PGIM FIXED INCOME

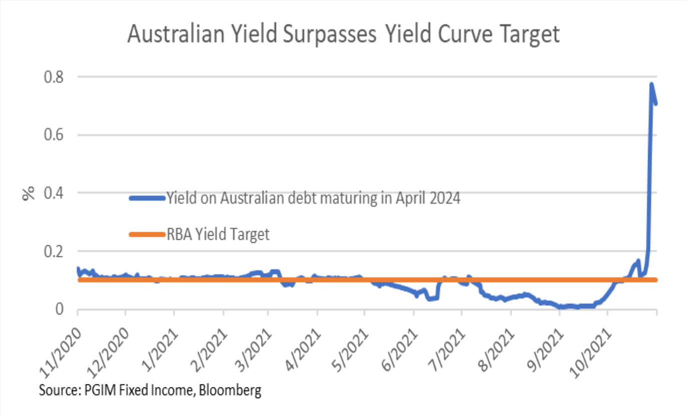
As Rates Reprice, Central Bank Toolkits Called Into Question

WEEKLY VIEW FROM THE DESK | November 1, 2021

QUICK LINK TO THE RETURNS TABLE

MACRO

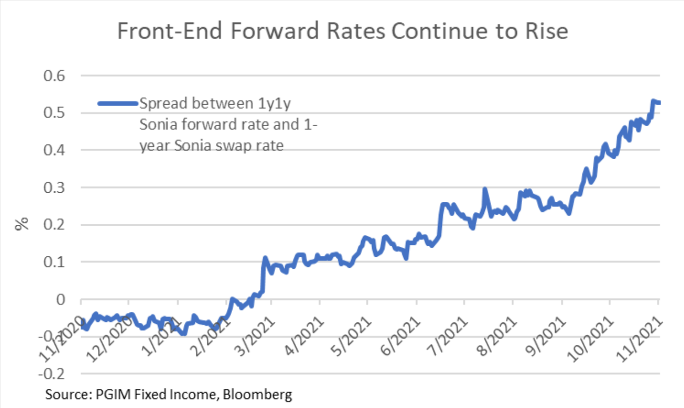
- As policy-sensitive rates rapidly reprice across global markets amid relentless inflation pressure, it's evident that major central banks are being caught offside. In their defense, this is no typical economic cycle and it's difficult to predict the speed limit of inflation because of the unprecedented nature of the recovery. Also, monetary policy tools are developed to modulate business cycles and it's unclear whether central banks have the most appropriate tools to alleviate supply shocks.
- In this uncertain environment, central bankers risk acting too quickly, which could potentially short circuit economic growth, or doing too little too late, which presents the risk of inflation expectations taking hold and financial stability concerns.
- We are sympathetic to the dilemma faced by central banks of commodity producers, such as Canada and Australia, which are experiencing massive positive terms of trade shock. Officials there have to strike a fine balance between quickly changing policy course and maintaining their credibility in guiding markets through their policy intentions. The difficult circumstance was put on display in Australia, when the Reserve Bank refrained from defending its yield curve control policy in the open market and ultimately abandoned the target.



Source: PGIM Fixed Income, Bloomberg

RATES

- The selloff in rates continues apace ahead of Wednesday's FOMC meeting, with expectations for tapering fully baked in at this point. We are struck by how isolated and contained volatility has been in markets outside of rates, even repo markets in which Treasuries serve as the collateral. We suspect that positioning stop-outs have exacerbated the rise in front-end rates. Many global macro hedge funds allocated capital to trades that will benefit from inflation fears subsiding, such as 1y1y OIS forward and 1-year OIS spread compression, and are forced to exit positions amid mounting losses and redemptions.
- The epicenter of the global rates selloff occurred in markets like Canada and Australia that are smaller and have relatively worse liquidity, which further magnified the moves. Looking across rates, the synchronous nature of the selloff has made market pricing in some areas appear overdone. Europe is a prime example, with market pricing in a high likelihood of rate a hike in the next 12 months even though the ECB is still far from reaching its inflation target.
- Market dislocation is not limited to the front-end, as the Treasury 20-year sold off disproportionately compared to 10- and 30-year. We think the inverted 20-30 yield curve will further motivate the Treasury Department to significantly reduce supply in the sector at the upcoming announcement on Wednesday. Overall, from historical experience, we have seen large relative-value mispricings mean-revert within a few months' time, and we think the current valuations present a rare opportunity for investors with relatively long investment horizon.
- Agency mortgage-backed securities have not been affected by the volatility in rates, with spreads continuing on a narrowing path. The risks of convexity selling never materialized, prompting some buying and more short covering. We expect the Fed to announce $5 billion/month reduction of purchases while maintaining reinvestments of maturing Treasuries into MBS.



Source: PGIM Fixed Income, Bloomberg

IG CORPORATES

- U.S. IG spreads widened slightly last week. Banks underperformed amid robust supply while energy widened amid profit taking. Issuance totaled $19B, with concessions averaging +2.9 bps and deals about 2.8x oversubscribed on average. This week, issuance is expected to total $20-25B with November issuance expected to total approximately $100B.

- The strong corporate earnings performance has continued, with 56% of companies in the S&P 500 now having reported Q3 results. Of those, 82% have posted a positive EPS surprise and 75% have reported a positive revenue surprise. Meanwhile, profit margins are tracking at 12.8% for Q3 versus a record high of 13.1% in Q2.
- European IG spreads also widend slightly with a busier-than-expected primary market totaling €14B. Meanwhile, new issue performance was underwhelming, with most deals bid wide of re-offer as limited new issue concessions insufficiently compensated for the macro volatility. We expect primary to remain busy this week with dealers calling for €10-15B of supply concentrated over a holiday-shortened week.

HIGH YIELD

- U.S. high yield prices remained subdued despite continued inflows, limited primary activity, and rising stock prices. Despite recent inflows and a slowing primary calendar, a JP Morgan mutual fund survey noted that cash balances for high yield funds are currently at 2.66%, tied with 2Q 2018 for an 11-year low. Secondary activity reflected these lower cash balances, with buyers only selectively adding risk.
- By quality, BBs (+0.16%) outperformed both Bs (-0.03%) and CCCs (-0.02%). By industry, autos (+0.48%) outperformed, led by Ford, which reported strong earnings and raised guidance. Food & beverage (+0.46%) also performed well on the back of Kraft Heinz. Cable (-0.19%), technology (-0.19%), and chemicals (-0.07%) lagged. High yield primary activity slowed, with nine deals pricing for $5.6B in proceeds. This brings October issuance to $30B, lower than the $45B monthly average so far in 2021. For November, banks are guiding to about $20-25B in primary activity.
- U.S. leveraged loans posted positive returns last week even as managers were selling to create room for primary allocations. In all, 17 issues priced for $10.1B in proceeds, which brings October's issuance to $50.1B. Approximately two-thirds of last month's issuance backed M&A/LBO activity, which was the largest share of any month so far this year. Currently, 25% of the loan index is trading above par, down from recent peaks, which lowers the probability of a broader repricing wave over the short term.
- In Europe, high yield bond and loan returns were modestly positive as both markets continue to absorb heavy supply. HY and loan issuance has totaled €109B and €118B YTD. For HY, this marks a record high for issuance. For loans, issuance should soon surpass the prior record of €120B issued in 2017.

EMERGING MARKETS

- Emerging Market hard currency markets posted positive returns last week, with overall spreads largely flat and spreads on the investment grade portion of the index widening on the week. New supply was consistent with prior weeks, while fund flows were supportive, with over $1.3B flowing into hard currency funds.
- Pemex tightened 10-20 bps across the curve after the government said it would take over its amortization payments. Although Petrobras reported strong earnings, its bonds widened alongside the sovereign on the back of fiscal and debt concerns. Argentina's sovereign widened 40 bps on news that the country may not repay the IMF.
- Emerging market local debt posted negative returns, with the yield on the Index rising to a YTD high of 5.65% on the back of bear flattening in many EM countries, such as Brazil, Russia, Poland, and Colombia. A 150 bp rate hike by the Brazilian central bank and a 75 bp hike by the Russian central bank failed to contain a selloff. We have modestly reduced our short-term outlook on local rates given the ongoing upside surprises in inflation prints and the potential that the upcoming FOMC meeting could increase pressure on EM central banks.
- EMFX was relatively flat, with Asia currencies outperforming and LatAm lagging. Cyclical and rates-sensitive currencies, such as the South African rand, Mexican peso, and Russian ruble, underperformed. We continue to believe the macro backdrop is not supportive of EMFX as the Federal Reserve moves closer to tapering and global growth slows.

SECURITIZED PRODUCTS

- U.S. conduit AAA CMBS spreads were slightly wider on new issue flows, with two conduit new issues expected this week. SASB spreads remain softer amid steady supply.
- U.S. CLOs were generally unchanged at the top of the capital structure. However, we did see some pressure on lower mezzanine tranches as supply remains elevated. U.S. CLO primary spreads for higher quality portfolios were ~3L+112/160/195/300/625 bps for AAA/AA/A/BBB/BBs, respectively for 5-year reinvestment period deals.
- ABS spreads continued to trade range bound with a softer tone for benchmark securities due to increased near-term supply. We continue to find on-the-run ABS less compelling relative to other securitized products. Within ABS, we prefer senior and subordinate classes in branch bank unsecured consumer loans and top tier subprime auto subordinates.

MUNICIPAL BONDS

- Tax-exempt municipal bonds underperformed Treasuries across the curve last week. However, the overall tone turned positive mid-week on the heels of the rate rally. The 5-, 10-, and 30-year portions of the AAA-rated muni curve ended the week at 54.0% (up from 50.1% the prior week), 77.7% (up from 75.8%), and 87.3% (up from 83.5%), respectively.
- Muni funds saw net inflows of $397M, with long term, high yield, and intermediate funds experiencing inflows of $207M, $3M, and $172M, respectively. Municipal funds have now seen inflows in 75 of the past 76 weeks, totaling a record $152.9B over than span. We have modestly raised our short-term outlook on taxable munis given the expectation of negative net supply in November and December. We have also modestly reduced our short-term outlook on taxable munis given the expectation of an uptick in supply.
- In Puerto Rico news, the oversight board agreed to drop its opposition to the legislation enacted earlier last week, allowing the debt adjustment plan to move forward. Puerto Rico's GO bonds rose on the news, while the yield on the COFINA 5% tax-exempts due 2058 tightened by 18 bps. Confirmation hearings on the plan set to begin November 8, with expectations that the plan will be approved by the court.

THE RETURNS TABLE As of November 1, 2021

				Yield/ OAS Change (BPS)				Total Return (%)			
Sovereign Rates	**Duration**	**YTM**	**OAS**	**WTD**	**QTD**	**YTD**	**Prior Year**	**WTD**	**QTD**	**YTD**	**Prior Year**
U.S. 2-Year	2.0	0.50	---	4	22	38	35	0.02	-0.30	-0.31	-0.22
U.S. 5-Year	4.8	1.18	---	-1	22	82	81	0.17	-0.79	-2.72	-2.52
U.S. 10-Year	9.1	1.56	---	-8	7	64	73	0.93	-0.12	-4.51	-4.98
U.S. 10-Year Breakeven	--	2.59	---	-5	21	60	88	---	---	---	---
U.S. 10-Year TIPS	4.8	-1.03	---	-3	-14	5	-15	0.05	1.39	4.12	6.33
U.S. 20-Year	16.5	1.99	---	-8	-2	53	61	1.38	0.91	-7.79	-8.26
U.S. 30-Year	22.3	1.94	---	-14	-11	29	33	3.44	3.56	-5.95	-6.18
UK 10-Year	9.6	1.03	---	-11	1	84	81	1.09	-0.04	-6.68	-4.75
Germany 10-Year	9.8	-0.11	---	0	9	47	53	0.01	-0.92	-0.99	-0.99
Japan 10-Year	9.8	0.09	---	0	3	8	7	-0.02	-0.14	-0.14	-0.14
Australia 10-Year	9.4	2.09	---	29	60	112	127	-2.68	-5.42	-8.59	-9.96
Canada 10-Year	8.8	1.72	---	7	21	105	109	-0.60	-1.75	-0.27	-0.27
MAJOR FI MS INDICES											
Global Aggregate Unhedged	7.5	1.29	34	1	1	-2	-13	0.02	-0.24	-4.29	-1.30
Global Aggregate Hedged	7.5	1.29	34	1	1	-2	-13	0.26	-0.26	-1.69	-0.92
U.S. Aggregate	6.8	1.66	33	1	1	-8	-21	0.52	-0.03	-1.58	-0.55
Euro-Aggregate (Unhedged)	7.7	0.23	54	4	5	6	-6	-0.16	-0.61	-2.89	-2.53
Japanese Aggregate	9.6	0.13	1	0	0	0	0	0.09	-0.12	-0.18	-0.15
MAJOR FI CREDIT INDICES											
Mortgage-Backed (Agency)	4.9	1.89	24	0	-3	-15	-30	0.28	-0.19	-0.86	-0.55
Global IG Corporate Bonds	7.4	1.79	91	1	3	-9	-37	0.31	0.03	-2.42	1.68
U.S. IG Corporate Bonds	8.7	2.22	87	1	3	-9	-38	0.80	0.25	-1.02	2.04
European IG Corporate	5.3	0.49	87	1	3	-5	-29	-0.10	-0.74	-1.05	0.05
U.S. High Yield Bonds	4.0	4.23	287	1	-2	-73	-221	0.09	-0.17	4.35	10.47
European High Yield Bonds	3.6	3.08	309	-9	9	-48	-180	0.07	-0.42	3.77	8.85
U.S. Leveraged Loans	0.3	5.25	437	-1	-10	-62	-124	0.02	0.24	4.94	8.53
European Leveraged Loans	0.3	3.75	411	-1	+5	-48	-133	0.09	0.13	4.18	7.47
EM Hard Currency Sovs.	8.0	5.14	358	1	2	7	-64	0.53	0.02	-1.34	4.41
EM Corporates	5.0	4.49	300	0	-1	-28	-93	0.14	-0.46	1.06	5.28
EM Currencies	---	3.32	358	1	2	7	-64	-0.10	0.31	-1.86	3.56
EM Local Rates	5.2	5.65	6	0	0	1	1	-0.18	-1.65	-5.40	-3.43
CMBS	5.1	1.73	60	1	0	-20	-44	0.30	-0.39	-0.92	0.51
ABS	2.3	0.87	36	3	7	3	-3	0.02	-0.35	-0.11	0.23
CLOs		1.01	101	0	-1	-15	-42	-0.02	0.04	0.15	0.96
Municipal Bonds	4.9	1.21	---	-1	9	14	-20	0.10	-0.29	0.50	2.62

		Total Return (%)			
Equity/Volatility	**Level**	**WTD**	**QTD**	**YTD**	**Prior Yr**
S&P 500 Index	9,625	1.3	7.0	24.0	41.2
DAX	15,809	0.9	2.8	14.4	35.3
Stoxx 600	251	0.6	3.8	20.0	40.7
Nikkei 225					
Shanghai Comp.	29,647	0.3	-1.9	6.8	25.8
MSCI ACWI	3,544	-1.0	-0.5	4.3	10.7
FTSE 100	383	0.4	5.1	16.8	35.7
MOVE Index	7,269	0.5	2.2	15.5	34.4
VIX Index	75.5	4.7	23.5	54.0	23.1

		% Change			
FX/Commodities	**Spot**	**WTD**	**QTD**	**YTD**	**Prior Year**
EUR/USD	1.16	-0.73	-0.19	-5.39	-0.99
USD/JPY	114	0.40	2.39	10.36	8.93
GBP/USD	1.37	-0.53	1.54	0.09	5.82
USD/CHF	0.92	0.03	-1.67	3.49	0.10
USD (DXY)	94.12	0.51	-0.11	4.65	0.18
Oil	83.57	-1.23	11.38	72.24	131.05
Gold	1,783	-0.52	1.50	-6.06	-4.51

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

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U.S. Investment Grade Corporate Bonds: Bloomberg Barclays U.S. Corporate Bond Index: The Bloomberg Barclays U.S. Investment Grade Corporate Bond Index covers U.S.D-denominated, investment-grade, fixed-rate or step up, taxable securities sold by industrial, utility and financial issuers. It includes publicly issued U.S. corporate and foreign debentures and secured notes that meet specified maturity, liquidity, and quality requirements. Securities included in the index must have at least 1 year until final maturity and be rated investment-grade (Baa3/ BBB-/BBB-) or better using the middle rating of Moody's, S&P, and Fitch.

European Investment Grade Corporate Bonds: Bloomberg Barclays European Corporate Bond Index (unhedged): The Bloomberg Barclays Euro-Aggregate: Corporates bond Index is a rules-based benchmark measuring investment grade, EUR denominated, fixed rate, and corporate only. Only bonds with a maturity of 1 year and above are eligible.

U.S. High Yield Bonds: ICE BofAML U.S. High Yield Index: The ICE BofAML U.S. High Yield Index covers US dollar denominated below investment grade corporate debt publicly issued in the US domestic market. Qualifying securities must have a below investment grade rating (based on an average of Moody's, S&P and Fitch), at least 18 months to final maturity at the time of issuance, and at least one year remaining term to final maturity as of the rebalancing date.

European High Yield Bonds: ICE BofAML European Currency High Yield Index: This data represents the ICE BofAML Euro High Yield Index value, which tracks the performance of Euro denominated below investment grade corporate debt publicly issued in the euro domestic or eurobond markets. Qualifying securities must have a below investment grade rating (based on an average of Moody's, S&P, and Fitch). Qualifying securities must have at least one year remaining term to maturity, a fixed coupon schedule, and a minimum amount outstanding of €100 M. ICE Data Indices, LLC, used with permission. ICE DATA INDICES, LLC IS LICENSING THE ICE DATA INDICES AND RELATED DATA "AS IS," MAKES NO WARRANTIES REGARDING SAME, DOES NOT GUARANTEE THE SUITABILITY, QUALITY, ACCURACY, TIMELINESS, AND/OR COMPLETENESS OF THE ICE DATA INDICES OR ANY DATA INCLUDED IN, RELATED TO, OR DERIVED THEREFROM, ASSUMES NO LIABILITY IN CONNECTION WITH THEIR USE, AND DOES NOT SPONSOR, ENDORSE, OR RECOMMEND PGIM FIXED INCOME OR ANY OF ITS PRODUCTS OR SERVICES.

U.S. Senior Secured Loans: Credit Suisse Leveraged Loan Index: The Credit Suisse Leveraged Loan Index is a representative, unmanaged index of tradable, U.S. dollar denominated floating rate senior secured loans and is designed to mirror the investable universe of the U.S. dollar denominated leveraged loan market. The Index return does not reflect the impact of principal repayments in the current month.

European Senior Secured Loans: Credit Suisse Western European Leveraged Loan Index: All Denominations EUR hedged. The Index is a representative, unmanaged index of tradable, floating rate senior secured loans designed to mirror the investable universe of the European leveraged loan market. The Index return does not reflect the impact of principal repayments in the current month.

Emerging Markets U.S.D Sovereign Debt: JP Morgan Emerging Markets Bond Index Global Diversified: The Emerging Markets Bond Index Global Diversified (EMBI Global) tracks total returns for U.S.D-denominated debt instruments issued by emerging market sovereign and quasi-sovereign entities: Brady bonds, loans, and Eurobonds. It limits the weights of those index countries with larger debt stocks by only including specified portions of these countries' eligible current face amounts of debt outstanding. To be deemed an emerging market by the EMBI Global Diversified Index, a country must be rated Baa1/BBB+ or below by Moody's/S&P rating agencies. Information has been obtained from sources believed to be reliable, but J.P. Morgan does not warrant its completeness or accuracy. The Index is used with permission. The Index may not be copied, used, or distributed without J.P. Morgan's prior written approval. Copyright 2021, J.P. Morgan Chase & Co. All rights reserved.

Emerging Markets Local Debt (unhedged): JPMorgan Government Bond Index-Emerging Markets Global Diversified Index: The Government Bond Index-Emerging Markets Global Diversified Index (GBI-EM Global) tracks total returns for local currency bonds issued by emerging market governments.

Emerging Markets Corporate Bonds: JP Morgan Corporate Emerging Markets Bond Index Broad Diversified: The CEMBI tracks total returns of U.S. dollar-denominated debt instruments issued by corporate entities in Emerging Markets countries.

Emerging Markets Currencies: JP Morgan Emerging Local Markets Index Plus: The JP Morgan Emerging Local Markets Index Plus (JPM ELMI+) tracks total returns for local currency–denominated money market instruments.

Municipal Bonds: Bloomberg Barclays Municipal Bond Indices: The index covers the U.S.D-denominated long-term tax-exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds, and pre-refunded bonds. The bonds must be fixed-rate or step ups, have a dated date after Dec. 13, 1990, and must be at least 1 year from their maturity date. Non-credit enhanced bonds (municipal debt without a guarantee) must be rated investment grade (Baa3/BBB-/BBB- or better) by the middle rating of Moody's, S&P, and Fitch.

U.S. Treasury Bonds: Bloomberg Barclays U.S. Treasury Bond Index: The Bloomberg Barclays U.S. Treasury Index measures U.S. dollar-denominated, fixed-rate, nominal debt issued by the U.S. Treasury. Treasury bills are excluded by the maturity constraint but are part of a separate Short Treasury Index.

Mortgage Backed Securities: Bloomberg Barclays U.S. MBS - Agency Fixed Rate Index: The Bloomberg Barclays U.S. Mortgage Backed Securities (MBS) Index tracks agency mortgage backed pass-through securities (both fixed-rate and hybrid ARM) guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC). The index is constructed by grouping individual TBA-deliverable MBS pools into aggregates or generics based on program, coupon and vintage.

Commercial Mortgage-Backed Securities: Bloomberg Barclays CMBS: ERISA Eligible Index: The index measures the performance of investment-grade commercial mortgage-backed securities, which are classes of securities that represent interests in pools of commercial mortgages. The index includes only CMBS that are Employee Retirement Income Security Act of 1974, which will deem ERISA eligible the certificates with the first priority of principal repayment, as long as certain conditions are met, including the requirement that the certificates be rated in one of the three highest rating categories by Fitch, Inc., Moody's Investors Services or Standard & Poor's.

Palmer Square AAA CLO DM Index represents the discount margin of CLO AAA rated tranches in the Palmer Square CLO Senior Index, which is designed to reflect the investable universe of U.S CLO senior original rated AAA and AA debt issued after Jan 1, 2011.

Global Aggregate Bond Index is a measure of global investment grade debt from twentyfour local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging markets issuers.

U.S. Aggregate Bond Index: Bloomberg Barclays U.S. Aggregate Bond Index: The Bloomberg Barclays U.S. Aggregate Index covers the U.S.D-denominated, investment-grade, fixed-rate or step up, taxable bond market of SEC-registered securities and includes bonds from the Treasury, Government-Related, Corporate, MBS (agency fixed-rate and hybrid ARM passthroughs), ABS, and CMBS sectors. Securities included in the index must have at least 1 year until final maturity and be rated investment-grade (Baa3/ BBB-/BBB-) or better using the middle rating of Moody's, S&P, and Fitch.

Euro Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, euro-denominated, fixedrate bond market, including treasuries, government-related, corporate and securitized issues. Inclusion is based on currency denomination of a bond and not country of risk of the issuer.

Japanese Aggregate Bond Index The Japanese Aggregate Index contains fixed-rate investment-grade securities denominated in Japanese yen and registered as domestic bonds. The index is composed primarily of local currency sovereign debt but also includes government-related, corporate, and securitized bonds.

The S&P 500® is widely regarded as the best single gauge of large-cap U.S. equities. There is over U.S.D 9.9 trillion indexed or benchmarked to the index, with indexed assets comprising approximately U.S.D 3.4 trillion of this total. The index includes 500 leading companies and captures approximately 80% coverage of available market capitalization.

The DAX Index is a total return index of 30 selected German blue chip stocks traded on the Frankfurt Stock Exchange. The equities use free float shares in the index calculation. The DAX has a base value of 1,000 as of December 31, 1987. As of June 18, 1999 only XETRA equity prices are used to calculate all DAX indices.

The STOXX 600 Index is derived from the STOXX Europe Total Market Index (TMI) and is a subset of the STOXX Global 1800 Index. With a fixed number of 600 components, the STOXX Europe 600 Index represents large, mid and small capitalization companies across 17 countries of the European region.

The Nikkei 225 Index is a price-weighted average of 225 top-rated Japanese companies listed in the First Section of the Tokyo Stock Exchange. The Nikkei Stock Average was first published on May 16, 1949.

Shanghai Composite Index is a capitalization-weighted index. The index tracks the daily price performance of all A-shares and B-shares listed on the Shanghai Stock Exchange. The index was developed on December 19, 1990.

MSCI ACWI is a free-float weighted equity index. It was developed with a base value of 100 as of December 31 1987. MXWD includes both emerging and developed world markets.

FTSE 100 is a capitalization-weighted index of the 100 most highly capitalized companies traded on the London Stock Exchange. The equities use an investibility weighting in the index calculation. The index was developed with a base level of 1000 as of December 30, 1983.

MOVE Index is a yield curve weighted index of the normalized implied volatility on 1-month Treasury options. It is the weighted average of volatilities on the CT2, CT5, CT10, and CT30. (weighted average of 1m2y, 1m5y, 1m10y and 1m30y Treasury implied vols with weights 0.2/0.2/0.4/0.2, respectively).

VIX Index is a financial benchmark designed to be an up-to-the-minute market estimate of the expected volatility of the S&P 500® Index, and is calculated by using the midpoint of real-time S&P 500 Index (SPX) option bid/ask quotes.

Bloomberg Commodity Index Bloomberg Commodity Index (BCOM) is calculated on an excess return basis and reflects commodity futures price movements. The index rebalances annually weighted 2/3 by trading volume and 1/3 by world production and weight-caps are applied at the commodity, sector and group level for diversification. Roll period typically occurs from 6th-10th business day based on the roll schedule.

The U.S. Dollar Index indicates the general international value of the USD. The USDX does this by averaging the exchange rates between the USD and major world currencies. The ICE US computes this by using the rates supplied by some 500 banks.

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