COLUMBIA THREADNEEDLE INVESTMENTS

Your success. Our priority.

In Credit

20 APRIL 2020

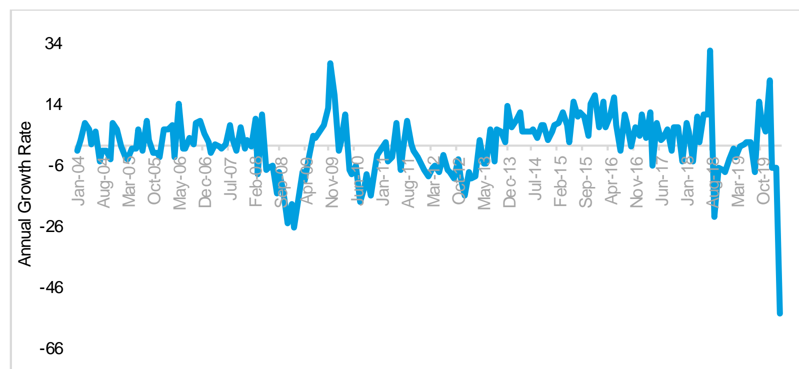
Risk market recovery.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	0.62%	-10 bps	0.3%	9.1%
German Bund 10 year	-0.49%	-14 bps	0.3%	2.4%
UK Gilt 10 year	0.30%	0 bps	1.9%	8.8%
Japan 10 year	0.02%	0 bps	-0.3%	-0.6%
Global Investment Grade	225 bps	-21 bps	4.0%	-0.6%
Euro Investment Grade	201 bps	-9 bps	2.2%	-4.0%
US Investment Grade	234 bps	-27 bps	5.0%	0.7%
UK Investment Grade	183 bps	-8 bps	3.6%	0.3%
Asia Investment Grade	300 bps	-8 bps	0.6%	0.1%
Euro High Yield	669 bps	-30 bps	5.5%	-9.8%
US High Yield	731 bps	-65 bps	5.4%	-8.5%
Asia High Yield	814 bps	-82 bps	5.5%	-6.2%
EM Sovereign	563 bps	1 bps	1.9%	-10.1%
EM Local	5.1%	-28 bps	2.2%	-13.3%
EM Corporate	551 bps	-33 bps	3.6%	-6.9%
Bloomberg Barclays US Munis	1.9%	-9 bps	0.5%	-0.2%
Taxable Munis	2.8%	-17 bps	2.1%	2.1%
Bloomberg Barclays US MBS	61 bps	20 bps	0.2%	3.1%
Bloomberg Commodity Index	131.78	-2.2%	0.4%	-23.0%
EUR	1.0876	-0.6%	-1.4%	-3.0%
JPY	107.71	0.8%	0.0%	1.0%
GBP	1.2456	0.4%	0.6%	-5.7%

Source: Bloomberg, Merrill Lynch, as at 20 April 2020.

Chart of the week: Eurozone car registrations (y/y%) 2004-2020



Source: Bloomberg, Columbia Threadneedle Investments, as at 20 April 2020.

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Macro / government bonds

Government bonds had a constructive week with core yields modestly lower, in spite of higher risk markets – such as equities and credit – and lower volatility.

Bond market direction reflects the interplay between fiscal and monetary policy with the US government issuing short-dated debt and the US Federal Reserve investing further along the yield curve. Actual economic data is, of course, poor with jobs being lost, consumption slashed and investment intentions on hold until the uncertainty lifts.

In EMEA, Italian bond spreads were under some pressure as the eurozone has failed, as yet, to produce a coherent plan for so-called 'euro' or 'corona' bonds – guaranteed by the member states.

Investment grade credit

Investment grade credit continued its recovery from the torrid times of March led by the US dollar market, which had underperformed the most in the sell-off. Spreads are now some 20% tighter than at the start of this month, the new issue market is alive and kicking and there are flows into the asset class.

Corporate results continue to reflect the downturn and company behaviour has become more defensive with dividends being reduced or removed (eg, Orange, Luxottica and LVMH). The global shutdown delivered an implosion in the sales of some cyclical items – eg, autos. EMEA auto sales were down by 55% year over year in March (c.f. -27% GFC) **– see chart of the week**. US bank results showed a rise in the so-called cost of risk. Corporate clients are drawing down credit facilities and depositing the cash in a similar fashion to risk-averse retail customers. Downgrade action continues at the ratings agencies with General Electric, Daimler and EDF amongst the latest to face negative outlooks or a reduction in credit rating.

High yield credit

US high yield bond prices continued to climb over the past week as sentiment benefits from the latest round of Fed and government support coupled with signs that parts of the US and European economies are progressing toward a reopening. Over the week, the ICE BofA US HY Cash Pay Constrained index returned 2.5% and spreads were 65bps tighter. According to Lipper, the asset class reported a record weekly inflow of $7.7 billion, just two weeks after the previous record was set with a $7.1 billion inflow. The last three weeks' inflows have recouped approximately 75% of the outflows from mid-February through March. In another sign of normalisation, the new issue market has reopened in recent weeks. Month-to-date gross issuance remains below average and approximately 80% of issuance has been secured as issuers have proactively added to liquidity. However, issuance has expanded to include companies / sectors directly impacted by the Covid-19 outbreak.

European high yield had another strong week as the asset class returned 1.7% and spreads tightened in 30bps to 630bps – this is a retracement of 240bps from the high in March. This asset class also experienced inflows of €372 million, of which €41 million went into ETFs, its highest for 2020. The door of the European high yield primary market edged open with a new issue from home security company, Verisure. The market dispersion theme continued as higher quality names have now retraced, in some cases, back to pre Covid-19 levels while those names most exposed to the pandemic continue to show little signs of a bounce back.

Leveraged loans

US leveraged loan prices rose last week to $86.3, up $10 from the lows touched in March and pushing total returns up 1.44% over the week. The market is increasingly more 'two-sided' as evidenced by spreads which have come in 300bps to approximately 700bps on a three-year take-out basis. High quality is outperforming low by a wide margin, and despite the recovery, the sub-$80 and sub-$90 buckets still stand at 13.12% and 35.96% respectively. The primary new issue market was quiet last week as the uncertainty and market volatility caused by the Covid-19 pandemic continues to impact deal flow.

Year-to-date volume is $91.2 billion, up from $84.6 billion last year. Retail investors are still in redemption mode albeit it at a slower pace. According to Lipper, outflows totalled $188 million – including mutual funds and ETFs – during the week.

Emerging markets

Emerging market hard currency spreads were basically unchanged last week, ending at 563bps. EM market flows returned to positive territory with an inflow of $657 million for the week. This was a turnaround from the previous week's outflow of -$1.4 billion. There were further rate cuts last week as the Philippines surprised the market with an emergency 50bps cut to 2.75% for its key rate – the central bank hinted that more is possible. Other central banks signalled more room for rate cuts (eg, China, Russia and India).

On the credit rating front, S&P became the first rating agency to put Ecuador as 'selective default'. Fitch downgraded Mexico to BBB- from BBB, while Moody's pushed its rating lower for the country from A3 to Baa1. Up to now, Moody's was the only rating agency to have Mexico in the single A rating band. Moody's followed the Mexican downgrade with a downgrade for Pemex, Mexico's oil company, to Ba2, matched by Fitch's downgrade for the company to BB-. The rating agency cited high liquidity issues and business risk. Other downgrades last week were Bolivia (B- from BB-), Argentina (C from CC).

In country specific news, the IMF announced it had granted Panama a loan of $500 million to alleviate some of the financial pressures from the Covid-19 effect. In Ukraine, the parliament voted to limit the number of proposals that could be attached to a legislation bill. This will hopefully enable the government to get the banking law passed, sooner than later, thereby allowing the much needed $8 billion package from the IMF to come through (originally, more than 16,000 amendments had been attached to the banking bill). In Turkey a law was passed to allow the country's sovereign wealth fund to take over private companies in distress. In Argentina, the exchange offer (restructure $66 billion bonds into notes) was posted over the weekend, Under the new terms, there will not be any coupon payment for three years and interest rates would be much lower. Finally, Ecuador had some good news, as their bond solicitation to halt coupon payments for four months was accepted by bond holders. This will delay payments until mid-August, saving the country $1.35 billion in interest payments.

Asian fixed income

S&P lowered the ratings outlook of several non-bank financial institutions from 'stable' to 'negative' due to S&P's expectation that the operating conditions for India's financial institutions are likely to weaken with higher credits costs and lower profitability. The India steel sector has come under further ratings pressure. Moody's placed the ratings outlook of JSW Steel and Tata Steel on 'review for downgrade' to reflect the weak steel demand from the automakers, manufacturing and other steel consumers.

S&P cut Indonesia's BBB ratings outlook to 'negative' due to the deterioration of the country's external position from the rupiah's depreciation. The SOEs in Thailand were also impacted by negative ratings action.

Commodities

The index was down 2% last week. Crude oil prices continued their downward spiral, falling more than 10%. This comes in spite of the agreement by OPEC+ to cut production by 10%, the largest production cut ever announced. There remain concerns that storage facilities In the US are nearing full capacity.

Precious metal prices were also down given improvement in equity markets. Agriculture prices dipped as the US government announced a plan to provide farmers with a $19 billion lifeline. Only base metal prices were higher on better demand coming from China. Fixed asset investment is something the Chinese government can put into effect relatively quickly.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

20th April 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	■ COVID- 19 has begun to wreak havoc on the economy-even if only temporary. Uncertainty is the word on fundamentals, but large fiscal stimulus could stem the tide. In tandem with monetary measures this could make the situation 'less bad' enough to improve markets ■ Valuations have cheapened from elevated levels to compensate for a 'normal' recession. Overall, spread risk looks attractive on a medium term horizon, however caution is warranted due to uncertainty being at or above Financial Crisis levels.	■ Major economies cannot 'flatten the curve' of COVID-19 and 'recession' becomes 'depression' ■ Fiscal and monetary stimulus is extremely successful and buying demand and there is significant innovation on the medical fight against COVID-19
Duration (10-year) ('P' = Periphery)	P (+1), ¥ (0), $ (+1) Short -2 -1 0 +1 +2 Long € (0), £ (+1)	■ Disinflationary global recession now a base case ■ Central bank accommodation back in play; flatter, lower curves a policy goal for most ■ Monetary trumps fiscal policy: QE buying to outweigh increased issuance ■ Duration remains best hedge for further risk asset correction	■ Rapid levelling off of virus infection rate ■ Extraordinary fiscal/monetary accommodation inspires consumption-driven cyclical upswing and higher inflation expectations ■ Fiscal largesse steepens curves on issuance expectations
Currency ('E' = European Economic Area)	E (0), A$ (+1), EM (0), £ (+1) Short -2 -1 0 +1 +2 Long $ (-2), ¥ (+1)	■ The Dollar is richly valued on the basis of growth outperformance and high carry. Twin deficits indicate a weaker dollar longer term ■ The convergence of policy rates is a material negative for the dollar, where carry advantage had kept it supported. Expect USD weakness vs safe havens.	■ Federal Reserve moves away from ultra accommodative stance ■ Investors reappraise US crisis/fiscal response as more likely to speed a return to normality then other regions
Emerging Markets Local (rates (R) and currency (C))	R (+1) Under-weight -2 -1 0 +1 +2 Over-weight C (-1)	■ COVID-19 threatens global risk sentiment and populated EM positions ■ Many EMs lack the policy space to offset demand destruction ■ Investor capitulation has left 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	■ Technicals in other credit markets are exaggerated in EM, leaving the current market extremely challenged. ■ Many oil exporters use the proceeds to fund their government and/or maintain currency valuations, which are now under pressure ■ Asia is close to returning to business as usual following COVID-19 curfews. The virus may return as this happens, but if the ramp up continues, a key source of demand for many economies will be back	■ COVID-19 begins to spread in countries with poor health infrastructure, causing higher death rates ■ The US dollar remaining at all time highs will regardless be a headwind ■ Reversal of recent electoral trend towards market-friendly candidates
Investment Grade Credit	Under-weight -2 -1 0 +1 ■ +2 Over-weight	■ Fundamentals have worsened, like in all credit sectors, but not as uniformly as spreads have widened. But, companies still have levers to pull to prevent the most dramatic of credit deterioration. ■ Valuations are as attractive as any time since 2009. ■ The potential for Corporate QE in the US & expansion in Europe is beginning to be discussed and would be a significant technical tailwind.	■ The existing Fed credit facilities do not alleviate the market's liquidity problems. ■ Prolonged recession begins to weaken even the strongest business models and balance sheets.
High Yield Credit	Under-weight -2 -1 0 ■ +1 +2 Over-weight	■ HY remains an energy-heavy sector, and these energy companies are extremely vulnerable to prolonged periods of WTI crude <$50. HY companies are rated as such because of their vulnerability to recession. This gives us caution. ■ Valuations imply a 9% default rate, and it may get worse in the short term. But historically, these spread levels imply strongly positive returns 6-12 months in the future	■ Prolonged COVID-19 related slump in activity would hurt there companies most ■ Potential corporate QE lures investors to higher quality assets, instead of encouraging reallocation into lower quality credit
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 quickly deteriorating fundamentals ■ The precipitous decline in mortgage rate + weaker household balance sheet leads to worse fundamentals	■ Interest rates continue falling aggressively ■ Bonds will underperform other spread products in a sharp risk-on move
Non-Agency MBS & CMBS	Under-weight -2 -1 0 ■ +1 +2 Over-weight	■ Households entered 2020 in a relatively healthy pace, but they are being put to the test relatively quickly with unemployment expected to rise sharply. ■ Direct fiscal stimulus (checks to households) during 'social distancing' may not bring back service jobs, but it can lessen the blow and prevent widespread delinquencies and bankruptcies ■ The CMBS market is understandably taking a hit from less shopping and travel, however valuations are widening to match these expectations. Many of these structures have robust credit enhancement and are attritive high quality assets	■ Consumer behaviour and employment are fundamentally changed by even a brief, successful 'social distancing' effort. ■ Housing – which was set up for a great 2020 – starts to feel pressure
Commodities	Under-weight -2 -1 ■ 0 +1 +2 Over-weight	■ o/w Base Metals ■ u/w Crude ■ o/w Soybeans vs Corn ■ o/w Livestock	■ Severe global recession

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