WEEKLY VIEW FROM THE DESK

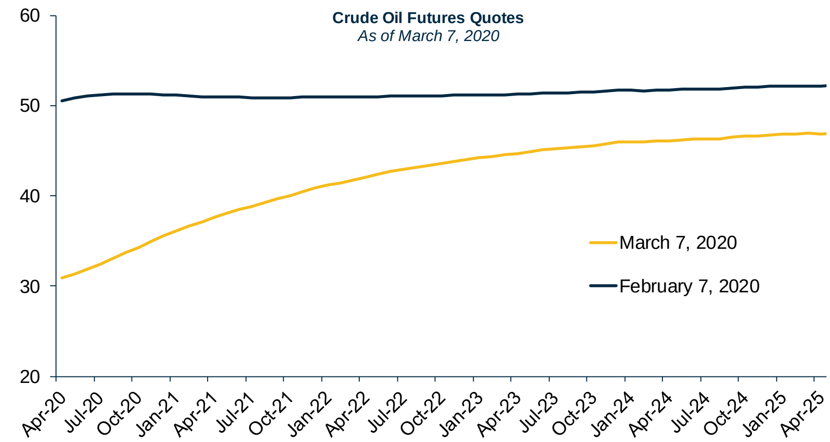
Ramifications from the Collapse in Crude

PGIM FIXED INCOME

March 9, 2020

COLLAPSE IN CRUDE

- We viewed Saudi Arabia's decision to cut prices and increase production as not only targeted at Russia, but also aimed at U.S. shale producers who have increased their market share by about 5M barrels/day over the last five years. When compared to Saudi Arabia's attempt at increasing market share in 2014-2015, the prior scenario concluded with a V-shaped recovery amid consistent global demand.
- The current situation includes a shock to supply and demand with the coronavirus situation reducing demand by an estimated 2-3M barrels per day. Thus, from a U.S. perspective, estimated production of 12.4 M barrels/day in 2019 may need to decline by 3-4M BPD to the levels last seen in 2014 and 2016.
- In order to clear the supply glut in the current situation, crude oil prices may have to stay in the low $30 range—all else being equal—for 12-18 months. We estimate the marginal cost of production for the more efficient U.S. shale producers at $40, down from $70 circa 2015, and with little room to reduce costs from here (but a sharp drop in capital expenditures, e.g. rig counts, should be expected). Thus, the surviving firms from here may depend on how long they can withstand crude oil prices in the low $30 range.
- As the lowest-cost producer, we estimate Saudi Arabia's breakeven cost of production at $10/ barrel, but with a fiscal breakeven of $70-80 per barrel. Russia's fiscal breakeven is at an estimated $45 a barrel. Russia and Saudi Arabia have massive FX reserves and are likely to be reasonably well positioned to absorb months of low prices.
- One notable development in Monday's price declines was the relatively minimal movement in the crude oil futures curve. In what has become a steeper forward curve, the 2025 contract has only declined by about $4 to about $44-45 per barrel (see accompanying chart). The relatively steep curve indicates some expectations that the recent reduction in demand should be restored over the years.



Source: Bloomberg as of March 9, 2020.

MACRO

- The global economy now seems likely to contract in both the first quarter (by -0.85%) and the second quarter of 2020 (on a quarter-to-quarter annualized basis). We recently reduced our 2020 GDP growth forecasts for China—from 4.8% to 4.1%—and the U.S.—from 1.9% to 1.7%. We're anticipating a Q1 contraction in China of 7.0% (on a SAAR basis).
- Providing an elastic supply of liquidity in volatile times is a critical role of central banks—i.e. make funds available and at a low cost (it was critical for the Fed to cut rates last week, and it will likely cut at least another 50 bps, possibly before its meeting next week). Another 50 bps cut is likely over the next couple of months. If the situation continues to worsen appreciably, zero policy rates are a distinct possibility—and renewed asset purchases cannot be ruled out. As the situation deteriorates, the ECB and BoJ are likely to do more as well.
- We see global growth running well above trend during the second half of the year at perhaps around 4% (or possibly higher)—as the bounce back takes hold. As this episode eventually passes, it's unlikely to leave permanent scars on the global economy.
- Fiscal policy across DM has a lot more room to ease, and targeted fiscal packages—such as support to liquidity challenged industries and small-business loans—may be more likely than broad-based packages at this point.
- We'll be watching U.S. jobless claims closely for indications of layoffs in the energy sector and the associated service industries. The employment numbers in the sectors are not overly significant from broad perspective, but the jobs are generally high-paying positions.
- From a U.S. perspective, the deficit is high at 4.6% of GDP in FY 2019 and FY 2020 and expected to rise to 5.4% by 2030, according to projections as of January 2020. The deterioration in the baseline projection is due to projected rising interest costs amid rising debt levels and higher projected interest rates. Lower interest rates could mitigate at least part of the potential deterioration. For example, projections assume UST 10-year averages 1.9% in 2020, rising to 3.1% by 2030; this projected rise in interest rates accounts for 40% of the baseline expected increase in interest expense.

RATES

- After the latest drop in U.S. Treasury yields left the 10-year at 0.58%, going forward, the trading range could be 0.25-1.00% as long as the volatility persists. As conditions stabilize, the trading range could widen to 0.50%-1.50%.
- For some perspective on the ongoing bid for Treasuries, trading in the long Treasury future hit the up-limit a handful of times in Monday's intra-day trading. The demand for liquidity was also apparent amid the differentiated trading of off-the-run securities (underperformed; including the 20-year segment of the curve) relative to on-the-run securities, which outperformed.
- While we're moderating our view at long end of the U.S. Treasuries curve, we're maintaining an underweight to the front of the curve. Swap spreads in the intermediate portion of the curve have widened recently, prompting more neutral positioning in that segment of the curve. We continue to expect tighter swap spreads at the front end of the curve and wider swap spreads at the back end.
- We're also monitoring the dislocation between the ultra-long futures contract and the 30-year cash Treasury bond with the futures contract trading at historically rich levels, i.e. a 200 bps arbitrage per year. While Bund and JGB yields have also declined recently, the moves further into negative territory did not induce a dislocation across the respective rate complexes as was observed in the U.S.

- With TIPS selling off with the collapse in crude oil prices, inflation expectations also slid with the five-year breakeven rate quoted 100 bps lower than a month earlier at 85 bps.
- In U.S. MBS, lower coupons continued to trade short into the rally, while high premium coupons outperformed on the stack. The market-cap weighted T-OAS closed at 37 (+4 bps, same move as last week), while the L-OAS closed at 32 bps (-3 bps, larger than last week) as swap spreads widened by up to 8 bps (bigger move than last week). Production 30-year coupons widened, while higher coupons were tighter. 30-year 2.5s and 3s underperforrmed again versus stated durations. Fifteen-year production coupons outperformed 30-year production coupons (again).

CORPORATES

- Although U.S. IG spreads had only backed up by about 6 bps through Thursday, spreads moved significantly wider on Friday as virus-related concerns intensified. The index OAS ended the week wider by 22 bps and continued widening by an additional 35 bps through Monday afternoon. Underperformance was led by the energy sector (+25-100 bps, led by some of the weaker BBB-rated names), followed by autos (+40-75 bps), healthcare/pharmaceuticals (+5-35 bps); telecom/media/technology (+5-30 bps), U.S. and European banks (+15-25 bps), and utilities (+15-20 bps). To date, the flattening of the spread curve has been relatively muted, but we expect the flattening will accelerate in the near term.
- In general, bid/ask spreads have remained wide, but demand for new issues has provided insight into investors' willingness to increase exposure to the U.S. IG market. A total of 23 issuers raised approximately $30B in the primary market last week, which was met with robust demand. Deals were covered by 3.5 times and priced 20 bps inside initial price talk. Concessions ranged from slightly negative to as much as 20 bps. The backlog of issuers in the new issue pipeline remains high, and dealers expect between $5-$25B of supply this week, largely depending on the market tone.
- While our short-term view on the asset class has become increasingly bearish amid expectations for additional softness, our favorable long-term view has prompted us to use the volatility as an opportunity to reduce exposure to the front end of the U.S. IG curve in favor of longer-dated issues that we believe offer greater long-term value.
- The latest developments have created a mixed picture on many IG energy names. On the positive side, their credit profiles are healthier than in years past as they are less leveraged, and they are not reliant on bank financing. On the negative side, their cash burn rates may increase going forward, their leverage levels will likely creep higher, and they have less of an equity cushion to raise equity capital. As for midstream energy names, companies that are more leveraged to pipelines will likely start scrambling for volume as they aim to survive.
- European IG spreads widened by 17 bps last week as cyclicals widened by +40-50 bps and the more defensive sectors backed up by +15-25 bps. Senior non-preferred banks widened by +30-40 bps on the week, and continued widening by an additional +30 bps on Monday. After widening by 40-50 bps last week, autos widened by an additional 30-70 bps on Monday. Although our short-term view on the European IG market has softened, our long-term view on the asset class remains constructive.

EMERGING MARKETS DEBT

- On Monday, hard currency sovereign spreads were quoted +100 bps wider from Friday's close of +400 bps (which was +100bps wider from mid-February levels). IG spreads were about +50bps wider and HY spreads were about 150bps+ wider. Some higher-beta spreads were said to be 200-300 wider on the day. Oil names led most of the price action, with Saudi Arabia's 2028s widening by 64 bps, Russia's 2027s widening by 80 bps and Pemex's 2028s widening by 210 bps. That said, transaction volumes remained relatively light, without much in the way of two-way flows.
- There is enough liquidity to buy assets, but subsequent days may be a better representation of liquidity in the market because Monday was mainly about price discovery. The color we are getting from the street is that volumes are very light. Bid/offers are anywhere from 2 to 5 price points, but these are just indicative runs. At this point it does not appear that dealers feel compelled to sell positions under duress because they have yet to see large scale sale inquiries from investors.
- Liquidity in EMFX was spotty/poor for most of Monday's trading and oil centric names underperformed. The yen and euro outperformed on safe haven bids and some continued short covering. The three major Central and Eastern European currencies rallied on back of euro move.
- While we believe spreads could widen from here, they already appear attractive at current levels. Notably, in prior periods when the spreads widened near 500 bps (e.g. 2011 and 2016), they tightened relatively quickly in the following months.
- Last week, EM assets reversed some of the declines posted the week prior, with hard currency sovereigns generating a total return of 1.14% after posting a return of -2.10% the week before. EMFX, corporates, and hedged local rates were also positive last week, posting returns of 0.72%, 0.67% and 1.10%, respectively.
- Nevertheless, outflows accelerated, with hard currency bonds experiencing their largest weekly outflow at over $3 billion. Hard currency sovereign spreads widened by 29 bps to 402 bps last week, with most of that taking place on Friday after OPEC failed to agree on a deal to cut oil production.
- Lebanon's likely default over the weekend had more or less become the base case. Weaker bond prices made it much harder politically to repay these bonds. Longer dated bonds declined by roughly 2-5pts to the low 20s and traded flat of accrued interest and the 2020 maturities are down substantially, but still trading in the higher $20s. There is still some sense that the more consolidated foreign holdings in these shorter maturities will drive a more favorable restructuring. Indeed, recent prices built in a hefty haircut and actually bounced on Monday after the long bonds traded more than 5 pts lower.

HIGH YIELD

- Amid Monday's sharp selloff in equities and oil, U.S. high yield bonds spreads widened by approximately 100 bps to +666 bps amid relatively limited and orderly trading activity. We are maintaining our overweight to independent power producers, natural gas producers, and U.S. consumer-related names. We are underweight BB-rated bonds, while looking to opportunistically add virus-impacted consumer sectors (e.g. certain cruise lines and gaming names).
- The paradigm shift in crude oil prices significantly repriced much of the high yield energy sector with some names trading in the single-digit dollar range after trading in the $60 range two weeks earlier. In general, as a portion of the sector aims to survive the drop in crude prices, they will halt capex spending and focus solely on managing costs. Given the ongoing hit to energy bond prices, a meaningful pickup in default rates across the $130B high yield energy sector shouldn't have an oversized impact on the broader $1.1T U.S. high yield market.

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- The U.S. high yield bond market returned -0.42% last week, bringing the year-to-date return to -1.99%. Lower-rated credits underperformed, with CCC-rated and B-rated credits returning -2.45% and -0.64%, respectively. Conversely, BB-rated bonds rose on the week, generating returns of 0.20%. Average yields rose last week by 17 bps, ending the week at 6.42%, while spreads widened by 58 bps to 564 bps as Treasury yields declined to historic lows. Year to date, high yield spreads have widened by 204 bps. High yield bond mutual funds reported outflows of $4.1 billion last week, bringing year-to-date outflows to $8.8 billion.
- By sector, high yield bond performance was mixed last week. Airlines (-3.99%), gaming (-2.04%), and lodging (-1.10%) were among the weakest performing sectors. Energy (-2.48%) continued to decline as talks between OPEC members to maintain production cuts broke down. Year to date, the energy high yield sector is down by more than 11%. The automotive sector was also generally lower after China reported an 80% decline in auto sales in February. Conversely, defensive sectors outperformed, with food, beverage & tobacco (+2.12%), utilities (+0.54%), cable (+0.42%), and supermarkets (+0.33%) all generating positive returns last week.
- Similar to the U.S markets, European high yield widened Monday amid light trading volume and ongoing price discovery, with some travel & leisure bonds down by as much as 10-20 points over the past week. To date, we have seen little in the way of forced selling, but we are opportunistically looking to source high-quality paper at these wider levels.
- In Europe, the high yield index returned -0.92% last week, with higher-rated areas of the market outperforming. By quality, BB-rated, B-rated, and CCC-rated bonds returned -0.51%, -1.82%, and -1.91%, respectively. Average yields and spreads widened by 25 bps and 38 bps, respectively. European leveraged loans returned -0.98% last week.
- U.S. leveraged loans continued to outperform high yield bonds last week, generating returns of -0.84%, which brings the year-to-date returns to -1.05%. Similar to the high yield asset class, higher-rated areas of the market generally outperformed their lower-rated peers. Limited sell-side pressure has come mostly from bank loan mutual fund redemptions, as well as relative-value investors looking to free up cash to buy high yield bonds. Meanwhile, bid-ask spreads widened out to as much as 3-4 points on Monday amid light trading volumes. Notably, about one-third of U.S. leveraged loan issuers currently benefit from LIBOR floors of 100 bps, providing some level of protection from a declining base rate. European loans returned -0.98% last week.

SECURITIZED CREDIT

- U.S. and European CLO spreads moved wider across the capital structure last week on the broad market volatility. CLO spreads for top-tier managers ended at about ~3L+125I180/250/360/750 bps for AAA/AA/A/BBB/BBs, respectively. On the week, the capital structure was wider: AAA +5-10 bps, AA +15-20 bps, A +25-35 bps , BBB +30-50 bps, and BB by at least +100 bps.
- ABS spreads continued to widen due to broader market weakness. While spreads are significantly wider, markets remain orderly. New issuance is expected to slow in the near-term as issuers are postponing transactions due to market volatility. We are cautious on ABS technicals at this juncture given the lagged pricing effect of these markets.

Notice:
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