PGIM India Mutual Fund

WEEKLY VIEW FROM PGIM FIXED INCOME DESK

Eyeing a Shifting Yield Curve and Fed Expectations

April 05, 2021

MACRO

- We believe the labor market recovery indicated by the 916,000 surge in U.S. non-farm payrolls last month will continue with support from three sources: positions in COVID-suppressed sectors, broad-based additions amid rising incomes supported by fiscal and monetary support, and sector-specific trends (e.g. demographic support for housing and the continued introduction and adoption of 5G technologies). Although U.S. GDP is expected to reach pre-virus levels in Q2, employment will still likely lag by several quarters, which should provide a temporary boost to productivity in the quarters ahead.
- While the improvement in the labor market may keep the Fed on the pace to taper its QE purchases by the end of 2021, the reaction function in terms of hiking rates remains particularly loose under its average inflation targeting framework, and the policy rate could remain highly accommodative for up to two additional years. In terms of the market expectations, it's pricing in the first Fed hike by December 2022 and three additional hikes in the first half of 2023. We view those expectations as overly aggressive.
- With virus cases again rising in Europe and possibly threatening the summer tourism season, we're closely monitoring the risk that GDP growth in the euro area fails to return to its pre-pandemic trend by the end of 2022. This not only indicates a widening gap between U.S. and euro area growth estimates, but it also indicates the potential for a widening gap to the EA's pre-pandemic growth trend.

RATES

- The movement in the U.S. yield curve has shifted from a bear steepening (led by the back end) to a bear flattening (led by the front end of the curve). While the flattening on the 2- to 7-year portion of the curve reflects expectations for a higher Fed Funds rate in the relatively-near future, an unusual, concurrent flattening along the 7- to 30-year portion of the curve could indicate some oversold conditions in long-term rates.
- Thus, with credit spreads resuming their tightening trend on the back of the recovering labor market, we believe that duration, rather than credit exposure, may drive potentials gains for the bond market going forward. We would continue scaling into U.S. 10-year nominal rates in the range of 1.75-2.00%, and we're also maintaining short positioning in 5-year real rates and 10-year real rates in the UK.
- U.S. MBS spreads firmed over the last two weeks as month-end demand and lower supply helped. The market-cap weighted Treasury OAS closed at 6 bps (-1 bp) and the LIBOR OAS closed at 4 bps (-5). At the end of March, we observed better demand down-in coupon to match the extended duration of the MBS index. MBS excess returns ended March +17 bps and ended Q1 +15 bps.

CORPORATES

- U.S. IG spreads tightened by 7 bps last week on slower primary market issuance and robust month-end buying. Following last week's rally, the U.S. corporate index OAS is just 1 bp wide to its year-to-date tight and 4 bps wider than the post crisis tight of 85 bps. Spread curves continued flattening, with the long corporate index tightening by 9 bps last week. Cyclicals and BBBs also outperformed.
- New issue activity was limited, totaling $8B from 10 issuers, with much of the supply concentrated in short and intermediate maturities. Order books increased to 3.5 times covered and concessions moderated. In general, performance improved in line with the improved market tone and technicals. Dealers are calling for $20-$30B of supply this week and $90-$120B in April. Near term, favorable technicals and improving fundamentals bode well for the U.S. investment grade market going forward.
- The liquidation of U.S. family office Archegos Capital dominated the financial headlines for most of the week with a handful of the fund's prime brokers facing heavy losses. Initial loss estimates for Credit Suisse are in the $3-$5B range, while Nomura's losses could reach $2B. Following the news, spreads on Credit Suisse's 10-year dollar-denominated bond widened by about 8 bps, while Nomura's five-year issue widened by 10 bps. To date, the subsequent fallout seems to be relatively well contained, but serves as a reminder that volatility often lurks near the surface of orderly markets.
- The European IG market tightened by 3 bps last week, with long-dated cyclicals notably outperforming on the back of a notable rebound in market risk appetite. Primary market activity slowed in the shortened week, with just €5.5bn of supply. New issue performance was generally solid, with the higher-beta deals faring the best. With a quiet primary market expected this week, it's possible technicals prompt a further rally in spreads.

EMERGING MARKETS DEBT

- Emerging market hard and local currency assets were roughly flat on the week. EM hard currency returned +0.01%, EM corporates returned +0.03%, hedged local rates returned 0.04%, and EMFX returned -0.03%. EM hard currency spreads were flat at +355 bps, while EM corporate spreads tightened by -5 bps to +285 bps as corporates continue to benefit from the strong global recovery, higher commodity prices, and low default rates.
- Emerging market bond fund flows were negative, totaling -$780M. Hard currency funds saw outflows of $278M, local currency funds saw outflows of $734M, and blend funds saw an inflow of $233M. This brings year-to-date total flows into EM bond funds to $17.94B, with hard currency, local currency, and blend strategies accounting for $4.90B, $8.60B, and $4.45B, respectively. While outflows have persisted in recent weeks, they appear relatively muted when compared to similar periods of rising U.S. rates and a stronger dollar seen over the past 20 years.
- In hard currency sovereigns, performance remained largely country specific, with Ghana underperforming after coming to market with $3B of bonds at concessions across the curve. Meanwhile, Ecuador outperformed as a more market-friendly presidential candidate gained in the polls. Quasi-sovereign issuer Petrobras gained as it commenced a tender offer for its U.S. dollar-denominated notes.
- In EM local rates, the Index yield declined 3 bps to below 5.0% as country-specific inflation and COVID response remains the main drivers of performance. Turkey, Malaysia, Chile, Indonesia, and Czech Republic were outperformers last week, while Peru, Mexico, Colombia, Brazil, and Poland lagged.
- In EMFX, the South African rand, Chilean peso, Polish zloty, Argentine peso, and Brazil real outperformed; the bottom performers were the Turkish lira, Indian rupee, Romanian leu, Indonesian rupiah, and Russian ruble. Month-end flows were heavily skewed toward U.S. dollar selling, which offset the strength of earlier in the week. With U.S. nonfarm payrolls coming in better than expected, we remain neutral on EMFX over the short term.

HIGH YIELD

- U.S. high yield returned +0.46% during the holiday shortened week as Biden's proposed $2T infrastructure plan bolstered sentiment. Average yields fell 21 bps to 4.20%, 26 bps wide of the all-time low of 3.94% set on February 15. Spreads tightened by 22 bps to +333 bps.
- By quality, CCCs (+0.50%) outperformed both BBs (+0.47%) and Bs (+0.42%). Year to date, CCCs have returned +5.46%, while Bs and BBs have returned +1.34% and -0.02%, respectively. All high yield sectors posted positive returns last week, led by energy, aerospace, retail, airlines, and metals & mining. The media and technology sectors lagged.
- U.S. high yield mutual funds reported an inflow of $1.7B, trimming the year-to-date outflow to $9.0B. Primary activity remained busy with $8B in issuance across 12 deals, with most deals 3 to 4 times oversubscribed and trading well on the break. Year to date, total issuance is a record high $145B, although most of the issuance has backed refinancing activity.
- U.S. leveraged loans returned +0.05%, with most of the focus on primary market activity. While refinancing and repricing activity comprised the bulk of last week's $17B of issuance, a couple of large new money deals were also announced, which led to some selling as accounts made room for new supply. Still, technicals remained robust, as loan mutual funds posted their 17th consecutive weekly inflow and CLO formation continued to drive demand.
- Notably, Belron SA issued an ESG-linked leveraged loan last week to back a dividend recapitalization, with coupon pricing on the windshield repair company's new loan ratcheting up by +10 bps if it fails to meet certain thresholds and down by -7.5 bps if it meets certain ESG thresholds.

SECURITIZED PRODUCTS

- U.S. conduit AAA CMBS spreads were unchanged last week as limited primary and secondary market supply kept spreads resilient. Only three conduit deals are expected in April. 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 with vaccine rollouts increase. 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 continued to soften last week, hitting what we believe is likely the midpoint for near-term spread range; we don’t expect a meaningful move wider. New issue spreads started to reflect some of the prior week’s widening as deals saw more dispersion between benchmark issuers. While we continue to see large anchor investors looking to source bonds, supply continues to impact spreads. We continue to expect robust issuance volumes in 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+114/165/205/335/690 for AAA/AA/A/BBB/BB, respectively.
- ABS spreads were generally unchanged last week. New issuance was light, but is expected to pick-up this week. Notably, Ford is pre-marketing its first prime auto revolving deal in 2021. The total deal size is $1.1B, with 5-year, class-A initial price talk of swaps+ the mid- to high 40 bps range. We continue to see some dealers looking to reduce aged inventory, which could cause additional near-term softening of spreads. Longer term, we expect ABS spreads to remain supported due to our expectation for flat/negative net new issuance in 2021.

MUNICIPAL BONDS

- Tax-exempt municipal bonds benefited from a strong tone last week, with muni/Treasury ratios tightening across the curve. Year to date, the high-grade index has returned -0.35% and the high yield index has returned +2.11%. The 5-, 10-, and 30-year portions of the AAA-rated muni curve ended the week at 54.2% (down from 58.5% the prior week), 64.2% (down from 66.9%), and 72.5% (down from 73.5%).
- Municipal bond funds saw net inflows of $161M last week, with long term, high yield, and intermediate funds posting inflows of $179M, $254M, and $107M, respectively. Year to date, municipal bond funds have now seen net inflows of $31.7B. Year-to-date gross supply totals $111B, including $33B of taxable issuance, with this week's calendar estimated at close to $12B, including $4B in taxable muni issuance.
- In ratings news, Moody's Investors Service upgraded the State of Connecticut's GO rating to Aa3 from A1-Moody's first upgrade of a state since November 2019.
- While there will be months of negotiations before a final plan is passed, the proposed infrastructure package could impact the municipal market in several ways. Direct Federal money for infrastructure could lead to less tax-exempt or taxable issuance, while an increase in the corporate tax rate to 28% could make tax-exempt municipals more appealing to U.S. banks.

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

2021-2994