PGIM India Mutual Fund

# WEEKLY VIEW FROM PGIM FIXED INCOME DESK

## Evolving Global Fiscal Effects, GDP Trajectories

**May 03, 2021**

### MACRO

- While the euro area's Q1 GDP contraction of -0.6% in Q1 was better than the consensus expectations for a contraction of about -0.8%, the reading confirmed the region's technical recession—led by a 1.7% decline in Germany—and likely extends its recovery into 2022. As a result, we revised our 2021 GDP forecast for the Euro Area from 5.1% to 4.9%, while our 2022 GDP forecast improved from 3.5% to 4.0%.
- The euro area economy may benefit from an additional fiscal impulse from the Next Generation EU funds in 2023-2024, which is expected to be the peak years of disbursement. Spain and Italy are the largest recipients of the funds, and the grants and loans should stabilize fiscal conditions as the former's fiscal budget is expected to decline from more than 8% of GDP in 2021 to slightly more than 4% in 2022 and to about 4% in 2023. Italy's budget deficit is projected to decline from nearly 12% in 2021 to about 4% in 2022 and to less than 2% in 2023.
- Signs of the U.S economic recovery continue to extend. For example, the Conference Board's reading of consumers planning to buy a home reached the highest level dating back to 2005, while the reading of consumer's plans to buy a car and go on vacation also hit recent highs (however, the latter remains well below pre-COVID levels). Furthermore, the Census Bureau reported that consumer concerns over public places reached a 2021 low in April, and new business applications reached the highest level since 2010.
- Therefore, we recast our GDP scenarios for the U.S. with a baseline reading and two upside scenarios, one of which has a weaker expansion in 2022. The baseline reading projects annual average growth of 6.3% in 2021 and 4.5% in 2022. Our upside scenario sees average annual growth of 7.1% in 2021 and 5.4% in 2022. Our upside scenario with a weaker 2022 projects average annual growth of 7.1% in 2021 and 2.9% in 2022.
- Of the Biden administration's $4T in proposed infrastructure and social expenditures, we anticipate a package of $3-$3.5T that is potentially passed without Republican support via reconciliation. On the tax side, after proposed $700B from improved collection enforcement, we believe the administration could generate $1.5T in tax revenue on a standard 10-year timeframe via an increased corporate tax rate to 25-26% and a top capital gains rate of 30%. The result of the expenditure and revenue mix could widen the fiscal deficit from a baseline of about 4-5% of GDP to 5-6% under the proposals.

### RATES

- The Bank of Canada's recent tapering announcement was the initial sign of central bank divergence, and the markets may be anticipating further segmentation going forward. For instance, core European and peripheral rates sold off in April with the 10-year Bund yield rising from a low of -0.33% to -0.20% on Monday. The 10-year French yield rose from -0.08% in early April to 0.15% on Monday, and the 10-year Italian yield rose from 0.67% to 0.87%. We regard the euro area selloff as a potential indication that the markets are reading Fed policy as possibly looser than ECB policy. One consideration of the policy perception is that the ECB is due to complete its inflation framework review by mid-2021, which could also impact the markets' view on future policy in Europe.
- In the U.S., although 10-year inflation breakevens rose to a recent high of 2.43% after last week's uneventful Fed meeting, the 10-year nominal yield has remained relatively constrained at 1.62% as of Monday. More broadly, we are monitoring whether the 5-30 nominal yield could re-steepen in conjunction with the inflation expectations.
- Elsewhere in the U.S., we think even if the April payroll report this Friday comes in weaker than expected—the median forecasts call for an unemployment rate of 5.8% and non-farm payroll additions of 995,000—we believe the two-year yield will have limited room to run lower from current levels. We'll also monitor the Treasury's refunding announcement this week for potential decreases in auction sizes in the second half of the year.
- U.S. mortgage spreads continued to ratchet tighter last week amid Fed buying, short covering, month-end rebalancing, and limited supply. The market-cap weighted Treasury OAS closed at -2 bps (-3), while the LIBOR OAS closed at +1 bps (-3), both of which marked the richest valuations in years. April MTD excess returns closed at +11 versus Treasuries.

### IG CORPORATES

- U.S. IG spreads tightened by 2 bps to 88 bps last week as limited new issue supply and strong corporate earnings set the tone. Flows into the market remained positive, with net flows of +$5.2B coming into IG funds last week. Aside from the tobacco sector, all U.S. IG sectors posted positive total returns in April. By quality, the higher rated segments fared the best from a total return perspective, but all quality buckets ended the month in positive territory.
- Primary market activity slowed to $14B, and included Citigroup's three-tranche, $5.5B offering, which closes out an already record setting month for U.S. money center bank issuance. New issue demand was strong and prompted deals to price with minimal concessions. Dealers are calling for $25-$40B of supply this week and $135-$150B in May.
- In what was a quiet week, European IG spreads tightened by1 bp, ending at an index OAS of 84 bps. From a sector perspective, tobacco continued to underperform while autos spreads were notably unchanged following negative revisions in production and full year earnings estimates related to ongoing semi-conductor shortages. Technicals remained strong as new issue activity remained subdued. Primary supply totaled €7B and was easily absorbed by the market. We believe supply will pick up into May.

### EMERGING MARKETS DEBT

- Emerging market hard and local currency assets posted negative returns last week while EMFX was positive. The U.S. dollar saw a fourth straight weekly decline as the Federal Reserve signaled its intent to keep interest rates at currently low levels despite economic growth and a rise in inflation. EM hard currency returned -0.23%, EM corporates returned +0.01%, hedged local rates returned -0.32%, and EMFX returned +0.24%. EM hard currency spreads were flat at 339 bps.
- Emerging market bond fund flows were again positive, totaling +$757M. Hard currency funds saw inflows of $599M, local currency funds saw inflows of $96M, and blend funds saw an inflow of $63M. This brings year-to-date total flows into EM bond funds to $22.58B, with hard currency, local currency, and blend strategies accounting for $8.19B, $9.57B, and $4.83B, respectively. EM equity funds saw $473M 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 Argentina, Zambia, Ethiopia, Sri Lanka, and Costa Rica; while the underperformers were Morocco, Ukraine, El Salvador, Uruguay, and Paraguay.

- In EM local rates, the yield on the benchmark index rose 5 bps to 4.93% last week as a rebound in U.S. yields, increased backwardation in oil and grain curves, and political discord in many emerging markets weighed on the asset class. Czech Republic, Turkey, Brazil, Indonesia, and Romania outperformed, while Chile, Colombia, Mexico, Poland, and South Africa lagged.
- In EMFX, Asian currencies outperformed with the Indian rupee stabilizing despite the ongoing COVID surge. The Brazilian real, Hungarian forint, Chilean peso, and Turkish lira also outperformed, while the Argentine peso, Colombian peso, Mexican peso, Peruvian sol, and South African rand lagged.

## HIGH YIELD

- U.S. high yield returned +0.20% last week against the backdrop of lighter new issuance, strong U.S. GDP growth, and an uneventful U.S. Fed meeting. Spreads tightened 8 bps to +328 bps and average yields rose 4 bps to 4.12%. The excess return was +0.33%.
- High yield sectors produced mixed results with energy (+0.50%), media (+0.31%), and air transportation (+0.30%) outperforming. Meanwhile, paper (-0.08%), food & drug retail (-0.08%), and cable (-0.08%) lagged. By quality, CCCs (+0.51%) outperformed both Bs (+0.22%) and BBs (+0.11%).
- U.S. high yield mutual funds reported inflows totaling $272M last week, with ETFs posting inflows of $1.24B and active managers seeing an outflow of $970M. Meanwhile, the primary market closed out the month to set a new April record of $48.75B in issuance. For the week, new issuance of $8.55B was among the lightest seen over the past nine weeks. Looking forward, we expect issuance to pick up again this week.
- U.S. leveraged loans returned +0.09% last week, with lower-quality credits outperforming. Technicals weighed on the market as several BWICs combined with heavy new issuance created some technical weakness, especially among lower spread loans as managers sold in order to make room for new supply. Meanwhile, U.S. loan mutual funds posted another $931M inflow last week, which brings the year-to-date inflow to nearly $14B.
- Looking forward, the loan new issue calendar appears to be slowing and is lighter than it has been in recent months, which should contribute to a more favorable technical backdrop and may help support secondary levels over the short term.

## SECURITIZED PRODUCTS

- U.S. conduit AAA CMBS spreads were unchanged last week. One new issue conduit priced slightly tighter than initial talk and the secondary demand remained strong. Another conduit deal announcement is expected this week. Although dealers have revised 2021 conduit supply expectations lower, Single Asset Single Borrower (SASB) and commercial real estate (CRE) CLO issuance will likely be notably higher. 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 firm across the capital structure as demand remained strong. While we continue to see large anchor investors looking to source both senior and subordinate bonds, supply continues to impact AAA spreads and limit spread compression. We continue to expect robust issuance volumes in 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+112/165/190/300/650 bps for AAA/AA/A/BBB/BBs, respectively. Long term, we continue to favor senior CLO tranches in Europe and the U.S. and remain cautious about legacy junior mezzanine tranches.
- ABS spreads were generally unchanged last week as $3B of new issuance was well absorbed. This year's issuance now totals $80B, which aligns with 2019's pace. Secondary trading levels continue to meet some resistance but are clearing around year-to-date tights. We believe ABS fundamentals are favorable but are mindful of increased regulatory scrutiny over originators of consumer credit. ABS spreads are expected to remain supported due to flat/negative net new issuance expectation this year.

## MUNICIPAL BONDS

- Municipal bond funds saw another net inflow last week, contributing to a solid tone in tax-exempt and taxable muni markets. The 5- , 10-, and 30-year portions of the AAA-rated muni curve ended the week at 50.6% (up from 44.0% the prior week), 60.8% (up from 59.6%), and 69.0% (down from 69.3%). Year to date, the high-grade index has returned +0.48%, and the high yield index has returned +3.60%.
- Municipal bond funds saw net inflows of $1.6B, with long term, high yield, and intermediate funds posting inflows of $1.4B, $630M, and $55M, respectively. This brings year-to-date inflows to $41.5B. Year-to-date gross supply now totals $151B, which is 17.8% higher than the same period last year. This week's calendar is estimated at nearly $12B, including over $3B in taxable muni issuance.
- Negotiations on an infrastructure package are expected to begin this week. While too soon to predict what the final package will look like, expectations of higher taxes should provide continued support for tax-exempts. Regarding a potential Build America Bonds-type program, issuance will be driven by the subsidy level and the relative richness/cheapness of tax-exempt issues.

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



2021-3828