 0.5% on mortgage refinancings from Fannie and Freddie; 2) OAS model recalibrations due to the fee; and 3) the deteriorating seasonal effects as September approaches. The Treasury OAS widened by 13 bps to 30 bps while the LIBOR OAS widened by 15 bps to 31 bps. The new fee was announced last Wednesday night, and Thursday's market session was dominated by accounts moving up-in-coupon on the prospect of slower prepayment speeds. Originators then flushed pipelines trying to beat the Sept. 1 implementation date with supply reaching almost $14B on Thursday alone, leading production coupons to underperform. Given last week's spread widening, we've become slightly more constructive on the asset class.

CORPORATES

- U.S. IG spreads widened by 2 bps to +128 bps last week, with the more liquid names and sectors widening by about 5 bps, as an unexpected uptick of supply weighed on conditions. We would classify recent corporate issuance as the third wave of supply with about 86% of the proceeds slated to tender for near-term maturities and extend maturity profiles, which is double the pace for the entire year. August is set for about $30B in tender activity, which has supported the front end of the market, but the new longer-term issuance has slightly weighed on the back end of the market.
- The low-rate environment, long-dated issuance, and renewed spread tightening has continued to extend the duration of the Bloomberg Barclays Aggregate Index from about seven years at the end of 2018 to about nine years recently. The increased issuance at the back of the curve runs contrary to earlier estimates for a reduction in supply in the second half of the year. August began with initial estimates for $75B in issuance, and the MTD total has reached $84B with 11 deals emerging Monday and up to $40B expected to price during the week. The remainder of the month should be relatively quiet, before a renewed surge after the U.S. Labor Day holiday.
- Conversely, a lack of issuance contributed to an 8 bps tightening in European IG spreads to +115 bps, leaving spreads only 22 bps wider on the year. Given the lack of supply and quiet market conditions, the prevailing sentiment is not to be short IG spreads at this point until more normal conditions resume in September.

EMERGING MARKETS DEBT

- Emerging markets hard currency assets posted a modest loss last week as high yield gains were offset by high grade losses. EM hard currency declined -0.40%, EM corporates declined -0.05%, hedged local rates declined -0.27%, and EMFX gained +0.38%. Hard currency and corporate spreads tightened by -8 bps and -6 bps, respectively.
- Within local rates, the index bounced off an all-time low yield of 4.35%, widening to 4.42% last week as a pickup in inflation in certain countries, underperformance of EM currencies, and a slight increase in U.S. rates weighed on local markets.
- Total flows into EM bond funds remained positive at $1.0B. Hard currency, local currency, and blend strategies saw $957M, $116M, and -$53M of flows, respectively. Last week also saw -$1.6B in flows from emerging market dedicated equity funds.
- Turkey outperformed despite ongoing concerns over its current account deficit, depleting FX reserves, and decline in the Lira. Turkey's central bank attempted to reverse declines in the currency without raising interest rates by offering its lenders funding through a potentially more expensive channel. Belarus underperformed amid protests demanding the resignation of President Alexander Lukashenko amid allegations that the results of the August 9 election were manipulated.

- Israel and UAE reached an agreement to normalize relations and cooperate on investments and security if Israel suspends annexation of West Bank territory that it currently occupies. We believe this has the potential to change the geopolitical map in the Middle East as it may increase pressure on Saudi Arabia to follow suit, possibly mounting further to Iran's influence in the region.

HIGH YIELD

- U.S. high yield returned -0.52% last week as heavy new issuance and the Treasury move weighed on the market despite a rise in U.S. equities and strong inflows. With the 10-year Treasury backing up almost 20 bps in the last two weeks, BBs (-0.75%) underperformed both Bs (-0.36%) and CCCs (+0.13%).
- From a sector perspective, airlines (+1.0%) gained amid investor expectations that a stimulus package may be forthcoming, while aerospace (-1.9%) declined largely due to some negative headlines regarding the previously disclosed sale of Bombardier's rail division to Alstom.
- Fund flows were positive, with high yield bond mutual funds posting $1.5B in inflows. It was the sixth straight weekly inflow for a total of $13B over that span. Following a nearly two-month string of outflows, $63B has flowed into the asset class since March. Year-to-date inflows now total $41.6B.
- New issuance volume remained heavy, with $18B pricing across 21 deals last week. This comes on top of the $20B that priced the week before, marking the busiest August on record. Issuance was heavily skewed toward refinancings, with the majority of proceeds used to repay existing bonds or loans. While these paydowns should help the technical over the coming weeks, the market struggled somewhat to digest all the supply.
- While energy issuers continue to file for bankruptcy and low oil prices weighed on Q2 financial results, costs for shale producers continue to decline. We estimate that production costs have come down by approximately $5 per barrel to between $40-45 per barrel for most high yield shale producers, providing some level of support. We believe the outlook is better for natural gas producers as overall production has declined, demand has remained strong, and current gas prices are supportive.
- U.S. leveraged loans returned +0.54% as new CLO formation continues to be higher than many market participants expected. An uptick in the number of issuers turning to the high yield bond market to refinance existing loans has also contributed to a relatively strong technical backdrop for the asset class.
- In Europe, high yield bonds returned +0.46% as the primary market remained silent. By quality, BBs, Bs, and CCCs returned +0.44%, +0.45%, and +0.68%, respectively. Loans returned +0.36%, bringing the year-to-date total return to -2.22%.

SECURITIZED PRODUCTS

- U.S. conduit CMBS spreads were unchanged last week as demand remained steady. There are two conduit deals in the market this week before a slowdown in new issue supply until September. 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 secondary and primary markets moved tighter last week on strong demand. The senior portion of the capital structure was in focus as strength in AAAs led the rally tighter across the capital structure. We've seen very strong demand from asset managers drive spreads tighter. Shorter tenor and/or bonds with higher quality underlying pools also remained well bid. We continue to see bifurcation in primary versus secondary market spreads 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. Notwithstanding the current global recession, we believe net issuance may exceed pre-COVID estimates for 2020 as new issue production remains robust. U.S. CLO primary spreads for higher quality portfolios ended at about ~3L+155/190/255/400/800 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. CLOs while we remain cautious about legacy junior mezzanine tranches in particular given our views around impairments and respective valuations.
- Non-benchmark ABS spreads tightened last week as technicals remain strong. Notably, $1B of One Main unsecured consumer loans came to market with class A at +135 bps (from initial guidance of +165), class B at +175 (from +215), and class C at +230 (from +275 bps). As we continue to monitor issuer shelves and collateral performance, we maintain a preference for securities from select issuers with strong underwriting practices, servicing, and legal/compliance capabilities.

Source(s) of data (unless otherwise noted): PGIM Fixed Income, as of 08/17/2020.

2020-5191