U.S. Election Scenarios

PGIM FIXED INCOME

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U.S. ELECTIONS

- Based on our chief economist's interpretation of the latest U.S. general election polls, he continues to see a relatively diffuse set of outcomes and places the highest probability (less than 50%) on a Biden presidency and a Senate controlled by the Democrats, followed respectively by the probabilities for a Trump Presidency and a Republican Senate, a Biden presidency and a Republican Senate, and a Trump presidency and a Democratic Senate. The probabilities assume that the House stays in control of the Democrats.
- In terms of assessing the potential changes in a Biden-victory scenario, from an economic perspective, a Biden win could bring a large stimulus package in Q1 ($3+T), an eventual increase in corporate taxes to 26-28% and personal tax increases on high earners, tighter regulation (including on the tech sector), climate policies focusing on "green" initiatives, a tough but multilateral approach to China (possibly with steps to rejoin the Trans-Pacific Partnership), and a more conventional political operating style.
- Under a Biden presidency scenario, the sectors that could be helped include anything "green" or renewable, infrastructure providers, consumer staples and lower-tier retail, firms reliant on China, and the municipal bond sector. Sectors that could be hurt include oil and other carbon intense energy, technology, health insurance and pharmaceuticals, defense contractors and providers, and firearm manufacturers. We see neutral effects for large banks, utilities as well as commercial real estate, commercial MBS, and residential MBS.
- In terms of market implications, a Biden win could provide support to equities from fiscal stimulus, but a drag from higher tax rates and tighter regulation, interest rates could see some temporary upward pressure before reverting lower, the U.S. dollar could be mixed, emerging markets could benefit from reduced trade conflicts but heightened tensions with Russia, and the credit sectors would largely depend on the sectoral effects delineated by the winners and losers.
- In a Biden Presidency, there is increasing speculation that Lael Brainard could be appointed Treasury Secretary with Jerome Powell staying on as Fed Chair. A return by Janet Yellen could be another possibility as Fed Chair. A second Trump term would likely see Steve Mnuchin stay on as Treasury Secretary and possibly Kevin Warsh or James Bullard named as Fed Chair.
- As a measure of how short-term political uncertainty might affect risk assets, we looked at the performance of the S&P 500 Index from election day November 7, 2000 through December 12, 2000 (the Bush vs. Gore election), which is when the Supreme Court ruled that there would be no further vote recounts. While equities weakened notably, initial unemployment claims rose appreciably over the same timeframe, indicating that the economy was already on a weakening trajectory, which was likely the prevailing factor behind the equity declines. At the time, the Fed's Beige Book provided only passing, anecdotal comments regarding the effects of the election uncertainty.
- Finally, we're considering whether the process, rather than the outcome, might be the most important development from the general election. For example, could all outcomes essentially be neutral relative to the macro trends, such as the trajectory for the real economy and ongoing secular developments (e.g. deteriorating global demographics).

RATES

- We're viewing the recent backup in U.S. rates in relation to the downward move in German Bunds. For example, a 5-year Bund yield of -78 bps may reflect further easing from the ECB (perhaps not this week, but more likely in December and onward), which may be a reasonable assumption given the European inflation trajectory. However, the 5-year Treasury yield of 35 bps reflects an optimistic economic scenario and a tightening in monetary policy. For example, in five years, the markets are pricing in a Fed funds rate of 83 bps and a U.S. 5-year yield of 132 bps—both of which strike us as misplaced in a base-case scenario.
- Given the market pricing (indicating rate hikes combined with a steep term premium of 18 bps), attractive hedged yields for non-U.S. investors, and what has become a crowded trade in terms of positioning for higher rates, we've become more constructive on adding U.S. duration.
- Last week's SURE offering in Europe drew huge demand, and the 10-year and 30-year issues proceeded to tighten by 15 and 10 bps since pricing last week. EU-issued bonds should continue to meet investors search for yield as the issuance of €150-€200B per year will put the EU on par with the largest sovereign issuers in Europe.

CORPORATES

- With support from a subdued new issue calendar and positive technicals, U.S. IG spreads tightened by 2 bps last week to +123 bps. Primary market activity totaled $19B, which was in line with expectations. Demand for the new issues was strong, as order books were three times covered and priced with average concessions of 2 bps. Dealer forecasts expect about $15B of supply this week.
- Given our expectations for a more balanced market in the near term, a lack of meaningful progress in the U.S. fiscal stimulus negotiations, the continued rise in Covid cases, and the potential for election-related volatility, our short-term outlook is now neutral. Longer term, we're maintaining a favorable outlook on the U.S. IG market despite expectations for a coming increase in inflation, which we view as transitory.
- Despite continued macro uncertainty, the European IG market remained relatively stable and spreads ended the week 2 bps tighter at +111 bps. New issue activity exceeded expectations, totaling over €10B, and was dominated by issuance from the financial sector. Although order books were relatively modest and some deals priced at or through relative value, new issue performance was generally strong.
- Primary market activity is expected to remain light leading up to Thursday's ECB meeting, however syndicate desks suggest that November's new issue calendar could be relatively busy.

EMERGING MARKETS DEBT

- Emerging Market hard currency assets posted negative returns last week as global Covid cases continued to rise. EM hard currency returned -1.07%, EM corporates returned -0.13%, hedged local rates returned +0.10%, and EMFX returned +0.59%. Hard currency spreads widened by +6 bps to +416 bps.
- Investor appetite generally remained stronger for investment-grade credits, with the investment-grade portion of the sovereign index widening by +3 bps as the high yield portion of the index widened by +9 bps. By region, Asia and the Middle East led the widening, with investment grade commodity names Qatar and Saudi Arabia underperforming as oil prices came under pressure.

- Within sovereigns and corporates, BB spreads bucked the trend, tightening slightly last week as investors continue to find value in the segment. Unlike the B-rated and CCC-rated segments, BBs don't carry much in the way of idiosyncratic risk and continue to appear cheap relative to U.S. BB-rated credits.
- Fund flows remained positive, totaling +$2.16B last week. Hard currency funds saw inflows of $1.1B, while local currency funds saw an inflow of $514M. This brings the year-to-date total flows into EM bond funds to -$16.0B, with hard currency, local currency, and blend strategies accounting for $5.1B, -$19.9B, and -$1.2B, respectively. EM equity funds saw $2.6B of inflows last week.
- We continue to look through any potential short-term volatility due to the U.S. election and rising Covid cases, believing supportive liquidity conditions, low developed market yields, and accommodative policies will provide a tailwind for hard currency assets over the medium and longer term.
- Within local rates, the index yield tightened by 1 bp last week. Strong performance of commodity currencies, such as the Indonesian rupiah, Russian ruble, South African rand, and Chilean peso, drove the outperformance of their local rates. China rates also outperformed last week as the central bank increased liquidity via open market operations. We currently favor local rates in China, which have lagged recently, and believe index inclusion should provide support in the quarters ahead.

HIGH YIELD

- U.S. high yield returned +0.19% last week even as the new issue calendar remained busy and bond funds saw moderate outflows. Average yields declined 5 bps to 5.27% and spreads tightened 7 bps to +487 bps, their lowest level since early March. Most high yield sectors posted positive returns, with many of the Covid-affected industries outperforming. Airlines (+0.91%), metals/mining (+0.73%), and retail (+0.62%) outperformed, while broadcasting (-0.30%) lagged.
- High yield issuance was relatively busy with 13 new deals pricing for $6.4B in proceeds. Most deals were said to be 3-5 times oversubscribed and priced considerably tighter than initial price talk. Notably, as a sign of investors' comfort with more risky structures, two PIK dividend deals emerged, with the first pricing tight of initial talk and trading well above issue price by week's end and the other expected to price later this week. Although last week was active, most dealers expect new issuance to slow materially through year end.
- M&A activity continues in the energy sector, with Cenovus Energy's $2.9B all-stock deal to purchase Husky Energy being the latest in a string of recent energy deals. The announcement caused Cenovus bonds to tighten by 120 bps and sets the Ba2-rated issuer on a path towards investment-grade ratings. While we expect to see further consolidation in the energy space and believe such deals can create short-term benefits, we remain cautious of the oil industry over the long term. We continue to favor natural gas and expect the sector to similarly benefit from industry consolidation.
- U.S. leveraged loans returned +0.16% as BB-rated loans and B-rated loans performed in line with the index. Notably, loan mutual funds saw a second straight week of modest inflows, stemming a string of withdrawals that has pushed year-to-date outflows to $20B. In terms of supply, more than 20 new deals were recently launched and most investors remain focused on the relatively heavy primary pipeline. Covid-impacted names remain a focus in the secondary market, with theaters down another 3-5 points last week.
- In Europe, high yield bonds returned +0.33% as strong market technicals offset concerns around rising Covid cases. Average yields were 9 bps tighter even as new issue volume remained healthy. Loans returned +0.11% as ongoing CLO formation continues to drive strong demand for the asset class.

SECURITIZED PRODUCTS

- U.S. conduit CMBS spreads were unchanged last week as one deal priced in line with market spreads. Three conduit deals are expected after the election and there are several high-quality, single-asset/single-borrower deals are in the market. We expect secondary supply and new issue origination to be limited for the rest of the year. We continue to favor senior, well-enhanced CMBS tranches as the virus impact on CRE fundamentals remains to be seen.
- Secondary CLO spreads were generally unchanged across the capital structure as activity slowed. Primary market spreads were also unchanged as supply and demand remained firm. The senior portion of the capital structure continues to benefit from strong demand by asset managers. We expect some further softening in mezzanine tranches as supply and market volatility will continue to test market depth. We anticipate robust primary issuance volumes in U.S. and Europe with more than 100 deals being marketed across both markets. U.S. CLO primary spreads for higher quality portfolios ended at ~3mL+132/175/260/400/765 bps for AAA/AA/A/BBB/BB, respectively.
- ABS spreads were range-bound last week as $6B in new issuance priced. Primary origination is expected to decline heading into the election. New issuance now totals $160B this year, about 22% behind last year's pace. We prefer senior and subordinate securities from select issuers, which present upside to pre-Covid crisis levels. Most first-tier-issuer senior securities have retraced near or through their pre-Covid levels.

MUNICIPAL BONDS

- Tax-exempt municipal bonds had a firmer tone last week as the market worked through the heavy October issuance. Year to date, the high grade portion of the benchmark index has now returned 2.93% and the high yield portion has returned 0.39%. Along the 5- , 10-, and 30-year portions of the AAA-rated muni curve, the muni/Treasury yield ratios ended last week at 75.7% (down from 87.5% the prior week), 114.3% (down from 127.0%), and 105.5% (down from 112.4%), respectively.
- The market continues to absorb heavy new issuance, with all of last week's deals oversubscribed and launching tight of initial talk. Month to date, issuance now totals $63B (up 25% YOY), including $28B in taxable muni deals (up 78% YOY). Year-to-date supply now totals $425B (up 31% YOY), which includes $160B in taxable muni issuance (surpassing the prior record of $159B set in 2010). This week's calendar is estimated at $16B, including almost $6B in taxable muni deals. Given expectations that supply would be pulled forward ahead of the November election, we continue to expect to see lighter issuance post-election.
- Municipal bond funds saw net inflows of +$607M last week. High yield and intermediate funds experienced net inflows of +$21M and +$61M, respectively, while long term funds saw -$97M of outflows. Year to date, inflows now total +$25B.
- The trustee for Puerto Rico's COFINA bonds reported that full debt service payments for FY21 have been received less than four months into the fiscal year. This is faster than is typical and indicates that revenues have been coming in stronger in recent months.

Source(s) of data (unless otherwise noted): PGIM Fixed Income as of October 2020.

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