



June 1, 2021

MACRO

- With headline inflation in the euro area reaching 2% in May—which was the fastest rate in more than two years—attention is also turning to the likely direction of prices in Europe. We anticipate headline inflation may continue rising into the 2.5% area through the end of 2021 before declining back to the 1% area in 2022, which would be in line with the ECB's forecasts. While job vacancies in the region are recovering, those in Italy and Germany are the only markets above their pre-virus levels as France, the UK, and Spain continue to lag. Thus, wage prices generally remain subdued with year-over-year growth of less than 1.5%.
- We anticipate that in order for the ECB to achieve its inflation mandate, it will need to unveil a dramatic policy shift—such as a significant increase to its open-ended asset purchases—when it completes its inflation framework review in September 2021. We continue leaning in the direction that it will implement a notable policy initiative as it seeks a sustainable stabilization in chronically low realized inflation and inflation expectations.
- The transitory rise in inflation appears to be a global phenomenon as readings from Asian economies, such as China, India, Indonesia, Korea, Malaysia, and Thailand, show sizable increases in PPI inflation with rising energy prices likely leading to higher headline readings in the latter two countries. However, core inflation, excluding food and energy prices, generally remains mild in Asia.
- In the U.S., the jump in U.S. inflation is [hitting faster and harder than initially expected](#) based on the April reading of core PCE, which came in at 0.66% for a 12-month rate of 3.06%. However, we anticipate that core PCE inflation will be less than half of that pace in May and will continue declining to 0.15% per month through the end of the year and into 2022.
- Although it appears that Q2 global aggregate growth surpassed pre-virus levels, led by the substantial surge in China, the level excluding China remains well below pre-virus levels and even further below the pre-pandemic projected growth potential. Estimates based on personal consumption expenditure data place U.S. Q2 growth solidly above its pre-virus levels amid surging retail sales, goods expenditures, exports, and auto sales.

RATES

- With the date for the Jackson Hole symposium set for August 26-28, anticipation regarding the Fed's potential tapering of its asset purchases will continue to build, and we continue to believe the tapering process may start before the end of the year.
- From a tactical perspective, we're maintaining short positioning at the front of the U.S. curve and long positioning in 10s through 30s. We believe the back of the Australian Treasury curve appears attractive as well, and we're generally more neutral in the other areas of the developed market rate universe.
- U.S. mortgage spreads finished wider into month-end as the market-cap weighted Treasury OAS closed at +4 bps (+2), while the LIBOR OAS closed at +11 bps. More active convexity hedging, lumpier origination days, lower Fed purchases, and a shortened week resulted in the softer tone across the sector.

IG CORPORATES

- U.S. IG spreads grinded 2 bps tighter to 84 bps last week as investors remained focused on inflation data in an attempt to gauge the potential timing of the Fed's tapering process. Subsector spread movements mirrored the broader U.S. IG market. New issue supply totaled \$30B, with order books that were 3.5 times covered on average. Dealers are calling for about \$20B of supply this week and \$100B in June, which is more in line with historical monthly issuance averages.
- A trend that's emerged in the U.S. IG primary market has been the flatness of the 10s30s curve of recent new issues, which has largely been driven by a strong investor appetite for long bonds and the reemergence of overseas demand, particularly from insurers based in Asia. For example, the pricing of last week's multi-tranche offering from AstraZeneca left just 10 bps of spread in its 10s30s curve, which is notably tighter than the 25 bps average on most non-financial 10s/30s curves.
- Bolstered by some late-week firming, European IG spreads tightened by 1 bp to an index OAS of 85 bps. Primary market activity totaled €13B, about half of which carried the "green" label. A similar issuance theme continued into this week, with several green new issues pricing on Tuesday. Similar to previous weeks, lower-rated, higher-beta new issues generally garnered the most support and have performed strongly, while the lower-beta deals that priced with tighter spreads and limited concessions lagged.

EMERGING MARKETS DEBT

- Emerging market assets posted another week of positive returns against the backdrop of stable core rates and commodity strength. EM hard currency returned +0.45%, EM corporates returned +0.22%, hedged local rates returned +0.24%, and EMFX returned +0.45%. EM hard currency spreads tightened by 2 bps to 333 bps, with spreads on the investment grade portion on the index flat at 147 bps and spreads on the high yield portion tightening by 2 bps to 564 bps.
- Emerging Market bond fund flows were positive, totaling +\$1.41B. Hard currency funds saw inflows of \$954M, local currency funds saw inflows of \$311M, and blend funds saw an inflow of \$143M. This brings YTD inflows into EM bond funds to \$25.98B, with hard currency, local currency, and blend strategies accounting for \$9.22B, \$11.36B, and \$5.40B, respectively. EM equity funds saw \$609M of inflows this past week.
- In EM hard currency, spreads in select HY names tightened last week, with Argentina, Costa Rica, Lebanon, El Salvador, and Ghana notable outperformers. We continue to favor select IG and BB names for spread compression, as well as B and below names in the front end of the curve. While the broader growth backdrop remains supportive and EM spreads continued to hold up well given inflation and taper concerns, we are mindful of the potential re-emergence of pressure related to U.S. rate uncertainty.
- In EM local rates, the Index yield declined by 3 bps to 4.94% on the back of a weaker U.S. dollar and ongoing decline in core rate volatility. Peru, Brazil, Mexico, South Africa, and Philippines outperformed, while Chile, Turkey, Poland, Russia, and Thailand lagged. Brazil rallied by 32 bps even as its central bank is one of a number of EM central banks that have recently raised interest rates. After widening significantly after its central bank raised rates in early May, Brazil is now benefiting from improving fundamentals, appreciation in the Brazilian real, and positive flows.

WEEKLY VIEW FROM THE DESK

Inflation Hot Spots Appear Contained, Likely to Moderate



PGIM FIXED INCOME

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- In EMFX, the South African rand, Brazilian real, South Korean won, Taiwan dollar, and Singapore dollar outperformed while the Peruvian sol, Chilean peso, Turkish lira, Argentine peso, and Philippine peso underperformed. EMFX continues to be supported by strong global growth, hawkish EM central banks, and a growing U.S. current-account deficit.

HIGH YIELD

- U.S. high yield returned +0.34% last week despite another large weekly outflow from high yield bond funds and robust new issuance. Low and rangebound nominal interest rates continue to support risk-taking and an ongoing search for yield. Spreads tightened by 8 bps to +329 bps and are now 57 bps tighter on the year. Average yields tightened to 4.07%.
- By industry, all high yield sectors posted positive returns last week, led by airlines, autos, and hospitality, which benefited from increased confidence in vaccines, positive sector commentary from executives, and encouraging data for domestic air travel and leisure. YTD, energy (+7.3%), air transport (+7.0%), supermarkets (+4.3%), aerospace (+3.7%), and media (+2.2%) are the top performing sectors.
- By quality, CCCs (+0.41%) slightly outperformed BBs (+0.37%) and Bs (+0.26%) last week. YTD, CCCs (+7.40%) have outperformed both BBs (+1.1%) and Bs (+2.3%) by a wide margin.
- U.S. high yield mutual funds reported outflows totaling \$1.2B last week, bringing the YTD outflow to \$12.3B. Meanwhile, the primary market remained active, with \$10B of issuance. At nearly \$50B, May's new issuance figure eclipses May 2020's record of \$47.3B and marks the fourth month this year that an issuance record was achieved. YTD primary issuance is now well ahead of the \$150B issued in the year-ago period. Looking forward, we expect technicals to improve somewhat with an uptick in call, tenders and coupon payments, along with a slight easing of supply over the short term.
- U.S. leveraged loans returned +0.17% last week driven by a lighter new issue calendar and continued technical tailwinds. Loan funds experienced a weekly inflow of \$862M, which brings YTD inflows to approximately \$18B. Meanwhile, net new loan issuance slowed to \$19B in May from \$44B in April.
- The solid demand for loans allowed cruise line operator Carnival Corp. to reprice an outstanding loan last week from L+750 bps with a 1% LIBOR floor to L+300 bps with a 0.75% LIBOR floor. Conversely, the market continues to show some discipline as business-process provider Conduent last week pulled its refinancing from market citing lack of demand.
- In Europe, high yield bonds returned +0.29% as rate stability and better-than-expected earnings helped support the market. Average yields declined by 9 bps to 2.67% and spreads tightened by 16 bps to 305 bps. In HY there was only one primary issue last week. However, we expect issuance to pick up considerably in June. Loans returned +0.13% last week, which brings YTD returns to 2.65%.

SECURITIZED PRODUCTS

- U.S. conduit AAA CMBS spreads were unchanged last week as secondary flows remained balanced. No conduit new issues priced, however a few conduit and single asset/single borrower (SASB) deals will likely be announced this week. Private label supply has been increasing this year, although the increases have been driven by SASB and commercial real estate (CRE) CLOs. We expect the conduit supply will stay limited. 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 were generally unchanged across the capital structure in the U.S. despite seeing almost 25 deals come to market as demand remained strong. However, we continue to see some widening in Europe as market depth has been tested by elevated supply without corresponding demand. We continue to see deals getting placed via large anchor investors although we've begun to see more syndicated deals. Demand for CLO equity and mezzanine bonds remains robust as the market continues to seek higher-yielding investments. We expect robust issuance volumes in the 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+112/160/185/290/600 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 generally unchanged last week amid light primary and secondary activity. This year's new issuance now totals \$103B, which is in line with 2019's pace, and well ahead of 2020. We favor select issuers of senior and subordinate classes in branch-based, unsecured consumer loans and subordinate classes in prime and subprime auto. Regulatory/economic capital credit risk transfer trades in ABS offer compelling relative value but are difficult to source in size.

MUNICIPAL BONDS

- Technicals remained supportive of tax-exempt municipal bonds with yields moving lower across the curve last week. The 5-, 10-, and 30-year portions of the AAA-rated muni curve ended the week at 59.9% (down from 60.8% the prior week), 62.0% (down from 62.2%), and 66.1% (down from 67.6%). YTD, the high grade index has returned +0.78% and the high yield index has returned +4.79%.
- Municipal bond funds saw another net inflow last week, totaling \$1.5B. Long term and high yield funds saw inflows of \$1.3B and \$814M, respectively, while intermediate funds experienced an outflow of \$80M. YTD net inflows now total \$48.1B. The market easily absorbed \$7.4B in supply last week, with deals multiple times oversubscribed. YTD gross supply now totals \$184.7B, which is 15% higher than the same period last year and includes \$51B in taxable municipal issuance. This week's calendar is estimated at \$6B, including \$1B in taxable muni issuance.

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

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