WEEKLY VIEW FROM THE DESK

Views on FOMC Projections, Rate Liftoff

June 14, 2021

PGIM FIXED INCOME

MACRO

- With attention turning to Wednesday's FOMC decision, we believe the topic of tapered asset purchases will arise in some capacity (at the risk of being accused of ignoring the markets, which clearly initiated the tapering talk this time around), and our base case is that tapering begins in Q4 of this year. An alternative scenario is that the Fed waits until the unemployment rate drops into the 4% range before it begins the tapering process. In terms of the Fed's Summary of Economic Projections, there may be some adjustment to the Fed's inflation and unemployment rate forecasts, but we see less room for an adjustment to its growth forecasts.
- As it pertains to the dot plot, four FOMC members previously anticipated a rate liftoff in 2022 and seven members anticipated liftoff in 2023. Although we see some potential for additional dots to shift with the revised projections, we continue to believe that conditions may warrant a rate liftoff by the second half of 2023.
- On the heels of another jump in the monthly core CPI, we believe the core PCE for May could rise by 0.49%, which would put the 12-month rate at 3.36%. While we expect inflation may remain firm through the end of the year—we see 12-month core PCE of 3.46% by the end of December—the breakdown of price changes continues to show the largest price increases among more transitory categories, such as car prices, car rental prices, and airfares. Indeed, car rental prices have jumped nearly 110% over the prior 12 months.
- When looking at inflation globally, the jump in producer prices is occurring broadly, but only appears to have carried through to core consumer prices in the U.S. However, with the U.S. recovery setting the pace for much of the global economy, we expect other regions will also experience a temporary increase in consumer prices in the not too distant future.

RATES

- Treasury yields often move ahead of economic cycles, and we believe that this cycle continues this trend. Even though the U.S. is currently experiencing accelerating growth and inflation, the labor market could still take some time before it reaches full employment, delaying the Fed's eventual rate liftoff and potentially keeping the rate path on a relatively low trajectory.
- The USD OIS forward curve has priced in a steep Fed hike path in the front end, which shows sizable bets on aggressive Fed actions remain in place. While we believe Treasury yields will remain rangebound, liquidity could be challenging amid the summer trading lull, leading to occasional bouts of heightened volatility. In a scenario where the markets are adjusting to new policy expectations—i.e. perhaps a terminal Fed funds rate of 75-150 bps (as opposed to 250 bps as was previously priced in)—the U.S. 10-year yield could also be settling into a new range of 120-180 bps.
- Similarly, sovereign yields in other developed and emerging markets may have peaked in March, even if yields rise again in a "twin peak" scenario as they did during the 2009-2010 period. In terms of European rates, we believe the 10-year bund yield may have topped out at about -10 bps in May (at -27 bps more recently) with the spread on 10-year Italian BTP/bund yield possibly topping out at about 120 bps (trading at 101 bps more recently).
- Agency mortgages continue to cheapen despite low origination volume; we continue to observe reduced MBS allocations among investors and the Fed. The market-cap weighted Treasury OAS closed at +8 bps (+3), while the LIBOR OAS closed at +14 bps (+3). We think the supply of agency MBS for the rest of the year may not increase by as much as street analysts suggest as tight housing supply and improving availability of other forms of credit (e.g. Jumbo mortgages) limit origination going forward.

IG CORPORATES

- Although U.S. IG spreads remained unchanged through Thursday, spreads ultimately found some footing and tightened by 1 bp to 84 bps by week's end. While most sectors traded in a narrow range, energy outperformed as crude prices approached $70 per barrel and record consumer gas demand. Fund flows remained positive, with another $3.2B coming into IG funds last week, supported by overseas demand and pension buying.
- While U.S. IG spreads have traded in a narrow range over the past few weeks, several positive factors continue to support the market, including: companies' preference to continue paying down debt, positive momentum on credit ratings, increased pension and overseas allocations to IG. Supply remains manageable as cash continues to build, further supporting our positive outlook. We believe spreads could grind tighter from here.
- New issue supply totaled $34B last week, which was skewed towards front-end financial issuance. Order books were 2.4 times covered and average concessions were near zero as pricing tightened by an average of 22 bps from initial talk. Dealers expect $20-$30B of supply this week.
- In recent discussions with a Wall Street syndicate desk, topics included issuance, shareholder activities, and M&A. On issuance: there were virtually no significant supply-related concerns mentioned, aside from possible periods of congestion and the ability to get deals into the market. On shareholder activities: shareholder activism is at its highest level since 2015 as activists are lobbing for divestments and/or return of capital to shareholders. Lastly, on M&A: they continue to see 2-3 times more inquiries relative to the past, and some within their organization are classifying the current environment as the strongest they've seen.
- On the back of a firm week in the European IG market, spreads tightened by 1 bp, to an index OAS of 84 bps. The primary market was relatively active as supply totaled €15.4B, much of which priced ahead of Thursday's ECB meeting. The supply was well absorbed despite pricing with virtually no concessions. New issue performance was generally lackluster, and any outperformance was led by the longer-dated tranches.
- Looking ahead, with dealers calling for lower supply beginning this week and continuing into July, the ECB reaffirming its dovish stance, and an improving macro backdrop, we believe spreads could continue to grind tighter over the next several weeks.

EMERGING MARKETS DEBT

- Emerging market assets posted another week of positive returns. EM hard currency returned +0.96%, EM corporates returned +0.45%, hedged local rates returned +0.10%, and EMFX returned +0.29%. EM hard currency spreads tightened by 3 bps to 330 bps, with spreads on the investment grade portion on the index tightening by 1 bp to 149 bps and spreads on the high yield portion tightening by 5 bps to 556 bps.
- Emerging market bond fund flows were positive, totaling $1.74B. Hard currency funds saw inflows of $817M, local currency funds saw inflows of $1.26B, and blend funds saw an outflow of $343M. This brings year-to-date total flows into EM bond funds to $28.92B, with hard currency, local currency, and blend strategies accounting for $10.96B, $12.82B, and $5.14B, respectively. EM equity funds saw $418M of outflows.

- Saudi Aramco raised $6B in its first U.S.-dollar denominated sukuk sale to help fund a dividend. The issuer sold a $1B three-year tranche at UST+65 bps, a $2B five-year tranche at UST+85 bps, and a $3B 10-year tranche at UST+120 bps. Order books were said to total more than $60B, which allowed the issuer to tighten pricing on all three tranches, with the 10-year tranche initially talked at UST+160 bps.
- In EM hard currency, HY names tightened last week, with CCCs and select oil exporters outperforming. Nigeria, Angola, and Ghana tightened across the curve. Last week, the IMF approved a $772M disbursement to Angola citing the country's stable policy and debt reduction.
- In EM local rates, the Index yield was unchanged at 4.92% despite a 10 bp rally in U.S. 10-year Treasuries. Most EM curves continue to bear flatten on the back of a more hawkish stance from central banks. Turkey, South Africa, Indonesia, Thailand, and Mexico were the outperformers, while Peru, Brazil, Russia, Chile, and the Philippines lagged. The Russian central bank raised the base rate by 50 bps to 5.50% last week, while Brazil's central bank is widely expected to hike by 75 bps at its meeting on Wednesday.
- In EMFX, the Turkish lira, Russian ruble, Mexican peso, Argentine peso, and Colombian peso outperformed as the South African rand, Chilean peso, Peruvian sol, Brazilian real, and Polish zloty underperformed. The peso outperformed on the back of Mexico’s election results.

HIGH YIELD

- U.S. high yield returned +0.48% last week as flows turned positive and the high yield primary calendar remained active. A decline in U.S. 10-year Treasury yields also supported sentiment amid signs that market participants view the uptick in inflation as temporary. Spreads tightened by 7 bps to +321 bps and are now 65 bps tighter on the year, producing excess returns of +403 bps. For context, spreads are just 5 bps wide of their post financial crisis tights of +316 bps.
- By industry, all high yield sectors posted positive returns last week, led by energy, food & beverage, and home builders. By quality, CCCs (+0.63%) again outperformed BBs (+0.51%) and Bs (+0.36%). YTD, CCCs (+8.7%) have outperformed both BBs and Bs by a wide margin. Following their strong performance, CCC spreads at +442 bps are now tighter than at any time over the last five years. We’re consequently looking to reduce our CCC exposure in favor of select BB issues.
- U.S. high yield mutual funds reported inflows of $888M based on daily data. However, the more widely followed Thursday to Wednesday number was a $642M outflow. Meanwhile, primary issuance was active, with $9.9B pricing across 13 deals.
- U.S. leveraged loans returned +0.18% last week as strong CLO formation and positive inflows into loan mutual funds continued. The market saw, and easily absorbed, nearly $2B in BWICs. The loan forward calendar continues to build before the July 4 holiday, with more than 10 deals pricing last week.
- In Europe, high yield bonds returned +0.37% as rate stability and the ECB's announcement on the full use of the PEPP facility helped support the market. Average yields declined by 10 bps to 2.52% and spreads tightened by 13 bps to 294 bps. Loans returned +0.10% last week, which brings YTD returns to 2.91%. While the new issue pipeline for both high yield and loans remains robust, the quality of issuance has notably deteriorated in recent weeks.
- European high yield now looks less cheap relative to U.S. high yield. Based on a cohort of issuers that have both euro-denominated bonds and U.S.-denominated bonds, the spread premium for euro-denominated bonds has recently declined to nearly zero. Meanwhile, European B-rated bonds are now trading tighter than U.S. B-rated bonds for the first time ever.

SECURITIZED PRODUCTS

- U.S. conduit AAA CMBS spreads were unchanged last week. Two sizable high-quality, single asset/single borrower (SASB) new issues received strong demand. Three conduit deals are expected to price before early July. Private label supply has been increasing this year, although most of the increase is from 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.
- Spreads at the top of the U.S. CLO capital structure remained generally unchanged last week as mezzanine tranches had a softer tone amid persistent supply. European spreads continued to move wider at the top of the capital structure as supply outpaced demand. We continue to see deals getting placed via large anchor investors although we’ve begun to see more deals also go the syndicated route. Demand for CLO equity and mezzanine bonds continue to be very robust as market continues to seek higher yielding investments. We expect robust issuance volumes in U.S. and Europe this year as we are currently being marketed over 175 deals across both markets. Primary U.S. CLO spreads for higher quality portfolios ended the week at about ~3mL+112/170/200/320/650 bps for AAA/AA/A/BBB/BB, respectively. Long term, we continue to favor senior CLO tranches in Europe and the U.S.
- ABS spreads remained firm as $9B of supply priced, consisting predominantly of prime and subprime auto. This year’s new issuance now totals $112B which aligns with 2019’s year-to-date pace but remains well ahead of 2020’s pace. Net ABS supply is expected to remain near zero. We favor select issuers of senior and subordinate classes in branch-based, unsecured consumer loans and subordinate classes in prime auto and subprime auto. Additionally, regulatory and economic capital credit risk transfer trades in ABS offer compelling relative value but are difficult to source in size.

MUNICIPAL BONDS

- Tax-exempt municipal bond yields continued to tighten last week as demand far outstripped supply. The 5 , 10-, and 30-year portions of the AAA-rated muni curve ended the week at 53.9% (down from 56.4% the prior week), 61.2% (down from 61.7%), and 64.9% (down from 66.2%). YTD, the high-grade index has returned +1.45%, and the high yield index has returned +5.83%.
- Municipal bond funds saw yet another net inflow, totaling $2.5B. Long term, high yield, and intermediate funds saw inflows of $1.8B, $816M, and $281M, respectively. YTD net inflows now total $53.9B, or the third highest full-year calendar figure going back to 1992. YTD gross supply totals $205B, which is 11% higher than the same period last year and includes $57B in taxable municipal issuance. This week's calendar is estimated at $12B, including $4B in taxable muni issuance.
- Looking forward, technicals are expected to remain highly favorable, with JP Morgan expecting tax-exempt net supply of -$32B in June through August and -$55B for full-year 2021.

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

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