COLUMBIA THREADNEEDLE INVESTMENTS

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In Credit

29 JUNE 2020

Good as gold.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	0.65%	-5 bps	0.2%	9.2%
German Bund 10 year	-0.47%	-5 bps	0.4%	2.3%
UK Gilt 10 year	0.18%	-6 bps	-0.5%	9.7%
Japan 10 year	0.02%	0 bps	-0.3%	-0.8%
Global Investment Grade	160 bps	4 bps	1.8%	3.1%
Euro Investment Grade	147 bps	5 bps	1.4%	-1.2%
US Investment Grade	162 bps	5 bps	2.0%	4.8%
UK Investment Grade	146 bps	0 bps	1.2%	3.4%
Asia Investment Grade	275 bps	-3 bps	1.5%	3.1%
Euro High Yield	552 bps	16 bps	1.9%	-5.0%
US High Yield	641 bps	39 bps	1.3%	-4.4%
Asia High Yield	716 bps	-5 bps	3.7%	0.0%
EM Sovereign	433 bps	7 bps	2.9%	-1.9%
EM Local	4.5%	-1 bps	0.6%	-6.8%
EM Corporate	442 bps	2 bps	2.8%	-0.1%
Bloomberg Barclays US Munis	1.5%	-2 bps	0.8%	2.0%
Taxable Munis	2.4%	-12 bps	4.3%	9.0%
Bloomberg Barclays US MBS	72 bps	-3 bps	-0.1%	3.5%
Bloomberg Commodity Index	134.77	-2.1%	-0.5%	-21.6%
EUR	1.1253	0.4%	1.1%	0.1%
JPY	107.18	-0.3%	0.6%	1.3%
GBP	1.2340	-0.1%	-0.1%	-6.9%

Source: Bloomberg, Merrill Lynch, as at 29 June 2020.

Chart of the week: Gold prices, 2015-2020

Source: Macrobond, Columbia Threadneedle Investments, as at 29 June 2020.

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3143026 Issued June 2020 | Valid to end August 2020

Macro / government bonds

Core government bond markets remain rangebound.

The opposite but seemingly 'equal' forces of sequential economic data improvement and deteriorating Covid-19 cases in the US have held yields in stasis. The benchmark 10-year US treasury note has traded between a yield of 0.6% and 0.9% for most of the last three months and ended the week towards the lower end of that range.

Data continues to support the notion that the worst of the Covid-19 economic shock may be behind us. Indeed, retail sales (US and UK) and durable goods (US) data have all surprised to the upside. PMI sentiment data also is improving globally. US employment news has been less impressive; indeed, initial jobless claims recorded another 1.5 million in the last week though the number of continuing claims has fallen a little. In other news, Austria issued a 100-year bond thus securing low funding costs for a century.

Investment grade credit

Credit markets too have found it difficult to establish direction after rallying earlier in the month. After many weeks of inflows and heavy new issuance, last week saw a reveral of the former and a reduction in the latter.

The valuation case for investment grade has also weakened. Global spreads reached around three standard deviations cheap to the long-term average in late March when they were over 340 basis points (bps). Now that this number is closer to 160bps we are only around 0.3 sds cheap. Were one to conclude that the market had deteriorated in average credit quality from 'A' rated to say 'BBB' rated, then we are slightly expensive over that two-decade period.

High yield credit

US high yield bond prices were lower over the week.

A resurgence of Covid-19 cases in certain parts of the country threatens to slow progress on the economic reopening. The ICE BofA U.S. HY CP Constrained Index return was -1.26% and spreads were 39bps wider.

Although modest in size as $88 million, the asset class reported its first outflow since late-March. The previous 12 weeks have seen $47.7 billion of inflows. From the supply side, high yield new issue volume topped $10 billion for the seventh consecutive week. As such, June's issuance now totals $55.6 billion gross or $21.2 billion net of refinancing, which is comparable to $47.0 billion gross and $23.3 billion net of refinancing in May. For context, June is now the most active month for new issue on record, surpassing $55.5 billion in September 2013.

The European High Yield (EHY) market also retraced last week as spreads widened 16bps. Inflows continued though, with €223 million into the asset class.

The primary market was busy last week with names like Profine (German windows manufacturing group), Engineering Group (Centurion Bidco SpA, an Italian software company) and AMS (an Austrian technology firm). However, two of the deals were subsequently pulled/delayed on the back of newsworthy headlines of arrested employees in the case of Engineering Group and suspect share dealing in the case of AMS. In the latter case, the issuer denied they were under investigation by the Austrian regulators. Besides the bond market, firms have also been raising funds via equity issuance as was the case of Aston Martin who last week announced a £536 million rights issue, the second one in two months.

Another major European corporate became a Fallen Angel, as EDF, the French government owned utilities group, had its subordinated/hybrid bonds downgraded to BB- by S&P. The senior debt remains firmly investment grade. On default forecasts news, Citibank is going high, calling 10% for EHY. This is in sharp contrast to JPMorgan's lowered forecast of 4%, announced last week.

Leveraged loans

Leveraged loan prices also came under pressure over the past week.

Referencing the J.P. Morgan Leveraged Loan index, loan prices decreased -$0.33 to $91.82 over the past week, with the average price for BB loans decreasing -$0.84 to $95.50, Single B loans decreasing -$0.51 to $93.87, and Split B/CCC increasing +$0.14 to $75.52. Meanwhile, loan yields and spreads (3-year) increased 16bps and 17bps over the past week to 6.97% and 670bps, which compare to a range since mid-May of 6.62%/8.53% and 634bps/826bps. Note loan spreads (3-year) are now 48% above where they stood pre the sell-off on 21 February, which is comparable to 58% for high yield bond spreads. The leveraged loan index has gained +1.80% in June, with Double B (+0.65%) and Single B (+1.69%) loans underperforming CCC (+5.34%) loans. Loans are providing losses totalling -3.94% year-to-date with Split B/CCC-rated loans (-16.13%) underperforming BB (-3.77%) and B (-3.58%) loans. Outflows continued for the asset class with a $91 million outflow for the week.

Structured credit

Agency MBS posted modest positive returns last week, up 3bps. Spreads tightened marginally, ending the week at 72bps, as news of the surge in Covid-19 cases benefitted lower risk, higher quality assets. On the credit side of the market, new issuance continues to progress with spreads on the highest quality AAA bonds flat around 140bps. Year-to-date $45 billion of new issuance has been fairly evenly split between NPL/RPL, Prime/Alt A and Non-QM. CRTs also make up a fair percentage with nearly $8 billion of new issuance while Single Family Rental continues to be a smaller subset of the market with only $3.4 billion of newly originated bonds. At a macro level, mortgage originators have shifted focus to Agency production away from Non-Agency in light of the macro environment. CMBS spreads outperformed broader markets last week as AAAs moved 5bps tighter and mezzanine bonds rallied on limited supply. Sentiment is slightly more cautious but technicals remain overwhelmingly strong.

Emerging markets

Emerging Markets (EM) paused last week, as hard currency sovereign spreads retraced, widening 7bps but less so in EM corporate spreads (+2bps).

The asset class saw small net inflows of $118 million though this masked the solid inflows into hard currency sovereign funds ($570 million) which just outpaced the outflows seen in local currency funds.
In credit rating news, Oman was downgraded, for the second time this year, to Ba3, negative outlook, by Moody's. The rating agency cited expected large and long-term deterioration of debt, fiscal, and foreign currency buffers. This was based on an outlook of a longer-term lower oil price climate.

Central bank rate cuts continued. Rate cuts last week included Hungary (-15bps) as well as Mexico and the Philippines (-50bps for both). The EM primary market continues to be strong with Gazprom issuing $1 billion in a 7-year deal. Many EM issuers who had been waiting on the side lines, especially high yield issuers, are now coming to the market given the market reception for the asset class. South Africa announced its 2020 budget outlook. The severity of Covid-19 could be seen as Debt/GDP is now expected to peak at 83% by 2023/2024, driven by sizeable fiscal deficit which is being revised down from -6.6% to -15.5%.

In signs of China's influence on EM, Angola's bonds came in 200bps tighter this past week as China announced a 3-year moratorium on loan payments to China by the country. The news was well received as it was one of the last obstacles for IMF support. It is likely that the market can expect more of this type of loan forgiveness/repayment flexibility going forward from China.

Asian fixed income

The Pentagon has released a list of 20 Chinese companies, which it views as being owned or controlled by China's military. The Chinese companies on this list which could be subject to additional US sanctions, include among others, Huawei, Hikvision, China General Nuclear and China Railway Construction Corp.

Vedanta Ltd has received the approval from its minority shareholders to proceed with the privatisation by Vedanta Resources. The privatisation plan was approved by 93.3% of its shareholders, including Vedanta Resources which is a 50.1% stakeholder. The next major steps are determining the exit price, through a price discovery mechanism, that is acceptable to both minority shareholders and the acquirer Vedanta PLC.

The long-stop date for the merger of Bharti Infratel and Indus Towers has been extended again to 31 August 2020, albeit this delay is not surprising. The Infratel-Indus Towers merger is not straightforward because it hinges on Vodafone-Idea's long-term plan specifically whether Vodafone intends to exit India. Vodafone currently has a JV with Idea Cellular in India. The telecom operators such as Bharti Airtel and Vodafone-Idea are awaiting the resolution to the AGR (adjusted gross revenue) payment issue. The outcome will provide more clarity to Vodafone about the viability of its business in India. The next hearing about the AGR at the Supreme Court is scheduled for the third week of July 2020.

Moody's has downgraded two Indonesia quasi-sovereign companies, which are involved in EPC (engineering, procurement and construction) and toll road operations to reflect the high leverage and impact of Covid-19 on their financial profiles. Wijaya Karya was downgraded a notch to Ba3 with a negative outlook, while Jasa Marga was downgraded to Baa3 with a negative outlook.

Last week, the Asia new issues totalled $5.8 billion which brought the year-to-date issuance volume to $163.7 billion (-1% y/y). Despite having a backdrop of Covid-19 disruption and macro slowdown, the year-to-date new issue volume is strong, thanks largely to active supply by investment grade issuers (corporates, quasis and sovereigns) and Chinese high yield properties.

Commodities

Commodity prices fell by around 2%, led by energy as crude fell 5% while refined oil products were down by more than 8%. Oil prices were thought to be lower from the fall in the equity market and the overall risk off tone. Natural gas fell the most last week, down nearly 10% due to the mild weather (which extrapolates to lower energy usage from less air conditioning demand.) The US Department of Energy weekly numbers showed inventories continuing to build up as well also some improvement in gasoline demand. At the same time, there was news of 50 million barrels on boats off the coast of China, waiting to be unloaded and processed. It is believed that is a quarter of the supply that the Chinese bought earlier in the year.

Lastly, negative or low interest rates and bond yields as well as economic uncertainty have lent support to the gold market **(see chart of the week)** which was up 2% on the week and over 50% in the last five years. Base metals were up for the week as well, with copper prices especially strong due to the tight inventories in China as well as the strong industrial demand. Agriculture prices were weaker, overall due to the benign weather in the US.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

29th June 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	■ Valuations remain attractive at these wide levels, however the rally since March has taken moderated the opportunity. Worsening fundamentals argue for fair value being wider than before. ■ Central bank support remains a key technical for now, one that will be become more relevant if there are relapses (of market volatility and/or COVID 19 infections). ■ Fundamentals remain challenging for large swaths of issuers, despite some signs that they may be better than recent expectations. Sorting out issuers with the combination of fragile balance sheets and lasting industry headwinds is key.	■ Major economies cannot 'flatten the curve' of COVID-19 and 'recession' becomes 'depression'.' ■ Reopening begets a widespread reclosing. ■ Central banks pull back support too early and positive technicals vanish.
Duration (10-year) ('P' = Periphery)	Short -2 -1 0 +1 +2 Long Above: ¥ (0); P, $ (+1) Below: € (0); £ (+1)	■ Disinflationary global recession now a base case ■ Don't fight the Fed: (most) central banks seeking flatter, lower curves ■ Monetary trumps fiscal policy: QE buying to outweigh increased issuance ■ Duration remains best hedge for further risk asset correction	■ Unexpected medical advance allowing full, rapid economic re-opening ■ Extraordinary fiscal/monetary accommodation inspires consumption-driven cyclical upswing and higher inflation ■ Fiscal largesse steepens curves on issuance expectations
Currency ('E' = European Economic Area)	Short -2 -1 0 +1 +2 Long Above: EM (0); E (+1) Below: $, £ (-1); A$ (0); ¥ (+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))	Under-weight -2 -1 0 +1 +2 Over-weight Above: R (+1) Below: C (0)	■ 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	■ Balance sheets will be stretched by the fundamental COVID-19 shock, and exaggerated by DM financial turmoil, cheap oil, and a stronger USD. ■ Valuations have become more attractive even in the more stable credits. ■ 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 to normal continues, a key source of demand for many EM economies will be back.	■ COVID-19 begins to spread rapidly 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	■ IG sits at the confluence of 3 key positives 1) balance sheets the best equipped to handle economic pain, 2) Fed acting as a non-economic buyer and backstop, and 3) valuations that are attractive relative to history. ■ Credit quality has nonetheless deteriorated, meaning credit spreads are less attractive versus historical comps.	■ The Fed's purchases goal to maintain 'liquidity' are overwhelmed by economic deterioration. ■ Foreign buyer flow stops for geopolitical, financial, or regulatory reasons. ■ Downgrade pressures remain front and centre.
High Yield Credit	Under-weight -2 -1 0 ■+1 +2 Over-weight	■ Though not as positive as IG, HY technicals have improved. Markets are functioning again. ■ Fundamentals remain challenged for these lower-quality balance sheets, especially in the energy sector. There has been improvement in .. ■ Valuations: the breakneck speed of the rally means spreads are much closer to fair, but still mildly attractive.	■ Prolonged COVID-19 related slump in activity would hurt these 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 worse fundamentals, although fundamentals are better than expected ■ But valuations are much more neutral now, and the Fed's purchases have been meaningfully tapered. ■ However, forbearances have been better than expected, and are still relatively low (outside of GNMA, which has been hit hardest).	■ Interest rates continue falling aggressively and volatility rises again. ■ Bonds will underperform other spread product in a sharp risk-on move. ■ Fed continues to taper purchases.
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 has quickly rebounded. New issues have begun, but at much wider spreads. ■ CMBS: Non-payment by retail tenants, lockdowns on travel, and work-from-home have had serious fundamental worries to certain issuers and deals. ■ The sector has been uniformly punished and there exist many opportunities to pick out attractive property profiles & structures.	■ Consumer behaviour and employment are fundamentally changed by even a brief, successful 'social distancing effort. ■ Housing prices begin to fall in contrast to current trend.
Commodities	Under-weight -2 -1 ■0 +1 +2 Over-weight	■ o/w Base Metals ■ u/w Crude ■ o/w Soybeans vs Corn ■ u/w Cotton	■ Oil production disruption

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