WEEKLY VIEW FROM THE DESK

A Weaker Dollar Provides a Boost to Risk Assets

PGIM FIXED INCOME

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MACRO

- As the U.S. economy continues to re-open, the list of supply shortages also appears to include workers. April's far-weaker than expected payroll report—266,000 workers added vs. expectations for an addition of nearly one million—indicated that employers were struggling to fill vacancies, while the slight increase in the unemployment rate from 6.0% to 6.1% reflected an increase of workers returning to the labor force.
- Although total employment remains about 8.2M jobs lower than pre-virus levels, we estimate that number is closer to an equivalent of 5-6M lower when accounting for significant extension in average weekly hours, which tends to indicate the existence of open positions. A key question in terms of the strength of the economic recovery going forward centers on how long it will take most of those who have left the labor market to return—the longer they remain detached, the longer it historically takes for them to return.
- While further improvement in labor market conditions remains a prerequisite for policy tightening by the Federal Reserve, a consensus appears to be forming around a timeline when it may announce the tapering process of its asset purchases. One potential timeline, which was compiled prior to the April payroll report, has tapering discussed in August at the Jackson Hole Symposium, a formal announcement in November, the start of tapering in January 2022, and the conclusion of tapering by the end of 2022. For our part, we remain slightly more dovish than the consensus scenario and believe the timeline could be pushed back by a few months.
- Inflation concerns remain prevalent as U.S. inflation expectations have continued to increase since the latest FOMC meeting in late April. Although the 10-year inflation breakevens reached a new cycle high of more than 2.5%, the 5-year 5-year inflation breakeven remains near the 2.25% level from 2018-2019 and solidly below the levels well in excess of 2.5% in 2012-2013. Therefore, we do not believe market-based inflation expectations will alarm the Fed at this point, but we would become slightly more concerned if the 5-year 5-year rate broke out towards the 2.5% range.

RATES

- The divergence in developed market central bank policy—the Bank of Canada tapering, the ECB pulling purchases forward before potentially slowing over the summer, and the Fed standing pat before possibly announcing a tapering by the end of the year—is reflected in our global rate views as well. In the U.S., an acceleration in the tapering timeframe could lead to higher front-end yields—i.e. 2- to 3-year yields—while the back of the curve would likely remain stable amid attractive valuations. In Europe, we believe any deceleration in policy accommodation could lead to higher yields in the belly of the curve, while we expect cash bonds in Canada to underperform swaps amid the BoC's tapered asset purchases.
- In terms of tactical positioning, we favor the 7-year point on the curve in the U.S. vs. the 2-year and 10-year segments, and we continue to favor the 20-year point on the curve vs. the 25-year and 30-year segments.
- Mortgage spreads began to show some resistance last week as very tight valuations discouraged the pace of buying that we saw at the end of April. The market-cap weighted Treasury OAS closed at -2 bps (unchanged), while the LIBOR OAS closed at +3 bps (+2) as it cheapened off the richest valuations in years, as swaps tightened in longer maturities. MTD excess returns ended at -18 bps versus Treasuries, underperforming other sectors in the Agg.

IG CORPORATES

- The U.S. IG market drifted for most of last week before ending 1 bp tighter at 87 bps, which was its tightest level since February 2018. Activity was subdued last week, as we believe market participants generally remained on the sidelines amid expectations for a heavy new issue pipeline, which could total $100B over the next two weeks. Eight issuers priced deals by midday Monday, and the $27.85B that priced made it the heaviest issuance day of the year.
- Amazon's $18.5B eight-tranche offering was said to generate an order book of $41B, and the offering was generally thought to price with minimal concessions amid a ratings upgrade from Moody's to A1 from A2. The offering included a 40-year portion that priced at 95 bps over Treasuries and a 2-year Green Bond issue. Although the use of proceeds was classified as general corporate purposes, the proceeds will reportedly be used to refinance existing debt and to repurchase stock.
- Investors remain focused on Q1 earnings results, which have exceeded expectations and prompted several Wall Street analysts to make notable upward revisions to their 2021 earnings forecasts—full-year 2021 EPS growth estimates have risen 4.8% since the start of April, while 2022 estimates have since increased by 2.9%. The stronger-than-expected earnings have strongly benefited the commodity and cyclical sectors, with issuers opting to use the resulting windfalls for deleveraging activities and balance sheet repair, which have driven spreads tighter as a result.
- The European IG market was also quiet last week, with spreads ending unchanged at an index OAS of 84 bps. Despite a pickup in volume, new issue activity fell short of expectations, totaling €10B. While most deals generally performed well, the 3-to-5-year maturities within last week's offerings fared the best. Issuance is expected to remain subdued during a shortened week in Europe.

EMERGING MARKETS DEBT

- Emerging market assets were broadly positive last week against the backdrop of rising commodities, positive inflows, and a weaker U.S. dollar. EM hard currency returned +0.68%, EM corporates returned +0.37%, hedged local rates returned +0.33%, and EMFX returned +0.86%. EM hard currency spreads tightened 3 bps to 336 bps, with the investment grade portion tightening by 2 bps to 147 bps and the high yield portion of the index tightening 5 bps to a YTD tight of 570 bps.
- Emerging market bond fund flows were again positive, totaling +$565M. Hard currency funds saw inflows of $130M, local currency funds saw inflows of $56M, and blend funds saw an inflow of $379M. This brings year-to-date total flows into EM bond funds to $23.15B, with hard currency, local currency, and blend strategies accounting for $8.32B, $9.62B, and $5.21B, respectively. EM equity funds saw $965M of outflows last week.
- In hard currency sovereigns, high yield spreads in select names tightened last week, but overall performance was mixed. The top performers were Ecuador, Zambia, Sri Lanka, Lebanon, and Belize; while the underperformers were El Salvador, Argentina, Papua New Guinea, Pakistan, and Colombia. Tensions with the U.S. following the removal of several judges from the Supreme Court's constitutional chamber caused El Salvador's bonds to selloff.

- In EM local rates, the Index yield declined to 4.89% last week on the back of an appreciation in EM currencies and lower U.S. yields. With the exception of Brazil and Colombia, most commodity-producing countries rallied. South Africa, Peru, Chile, Mexico, and Indonesia were outperformers, while Colombia, Philippines, the Czech Republic, and Romania lagged. Brazil lagged as its central bank raised benchmark lending rates by 75 bps to 3.50%.
- In EMFX, higher-beta and growth currencies outperformed, with the Brazilian real, South African rand, Chilean peso, Russian ruble, and Indonesian rupiah among the better performers. Looking forward, we anticipate some further weakening in the U.S. dollar, and we favor commodity, EU, and select Asian currencies.

HIGH YIELD

- U.S. high yield returned +0.28% last week despite a weekly outflow and a busy new issue calendar. Spreads tightened 1 bp to +327 bps, just 11 bps wide of the post financial-crisis tights of 316 bps. Average yields tightened 8 bps to 4.04%, or just 10 bps higher than the all-time low of 3.94% seen in February 2021. By sector, energy and media outperformed, while healthcare lagged. By quality, CCCs (+0.52%) continued to outperform versus both Bs (+0.19%) and BBs (+0.28%).
- U.S. high yield mutual funds reported outflows of $1.4B last week, with ETFs posting outflows of $1.1B and active managers seeing an outflow of $300M. For April, net inflows totaled $2.7B. Meanwhile, the primary market saw $12B of new issuance last week, with the average deal trading up over 1.25 points on break and all deals ending the week above their new issue price. Notably, Renewable Energy Group's new BB/B2 rated "green bond" ended the week 3.5 points above issue after pricing inside of initial guidance.
- In April, there were two defaults totaling $401M. The trailing 12-month par-weighted U.S. high yield default rate decreased 162 bps month-over-month to 3.17%, the lowest level over the past 14 months. Following record-setting issuance in both March and April (for their respective months), the pace of issuance is expected to continue in the coming months. This year’s supply is expected to total $525B, about 17% higher than 2020's record total of $450B, according to J.P. Morgan.
- U.S. leveraged loans returned +0.07% last week, with lower-quality credits outperforming. Flows into loan mutual funds remained positive at $899M, including $275M into ETFs, while new supply totaling $11.8B was notably slower than recent weeks. On a price basis, 14% of all loans are now bid above par while 84% are bid above 98.
- In Europe, high yield bonds returned +0.04%, with CCCs (+0.45%) outperforming both Bs (+0.07%) and BBs (-0.01%). Spreads tightened by 10 bps to 310 bps and average yields were unchanged at 2.69%. Primary activity was slightly less busy during the holiday-shortened week but saw the clearance of the last pre-pandemic underwritten deal, with Golden Goose issuing €480M in FRNs to take out a bridge loan put in place in February 2020. Loans returned +0.12% last week, bringing the YTD total return +2.37%.

SECURITIZED PRODUCTS

- U.S. conduit AAA CMBS spreads were unchanged last week as secondary demand remained strong. One top-tier new issue conduit priced in line with current market levels. Another top-tier conduit deal announcement is expected this week. 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 remained firm across the capital structure last week on persistent demand. We continue to see large anchor investors looking to source both senior and subordinate bonds. We continue to 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+112/165/185/290/625 bps for AAA/AA/A/BBB/BB, respectively. In the long term, we continue to favor senior CLO tranches in both European and U.S. CLOs and remain cautious about legacy junior mezzanine tranches given our views around higher impairments and lower recovery rates.
- ABS spreads were generally unchanged last week ahead of this week’s expected new issuance pickup, which includes deals from Avis rental car and One Main. Early interest has been strong and we expect clearing levels on these deals to be tighter than initial talk. This year’s new issuance now totals $82B, which aligns with 2019’s pace. ABS spreads should remain supported due to flat/negative net new issuance expectation this year.

MUNICIPAL BONDS

- Tax-exempt municipal bonds continued to see strong demand last week, with new deals multiple times oversubscribed. The 5 , 10-, and 30-year portions of the AAA-rated muni curve ended the week at 58.0% (up from 50.6% the prior week), 61.4% (up from 60.8%), and 67.9% (down from 69.0%). Year to date, the high grade index has returned +0.68% and the high yield index has returned +3.99%.
- While inflows have moderated, municipal bond funds saw another net inflow last week. Muni funds saw net inflows of $585M, with long term and high yield funds posting inflows of $740M and $341M, respectively. Intermediate funds reported an outflow of $63M. YTD net inflows total $43.5B. YTD gross supply now totals $161B, which is 18.7% higher than the same period last year. This week's calendar is estimated at nearly $8B, including over $1B in taxable muni issuance.
- Some reopening effects were also seen last week as Moody's Investors Service revised the outlook on airport and toll road sectors to positive from stable and the outlook for mass transit has been revised to stable from negative.

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

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