

In Credit

24 FEBRUARY 2020

Rising risk aversion, falling bond yields.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	1.40%	-18 bps	0.5%	3.1%
German Bund 10 year	-0.47%	-7 bps	-0.1%	1.9%
UK Gilt 10 year	0.54%	-8 bps	0.4%	4.2%
Japan 10 year	-0.06%	-3 bps	0.1%	0.5%
Global Investment Grade	103 bps	2 bps	0.6%	2.7%
Euro Investment Grade	89 bps	-1 bps	0.2%	1.3%
US Investment Grade	105 bps	3 bps	0.8%	3.2%
UK Investment Grade	106 bps	0 bps	0.2%	3.0%
Asia Investment Grade	196 bps	0 bps	0.7%	2.1%
Euro High Yield	325 bps	-3 bps	0.9%	1.0%
US High Yield	366 bps	10 bps	1.2%	1.2%
Asia High Yield	554 bps	5 bps	1.2%	1.9%
EM Sovereign	293 bps	6 bps	1.2%	3.0%
EM Local	4.9%	-3 bps	-0.2%	-1.5%
EM Corporate	313 bps	5 bps	1.0%	2.5%
Bloomberg Barclays US Munis	1.4%	-10 bps	0.5%	2.3%
Taxable Munis	2.6%	-12 bps	1.4%	6.9%
Bloomberg Barclays US MBS	45 bps	2 bps	0.3%	1.0%
Bloomberg Commodity Index	161.04	1.2%	2.0%	-5.5%
EUR	1.0827	0.1%	-2.2%	-3.3%
JPY	111.47	-1.6%	-2.9%	-2.6%
GBP	1.2937	-0.6%	-1.8%	-2.2%



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Source: Bloomberg, Merrill Lynch, as at 24 February 2020.

Chart of the week: US 10-year treasury yield - LTM



Source: Macrobond and Columbia Threadneedle Investments, as at 24 February 2020.

Macro / government bonds

Core bond yields continue to drift lower in a 'bull flattening' amid fears about the spread of the COVID-19 coronavirus outside of China and most recently in Italy and Korea. This has led to concerns of a developing pandemic and a negative impact on global growth. As a result, the benchmark US 10-year treasury yield reached 1.4%, its lowest level since the summer of 2016 – [see chart of the week](#).

Business confidence figures are inconclusive about the impact of the virus thus far. Indeed, in Europe and the UK, PMI data actually rose. This increase was driven by an increase in supplier delays (normally a sign of increased demand). This time it likely relates to supply chain blockages. The US composite PMI was very weak indeed, and below the key 50 mark, indicating contraction.

Investment grade credit

Global investment grade spreads have been fairly range bound this year (8bps).

The effects of a high level of issuance and concerns about the coronavirus have been balanced by market inflows. In company specific news, Kraft Heinz, Renault and Macy's were all cut to high yield. Apple reduced its 2020 guidance given the expected effects of the virus. Meanwhile, HSBC revealed a plan to cut around 35,000 jobs and is cancelling its share buybacks.

High yield credit

US high yield bond prices decreased modestly over the past week as investors attempted to weigh the global economic and corporate earnings impact from the covid-19 outbreak. New issue activity slowed to its second lowest weekly total of 2020. Specifically, \$6.1 billion priced over the past week resulting in a month-to-date activity at \$29.2 billion, albeit of which only \$7.6 billion has been net of refinancing. The asset class reported a modest \$40 million outflow over the week, according to Lipper.

European high yield finished close to flat last week, up only 10bps. On the corporate news side, ThyssenKrupp's plan to sell its elevators business fell through, as potential buyer, Kone, pulled out from the deal. Additionally Vallourec, a French supplier to the energy industry, announced a capital raise plan, which pushed its bonds from 90 to above par. A large number of high yield corporates reported their full year 2019 reports last week, including Douglas, a German beauty products retailer, which surprised the market with top-line growth. The primary market was still active, despite the half-term break, and we had two new deals price. The asset class saw net inflows into the funds. The latest fallen angels entering the non-investment grade universe are sizeable ones: Renault with \$66 billion, Macy's with \$8 billion and Kraft Heinz with \$21 billion, outstanding debt. Given that cash balances are lower than the start of the year, there could be some digestion issues to absorb the latest new high yield entrants.

Leveraged loans

Risk continues to perform well buoying returns in the lowest quality segment of the bank loan sector. The best performance has come from the metals & mining, utilities and automotive sectors, while cable & satellite, gaming & leisure, and diversified media have lagged. The oil and gas sectors were hurt more recently in the downtick of oil prices. Defaults remain benign at 1.7% versus a long-term historical average of 3%. Record levels of new issuance in January are expected to taper off as M&A/LBO activity slows. This dynamic should create a better technical backdrop for the sector in the months ahead as outflows in retail mutual funds seem to have stabilized while still being net out and CLO creation is nicely ahead of last year. The price on the bank loan index is approximately \$97.49 at a yield of 6%.

Structured credit

The sharp interest rate rally widened MBS spreads, resulting in negative total returns, as prepayment risk accelerated. The MBA Refinancing index spiked to its highest level in the past five years, with approximately 66% of the universe refinancable at today's rates. Performance for the sector has become increasingly correlated to interest rates, and less so credit, as one might expect investors to gravitate towards agency MBS in a risk-off environment. Housing fundamentals remain healthy, while affordability has improved on better wages and slower home price appreciation. Mortgage delinquencies also remain at post-crisis lows. In ABS, the consumer remains healthy and bond performance in-line with expectations.

Emerging markets

Emerging markets finished down, for the week, as coronavirus worries plagued the market. Hard currency spreads were wider by 6bps while the local currency index fell 75bps, mainly due to deterioration in Asian FX currencies.

Central banks cutting rates last week were Mexico (-25bps to 7.00%), Russia (-25bps to 6.00%), and Turkey (-50bps to 10.75%) as growth concerns continued to dominate.

Announcements of lower 2020 growth forecasts are happening across the globe. The central bank of Thailand dropped its forecast to below 2% (from an earlier outlook of 2.8%) while in Nigeria, the IMF downgraded its growth forecast to 2% (from 2.5%) on the back of oil price volatility.

In Asia, Malaysia's prime minister Mahathir, resigned as his party pulled out of the four-party government coalition, throwing the government in turmoil. This comes just days from an expected government announcement of a \$3.5 billion equivalent stimulus package to counteract the repercussions of the coronavirus outbreak and boost the economy.

Asian fixed income

Asian credit posted a 0.5% gain last week, helped largely by the lower US treasury yields.

Hongkong Land (HKL) has acquired a 23.1 hectare mixed-used site in Shanghai for a consideration of \$4.4 billion. HKL plans to develop the commercial land in multiple phase and complete it by 2027. HKL is exploring various funding options, without recourse to shareholders, that include potential co-operation with strategic partners and debt. According to Moody's, the investment will weaken HKL's financial metrics but the company has ample financial buffers and could partly pre-sell the project to absorb any negative impact. Fitch downgraded Nan Fung International Holdings from BBB to BBB- to reflect the company's weaker financial profile during the construction of Kai Tak complex, which is its key investment property project.

MGM China is requesting its banks for some relaxation to its financial covenants. The financial profile of MGM is impacted by the suspension of its Macau casino operations due to the coronavirus outbreak.

The NCLAT (National Company Law Appellate) has approved JSW Steel's proposed acquisition of Bhushan Power & Steel Ltd. JSW Steel's financial metrics, however, are weaker with a net debt/EBITDA of 3.7x at December 2019 (March 2019: 2.4x) due to lower profitability in 2019. As such, we expect JSW Steel metrics to be weaker compared with its target of 3.75x, assuming that the acquisition is completed with material debt funding.

GMR Infrastructure announced the agreement to sell a 49% stake in GMR Airport. GMR Infrastructure's original plan of selling the stake to a consortium comprising Tata Sons, GIC Singapore and SSG Capital has been called off. Tata Sons, however, holds stakes in two airlines (Vistara and Air Asia); a regulatory issue that prevents it from acquiring the stake in GAL.

The primary market saw \$8 billion of supply, which takes total year-to-date supply to \$62 billion (+30% y/y)

Commodities

The asset class closed 1.2% higher for the week as crude oil (up 1.5%) and precious metal prices were higher. Base metals were overall stable for the week. Gold and Silver prices rallied 4%, each, last week as gold closed at a seven-year year high at \$1644/troy ounce. Iron ore prices are back to levels pre-coronavirus on tightening supply.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views 24th February 2020



Strategy and positioning (relative to risk free rate)	Views	Risks to our views
Overall Fixed Income Spread Risk 	<ul style="list-style-type: none"> Global economic data continues to register at low or contractionary levels across many sectors and regions. There are modest signs of stabilization, however spread levels appear to reflect this already. Trade headlines continue to fly back & forth, but we see risks that are more fundamental than these. 	<ul style="list-style-type: none"> Fast and fierce fiscal stimulus, especially in Europe or China. Reacceleration of growth trends
Duration (10-year) (P' = Periphery) 	<ul style="list-style-type: none"> Coronavirus risks derailment of nascent global recovery Manufacturing uptick may have been levelling off anyway Phase One trade deal fulfilment unrealistic Lower pace of US growth expected this year Policy normalisation remains 	<ul style="list-style-type: none"> Global trade détente stimulates improvement in risk sentiment Chinese efforts to successfully contain virus with minimal growth disruption US economy stages consumption-driven cyclical upswing
Currency (E' = European Economic Area) 	<ul style="list-style-type: none"> The Dollar is richly valued on the basis of growth outperformance and high carry. Twin deficits indicate a weaker dollar longer term The global reflation trade, which would have provided near term impetus for USD weakness, has been set back by the growth impact of the Coronavirus 	<ul style="list-style-type: none"> Further leg lower in global growth driven by increasing trade frictions and Coronavirus
Emerging Markets Local (rates (R) and currency (C)) 	<ul style="list-style-type: none"> EM real interest rates still relatively attractive EM growth likely to outperform DM, while inflation benign Fiscal and external fundamentals still largely sound 	<ul style="list-style-type: none"> Sharp escalation in global risk aversion Broad dollar strength
Emerging Markets Sovereign Credit (USD denominated) 	<ul style="list-style-type: none"> Fundamentals have been not deteriorated as much as would have been expected given a strong USD and catering global trade While spreads have tightened much like other asset classes, pockets of valuations gaps have open-ended up The number of idiosyncratic blow-ups is increasing: first Argentina, now Ecuador and Lebanon are precipitously deteriorating 	<ul style="list-style-type: none"> Oil & commodity rally will boost sentiment and current account balances. A rapidly weakening USD will ease financial conditions Reversal of recent electoral trend towards market-friendly candidates.
Investment Grade Credit 	<ul style="list-style-type: none"> Broad valuations have become unattractive on an absolute basis, even before considering higher debt levels and decelerating growth Fundamentals don't show signs of imminent crisis, but several of the tailwinds are fading. Valuations look even more offside when considering this 	<ul style="list-style-type: none"> A re-acceleration of growth especially in the more downturned European and Asian economies Beneficial technicals from low and negative yields globally continue to funnel cash to the market.
High Yield Credit 	<ul style="list-style-type: none"> Valuations are unattractive relative to other asset classes. Forecasted default rates have started rising faster than expected earlier this year. Technicals remain positive as net supply remains very negative through rising stars & called bonds. 	<ul style="list-style-type: none"> Oil quickly rebounds, likely from supply side shocks. US fiscal stimulus or unexpectedly large sentiment boost from trade war resolution boosts valuations.
Agency MBS 	<ul style="list-style-type: none"> Prepayments have increased as a result of lower rates, however they have lagged expectations given the fall in Treasury yields. Spreads have widened to near post-GFC widths despite relatively muted prepayment activity. 	<ul style="list-style-type: none"> Interest rates continue falling aggressively as they did through the summer Rate volatility increases.
Non-Agency MBS & CMBS 	<ul style="list-style-type: none"> Fundamentals remain relatively strong as the Household balance sheet is strong and house price appreciation is still positive. Leverage trends within these sectors have continued to be contained, especially compared to rising asset valuations. Valuations in CMBS are notably less attractive than non-agency MBS. 	<ul style="list-style-type: none"> Tightening in credit conditions for US consumer. Housing activity begins to contract. Stress in traditional mail-based retail becomes more entrenched across the board.
Commodities 	<ul style="list-style-type: none"> o/w Cu vs Zinc o/w Corn vs u/w Wheat o/w Brent vs WTI o/w Lean Hogs vs Live Cattle o/w Gasoline vs Distillates o/w Silver 	<ul style="list-style-type: none"> Material China slow down, weighing on economic growth, metals & petrol

Important information: For investment professionals only, not to be relied upon by private investors.

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