WEEKLY VIEW FROM PGIM FIXED INCOME DESK

Global Tapering Thoughts

April 26, 2021

MACRO

- Despite the re-emergence of COVID hot spots, such as India, the developed market recovery is maintaining its momentum as most GDP forecasts continue to increase. Forecasts for U.S. GDP in 2021 have risen from slightly less than 4.00% to start the year to 6.25% currently, which is leading the developed market economies. Canada is second with forecasts for 5.90% growth this year, and that prospect was enough for the Bank of Canada to become the first DM central bank to taper its QE bond purchases (by a quarter to C$3B) and accelerate the timing of a potential rate hike (now the second half of 2022).
- Although the ECB may resume tapering its activity under the Pandemic Emergency Purchase Prorgramme, we don't consider that a form of policy tightening. Once the worst of the market turbulence passed, the ECB started tapering its purchases by the second half of 2020. However, the ongoing tapering raises the question of how much open-ended stimulus might be agreed upon in Europe going forward as the ECB strives to reach its elusive inflation target.
- Forecasts for 2021 GDP growth in Japan have increased marginally over the course of the year to 2.90%, while projections for growth in the EU have declined from about 4.60% to 4.0%. However, Europe's stronger-than-expected PMIs in April indicate that the recovery may gain momentum into the second half of the year as the new orders component of the manufacturing survey surged to a record high.
- With Germany's federal elections approaching at the end of September, the Green Party continues to poll well and is only slightly behind the CDU/CSU. Greater representation by the Green Party could indicate increased fiscal spending on EU integration and climate-related public infrastructure, which will likely be a costly endeavor in Germany given it is one of the region's leading CO_2 emitters at 10 tons (2017 tons) per capita.
- We continue to expect that the Fed may start its tapering process by the end of the year, but we don't anticipate that it will provide any timing at this week's policy meeting. We believe more information may be forthcoming in upcoming speeches from various FOMC members or possibly at the Jackson Hole Symposium this summer. We still see a rate hike before 2023 as an unlikely scenario.

RATES

- Recent history shows a fairly tight correlation between global industrial production and the U.S. 10-year yield, and we believe we may be near the peak in the rate of activity in terms of the demand for physical goods. While the services sector certainly has room to accelerate, the demand for services is far less correlated to the level of rates. Once the peak of demand for physical goods passes, we believe conditions will moderate to their pre-virus levels over the next two years, i.e. generally slow growth and inflation, which is likely to keep Fed policy at historically low levels and the 10-year yield below 1.5%.
- Some observers are understandably concerned about a potential replay of the taper tantrum once the Fed indicates a reduction in its QE activity. However, we expect less of an impact from the upcoming tapering relative to the tantrum in 2013, which is when the 10-year yield jumped to about 2.2%. Once the market came to terms with 2013's tapering, the 10-year yield began declining past the Fed's first rate hike of the cycle in late 2015 to a level of about 0.80%, which was below its pre-taper levels.
- U.S. mortgage spreads reached the richest valuations in years with the market-cap weighted Treasury OAS closing at 1 bp and the LIBOR OAS closing at 4 bps. 30-year 3.5% issues outperformed and tightened by 5 bps. Buying activity remains centered in 30-year 2% and 2.5%. Domestic banks have added $182B through April 14th, and they may continue to add exposure into the second half of the year.
- Freddie Mac's first Green Bond offering traded well last week, and we view it as 2-5 bps rich of a similar traditional offering amid smaller loan sizes. The mortgage borrowers in the issue will use the refinancing proceeds to pay off existing debt that was used to purchase and install solar panels.

IG CORPORATES

- After widening through much of last week, U.S. IG spreads began to stabilize on Friday, ending the week wider by 1 bp, at an index OAS of 90 bps. Sector outperformance was led by U.S. money center banks, which tightened by about 5 bps. The tobacco sector underperformed amid headlines regarding the potential for tightened regulation and tax increases under the Biden administration.
- U.S. issuance came in at the low end of expectations, totaling $25B. Supply was once again dominated by banks, including a $7.5B multi-tranche deal from Morgan Stanley. Dealers are calling for $20-$30B of supply this week, and expectations are for the new issue pipeline to shift toward industrials. Initial forecasts for May expect up to $150B of issuance, which could serve as a headwind as investors attempt to digest the elevated supply.
- Following last week's tightening, U.S. money center bank spreads have now retraced to the levels last reached in the run up to the wave of bank issuance that followed Q1 earnings releases. And although our short-term outlook for U.S. money center banks generally remains constructive, we're shifting to a more neutral stance until spreads reach more attractive levels. On a related note, it's possible some U.S. money center banks price reverse-yankee offerings in the European IG market, and we may add these issues to our U.S. IG portfolios where possible.
- Bolstered by limited supply, European IG spreads were resilient and tightened by 1 bp last week. Similar to the U.S., European IG tobacco spreads also came under notable pressure. Although primary market activity picked up week-over-week, totaling about €10B, new issue supply remained fairly subdued and included only a few multi-tranche offerings. Supply is expected to pick up this week and continue into May, which could weigh on technicals.

EMERGING MARKETS DEBT

- Emerging market assets saw mixed performance last week as local currency assets posted negative returns and hard currency assets were flat to slightly positive. Uncertainty over the virus, vaccines, and idiosyncratic events contributed to wavering returns over the past few weeks. However, stability in U.S. yields has helped performance, while global liquidity and strong global economic growth remains supportive. EM hard currency returned +0.01%, EM corporates returned +0.06%, hedged local rates returned -0.12%, and EMFX returned +0.12%. EM hard currency spreads widened +1 bp to 340 bps, with the high yield portion of the index tightening -3 bps to 577 bps.
- Emerging market bond fund flows were again positive, totaling +$570M. Hard currency funds saw inflows of $161M, local currency funds saw inflows of $411M, and blend funds saw an outflow of $3M. This brings year-to-date total flows into EM bond funds to $21.82B, with hard currency, local currency, and blend strategies accounting for $7.59B, $9.47B, and $4.77B, respectively. EM equity funds saw $1.28B of outflows last week.

- In hard currency sovereigns, high yield outperformance was led by Bs and CCCs, with Ecuador, Argentina, Angola, and Ukraine outperforming. The IG portion of the index lagged last week, largely on country specific issues. Peru underperformed as leftist presidential candidate Pedro Castillo extended his lead in polls ahead of June's runoff.
- In EM corporates, uncertainty around China Huarong Asset Management and the spike in COVID cases in India remains an overhang for the Asian market. Huarong said its 2020 results would be delayed past the April 30 deadline, while India reported a record 314,835 new COVID cases on Thursday.
- In EM local rates, the Index yield declined 2 bps last week. However, country-specific events caused yields in Russia, Peru, and Turkey to rise 20-40 bps. The Russian central bank raised key rates by 50 bps last week in response to rising inflation. Meanwhile, Brazil outperformed on the back of its budget agreement.
- In EMFX, the Russian ruble, Brazilian real, Taiwan dollar, Czech koruna, Israeli shekel, and Romanian leu outperformed last week, while the Peruvian sol, Turkish lira, Argentine peso, Colombian peso, and Indian rupee underperformed.

HIGH YIELD

- U.S. high yield returned -0.05% last week as a combination of technicals, concerns around COVID-19 variants, and President Biden's proposal to raise the capital gains tax on wealthy individuals weighed on the market. After beginning the week with a softer tone, the market firmed toward week's end as investors found some comfort in strong corporate earnings and positive economic releases. Spreads widened 7 bps to +329 bps and average yields rose 6 bps to 4.08%.
- High yield sectors produced mixed results with capital goods, consumer products, and cable outperforming. Meanwhile, airlines and lodging were the worst performers, down -0.44% and -0.20%, respectively. Despite the pullback, the airline sector is still the top performer year to date (+5.93%), followed closely by energy (+5.81%).
- U.S. high yield mutual funds reported outflows totaling $2.1B last week, bringing year-to-date outflows to $8.1B. Meanwhile, primary activity remained busy with $8.7B in issuance across 16 deals. This brings month-to-date primary issuance to $42.3B, marking the most active April on record. Given expectations of continued robust primary activity against the backdrop of outflows from the asset class, we moderated our short-term outlook, but remain constructive over the medium to long term.
- U.S. leveraged loans were flat last week as the market primarily focused on the heavy new issue calendar. Tight spread names were weaker as accounts sold to make room for new issuance. In all, the market absorbed $17B of new supply last week, with another $23B of visible supply still remaining in the pipeline. Meanwhile, U.S. loan mutual funds posted another $1.1B of inflows last week, which brings the year-to-date inflow to $13B.
- In Europe, high yield bonds returned -0.12%, with travel names underperforming amid virus mutation concerns. By quality, BBs, Bs, and CCCs returned -0.15%, -0.12%, and +0.14%, respectively. Spreads widened by 2 bps to 307 bps and average yields rose 5 bps to 2.65%. Primary activity remains busy across bonds and loans. In the bond market, €4B of supply priced across eight deals, €2.6B of which was new money. Month to date, high yield issuance now totals €10B. Loans returned +0.09% last week as issuance remained robust, with month-to-date issuance rising to €10B.

SECURITIZED PRODUCTS

- U.S. conduit AAA CMBS spreads were unchanged last week despite strong secondary demand. One conduit new issue priced in line with initial talk, and another conduit deal is expected this week. Although dealers have revised 2021 conduit supply expectations lower, Single Asset Single Borrower (SASB) and commercial real estate (CRE) issuance will likely be notably higher. 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 primary spreads firmed slightly in mezzanines as AAAs softened. While we continue to see large anchor investors looking to source bonds, supply continues to negatively impact AAA spreads and limit compression. We continue to expect robust issuance volumes in U.S. and Europe this year as we are currently being marketed over 170 deals across both markets. Primary U.S. CLO spreads for higher quality portfolios ended the week at about ~3mL+114/170/205/315/680 bps for AAA/AA/A/BBB/BBs, respectively. Long term, we continue to favor senior CLO tranches in Europe and the U.S. and remain cautious about legacy junior mezzanine tranches.
- ABS spreads were generally unchanged last week as $3.5B of new issuance was well absorbed. This year's issuance now totals $76B, which aligns with 2019's pace. Secondary clearing levels remain around year-to-date tights. We view ABS fundamentals as favorable but are mindful of increased regulatory scrutiny over originators of consumer credit. ABS spreads are expected to remain supported due to our expectation for flat/negative net new issuance this year.

MUNICIPAL BONDS

- Tax-exempt and taxable municipal bonds continued to benefit from a strong technical backdrop, with another strong inflow into municipal bond funds last week. The 5 , 10-, and 30-year portions of the AAA-rated muni curve ended the week at 44.0% (up from 43.3% the prior week), 59.6% (up from 58.7%), and 69.3% (up from 68.3%). Year to date, the high grade index has returned +0.64% and the high yield index has returned +3.69%.
- Municipal bond funds saw net inflows of $1.9B last week, with long term, high yield, and intermediate fund posting inflows of $1.5B, $642M, and $200M, respectively. This brings year-to-date inflows to $39.9B, with municipal funds having seen net inflows in 48 of the past 49 weeks. Year-to-date gross supply now totals $145B, including $43B of taxable issuance. This week's calendar is estimated at $5.4B, including $1B in taxable muni issuance.
- Connecticut revised its revenue estimates higher by $53M, increasing the total FY21 revenue estimate by more than $1B since June as all major revenue categories exceeded expectations. The state's rainy day fund is estimated at about 19% of general fund spending.

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

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