PGIM FIXED INCOME

PGIM India Mutual Fund

WEEKLY VIEW FROM THE DESK

Evolving Political Backdrop Carries Through to U.S. Rates

January 11, 2021

MACRO

- The fallout from last week's events at the U.S. Capitol may continue to unfold until the 2022 midterm elections or even the 2024 presidential election. It reduces the probability that President Trump could become the Republican nominee in 2024 and may also affect the trajectories of some of his ardent supporters. From a policy perspective, even with Democrats set to narrowly control the Senate, the scope of a bold progressive agenda is likely to remain constrained. Legislative priorities will likely focus on additional fiscal stimulus (including additional payments to households and financial support for state and local governments), an infrastructure package, and adjustments to the tax code.
- We place a 75% probability on a ~$1T stimulus initiative that could arrive in the Spring via budget reconciliation and a 50% probability on a +$1T infrastructure package that could also arrive in the Spring via reconciliation. The timing of these two priorities could be flexible if 60 votes for passage exist in the Senate. We see a 30% probability that an initiative to lift tax rates emerges in the fall via reconciliation. Our current baseline view of U.S. GDP in 2021 without additional fiscal stimulus is 4.5% and our baseline projection ticks up to 5.4% in a scenario with additional stimulus under the Biden Administration. Our upside scenario is 6.1% and our downside scenario is 3.3%.
- On the tax front, a push to raise the corporate tax rate from 21% to the 25% area and reinstate the top personal income tax rate of 39.6% could emerge. However, an effort to reinstate the deduction on state and local taxes could also surface, which could complicate passage and mitigate the revenue effect of the tax increases. Overall, we believe the Biden Administration's agenda will need to be implemented mostly through executive orders and administrative actions given the thin majorities in the House of Representatives and the Senate.
- A key initiative of the Biden Administration already hit some headwinds prior to inauguration. The recently agreed-upon trade deal between the EU and China—the Comprehensive Agreement on Investment—means that Germany is unlikely to join any counter-China initiative that endangers its exports to the country. Therefore, the worst of the trade tensions between China and the West may be in the past.
- Other factors to consider in the U.S.-China relationship include the latter's opposition arrests in Hong-Kong, whether China might use its underperformance under the Phase 1 trade deal as a carrot for further negotiations, and whether climate change might be an area of agreement given President Xi's "net zero" pledge or discord considering the recent increase in China's coal-fired power generation. An over-reaction on Taiwan by either side remains a key risk in the relationship.

RATES

- Given the vaccine introductions and the Democrats' victory in Georgia, we don't think it's overly surprising that the U.S. 10-year yield recently topped 1.0%. Looking ahead, we see scenarios where the top of the range could be 1.25%, a smaller probability of 1.50% in a scenario with a fiscal package beyond what's being discussed, and a remote probability where the top of the range could be 2.0% in a scenario with a +$4 trillion multi-year infrastructure/renewable energy package.
- However, by the end of the year, significant slack will likely remain in the U.S. labor market and inflation will likely remain below 2%. Therefore, in that scenario, the markets will begin to price for a delayed lift off of the Fed funds rate, a shallower slope for rate hikes, and a lower ultimate peak for rates. That scenario brings our modal forecast for the 10-year yield to 1.0% with a long-term central tendency of 0.8% by 2022. As long-term secular trends reassert themselves, e.g. high global debt burdens, aging demographics, and below-target inflation, if and when the markets develop an expectation that the Fed cannot raise rates, it will difficult for the 10-year yield to exceed 1.0% on a sustained basis.
- In terms of tactical positioning, the potential for upcoming talk regarding tapering could be somewhat bearish for real rates, which recently hit all-time lows. Thus, we're unwinding long positioning in U.S. real rates and evaluating short positioning. However, we don't believe that would coincide with wider breakevens, which would imply higher nominal Treasury yields. During the remainder of the week, we'll monitor if global rates can hold their recent yield lows and if December's CPI report indicates an adjusted trajectory for inflation. Finally, Fed Chair Powell is speaking in a webinar on Thursday, and we'll listen for any updates to the Fed's potential reaction function to recent inflation data or expectations for additional fiscal stimulus.
- Mortgages tightened last week as yield buyers stepped in. The market-cap weighted Treasury OAS tightened to 25 bps (-3 bps), while the LIBOR OAS tightened to 24 bps (-3 bps) both richening to the best levels since August. Intermediate mortgages outperformed longer-duration bonds given the bear steepening of the Treasuries curve. Convexity-sensitive accounts remained quiet into the rate selloff as there was some need to move up in coupon, but no outright shedding of duration in cash MBS. Yield-sensitive buyers outside the U.S. have also become more active recently.

CORPORATES

- U.S. IG spreads tightened by 1 bp last week to 95 bps on the additional prospects for fiscal stimulus. With $50B in issuance pricing, it was the busiest first week of the year since 2009. Deals priced with zero or negative concessions with the exception of Broadcom's $10B BBB-rated five-tranche offering, which priced with concessions of 10 bps. Estimates indicate $25-30B may price this week.
- M&A activity remained steady last week with some additional examples negative credit ratings migration. For example, AmerisourceBergen's $6.5B acquisition of Alliance Healthcare from Walgreens Boots Alliance is set to take its S&P ratings from A- to BBB+. Cash on hand and new debt will provide most of the financing for the transaction.
- European IG spreads tightened by 4 bps last week to +88 bps. The primary market reopened briskly with €18B of supply over a shortened week. The majority of the new issues ended up pricing with zero / negative concessions, and order books were covered by about two times. Despite the heavy supply and lack of new issue concessions, performance was fairly solid with only a couple of senior non-preferred trades bid wide of re-offer. Syndicate desks expect primary issuance to be similarly active this week with estimates in the area of €25B.

EMERGING MARKETS DEBT

- Emerging Market assets saw mixed performance last week amid the U.S. rate selloff, consolidation in the dollar, and expectations for further U.S. stimulus measures. EM hard currency returned -0.18%, EM corporates returned -0.26%, hedged local rates returned -0.28%, and EMFX returned -0.01%. EM hard currency spreads tightened by -6 bps to 345 bps, with the high yield portion of the index outperforming.

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- New issuance was fairly robust, with approximately $30B of new supply last week. In the sovereign new issue market, Indonesia issued a $1.25B 10-yr, €1B 12-yr, $1.25B 30-yr, and a $500M 50-yr priced at T+95.3 bps, DBR+178.4, T+139.9, and T+169.9, respectively. Mexico issued a $3B 50-yr priced at T+209.3. In the corporate and quasi-sovereign new issue market, Export-Import Bank of India came with a $1B 10-yr priced at T+145.
- Emerging Market bond fund flows were positive, totaling $2.97B. Hard currency funds saw inflows of $1.29B, local currency funds saw inflows of $1.47B, and blend strategies saw inflows of $218M. EM equity funds saw -$1.61B of outflows.
- Within sovereign credit, high yield outperformed with spreads on the high yield portion of the index tightening by -11 bps to 597 bps. Notably, B-rated oil-sensitive names, such as Nigeria, Ghana, and Bahrain, saw strong performance. We continue to favor select investment grade, BB-rated credits for spread for compression, and front-end B-rated issues. We expect strong supply to pressure the investment grade market over the short term.
- Within local rates, the repricing of the long-end of the U.S. Treasury yield curve paused further yield compression. The index yield rose to 4.28% from an all-time low of 4.19%. Higher-yielding names, such as Brazil, Peru, Mexico, and Indonesia, underperformed last week. Indonesia sold a record amount of local government bonds as the Bank of Indonesia considers the rupiah undervalued. Romania, Colombia, Philippines, Poland, and Russia outperformed.
- In EMFX, the index was flat but currency performance was mixed, with pro-cyclical FX, by and large, depreciating. We expect increased U.S. fiscal stimulus coupled with higher U.S. growth to lead to upside pressure and consolidation in the U.S. dollar over the near term. However, we believe the dollar is likely to resume a weakening trend over the medium term.

HIGH YIELD

- U.S. high yield returned +0.23% last week amid the increase in the U.S. Treasury yield. While the market saw a few sellers of duration in response to the rate move, demand remained strong and high yield bond spreads tightened by -10 bps to 376 bps as additional fiscal stimulus would likely benefit high yield issuers and smaller companies.
- Lower-quality credits continued to outperform, with CCC-rated bonds returning +0.95. By comparison, BBs and Bs returned +0.11% and +0.17%, respectively. From a sector perspective, energy (+1.48%), retail (+0.50%), and metals & mining (+0.42%) outperformed. Meanwhile, airlines (-0.39%) and food & drug retail (-0.32%) lagged.
- U.S. high yield mutual funds reported a small outflow of $196M. However, ETFs saw an outflow of $358M, implying that active managers saw an inflow of $162M. In 2020, high yield funds saw a record $44.2B of inflows. The primary market saw $10B pricing across 13 issuers last week.
- U.S. leveraged loans also had a strong week, posting a total return of +0.86% as investors continued to put cash from year-end paydowns and amortizations to work. Meanwhile, robust CLO issuance and a relatively muted new issue pipeline also provided a strong technical backdrop for the asset class. Lower-quality loans outperformed as high-yield accounts looked to put cash to work in the loan market. Notably, loan ETFs saw $735M of inflows last week, which also contributed to the strong technical bid.
- Currently 38% of the loan market is bid above par and 82% of the market is bid north of 98 (the same percentage as before the COVID crisis). As we see more of the index above par, we naturally expect much higher repricing and refinancing activity to materialize. This week, we have already seen three issuers return to the market to reprice their loans at a lower spread.
- In Europe, high yield bonds returned +0.64% last week despite additional lockdowns and rising COVID cases. Spreads tightened -23 bps to 346 bps as the prospect of the Democrat-controlled U.S. Senate boosted expectations for further stimulus. Meanwhile, the calendar is growing, with €20B of new supply expected to come to market over the next three to four weeks. Loans were also strong, returning +0.40% last week.

SECURITIZED PRODUCTS

- U.S. conduit CMBS spreads were 2 bps tighter last week. The demand for new issue high quality SASB (single asset/single borrower) deals was considerable, which drove SASB mezzanine (non retail/hospitality) spreads to pre-COVID levels on the secondary market. The conduit supply remains limited, but with the refinance market beginning to open, we could see conduit supply increase in late Q1. We continue to favor senior, well-enhanced CMBS tranches with COVID-19 overhanging CRE fundamentals.
- CLO spreads tightened across the capital structure in both the secondary and primary markets last week as investors aggressively looked to buy bonds. While we still expect issuance to ultimately hinder meaningful spread compression, we see a path for tighter spreads in short run given very strong demand technicals across all tranches and market segments. U.S. CLO primary spreads for higher-quality portfolios ended the week at about ~3L+116/150/210/330/630 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 legacy junior mezzanine tranches given our views on higher impairments amid lower recovery rates.
- ABS spreads were slightly tighter last week on light trading. Notably GM and Santander are marketing prime auto transactions, with mezzanine tranches significantly oversubscribed. We expect the technical environment to remain very strong in ABS with negative net new issuance in 2021 and steady demand due to the breadth of market participants with unfulfilled investment needs.

MUNICIPAL BONDS

- Municipal bonds continue to benefit from strong technicals as new supply was muted and inflows remained positive last week. MTD, the high grade portion of the benchmark index has returned -0.09% and the high yield portion has returned +0.72%. Along the 5-, 10-, and 30-year portions of the AAA-rated muni curve, the muni/Treasury yield ratios ended the week at 52.9% (down from 60.5% the prior week), 69.0% (down from 77.0%), and 77.1% (down from 84.1%), respectively.
- Municipal bond fund flows were positive, totaling $1.1B. Long term, high yield, and intermediate funds reported inflows of $465mm, $98mm, and $150mm, respectively. Meanwhile, this week's calendar is estimated at $8B.
- While the results of the Georgia run-off are favorable for broader muni credit amid expectations of additional stimulus for state and local governments, potential outflows are a concern given the back up in rates. The technical backdrop for tax-exempts remains extremely supportive, with expectations of negative net supply in January and February.

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