INFORMATION FOR INVESTMENT PROFESSIONALS

Your success. Our priority.

In Credit

2 MARCH 2020

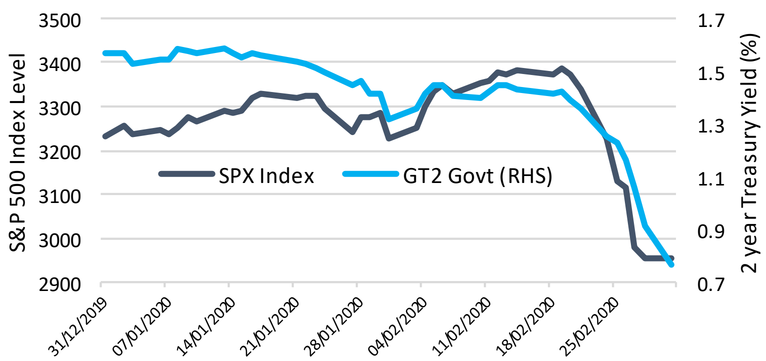
Two months down.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	1.09%	-38 bps	2.7%	5.4%
German Bund 10 year	-0.63%	-20 bps	1.4%	3.4%
UK Gilt 10 year	0.40%	-18 bps	1.3%	5.2%
Japan 10 year	-0.12%	-6 bps	0.8%	1.3%
Global Investment Grade	127 bps	24 bps	0.8%	2.8%
Euro Investment Grade	115 bps	26 bps	-0.4%	0.8%
US Investment Grade	130 bps	25 bps	1.3%	3.7%
UK Investment Grade	120 bps	14 bps	-0.3%	2.5%
Asia Investment Grade	211 bps	14 bps	1.3%	2.8%
Euro High Yield	431 bps	106 bps	-1.8%	-1.7%
US High Yield	506 bps	140 bps	-1.6%	-1.6%
Asia High Yield	602 bps	48 bps	0.1%	0.8%
EM Sovereign	354 bps	61 bps	-0.8%	0.9%
EM Local	4.9%	4 bps	-3.4%	-4.7%
EM Corporate	358 bps	45 bps	0.0%	1.5%
Bloomberg Barclays US Munis	1.3%	-13 bps	1.3%	3.1%
Taxable Munis	2.3%	-28 bps	4.1%	9.8%
Bloomberg Barclays US MBS	54 bps	9 bps	1.0%	1.7%
Bloomberg Commodity Index	153.71	-6.9%	-5.0%	-12.0%
EUR	1.1080	1.7%	-0.6%	-1.7%
JPY	107.86	3.2%	0.2%	0.5%
GBP	1.2764	-1.1%	-2.9%	-3.3%

Source: Bloomberg, Merrill Lynch, as at 2 March 2020.

Chart of the week: Falling equity prices and bond yields 2020



Source: Columbia Threadneedle Investments, as at 2 March 2020.

David Oliphant
Executive Director,
Fixed Income

‘In Credit’ contributors

David Oliphant
Macro / Government bonds,
Investment Grade credit

Angelina Chueh
Euro High Yield credit,
Emerging Markets,
Commodities

Chris Jorel
US High Yield credit

Katherine Nuss
US Investment Grade credit

Kris Moreton
Leveraged Loans
Structured Credit

Justin Ong
Asian Fixed Income

Doug Rangel
Municipals

2974671 Issued March 2020 | Valid to end May 2020

Macro / government bonds

Core government bonds remain the favoured asset class in these times of turmoil. Indeed, last week the benchmark 10-year US treasury reached a new all time yield low of 1.14%. The ICE BofA US Treasury 15+ year bond index has delivered a return of nearly 14% this year so far. **Chart of the week** plots the correlation between falling equity prices (S&P500) and bond (US 2-year treasuries) yields this year.

Table 1: Changes in short-dated and long-dated government bond yields in 2020

Country	Change in 2-year yield	Change in 10-year yield
USA	-85bps	-85bps
Germany	-21bps	-47bps
Italy	+7bps	-23bps
UK	-30bps	-44bps
Japan	-13bps	-11bps

Source: Bloomberg, as at 2 March 2020.

As the coronavirus spreads extensively beyond China there is a rising risk of lower growth in a number of areas of the world. This has pulled both bond yields and interest rate expectations lower still. The table below outlines the interest rate expectations over the next few years in some key areas of developed markets. Hence, financial markets are now priced for interest rate cuts in the US and the UK.

Table 2: Market expectations of interest rates

Country	Present	6 months	12 months	24 months	36 months
US	1.625%	0.66%	0.55%	0.60%	0.75%
Europe	-0.50%	-0.63%	-0.66%	-0.58%	-0.72%
UK	0.75%	0.36%	0.31%	0.34%	0.37%

Source: Bloomberg, as at 2 March 2020.

It was a light week for economic data releases.

US consumer sentiment remains elevated but was lower in the last month and remains vulnerable to the recent drop in equity prices and to virus fears. Sales of new homes reached the fastest pace since mid-2007. Unseasonably warm weather and lower borrowing costs (bond yields) were of help here.

Corporate Credit Market Valuations – February 2020 update

Since the beginning of the year and given the rapid proliferation of the coronavirus, equity and spread markets have been under some pressure. Indeed, spread moves have been material and rapid. Table 3 on the next page details the change in spreads in major credit markets and the risk-adjusted change (percent) in spreads.

The more energy heavy US markets have been hit hardest while high yield has underperformed investment grade credit when adjusted for each markets credit risk. The standout market is UK investment grade where in the wake of the general election and prior Brexit related weakness spreads are remarkably little changed.

The last two columns show where spreads have averaged over the last five and 20 years. So, the extreme sell-offs we have had means that in some places, spreads are now wider than short-term averages.

Table 3: Credit market spread update

Credit Market	Spread (bps) End Feb 20	Spread (bps) End Dec 19	Change (bps)	Change (%)	5 year Average	20 year Average
US IG	130	101	29	29%	133	162
Euro IG	115	94	21	22%	115	122
UK IG	120	114	6	5%	124	128
US HY	506	360	146	41%	456	577
Euro HY	431	328	103	31%	407	586

Source: Columbia Threadneedle Investments, Bloomberg, ICE BofAML indices, as at 29 February 2020.

Investment grade credit

The corollary of the strong performance in core government bond markets has been some weakness in their credit market cousins as described above. We note spreads, which have been expensive, are now back to close to the five-year average.

Meanwhile, a number of firms have revised earnings guidance lower as a result of the expected demand reduction caused by the virus. Diageo, Anheuser Busch InBev and Danone were among the major companies reducing their expectations last week, while in banking Standard Chartered and HSBC also noted the risk of additional loan losses in Asia. There is also increased evidence of forbearance from banks to clients given the background. Examples include HSBC and BoC in Hong Kong providing flexibility to SMEs. Similarly, UniCredit is providing relief to smaller companies in Northern Italy. Finally, in China there has been a six-month moratorium on principal and interest to qualifying SMEs.

As might be expected as risk aversion has risen, what was a buoyant new issue market has also grown more quiet with few primary deals being brought to the market.

High yield credit

US high yield bond prices came under heavy pressure alongside the sharpest decline in the S&P500 on record as investors brace themselves for the economic and corporate earnings fallout from the spread of the coronavirus. High yield bonds spreads widened 105bps over the week to a 13-month high, the second most severe 4-day spread widening episode of the credit cycle behind only August 2011's 113bps widening. The asset class reported a $4.2 billion outflow over the week, which was the largest since October 2018 and brings year-to-date net outflows to $1.9 billion, according to Lipper.

European high yield experienced similar pressure as the high yield index spread widened over 100bps for the week to 431bps. The return to over 400 brings the European high yield spread back above the 7-year average. Crossover spreads were 85bps wider and cash bond prices were 3 points lower. The primary market was sparse with only one deal offered but which was then pulled before pricing.

As in the case of investment grade, some high yield issuers have started to revise their earnings expectations. This has been especially in the case of sectors hardest hit by the coronavirus story as in the case of E-Dreams (better known as Opodo) from the travel industry. This week, the recently downgraded Kraft and Renault are entering the high yield indices.

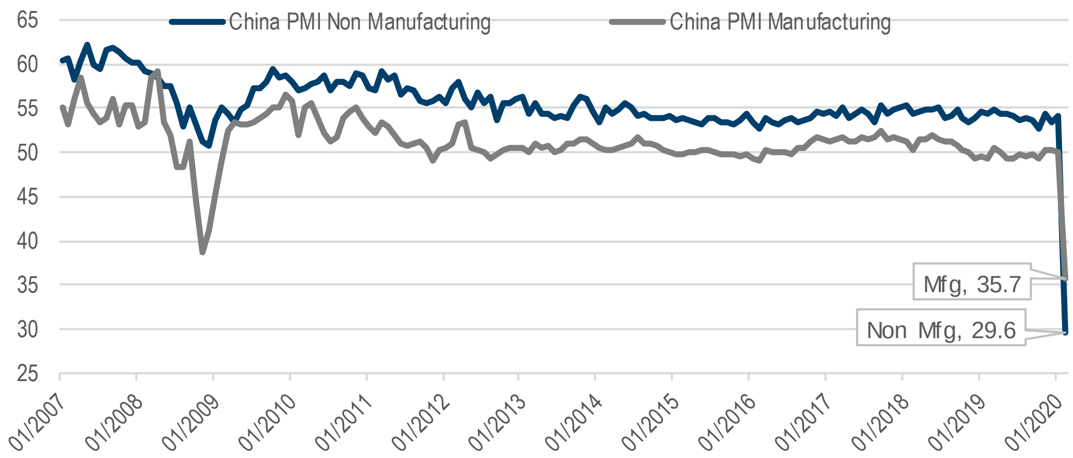
Emerging markets

As was the case with other asset classes, emerging markets were also hit by the massive risk aversion move seen this week. Hard currency spreads widened by 61bps while local currency fell due to both weakness in rates as well as in FX. Higher beta names underperformed, widening 30 to 40bps.

Interestingly, there were net inflows into EMD of $330 million even as EM equity ETFs experienced outflows of $3 billion. This is in sharp contrast to the inflows into EMD of $ 2.2 billion, as seen the previous week.

China's recent PMI may be one of the first real indicators of the severity that the virus will have on economic growth prospects. At 35.7 for manufacturing and 29.6 for non-manufacturing for, it is sharply lower than the previous figure of 50.0 and 54.1, respectively as shown in the **2nd chart of the week.**

2nd Chart of the week: Sharp deterioration of China PMI (Manufacturing and Non-Mfg)



Source: Bloomberg and Columbia Threadneedle Investments, as at 2 March 2020.

In other country specific news, both Turkey and Russia's bonds markets fell, as the focus moved to the escalated fighting in Syria between the two countries as a Russian airstrike attacked Turkish troops in Idlib, killing 33 Turkish soldiers. Market intervention by the Turkish central bank in the FX market was to the tune of $1 billion to slowdown the Turkish lira deterioration. In Argentina, the IMF announced last week that a team would go there to discuss further the country's debt restructuring. In Indonesia, the central bank continues to try to stem the market sell-off of the country's currency and bonds. The latest acts are the central bank's offer to buy 2 trillion-rupiah ($140 million) worth of sovereign bonds from the secondary market and the lowering of banks' reserve requirement ratios by half (from 8% to 4%).

Asian fixed income

Fitch downgraded Singtel from A+ to A because the growth prospects remain challenging over the next 12-24 months due to the intense competition in Singapore and Australia. Furthermore, high capex including spectrum payments will pressure the company's financial metrics.

In India, the Department of Telecommunications approved the merger of Bharti Infratel and Indus Towers. Bharti Infratel has also extended the long-stop date for the merger completion by 60 days to 24 April 2020.

In Hong Kong, Wheelock & Co is offering HKD12/share (a 52% premium) to its shareholders for the privatization of the company as well as one share each in Wharf Real Estate Investment (Wharf REIC) and Wharf Holdings. Wheelock & Co currently holds a 66.5% stake in Wharf REIC and a 70.7% stake in Wharf Holdings.

In the primary market, $9 billion was issued last week, which bring the year-to-date volume to $71 billion (+32.5% y/y)

Commodities

It has not been an easy year for commodity prices either. Fears of demand destruction and supply chain disruption have weighed on energy and industrial metals prices. The exception has been in precious metals such as Gold, which have unsurprisingly been the recipient of ‘safe-haven’ accumulation.

For the week, the index fell 6.85% as all sectors were down. Energy led the deterioration as crude oil prices fell 16% while base metals and grain, though weaker, performed relatively better, falling only 3% in the case of the latter. Surprisingly, given the risk off move, gold and silver also fell, by 6.4%, on market talk of profit taking.

Helping crude oil prices find a bottom, was the news that Putin was ready to reduce production (even as he also said he was fine with the current price level.) The OPEC policy meeting is held this Thursday and Friday.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

2nd March 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	■ Global economic data continues to register at low or contractionary levels across many sectors and regions. There are modest signs of stabilization, how ever spread levels appear to reflect this already. Trade headlines continue to fly back & forth, but w e see risks that are more fundamental than these.	■ Fast and fierce fiscal stimulus, especially in Europe or China. ■ Reacceleration of grow th trends
Duration (10-year) ('P' = Periphery)	P ¥ $ Short -2 -1 0 +1 +2 Long € £	■ COVID-19 likely to derail nascent global recovery, mutating from supply chain disruption to serious demand shock ■ Central bank accommodation back in play ■ Duration remains best hedge for risk asset correction ■ Phase One trade deal fulfilment unrealistic	■ Global trade détente stimulates improvement in risk sentiment ■ Rapid levelling off of virus infection rate ■ US economy stages consumption-driven cyclical upsw ing
Currency ('E' = European Economic Area)	E EM A$ Short -2 -1 0 +1 +2 Long ¥ $ £	■ The Dollar is richly valued on the basis of grow th outperformance and high carry. Tw in deficits indicate a w eaker dollar longer term ■ The global reflation trade, w hich would have provided near term impetus for USD w eakness, has been set back by the grow th impact of the Coronavirus	■ Further leg low er in global grow th driven by increasing trade frictions and Coronavirus
Emerging Markets Local (rates (R) and currency (C))	R Under-weight -2 -1 0 +1 +2 Over-weight C	■ COVID-19 threatens global risk sentiment and populated EM positions ■ EM real interest rates still relatively attractive ■ EM grow th likely to outperform DM, w hile inflation benign ■ Fiscal and external fundamentals still largely sound	■ Sharp escalation in global risk aversion ■ Broad dollar strength
Emerging Markets Sovereign Credit (USD denominated)	Under-weight -2 -1 0 +1 +2 Over-weight	■ Fundamentals have been not deteriorated as much as w ould 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	■ Oil & commodity rally w ill boost sentiment and current account balances. ■ A rapidly w eakening USD w ill ease financial conditions ■ Reversal of recent electoral trend tow ards market-friendly candidates.
Investment Grade Credit	Under-weight -2 -1 0 +1 +2 Over-weight	■ Broad valuations have become unattractive on an absolute basis, even before considering higher debt levels and decelerating grow th ■ Fundamentals don't show signs of imminent crisis, but several of the tailw inds are fading. Valuations look even more offside w hen considering this	■ A re-acceleration of growth especially in the more dow ntrodden European and Asian economies ■ Beneficial technicals from low and negative yields globally continue to funnel cash to the market.
High Yield Credit	Under-weight -2 -1 0 +1 +2 Over-weight	■ 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.	■ Oil quickly rebounds, likely from supply side shocks. ■ US fiscal stimulus or unexpectedly large sentiment boost from trade w ar resolution boosts valuations.
Agency MBS	Under-weight -2 -1 0 +1 +2 Over-weight	■ Prepayments have increased as a result of low er rates, how ever they have lagged expectations given the fall in Treasury yields. ■ Spreads have w idened to near post-GFC w ides despite relatively muted prepayment activity.	■ Interest rates continue falling aggressively as they did through the summer ■ Rate volatility increases.
Non-Agency MBS & CMBS	Under-weight -2 -1 0 +1 +2 Over-weight	■ Fundamentals remain relatively strong as the Household balance sheet is strong and house price appreciation is still positive. ■ Leverage trends w ithin these sectors have continued to be contained, especially compared to rising asset valuations. ■ Valuations in CMBS are notably less attractive than non-agency MBS.	■ Tightening in credit conditions for US consumer. ■ Housing activity begins to contract. ■ Stress in traditional mall-based retail becomes more entrenched across the board.
Commodities	Under-weight -2 -1 0 +1 +2 Over-weight	■ 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	■ Material China slow down, weighing on economic grow th, metals & petrol