PGIM FIXED INCOME

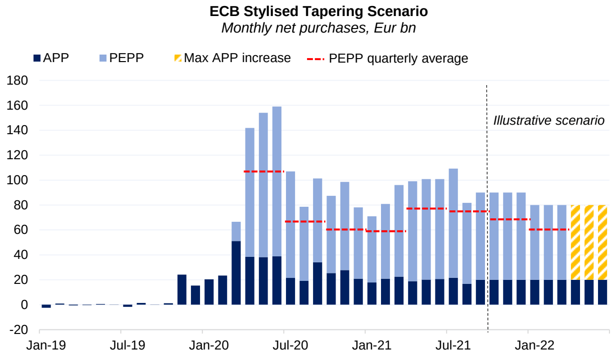
ECB: Less QE, Just Don’t Call it Tapering

WEEKLY VIEW FROM THE DESK | SEPTEMBER 13, 2021

QUICK LINK TO THE RETURNS TABLE

MACRO

- Last week, the ECB pulled off a small reduction to the pandemic bond purchase program and, judging from the lack of market reaction following the announcement, quite successfully convinced the market that the move does not amount to tapering. It isn't clear that investors should interpret this move as a signal regarding the stance of monetary policy; rather, we think the reduction should be seen as a result of improved market functioning since the onset of the pandemic.
- The slightly slower pace puts the market's focus on the future of the ECB's overall stimulus when the central bank transitions away from the PEPP in March 2022. We think it will be increasingly tricky for Governing Council members to reach a consensus given their disagreements over the trajectories of growth and inflation as well as key issues, such as raising the issuer limit for bond buying.
- To us, the recent rebound in European inflation and growth appears temporary and indicates the need for continued stimulus in the euro area. Our economic forecasts are broadly in line with the ECB's estimates for inflation to moderate to 1.7% and 1.5% annually in 2022 and 2023, respectively, from 2.2% this year. The ECB will release its projections for 2024 in December, which will provide some clarity to officials' policy views beyond March 2022. The risk is that near-term inflation will prove to be persistently high, hurting dovish Council members' case to materially increase the regular APP stimulus program when the pandemic program ends.

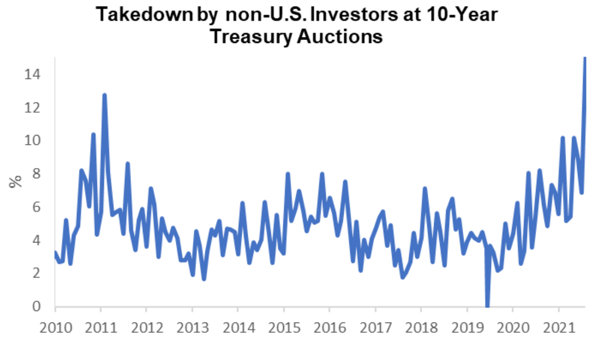


Source: PGIM Fixed Income, ECB

- While the ECB insists the adjustment is not “tapering,” it highlights the trend of central banks reducing, or signaling a reduction in, monetary support. These include the central banks in Canada, Australia, and Poland. We expect the Fed will begin tapering in Q4 at about $15B/month, but, in the interim, concerns may also mount about the Fed falling behind the inflationary curve.

RATES

- To that prior point, the front end of the Treasury curve could see some volatility if inflation expectations become unanchored to the upside going forward. The market is currently pricing in less than one hike for 2022, but judging by the persistent inflation pressure and the progression of the Fed's dot plot, up to three hikes may be possible in 2022. Such a sudden tightening of financial conditions could negatively affect spread markets and expose weaknesses in EM nations with high external debt balances. However, we think the overall impact on long U.S. rates should be limited if policy maintains its credibility for containing inflation.
- U.S. Treasury yields have been little changed in recent weeks and the market has been able to weather the deluge of corporate supply and long-end Treasury auctions. That's a departure from the well-established seasonal trends over the past decade, when the 10-year yield on average increases by around 12 bps in the first two weeks of September. Long-dated Treasuries have also outperformed recently compared to other developed markets. We think demand from non-U.S. real money investors has driven price action, which is evident in the Treasury data showing their increase in recent auction activity.
- The U.S. debt ceiling issue continues to loom on the horizon. We still think that the ceiling will be extended by Senate Democrats via reconciliation if bi-partisan efforts fail. Currently, most experts believe the Treasury will run out of money by mid-November at the latest.



Source: PGIM Fixed Income, U.S. Treasury Department

- Agency MBS spreads continued to tighten last week as investors shortened duration amid increased heavy Treasury and corporate issuance. August prepayments met expectations and speeds were more responsive in lower 30-year conventional coupons given the removal of the FHFA adverse market refinance fee.

IG CORPORATES

- U.S. IG spreads appeared well braced for the influx of about $64B over the course of only three days last week. Investors were not only ready for the issuance with sufficient cash balances, but dealers ended up only buying an estimated $850M of the issuance and may have been lifted out of some inventory positions over the course of the week. After pricing with slightly more than 2 bps of average concessions on order books than were more than three times covered, most of last week’s transactions tightened by 5-6 bps by the end of the week. Most of the proceeds were used to refinance existing debt and some was slated to finance M&A transactions, but very little was tagged for capital expenditures.

- The banking, telecom, and energy sectors outperformed last week with spreads in the latter ratcheting tighter amid rising prices for liquified natural gas, natural gas, and oil as Europe experiences a surge in electricity prices. Given the growing global use of wind, solar, and other renewable sources, we continue consider the inflationary effects of the global expanding ESG push.
- Issuance was also brisk in Europe with €15B pricing last week on minimal concessions. The new deals drifted slightly wider, but firmed following the ECB's announced reduction of its PEPP purchases. The use of proceeds on many of the deals involved tendering for bonds and reissuing debt in a currency that may provide a lower cost of capital or may better match respective assets. Last week's issuance included a 40-year issue from Eli Lilly, which became the issue with the longest tenor in the sector.

HIGH YIELD

- U.S. high yield posted positive returns last week despite a decline in U.S. equities as the heavily anticipated post-Labor Day calendar was slow to develop and continued positive flows provided a supportive technical backdrop. By quality, Bs (+0.19%) outperformed BBs (+0.11%) and CCCs (-0.02%).
- The primary calendar picked up, but not by as much as expected with eight deals pricing for just over $5.7B. As evidence of strong demand, many of the deals priced tight of original price talk yet still traded up over a point on the break. Among the larger deals was Caesars Entertainment's $1.2B refinancing of its 2025 notes, which priced tight of initial talk, yet still traded up 1.25 points in the secondary market. We expect the calendar to ramp up significantly over the next three weeks as most dealers are expecting $50B in issuance in September.
- U.S. leveraged loan prices continued to move higher as only one small add-on loan allocated last week even as the loan pipeline continued to ramp up. Due to the lack to primary loan allocations, CLO ramping and another weekly inflow into loan mutual funds contributed to a healthy technical backdrop. Looking forward, we expect a technical rebalancing as the forward calendar grows. Last week saw the addition of 31 new deals totaling $25B to the loan pipeline, which should allocate in the coming weeks. Notably, M&A-related activity now makes up a majority of the expected issuance.
- In Europe, high yield bond and loan returns were positive last week. It was a slow start to the primary market with only €3B of new BB issuance. However, the primary market remains in focus with €20-30B in gross issuance expected across bonds and loans over the next four to five weeks.

EMERGING MARKETS

- Emerging market hard currency assets were flat last week with the high yield portion of the index underperforming IG. Performance remained differentiated and country-specific with the lower-rated segments (B and CCC) 5 bps wider while the higher-rated segments were largely tighter. Countries with challenging funding needs underperformed, with El Salvador, Ghana, Costa Rica, and Kenya widening. Pemex was a notable outperformer with spreads tightening 20 bps across the curve as the government suggested it was willing to swap out some Pemex debt for government debt and reduce its tax burden from 54% to 40%.
- In EM corporates, the market tone remained resilient despite heavy new supply. J.P. Morgan raised its 2021 default rate forecast from 2.5% to 5% largely on the back of the recent turmoil in China property markets. While lower-quality property names, such as Evergrande, have continued to struggle, we have yet to observe contagion creeping into higher-quality property names.
- EMFX weakened vs. the U.S. dollar last week with country-specific factors weighing on some currencies. The Brazilian real and Chilean peso lagged amid political concerns and the Turkish lira, Polish zloty, and Czech koruna lagged amid high inflation prints.
- Within local rates, the Index yield rose to a YTD high of 5.095% as front-end yield curves in Brazil, Chile, Peru, and Colombia saw another round of policy-rate repricing on the back of high inflation prints. Poland, Mexico, Philippines, Malaysia, and Hungary outperformed last week.

SECURITIZED PRODUCTS

- At this point, there are three CMBS conduit deals in the market as well as several large SASB deals. So far, there has been sufficient demand to absorb supply, and we remain constructive on senior, well-enhanced CMBS tranches.
- U.S. CLO spreads were generally unchanged last week. European spreads were also unchanged as the tone at the top of the capital structure remains firm. We expect issuance volumes to remain elevated in the US and Europe through yearend as we believe there are over 175 deals currently being marketed across both markets. U.S. CLO primary spreads for higher quality portfolios were ~3L+113/160/195/280/625 bps for AAA/AA/A/BBB/BB, respectively for 5-year reinvestment period deals.
- ABS spreads remained firm with most sectors trading at/near YTD tights. Issuance is expected to pick-up in September with 15 deals being premarketed. YTD supply reached $173B, 6% ahead of 2019 pace and well ahead of 2020.

MUNICIPAL BONDS

- Municipal bond fund saw another net inflow last week, totaling $1.1B. The 5 , 10-, and 30-year portions of the AAA-rated muni curve ended the week at 50.1% (down from 52.2% last week), 69.8% (down from 70.1%), and 79.0% (down from 78.1%), respectively. YTD net inflows total $85.3B, with municipal bond funds now having experienced inflows in 68 of the past 69 weeks for a total of $147B over that span.
- Tax-exempt technicals are expected to soften over the near term as J.P. Morgan expects net supply of +$8.3B over September and October. However, we view any softening over the next month as a buying opportunity as technicals are expected to improve toward year-end, with J.P. Morgan estimating net supply of -$15B in November and December.
- The draft of the infrastructure bill from the House Ways & Means Committee includes a BAB-like program with an issuer subsidy starting at 35% and declining to 28% over five years. The draft bill also includes a return of tax-exempt advance refunding bonds.

THE RETURNS TABLE As of September 10, 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	0.21	---	1	-4	9	7	-0.01	0.18	0.07	0.17
U.S. 5-Year	4.9	0.81	---	3	-7	46	55	-0.13	0.52	-1.18	-1.40
U.S. 10-Year	9.3	1.34	---	2	-13	43	67	-0.13	1.38	-2.78	-4.54
U.S. 10-Year Breakeven	--	2.40	---	5	6	41	70	---	---	---	---
U.S. 10-Year TIPS	4.9	-1.05	---	-3	-18	4	-4	0.44	3.41	4.33	5.69
U.S. 20-Year	16.7	1.86	---	0	-16	fa	65	0.08	2.86	-6.04	-9.05
U.S. 30-Year	22.5	1.93	---	-1	-15	29	52	0.22	3.51	-6.02	-10.29
UK 10-Year	9.7	0.76	---	4	4	57	53	-0.39	0.88	-4.28	-2.30
Germany 10-Year	9.9	-0.33	---	3	-12	24	10	-0.31	1.19	1.25	1.25
Japan 10-Year	9.7	0.04	---	1	-1	3	2	-0.06	-0.05	-0.05	-0.05
Australia 10-Year	9.6	1.22	---	0	-31	25	29	0.02	3.33	-0.93	-0.71
Canada 10-Year	8.9	1.24	---	5	-15	56	67	-0.41	1.63	-3.96	-4.36
MAJOR FI MS INDICES											
Global Aggregate Unhedged	7.6	1.06	34	0	1	-3	-15	-0.22	0.94	-2.30	0.81
Global Aggregate Hedged	7.6	1.06	34	0	1	-3	-15	-0.06	0.93	-0.60	0.45
U.S. Aggregate	6.8	1.44	35	-1	3	-7	-22	0.02	0.88	-0.74	-0.21
Euro-Aggregate (Unhedged)	7.7	-0.01	49	-1	1	1	-11	-0.08	0.90	-1.41	0.58
Japanese Aggregate	9.7	0.09	1	0	0	0	0	-0.11	0.27	0.13	0.23
MAJOR FI CREDIT INDICES											
Mortgage-Backed (Agency)	4.6	1.71	32	-1	5	-7	-23	0.01	0.48	-0.30	-0.12
Global IG Corporate Bonds	7.4	1.54	89	-1	4	-10	-41	-0.11	0.85	-0.86	2.83
U.S. IG Corporate Bonds	8.7	2.01	86	-1	6	-10	-44	0.11	1.08	-0.20	2.43
European IG Corporate	5.3	0.24	84	0	2	-7	-30	-0.11	0.55	0.16	2.34
U.S. High Yield Bonds	3.7	3.79	279	0	11	-81	-214	0.11	1.20	4.85	10.75
European High Yield Bonds	3.3	2.48	289	-3	-1	-69	-144	0.12	0.96	4.56	9.22
U.S. Leveraged Loans	0.3	5.00	445	-1	+13	-26	-139	0.18	0.76	4.27	7.77
European Leveraged Loans	0.3	3.72	406	0	-3	-52	-192	0.09	0.71	3.70	8.24
EM Hard Currency Sovs.	8.0	4.81	341	0	0	-11	-59	0.00	1.57	0.90	4.20
EM Corporates	4.9	4.20	300	-3	4	-28	-87	0.14	1.12	2.41	6.10
EM Currencies	---	2.86	341	0	0	-11	-59	-0.36	0.15	-0.46	4.36
EM Local Rates	5.2	5.09	5	0	0	1	1	-0.24	-0.07	-2.98	-0.90
CMBS	5.1	1.45	62	0	4	-19	-45	-0.07	0.61	0.11	1.28
ABS	2.2	0.54	28	1	6	-5	-16	-0.03	0.17	0.35	0.81
CLOs	---	1.01	101	0	-3	-15	-32	0.01	0.06	0.12	0.61
Municipal Bonds	4.8	0.97	---	0	-3	-10	-35	0.00	0.42	1.49	3.39

		Total Return (%)			
Equity/Volatility	**Level**	**WTD**	**QTD**	**YTD**	**Prior Yr**
S&P 500 Index	9463	0.6	5.8	22.0	33.2
DAX	15907	-0.4	1.6	15.0	20.9
Stoxx 600	253	0.1	4.5	19.7	31.8
Nikkei 225	29916	5.4	1.2	7.1	26.2
Shanghai Comp.	3677	1.7	0.7	5.2	8.0
MSCI ACWI	384	1.3	4.0	16.8	30.8
FTSE 100	7172	0.0	2.6	13.7	26.4
MOVE Index	53	-8.1	-7.0	8.7	16.4
VIX Index	17	0.1	3.7	-27.9	-51.2

		% Change			
FX/Commodities	**Spot**	**WTD**	**QTD**	**YTD**	**Prior Year**
EUR/USD	1.2	0.7	0.2	-2.8	0.2
USD/JPY	109.7	-0.1	-1.3	6.3	3.3
GBP/USD	1.4	0.8	0.3	1.5	4.4
USD/CHF	0.9	0.2	-1.3	3.2	0.4
USD (DXY)	92.0	-0.7	-0.4	2.3	-0.8
Oil	69.3	0.8	-5.7	42.8	67.5
Gold	1827.7	0.6	3.3	-3.7	-5.3

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

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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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