COLUMBIA THREADNEEDLE INVESTMENTS

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In Credit

1 JUNE 2020

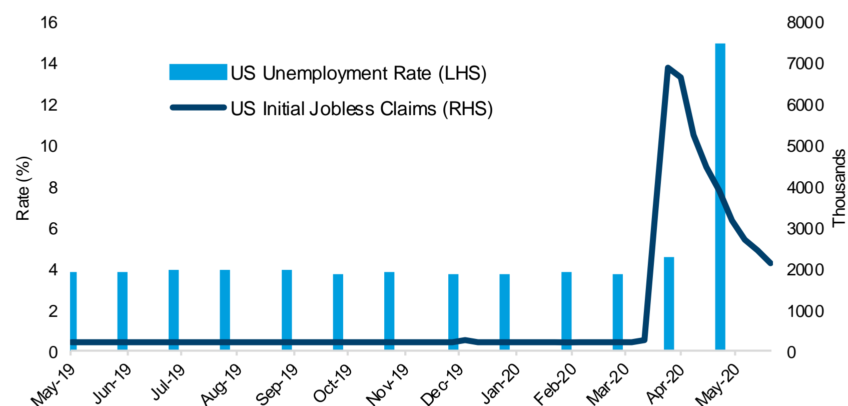
The risk rally continues.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	0.66%	0 bps	-0.3%	8.9%
German Bund 10 year	-0.42%	7 bps	-1.3%	1.9%
UK Gilt 10 year	0.21%	3 bps	0.0%	10.2%
Japan 10 year	0.01%	1 bps	-0.5%	-0.5%
Global Investment Grade	184 bps	-11 bps	1.3%	1.3%
Euro Investment Grade	166 bps	-18 bps	0.2%	-2.5%
US Investment Grade	187 bps	-10 bps	1.7%	2.8%
UK Investment Grade	164 bps	-10 bps	0.8%	2.1%
Asia Investment Grade	291 bps	1 bps	1.4%	1.6%
Euro High Yield	593 bps	-61 bps	3.0%	-6.7%
US High Yield	654 bps	-52 bps	4.6%	-5.7%
Asia High Yield	777 bps	2 bps	3.3%	-3.5%
EM Sovereign	476 bps	-10 bps	5.9%	-4.5%
EM Local	4.5%	-3 bps	5.2%	-7.3%
EM Corporate	487 bps	-12 bps	3.8%	-3.0%
Bloomberg Barclays US Munis	1.6%	-4 bps	3.2%	1.2%
Taxable Munis	2.7%	-8 bps	2.1%	4.5%
Bloomberg Barclays US MBS	73 bps	0 bps	0.1%	3.6%
Bloomberg Commodity Index	135.38	1.3%	4.3%	-21.2%
EUR	1.1137	1.8%	1.3%	-1.0%
JPY	107.45	-0.2%	-0.6%	0.8%
GBP	1.2414	1.4%	-2.0%	-6.9%

Source: Bloomberg, Merrill Lynch, as at 1 June 2020.

Chart of the week: US initial jobless claims vs. unemployment rate



Source: Bloomberg and Macrobond, Columbia Threadneedle Investments, as at 1 June 2020.

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Macro / government bonds

It has been a rather range-bound period for core government bond markets. This comes in spite of stronger performance from risk markets such as equities and credit.

What has changed is the shape of the US yield curve. The 5-30-year curve is the now the steepest in a few years reflecting a mixture of improving economic sentiment as well as the dynamics of supply and demand in the US treasury market.

Notably there was an improvement in the employment situation with an ongoing decline in jobless claims **(see chart of the week).**

Investment grade credit

As mentioned, it was a strong week for investment grade credit.

Spreads are materially tighter in spite of record issuance in both the US and Europe. The global market spread has tightened from over 340bps in late March to end May at 184bps (these spreads were below 100bps at the beginning of the year for context). US dollar credit outperformed on a risk-adjusted basis with spreads around 14% tighter while sterling credit lagged, being only 5% tighter through May.

High yield credit

US high yield bond prices continued to climb over the past week as easing restrictions and additional policy support are reinforcing the expectation that global activity has bottomed and will recover. The ICE BofA US HY Cash Pay Constrained Index returned 1.81% over the holiday shortened week and spreads were 53bps tighter. The asset class continues to experience strong inflows – according to Lipper, inflows over the week were $6.3 billion, representing the third largest weekly inflow on record. Notably, five of the 10 largest inflows into the asset class have occurred in the last nine weeks. Record inflows have helped balance strong new issue supply as May's gross issuance of $41.2 billion is the highest since September 2017.

European High Yield (EHY) spreads tightened 61bps, finishing the month at 593bps. Lower rated single B and CCC issues outperformed in May, with CCCs returning 6.7% for the month. Inflows over the last week into the asset class were €149 million, of which only €33 million were via ETFs.

There were only two EHY primary issues last week: Wienerberger, German building materials, and Firmenich, a Dutch chemicals company for a total size of €1.150 billion issuance.

On the auto-related front, Renault confirmed that it will receive €8 billion in French state aid but with caveats attached. The French government is using this opportunity to focus on reducing emissions with benefits going to buyers of lower emissions cars (ex. electric) – this is clearly to avoid a case of "cash for clunkers." Additionally, minimum layoffs would be allowed in France, requiring any large layoffs to be overseas. Meanwhile, Hertz, the rental car agency, which had deferred a leasing payment in the hopes of renegotiating long-term agreements with lenders, defaulted on 27 May, after bankruptcy was announced. The firm has $19 billion of debt of which €725 million is in euro-denominated bonds.

A number of 'Fallen Angels' were added into the EHY indices at the end of the month. These included Arcelor Mittal, Bertelsmann, British Airways (IAGLN), Carnival Corp, and Ado Properties.

Leveraged loans

US leveraged loans also witnessed a big rally last week alongside other risk assets. Posting a 1.72% gain, leveraged loans experienced a +$1.43 increase in price to $88.56 on average with the lowest quality rung, Split B/CCC, increasing the most. Prices have recouped about 60% of their value from the lows hit in March. Spreads have tightened 56bps over the past week to 734bps. For the month of May, the leveraged loan index returned 3.8% while the sector remains in negative territory for the year at -6%. With 1-month Libor near zero and a lack of Libor floors on the vast majority of the sector, income generation from loans has declined dramatically such that strong total return is increasingly reliant on continued price appreciation.

Emerging markets

Emerging markets were relatively quiet last week as hard currency spreads tightened in 10bps, finishing off a strong month, 82bps tighter for May – single B and higher beta names were the outperformers. EM local bonds also performed strongly, finishing May with 5.2% for the month, the return was due to both a strong duration rally as well as solid FX performance.

The asset class experienced an inflow of $367 million last week, bringing the year-to-date figure to -$34.4 billion. Flows were heavily weighted in favour of hard currencies with modest outflows in local currencies, continuing the weekly outflows trend seen since the end of February.

EM rate cuts continued as Mexico (-50bps to 5.5%); Poland -40 bps to 0.1%); Nigeria (-100 bps to 12.5%); and Columbia (-50 bps to 2.75%) all cut their interest rates. There was also more government fiscal stimulus with Saudi Arabia announcing a $13.3 billion stimulus package to support banks against a fall in profits and rise in non-performing loans.

The G20 debt relief story continues. Approved in April, so far 36 countries have applied for debt relief through the suspension of bilateral debt payments. The overall size of the programme could reach $14 billion, depending on the number of participants. Additionally, a number of EM countries with outstanding loans to China are said to be in talks to renegotiate their debt with them directly, and not via the G20.

On the IMF front, high quality EM countries are now also getting flexible credit lines with the organisation. Peru was granted $11 billion and Chile will get $23.9 billion in their battle against the economic ramifications of Covid-19.

Asian fixed income

S&P downgraded Genting Berhad Malaysia to BBB with a negative outlook. S&P expects at slow recovery in the Malaysia and Singapore gaming operations and the debt/EBITDA ratio will exceed its downgrade ratios.

Alibaba Group reached its FYE March 2020 revenue guidance of over CNY500 billion (+35% y/y), supported by its domestic retail business and cloud computing. While Covid-19 affected most of its domestic core e-commerce business in late January, the company has seen a steady recovery since March. Based on management's current view of Chinese domestic consumption and enterprise digitization, Alibaba expects to generate revenue of over CNY650 billion in FYE March 2021.

Indika Energy reported mixed Q1 results, with weak y/y trend but sequentially better operating profit. Q1 revenue was $642.6 million (-8.5% y/y, -8.7% q/q) and operating profit was $68.7 million (-16.9% y/y, +10.7% q/q). The Q1 average selling price was slightly weaker at $43/t (Q419: $43.2/t, FY19: $45.1/t). Liquidity remained healthy with cash balances of $578 million (Dec 2019: $568.6 million), compared with short-term debt of $125 million (Dec 2019: $121 million).

Commodities

The index was up 1.3% for the week, bring the month's performance to up 4.3%. However, year-to-date, performance is still down more than 20%. WTI was higher over the week, finishing up 6% as the price returned to the mid $30s area. There are, however, demand worries given the riots and general unrest in the US. This is offset by the news that OPEC+ is meeting this week (4 June) to discuss extending production cuts.

In precious metals, gold was pretty steady this week and overall for the month of May. Base metals were flat to 3% up last week while grains and livestock were flat to up 2%.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

1st 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, as well as in potential relapses (of market volatility and/or COVID-19 infections). ■ Fundamentals remain challenging for large swaths of issuers, and there are many value traps lurking. Sorting out those 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'.' ■ Returning to normalcy brings resurgence in case counts, which ultimately puts the economy on ice for longer. ■ Central banks pull back support too early and positive technicals vanish.
Duration (10-year) ('P' = Periphery)	P ¥ $ Short -2 -1 0 +1 +2 Long € £	■ 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)	EM E Short -2 -1 0 +1 +2 Long $ A$ ¥ £	■ 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 Under-weight -2 -1 0 +1 +2 Over-weight C	■ 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. Even with a bounce in oil prices, no US companies are profitable if these prices persist. ■ Valuations: historically, spreads this wide typically lead to positive excess returns 6-12 months in the future.	■ 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. ■ 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 ■ o/w Livestock	■ Oil production disruption

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