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In Credit

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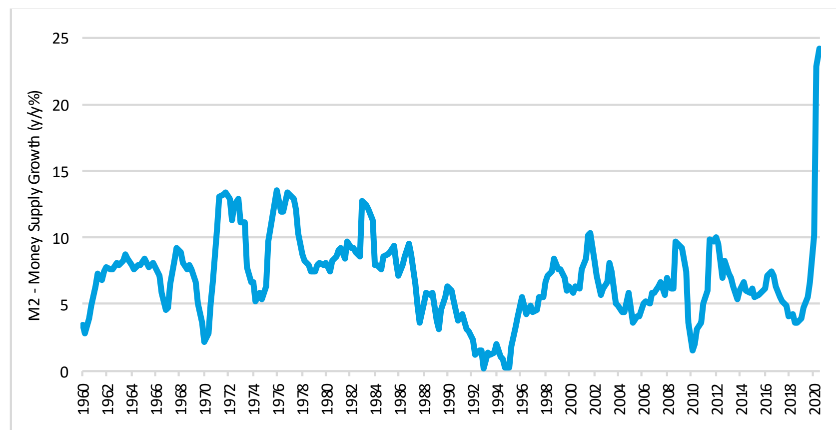
Money for nothing, and VIX for free.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	0.81%	6 bps	-1.1%	8.1%
German Bund 10 year	-0.57%	5 bps	0.4%	3.0%
UK Gilt 10 year	0.27%	9 bps	-1.0%	7.1%
Japan 10 year	0.04%	1 bps	-0.2%	-0.9%
Global Investment Grade	126 bps	-3 bps	0.2%	5.2%
Euro Investment Grade	109 bps	-3 bps	0.8%	1.5%
US Investment Grade	130 bps	-3 bps	0.1%	6.7%
UK Investment Grade	120 bps	-4 bps	0.2%	4.8%
Asia Investment Grade	251 bps	-1 bps	-0.1%	5.0%
Euro High Yield	463 bps	-12 bps	1.4%	-1.2%
US High Yield	487 bps	-7 bps	1.6%	1.3%
Asia High Yield	685 bps	-10 bps	0.4%	2.5%
EM Sovereign	382 bps	4 bps	0.5%	0.8%
EM Local	4.4%	-1 bps	1.9%	-4.5%
EM Corporate	387 bps	-3 bps	0.7%	3.3%
Bloomberg Barclays US Munis	1.4%	2 bps	-0.4%	2.9%
Taxable Munis	2.3%	7 bps	-1.8%	8.1%
Bloomberg Barclays US MBS	55 bps	-3 bps	-0.1%	3.5%
Bloomberg Commodity Index	156.00	0.2%	3.8%	-8.7%
EUR	1.1814	1.2%	1.2%	5.8%
JPY	104.99	0.6%	0.7%	3.7%
GBP	1.3026	1.0%	0.9%	-1.6%

Source: Bloomberg, Merrill Lynch, as at 23 October 2020.

Chart of the week: US - M2 Money Supply Growth (y/y%), 1960-2020



Source: Bloomberg and Columbia Threadneedle Investments, as at 26 October 2020.

Macro / government bonds

Core government bond yields were higher last week. The benchmark 10-year US treasury yield has now risen from 0.5% in early August to around 0.8% today.

The US now faces the possibility of a combination of expansionary montary policy and a political 'Blue Wave' that seems likely to bring further fiscal expansion. There is a wash of money 'sloshing' round the system as well, which has helped drive up inflation expectations (**see chart of the week)**. However, all the while, stagnant growth continues to force real yields lower. So although 10-year inflation expections have risen from 0.6% in mid March to 1.75% more recently, the real yield in inflation-protected bonds has fallen from 0.6% to -0.9% in the same period.

Inflation has been dampened by the combined effects of technology (Amazonification / WFH etc); deunionisation (and its effect on collective bargaining); globalisation (under threat!); and an ageing population with a higher propensity to save than spend, as well as the effects of high debt burdens.

Investment grade credit

Risk markets have benefited from a decline in market volatility. The VIX measure of equity market volatility is perhaps the most widely watched. Indeed, this index has fallen from around 66 in mid march to high 20's today.

Global investment grade spreads were tighter last week and have been on a gradual grind tighter in October that has unwound the widening seen last month. We are the middle of company reporting season with 'beats' exceeding 'misses' in a similar story to the prior quarter.

We have added a thought piece with our views on the relative merits of the senior part of the bank capital structure at the end of this document.

High yield credit

US high yield bond spreads tightened modestly over the past week amid a rise in US treasury yields and as investors continue to assess the state of US stimulus talks. The ICE BofA US HY CP Constrained Index returned 0.18% and spreads were 7bps tighter, ending at +490bps. The primary calendar remained manageable while inflows were modest at $151 million, according to Lipper.

European high yield spreads tightened back in the 9bps from the previous week even as there were outflows in the asset class (-€195 million), half via ETFs. The market still was quite balanced with selective buying of duration in single B paper given the outperformance of BB the previous week. This resulted in single B being the outperformer of the week. Primary markets continued to be robust with €4 billion of new issuance. Issuer names included, GetLink (a green bond from the Channel Tunnel company), Ineos (chemicals), Adevinta (internet networks) DRAX (UK utilities), and Garfunkelux (financial services). News on the M&A front as Cellnex announced an acquisition in Poland (€800 million) while the Atlantia board rejected the CDP led group offer but still left room for further negotiations.

Moody's commented that it sees Brexit as a bigger threat to UK car manufacturers than Covid-19.

US leveraged loans

Leveraged loan prices rose modestly over the past week as equity markets oscillated and investors focused on primary activity. The average price on the J.P. Morgan Leveraged Loan index increased +$0.07 to $94.93 over the past week with the average price for BB loans increasing $0.07 to $97.30, Single B loans increasing $0.05 to $96.73, and Split B/CCC increasing $0.18 to $80.72. The

leveraged Loan index is providing a +0.69% gain in October with Split B/CCC loans (+0.85%) outperforming B loans (+0.75%) and BB loans (+0.38%). The asset class saw a 2nd consecutive weekly inflow for the first time since January with $76 million of retail demand. That said, year-to-date outflows for leveraged loans total $26 billion.

Structured credit

The Agency RMBS market was slightly negative last week alongside higher quality fixed income assets on a steeper yield curve.

Trading volumes were elevated as investors reinvested heavy paydowns. The US Federal Reserve continues to be an active buyer at $40 billion a month, as do banks needing to put cash to work. Foreign buying had stalled out earlier in the year in the midst of the volatility but has more recently resumed. In terms of credit, October has been a better month for spreads. Housing continues to be a bright spot in the US economy. September's existing home sales were the highest level since the financial crisis in 2008. CMBS spreads were softer as the pace of improving delinquencies slowed alongside the broader economy.

Emerging markets

Emerging markets also gave back last week as spreads widened, marginally, for both hard currency sovereign and corporate bonds. Local debt, however, performed positively, largely due to FX movements (84% of the local debt performance). Still, the asset class experienced strong inflows of $2.2 billion into both hard and local currency funds. This was the highest level seen since the end of August.

In central bank news, Turkey, surprisingly, kept rates unchanged. It had been expected to hike rates by as much as 200bps given the continued weakness in the currency. In other central bank news (Russia, Ukriane, Israel) rates were kept unchanged supporting the impression that the market is nearing the end of the rate cutting cycle.

In rating news, S&P has put Zambia on selective default given the country's announcement that it would not pay the coupon on its eurobonds. This follows our comment the previous week that the Zambia government was trying to convince bond holders to agree to some debt re-profiling and a delay in coupon payments, but with little success.

On the issuance side, NAFTAGAS came to market with a new bond but then withdrew it in spite of over subscription. This is not the first time, as the firm did this previously in September 2018.

In country specific news, recent protests in Nigerla against police brutality culminated last week in what is now being called Lekki Massacre. This means it is unlikelily to receive a World Bank loan in the near future.

Asian fixed income

SK Hynix announced that it will acquire the NAND flash and SSD drive business from Intel Corp for KRW10.3 trillion (around $9 billion). The impact of this significant acquisition is cushioned by the phase manner in which SK Hynix will complete the transaction. SK Hynix will pay a first tranche of $7 billion, likely by end-2021 and a second tranche of $2 billion by March 2025. This transaction will strengthen SK Hynix's scale in the NAND flash business by almost doubling its pro-forma global market share (currently around 11%). Samsung is presently the market leader in NAND flash and SSD with a global share of 32%.

Hindustan Zinc Limited (HZL) has declared a large dividend of INR90 billion (around $1.2 billion). Vedanta Ltd which holds a 64.9% stake in HZL, stands to gain around $779 million of the dividend. Subsequently, Vedanta Ltd also announced interim dividend of INR35 billion (around $470 million). This is a positive development for Vedanta Resources (holding company), which owns a 50.1% stake in Vedanta Ltd. Moody's currently holds a B1 ratings with a review for downgrade outlook on Vedanta Resources while S&P maintains a B- rating with a negative outlook. Both agencies are monitoring Vedanta Resources' progress in refinancing its high debt maturities over the near term.

Last week, Fitch downgraded Pan Brother's credit rating from B to B- with a 'watch negative' outlook to reflect the increased pressure on its refinancing ability. The company has $138.5 million of loan facilities due in February 2021 and $171 million of bonds in January 2022. At June 2020, Pan Brothers reported $40 million of cash balances and $10 million of undrawn loan facilities. Earlier on 16 October, Moody's downgraded Pan Brothers from B3 to Caa1 with a negative outlook for the same reason.

Commodities

The Index was marginally up (+0.25%) on the week.

Crude oil and heating oil fell by 3.5% and 3.3% respectively. This decline can be attributed to concerns regarding stricter lockdown measures overwhelming any news of plans to extend OPEC production cuts. The cuts currently stand at 7.7 million barrels per day, 8.5% of global demand. Production increases were originally planned for January; however, it's now expected these cuts will be extended further into 2021. In Libya, the last major oil field has reopened following a ceasefire in the civil war. The National Oil Corporation aims to boost production to 1 million barrels per day within a month.

Base metals rallied 1.5% on the back of further Chinese buying, most notably zinc surged by 5.0%. Prices were also supported by strong demand from North America and Europe, where manufacturing has been recovering post lockdown. Agricultural commodities rose by 2.7% last week. This consisted of a rally of 2.6% in wheat and 2.2% in soybeans. This was also driven by continued Chinese wheat purchases, which were US focused, specifically in the Pacific Northwest region. In precious metals, gold fell by -0.4% and silver rallied 1.3%.

INFORMATION FOR INVESTMENT PROFESSIONALS

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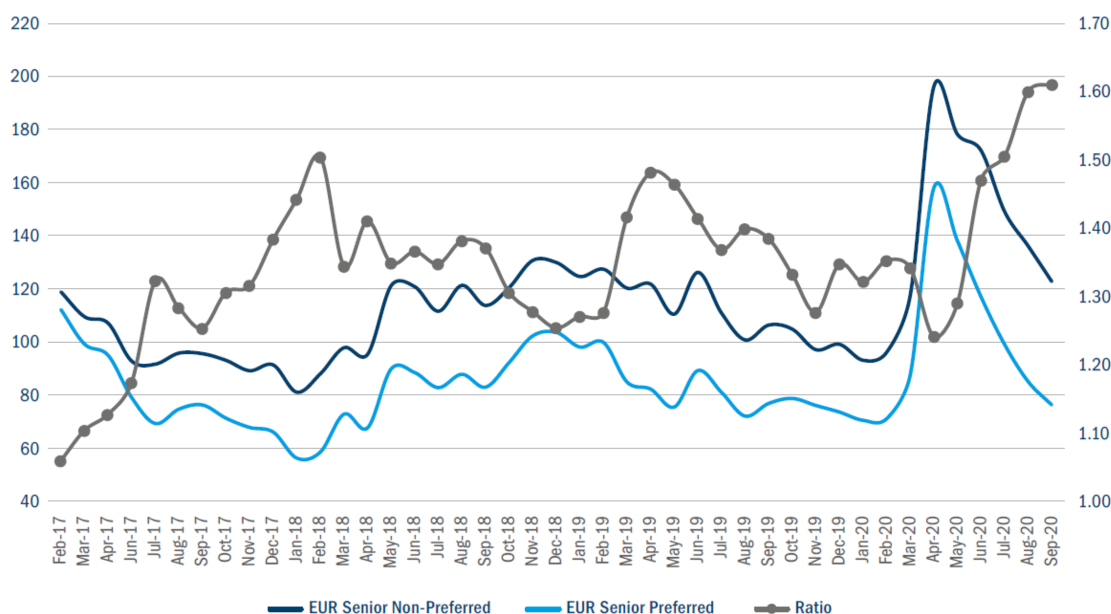
UPDATE ON OUR VIEWS OF SENIOR BANKS - OCTOBER 2020

A year ago, in a viewpoint "All credit to European banks' senior preferred bonds", we outlined our thoughts on why senior preferred (SP) bank bonds were an interesting late-cycle opportunity and the last big piece of a decade-long regulatory overhaul of the banking sector. Since then a lot has changed in the world – and especially in banking regulation – in response to the Covid-19 pandemic.

In our original thesis we outlined the view that SP bonds could eventually trade close to covered bonds with spreads to swaps in the low double-digits as they became fewer and increasingly less remote. It was a defensive, end-of-cycle trade and we were positioned for the cycle to turn and credit to deteriorate. Clearly, we did not predict the catalyst, but our SP positions have outperformed senior non-preferred (SNP) positions, ie, the ratio in Figure 1 has increased.

Figure 1: Senior preferred (SP) versus senior non-preferred (SNP)[1]



Source: Bloomberg/Columbia Threadneedle Investments, September 2020.

[1] Index constructed by CTI using ICE Indices including all issuers that have index eligible SP and SNP, this ensures we have the same constituents in the numerator and denominator of our ratio, reducing the risk of constituent mismatches.

As a result of Covid-19 and the various support packages and regulatory changes, we were forced to examine the impact on our thesis.

On the one hand, we have an elevated SNP-SP ratio, an extended deadline to meet minimum requirement for own funds and eligible liabilities (MREL) and lower risk of SNP bail-in as regulators have effectively wrapped their arms around senior bank bonds, all supporting the idea of switching into SNP. On the other hand, arguing for keeping SP, banks now have more deposits, near unlimited liquidity at the European Central Bank via targeted longer-term refinancing operations (TLTRO) and less need for SP bonds. Could this lead to a wave of Liability Management Exercises (LME) and for SP bonds to continue to outperform?

Our view is that issuers have to consider the fact that TLTRO and rising deposits are not permanent sources of funding; they do not want to be seen as overly arbitraging emergency facilities; and must maintain a good relationship with regulators. So, we think the outcome is in fact a marginally improved technical picture for SP as there is less need for them, partly offset by the delay in the MREL deadline. We don't expect a wave of LMEs, rather a slight shift from SP to a slight increase in funding from deposits and TLTRO at the margin.

The net impact of the measures implemented support our thesis and we continue to favour SP over SNP bonds, despite recent outperformance. If the current ratio of SNP-to-SP had existed back in 2019 we would probably have been tempted to switch several of our SP holdings into SNP. However, given today's very different regulatory and economic backdrop we think this ratio can remain elevated for a while and have only selectively chosen to switch into SNP where the ratio is well above the historical average, ie, where we are over-compensated for SNP's added risks, and predominantly in regions with a solid fiscal stance.

Christopher Hult, Portfolio Manager, Investment Grade, Paul Smillie, Senior Credit Analyst, Rosalie Pinkney, Senior Credit Analyst

To read a full thought piece on this topic visit https://www.columbiathreadneedle.co.uk/en/insights/?it=Institutional

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

26th October 2020

Strategy and positioning (relative to risk free rate)		Views	Risks to our views
Overall Fixed Income Spread Risk	Under-weight -2 -1 0 +1 +2 Over-weight	▪ The spread tightening of the last 5 months leaves valuations much closer to long-term averages, and a more modest overweight to credit risk is warranted. There are still enough attractive opportunities to build a portfolio that is overweight credit risk, although some sectors are offer little upside. ▪ Technicals are positive across the board. The Fed's new strategy underlines lower for longer and targeting easy financial conditions. The demand for credit products remains high. ▪ Fundamentals continue improving, even if slower than in the summer. Vaccine progress is coming steadily.	▪ The Feb garbles its messaging in how it will carry out its new policy framework ▪ Cooler weather leads to virus acceleration and school closures hamper labour productivity. ▪ The damage done to the labour market is deep & long-lasting. ▪ Vaccine development slows.
Duration (10-year) ('P' = Periphery)	P ¥ $ Short -2 -1 0 +1 +2 Long € £	▪ Recovery pace to slow as government support wanes, consumption rebound fades ▪ Reflation credibility still low, despite Fed framework review ▪ Fed QE and high personal savings underpin demand for treasuries ▪ ECB readying new stimulus effort ▪ Duration remains best hedge for further risk asset correction	▪ Unexpected medical advance allowing full, rapid economic re-opening ▪ Permanent fiscal policy shift rebuilds reflationary credibility ▪ Fiscal largesse steepens curves on issuance expectations ▪ Risk hedge properties deteriorate
Currency ('E' = European Economic Area)	¥ E EM £ Short -2 -1 0 +1 +2 Long A$ $	▪ Recent USD weakness has come as a result of relatively worse interest rate, Covid and fiscal dynamics. This is now largely priced and we expect a pause in the downtrend. ▪ Longer term, expensive valuations and twin deficits presage a weaker Dollar	▪ A second Trump term could lead to USD strength through more aggressive trade policy ▪ Reimposition of Covid restrictions in Europe
Emerging Markets Local (rates (R) and currency (C))	R Under-weight -2 -1 0 +1 +2 Over-weight C	▪ Many EMs lack the policy space to offset demand destruction ▪ Currencies the likely pressure valve as central banks finance fiscal deficits ▪ EM real interest rates relatively attractive	▪ Further sharp escalation in global risk aversion ▪ EM funding crises drive curves higher and steeper
Emerging Markets Sovereign Credit (USD denominated)	Under-weight -2 -1 0 +1 +2 Over-weight	▪ The stable/weaker USD over the last 4 months has eased fundamental and technical pain. ▪ EM IG has tightened inside long-term averages versus US IG, but EM BB/B remains attractive versus US BB/B. ▪ The peak in defaults and restructurings has passed and the landscape of EM is relatively stable. ▪ The wave of global liquidity is reaching EM, but after it ran through developed market credit.	▪ The USD strengthens. ▪ Growth scars from COVID persist and hurt commodity prices & ability to grow out of deficits. ▪ Governments show little willingness to address deficits post-COVID.
Investment Grade Credit	Under-weight -2 -1 0 +1 +2 Over-weight	▪ IG valuations were the most directly affected by the Fed and normalized most quickly. Valuations are now at long-term medians, but the index duration is 30% longer. ▪ Fundamentals have been more positive than expected. Leverage has risen, but so too has cash. ▪ With Treasury yields likely very low for an extended period of time, technicals favour IG as a safe asset substitute.	▪ The Fed does not renew its Corporate Credit Facilities. ▪ Foreign buyer flow stops for geopolitical, financial, or regulatory reasons. ▪ The cash stockpiles taken out at the depths of the crisis are deployed on large-scale M&A instead of deleveraging.
High Yield Credit	Under-weight -2 -1 0 +1 +2 Over-weight	▪ Spreads & new issue supply underline that companies with sounds economics have no issue accessing financing. Valuations are mostly back in line with long-term ranges and are moderately attractive versus IG, but less compelling than earlier in the recovery. ▪ The ability to access financing has dramatically improved the prospects for many companies, and the impact of COVID on companies with bonds >$80 is manageable.	▪ Prolonged COVID-19 related slump in activity would hurt these companies most. ▪ The sector most sensitive to changing financial conditions.
Agency MBS	Under-weight -2 -1 0 +1 +2 Over-weight	▪ The Fed's QE including Agency MBS has been a significant tailwind for a sector with worse fundamentals. ▪ But valuations are much more neutral now, although the Fed's quantity of buying is overwhelming the market. ▪ Forbearances have been better than expected, and are still relatively low (including GNMA, which has been hit hardest).	▪ Fed reallocating MBS purchases towards Treasuries. ▪ Bonds will underperform other spread product in a sharp risk-on move. ▪ Renewed interest rate or curve volatility.
Non-Agency MBS & CMBS	Under-weight -2 -1 0 +1 +2 Over-weight	▪ Non-Agency MBS: fundamentals have held up better than expected into this crisis, and the housing market is the strongest sector in the economy thanks to low interest rates and desire for more space for continued WFH. CMBS: Retail tenant payments & hotel occupancy are improving. Office is still struggling but valuations reflect this. ▪ Valuations vary wildly, but are broadly attractive. Given performance, trimming some riskier positions & doubling down on conviction credit is due.	▪ Changes in consumer behaviour in travel and retail last post-pandemic. ▪ Work From Home continues full-steam-ahead post-pandemic. ▪ Built-up savings from fiscal stimulus/enhanced unemployment benefits are drawn down and mortgage forbearance increases.
Commodities	Under-weight -2 -1 0 +1 +2 Over-weight	▪ o/w Copper vs Aluminium ▪ u/w Crude, u/w natural gas ▪ o/w Soybeans vs Corn ▪ o/w refining margins (o/w products, u/w Brent)	▪ Oil production disruption

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