PGIM
India Mutual Fund

WEEKLY VIEW FROM PGIM FIXED INCOME DESK

Risk Rally Resumes as Rates Stabilize

April 12, 2021

MACRO

- While there is some trepidation about how potential increases in U.S. corporate tax rates might affect corporate profits, the scale of monetary and fiscal stimulus that will remain in the system into next year should mask the potential effects of changing business models and possible tax increases. In terms of gauging how a potential increase in the corporate tax rate might affect macro conditions, a scenario where the corporate tax rate is lifted from 21% to 25% or 28% could contract GDP by -0.4% to -0.8%, respectively, according to the Tax Foundation. Similarly, an increase to 25% or 28% could decrease the wage rate by -0.4% to -0.7% and reduce full-time equivalent jobs by about 84,000 to 159,000, respectively.
- Although we expect that U.S. GDP growth of 4.5% in 2022 will place the current expansion above its pre-pandemic trend, or potential, by the end of 2022, the end of next year could also bring a distinct moderation in growth. For example, a survey of forecasts by six major banks culminates with an average GDP of 9.9% in Q2 2021. However, from there, the forecasts moderate to an average of 1.9% by Q4 2022 with a forecast of 1.0% by Barclays and 0.5% by UBS.
- With inflation expected to rise off of the base effects from last year, we anticipate U.S. core PCE could reach a near-term peak of 2.15% in April before it subsequently moderates to 1.75% by August 2021. The housing sector—rents and owner equivalent rents—is a factor we're watching closely as it has pressured the inflation rate lower amid falling rents and historically low mortgage rates while other components, such as energy goods and services, have risen strongly since April 2020. For reference, the March CPI rose by 2.6% year-over-year at the headline level and by 1.6% at the core level.

RATES

- It may be still too early to call a crest in long-term developed rates, but we see a couple indications that longer-term U.S. rates may be nearing the end of their selloff. For example, inflation expectations rose significantly during the selloff with the 10-year breakeven rate rising to 2.35%. However, the move in inflation breakevens has paused and they would need to renew the upward move in order for the nominal rate to notably increase from its recent range of 1.60-1.75%.
- Furthermore, we've seen correlations between forward rates behaving more normally in recent trading sessions. For instance, in February, the relationship between the 5-year 5-year and the 1-year 1-year forward rate was about 40 bps off of its historical norms, while the relationship between the 10-year 10-year and 5-year 5-year was about 15 bps off of its historical norms. The reduced dislocations in the forward-rate complex could also be a harbinger that the volatility in nominal rates might be set to recede as well.
- In the near term, we'll trade tactically in the U.S. amid this week's incoming supply, and we continue to see value in the 7-year and 20-year portions of the yield curve. We continue to see attractive value at the back of the U.S. curve from a longer-term perspective, and the term premia at the back of the curves in Canada and Australia also appear attractive.
- U.S. mortgage spreads continued to tighten in nominal spreads amid lower supply, continued bank demand and some opportunistic selling into basis strength. The market-cap weighted Treasury OAS closed at 6 bps (unchanged) and the LIBOR OAS closed at 5 bps (+1 bp). With rates (led by 5-year to 7-year part of the curve) rallying back from the peak in yields seen at the end of March, lower coupons outperformed on the stack, thanks to servicer activities and reinvestment needs from the Fed and banks. Higher coupons underperformed, widening out 6 bps in LIBOR OAS. 15-year issues lagged 30-years despite the outperformance on the 5-year portion of the rate curve.

CORPORATES

- In a week in which the U.S. IG market saw its lowest volumes of the year, spreads ended the week unchanged. Apart from BBBs, which modestly outperformed, performance was relatively flat across quality buckets. After some recent underperformance, front-end banks rebounded last week.
- New issue supply slowed to $13B from 16 issuers and included just one 30-year deal. Order books were almost 3 times covered and concessions averaged 2 bps. Dealers expect up to $20B of supply this week. U.S. IG technicals remain strong as fund flows have continued and dealer inventories have fallen below average, with particularly low 30-year volumes. Additional technical support could emerge from overseas investors with ample cash balances amid selectively attractive hedged yields in the sector.
- Looking ahead, we believe BBBs, particularly those in select sectors, have the most potential for additional spread tightening relative to A-rated segment of the U.S. IG market.
- Driven by an early rally, European IG spreads tightened by 3 bps last week. Momentum eventually slowed later in the week as profit taking prompted some opportunistic selling. Primary market activity was expectedly slow, totaling €7B, with issuance skewed towards financial issuers. With supply expected to remain light over the next few weeks, we could see spreads can grind tighter from current levels. Given the relatively low absolute level of spreads, we believe further tightening would likely be driven by compression within BBBs and a continued rebound by COVID-sensitive credits.

EMERGING MARKETS DEBT

- Emerging market hard and local currency assets posted positive returns last week, helped by a stabilization in U.S. Treasury rates and broader growth backdrop. EM hard currency returned +0.61%, EM corporates returned +0.16%, hedged local rates returned +0.55%, and EMFX returned +0.40%. EM hard currency spreads tightened -6 bps to 340 bps, with the high yield portion of the index tightening -12 bps to 605 bps.
- Emerging market bond fund flows turned positive, totaling +$1.77B. Hard currency funds saw inflows of $1.48B, local currency funds saw inflows of $36M, and blend funds saw an inflow of $250M. This brings year-to-date total flows into EM bond funds to $19.71B, with hard currency, local currency, and blend strategies accounting for $6.38B, $8.63B, and $4.70B, respectively. EM equity funds saw $70M of outflows last week.
- Corporate and quasi-sovereign issuance was quiet last week. However, in the sovereign new issue market, Romania came to market with a €2B 12-yr and €1.5B 20-yr priced at MS+195 bps and MS+235 bps, respectively. In its second foray into the market this year, Mexico issued a $3.26B 20-yr priced at T+205 bps. PEMEX tightened 15-18 bps on the heels of Mexico's offering.
- In hard currency sovereigns, performance remained largely country specific with Russia underperforming on ongoing sanction concerns and Angola outperforming following its underperformance the prior week. Ecuador bonds rallied after a more market-friendly candidate won the presidential election.

- In EM local rates, the Index yield declined 7 bps to below 4.9% as lower U.S. Treasury yields and slightly stronger EM currencies helped performance. Colombia, South Africa, Mexico, Peru, and Chile outperformed, while Russia lagged.
- In EMFX, Central and Eastern European currencies benefited from a pickup in vaccinations across the EU. The Peruvian sol, Polish zloty, Czech koruna, Hungarian forint, and Mexican peso outperformed; the Argentine peso, Indian rupee, Thai baht, Russian ruble, and Turkish lira underperformed. Going forward, we expect the EU region to outperform amid an expected economic rebound.

HIGH YIELD

- U.S. high yield returned +0.59% last week amid optimism around post-vaccine normalization and the anticipated economic recovery. Low and rangebound nominal rates continued to support risk appetite and an ongoing search for yield, with the U.S. 10-year Treasury yield relatively unchanged on the week. Average yields declined to 4.02% by the end of the week, nearing the all-time low of 3.94% set in mid-February.
- U.S. high yield spreads tightened by 12 bps to +321 bps last week and approached their pre-crisis tights of 318 bps. However, we believe spreads could subsequently tighten into 300 bps by the end of the year on the way to 275 bps in 2022.
- Performance was relatively evenly dispersed across ratings categories, with BBs (+0.62%) modestly outperforming Bs (+0.55%) and CCCs (+0.53%). All high yield sectors posted positive returns last week, led by airlines, energy, and autos.
- U.S. high yield mutual funds reported a third consecutive weekly inflow. At $3.8B, the inflow was the largest since last November and trims year-to-date outflows to $7.2B. For context, net inflows totaled $45B in 2020. Primary activity remained busy with $11.7B in issuance across nine deals, which brings year-to-date primary issuance to $173B.
- The high yield default rate ticked lower in March, with one default and one distressed exchange. The trailing twelve-month par-weighted high yield default rate declined 130 bps sequentially to 4.8%, according to JP Morgan.
- U.S. leveraged loans returned +0.34% last week, with performance fairly evenly dispersed across credit quality. The new issue calendar remained robust, with $11B in new deals coming to market, only $1B of which backed refinancing activity. The heavy new issue calendar contributed to some softness toward week's end as some accounts sold to make room for new supply. Still, technicals remain robust as loan mutual funds posted another $1B in weekly inflows and CLO demand remained strong.
- In Europe, high yield bonds returned +0.29% amid the shortened, post-holiday week. By quality, BBs, Bs, and CCCs returned +0.27%, +0.30%, and +0.52%, respectively. Spreads tightened by -13 bps to 308 bps as primary activity totaled €1.85B. Loans returned +0.12% last week, which brings the YTD return to +1.95%.

SECURITIZED PRODUCTS

- U.S. conduit AAA CMBS spreads tightened by 5 bps last week on strong demand and limited supply. One conduit deal is expected to price this week. The commercial real estate (CRE) refinance market continues to reopen and now includes some high quality hotel and retail properties. Supply is expected to increase throughout the year as vaccine rollouts continue. We expect COVID to continue to weigh on CRE fundamentals in the hospitality, retail, and office sectors, and we remain constructive on senior, well-enhanced CMBS tranches.
- Primary CLO spreads remained relatively stable across the capital structure last week with very marginal softness in junior mezzanine tranches. We're starting to see primary spreads reflect market levels as deals committed in March begin to clear the market. While we continue to see large anchor investors source bonds, supply continues to negatively impact spreads. We continue to expect robust issuance volumes in the U.S. and Europe this year as we are currently being marketed over 160 deals across both markets. U.S. CLO primary spreads for higher quality portfolios ended the week at about ~3mL+114/170/225/335/690 bps for AAA/AA/A/BBB/BB, respectively. Long term, we continue to favor senior CLO tranches in Europe and the U.S. and remain cautious about legacy junior mezzanine tranches given our views around higher impairments amid lower recovery rates.
- ABS spreads were unchanged to tighter last week. Longer duration ABS securities benefited from Ford's $1.1B, five-year prime auto revolver at an all-time tight. Year-to-date new issuance now totals $65B, which is on pace with 2019. We expect ABS spreads to remain firm due to expectations for flat/negative net new issuance this year.

MUNICIPAL BONDS

- Tax-exempt municipal bonds benefited from a strong tone last week with the stabilization in Treasury rates helping fund flows. The 5 , 10-, and 30-year portions of the AAA-rated muni curve ended the week at 54.3% (from 54.2% the prior week), 62.0% (down from 64.2%), and 70.3% (down from 72.5%). Year to date, the high grade index has returned +0.11% and the high yield index has returned +3.05%.
- Municipal bond funds saw net inflows of $2.1B last week, with long term, high yield, and intermediate funds posting inflows of $1.7B, $821M, and $259M, respectively. This brings year-to-date inflows to $35.6B. Year-to-date gross supply totals $124B, including $38B of taxable issuance, with this week's calendar estimated at close to $8B, including over $3B in taxable muni issuance.
- Moody's Investors Service revised the outlook on New Jersey's A3 GO rating to stable from negative citing better-than-expected revenue collections in FY2021 and the expectation of larger fund balances. New York State lawmakers reached an agreement on a $212B FY2022 budget that includes temporary tax hikes for top earners. The Governor of Illinois signed a bill that will increase the pension COLA adjustment for certain Chicago firefighters that are 55 or younger to 3% from 1.5%, raising the city's unfunded pension liabilities and its annual contribution requirements.

Source(s) of data (unless otherwise noted): PGIM Fixed Income as of April 2021

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