INFORMATION FOR INVESTMENT PROFESSIONALS

COLUMBIA THREADNEEDLE INVESTMENTS

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In Credit

9 MARCH 2020

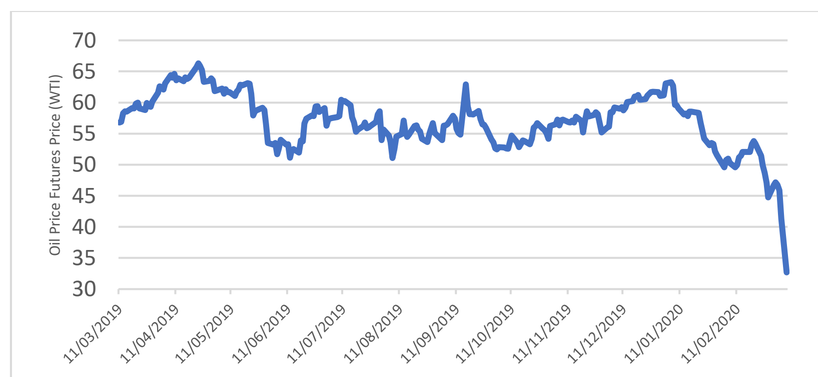
Falling yields and faltering confidence.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	0.49%	-66 bps	5.8%	8.5%
German Bund 10 year	-0.83%	-22 bps	2.5%	4.5%
UK Gilt 10 year	0.13%	-31 bps	5.1%	9.1%
Japan 10 year	-0.16%	-1 bps	0.7%	1.1%
Global Investment Grade	143 bps	16 bps	1.3%	4.2%
Euro Investment Grade	127 bps	13 bps	-0.4%	0.7%
US Investment Grade	149 bps	18 bps	3.2%	5.6%
UK Investment Grade	129 bps	9 bps	1.1%	3.9%
Asia Investment Grade	221 bps	10 bps	2.6%	4.2%
Euro High Yield	470 bps	37 bps	-0.9%	-2.6%
US High Yield	564 bps	60 bps	-2.0%	-2.0%
Asia High Yield	630 bps	28 bps	0.2%	0.9%
EM Sovereign	379 bps	26 bps	0.6%	2.3%
EM Local	4.8%	-19 bps	-1.8%	-3.1%
EM Corporate	382 bps	23 bps	0.7%	2.2%
Bloomberg Barclays US Munis	1.2%	-6 bps	1.6%	3.4%
Taxable Munis	2.0%	-30 bps	7.5%	13.3%
Bloomberg Barclays US MBS	66 bps	12 bps	1.5%	2.2%
Bloomberg Commodity Index	144.16	-0.2%	-5.3%	-12.2%
EUR	1.1380	2.3%	1.7%	0.6%
JPY	102.53	2.5%	2.8%	3.0%
GBP	1.3123	1.8%	-1.2%	-1.6%

Source: Bloomberg, Merrill Lynch, as at 9 March 2020.

Chart of the week: Oil price collapse



Source: Bloomberg, Columbia Threadneedle Investments, as at 9 March 2020.

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Macro / government bonds

Core government bond yields are at all-time lows as risk aversion and volatility in 'risk assets' remains heightened. The US Treasury index has returned around 8.5% year-to-date. Markets are now priced for four more rate cuts in the US this year.

There was little in the way of market moving economic data as all attention focused on the spread of the coronavirus. Economic data remains of limited use at present as it is unclear what the extent and severity will actually be. However, in the US the ISM Non-Manufacturing series (which is more domestically focused than its weaker Manufacturing cousin) was relatively robust. This barometer of business confidence came in at 57.3, up from 55.5, and ahead of consensus and the strongest in the last 12 months. Meanwhile the employment report showed larger job creations than expected and a fall in the unemployment rate to 3.5%.

Investment grade credit

Credit markets tried to stabilise somewhat after the material widening in spreads seen in February but ended last week on a very weak note. This has rolled over into early trading this week.

The global investment grade index has now widened from under 100bps in mid-January to over 140bps at the end of last week. For context, this takes spreads back to levels seen in early 2019. In this widening higher quality credit (AAA/AA) has underperformed on a risk adjusted basis. Geographically, US dollar credit is weaker than euro or sterling markets.

High yield credit

US high yield bond prices briefly rallied early in the week but came under renewed pressure as the week progressed as new confirmed cases of COVID-19 globally surpassed 100,000. Notably, Thursday's 33bps of spread widening joined Monday (38bps) and Friday (35bps) of the prior week as among the largest daily spread widenings of the credit cycle. According to Lipper, the asset class reported a $5.1 billion outflow for the week, comparable to the prior week's $4.2 billion outflow and represent the largest outflows for the asset class since early 2017. In fact, these were the fourth largest weekly withdrawal on record.

It was a tough week for European high yield with selling happening, at one point, even below bid prices. European high yield spreads widened 38bps to 470bps, bringing the asset class back to above 5, 7 and 10- year long averages for the spread. The Crossover index spread rose to 500bps, widening by 125bps (the largest weekly move).

Leveraged loans

With outflows accelerating on widespread risk-off momentum and almost no risk of higher rates, the US leveraged loan sector posted a 96bps loss last week, markedly underperforming its high yield bond counterparts. The weighted average price of the index dropped to $94, while the yield to a 3-year take-out rose to 6.15%. What's on investors' minds now is how a declining LIBOR will impact overall yields going forward. Roughly 40% of the loan market has a LIBOR floor today compared to 90% leading into the FOMC hiking campaign. It may be a year before we see those floors back in play as loans refinance and documentation is updated to include a floor again.

Emerging markets

A full on, risk-off week as the asset class saw out flows of $4.8 billion across hard and local currencies but with local EM debt experiencing the brunt. EM spreads widened 26bps for hard currency and 23bps for EM corporate debt. This brings hard currency EM spreads to 1 standard deviation cheap relative to the long-term average spread.

In economic news, South Africa becomes the first country this year to go into recession as Q4 GDP was posted at -1.4%. This follows the Q3 2019 print of -0.6%.

On the credit rating front, Oman's country rating was downgraded to Ba2 by Moody's as it was assessed that the upcoming fiscal reform would be insufficient. Oman government bonds widened by 30bps on the news.

Lebanon announced over the weekend that it would not repay the $1.2 billion Eurobond due this Monday. This likely means the country's first default in its history. Lebanese government bond prices fell 7 points on the announcement to prices below 20 cents on the dollar.

Asian fixed income

Fitch Moody's has affirmed JSW Steel's Ba2 ratings but it lowered the outlook from positive to stable due to the weak operating performance and the expectation that JSW Steel's adjusted debt/EBITDA will remain at around 4.6x at end-March 2020, which is above the upgrade trigger of 4x. Moody's also expects JSW Steel to complete the acquisition of a minority stake in Bhushan Power and Steel Limited, which comes with some execution risk. S&P cut Jain Irrigation's ratings to default because the company failed to make interest payment on its 2022 bond.

Adaro Energy reported weak FY19 results with an EBITDA of $1.2 billion (-14% y/y), which came at the higher end of management's guidance ($1-1.2 billion). The pressure on operating results was mitigated by the high level of vertical integration (coal transportation and coal barging). For 2020, management guided that production level will be around 54mt to 58mt (2019: 58mt) and operational EBITDA will be around $900 million and $1.2 billion (2019: $1.2 billion).

China National Petroleum has issued a 'force majeure' on LNG shipments due to the sharp decline in gas consumption and filled storage capacity.

JD.com reported good FY results with upbeat guidance for Q1. FY19 results was $82.9 billion (+24.9% y/y) and EBITDA was $1.98 billion (more than doubled y/y). Despite the negative impact of the COVID-19 outbreak on its peers (Baidu, Ali Baba), JD.com was more constructive with its Q1 performance, which is underpinned by its logistics network that supports its fulfilment capability. Management expects double-digit revenue growth (potentially 10% y/y), largely in the 1P channel. The 1P channel is the online direct sales channel through which JD.com acquires products from 24,000 suppliers, which it sells directly to end customers.

Commodities

Covid-19 is now not the main worry for commodities.

At the OPEC meeting, last Thursday, Saudi Arabia announced an output cut of 1.5 million barrels, much higher than the 600,000-number mentioned earlier. Russia, however, refused to follow suit on the production cuts. In response, Saudi Arabia did a turn around and announced over the weekend not only a cut in oil prices by $8 to $10 dollars (the largest cuts in 20 years), bringing Brent crude oil prices tumbling down into the $30 range (**see Chart of the Week**) but also that they could actually increase production by as much as 1.2 million barrels/day. This is as global consumption figures showed a sharp drop from already lower demand levels due to slower economic growth and exceptionally warm weather in the US. Additionally, the International Energy Agency reported expectations of a fall in demand in 2020 of 99.9 million barrels due to lower China demand and disruption in global trade following the effects of Covid-19.

Gold prices rose 6% last week, closing at $1674.00.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

9th 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 convergence of policy rates is a material negative for the dollar, w here carry advantage had kept it supported. Expect USD w eakness vs safe havens.	■ Federal Reserve disappoints the market's expectations for policy easing.
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	■ Further 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

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