COLUMBIA THREADNEEDLE INVESTMENTS

Your success. Our priority.

In Credit

27 JULY 2020

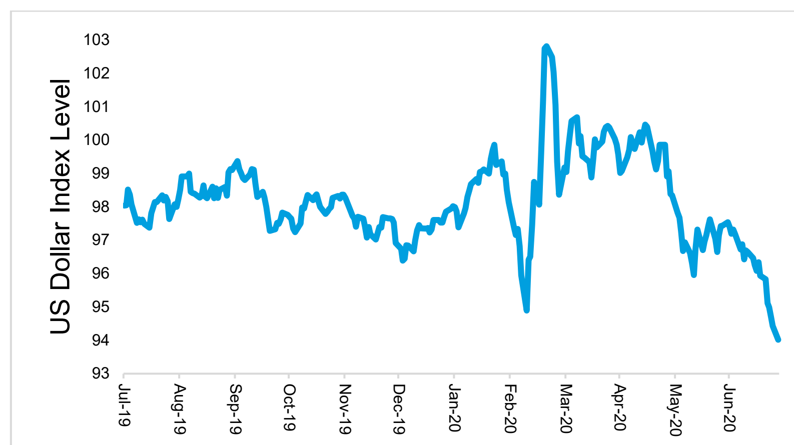
Climbing the wall of worry

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	0.57%	-6 bps	0.9%	10.0%
German Bund 10 year	-0.47%	-3 bps	0.0%	2.2%
UK Gilt 10 year	0.12%	-4 bps	-0.1%	9.5%
Japan 10 year	0.02%	0 bps	0.2%	-0.8%
Global Investment Grade	139 bps	-7 bps	2.3%	5.5%
Euro Investment Grade	125 bps	-9 bps	1.2%	-0.1%
US Investment Grade	139 bps	-7 bps	2.9%	7.9%
UK Investment Grade	134 bps	-4 bps	1.2%	4.6%
Asia Investment Grade	259 bps	-10 bps	1.3%	4.5%
Euro High Yield	503 bps	-22 bps	2.0%	-3.1%
US High Yield	529 bps	-45 bps	3.9%	-1.1%
Asia High Yield	692 bps	-18 bps	1.7%	1.4%
EM Sovereign	409 bps	-10 bps	2.9%	1.0%
EM Local	4.4%	-8 bps	2.8%	-4.3%
EM Corporate	419 bps	-11 bps	1.8%	1.6%
Bloomberg Barclays US Munis	1.3%	-7 bps	1.3%	3.4%
Taxable Munis	2.2%	-7 bps	2.5%	11.2%
Bloomberg Barclays US MBS	70 bps	3 bps	-0.1%	3.4%
Bloomberg Commodity Index	146.16	2.5%	4.9%	-15.5%
EUR	1.1682	2.0%	3.8%	4.0%
JPY	105.54	0.8%	1.7%	2.4%
GBP	1.2834	1.8%	3.2%	-3.5%

Source: Bloomberg, Merrill Lynch, as at 27 July 2020

Chart of the week: US Dollar Index level (last 12 months)



Source: Bloomberg and Columbia Threadneedle Investments, as at 27 July 2020

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Macro/government bonds

Worries about the rise in coronavirus cases in the US, worries about the economic recovery stalling and worries about the state of relations between the US and China were key to the direction of markets last week. Core government bond yields fell in the week with the US market outperforming.

Corona cases and fatalities continue to rise in Florida and California. Meanwhile, the weekly employment data showed the first rise in claimants in many weeks. Likewise, there was a tit-for-tat exchange of consulate closures in Houston and Chengdu, while the rhetoric from both sides continues to escalate and undermine confidence.

In a quiet week for economic news there was better data in the UK and Europe. UK retail sales grew by a staggering 13% in June, while ISM data for Europe's largest two economies both looked encouraging, as was the same in the UK. The US PMI came in at 50, which disappointed. As a result of the divergence in economic performance the US dollar was weaker through the last seven days. **See Chart of the week.**

Investment grade credit

Credit spreads continued to tighten in the past week. Global spreads were around 5% tighter led by the European market. There was little supply to digest given we are in the midst of what appears a relatively encouraging earnings season. UK utility Centrica performed particularly well last year on the back of the sale of its Direct Energy business. Bonds were around 30bps tighter on the news.

High yield credit

US high yield bond prices increased sharply over the past week amid a firm technical backdrop and as positive vaccine news and progress on stimulus packages in Europe and the US boosted sentiment in the face of escalating China tensions and a surge in Covid-19 cases across certain parts of the country. The ICE BofA US HY CP Constrained Index returned 1.51% over the week and spreads were 45bps tighter. Inflows for the asset class continued over the week, totalling $3.91 billion. This was the largest inflow since the week ending 10 June. Meanwhile, nine deals totalling $4.9 billion were priced over the past week, which has month-to-date activity totalling $19.3 billion following a record $61.5 billion in June.

European HY continued to rally with another strong week, as spreads tightened 22bps. Inflows picked up again, after last week's almost flat figure, with €194 million, mostly in managed accounts as only €56 million went into ETFs.

After several weeks of strong issuance, the pipeline has started to slowdown. This week's primary market included Stonegate (a UK pubs group) and Intrum (a Swedish debt collector group). There was more news on capital raising with Cellnex, the Spanish telecom, announcing a plan for capital increase of €4 billion with plans for €11 billion M&A, and IAG (British Airways) planning to raise up to €2.5 billion with a share issue.

There was another entry into the European HY index, as S&P downgraded Schaeffler, the German auto parts firm, from BBB- to BB+, following Moody's downgrade last month from Baa3 to Ba1. This adds another €2 billion into the European HY index universe.

There was also more government support for high yield corporates as Tereos (a sugar producer but also a significant supplier of pharmaceutical alcohol) received a €230 million loan, 80% guaranteed by France with a maturity up to five years (and post the maturity of the firm's €600 million bond which matures in 2023).

Leveraged loans

Leveraged loan prices rallied over the past week alongside broader markets, as optimism around a vaccine and a forthcoming stimulus package in the US boosted sentiment. The J.P. Morgan Leveraged Loan index price rose $0.72 to $93.03 over the past week, with the average price for BB loans increasing $0.68 to $96.69, Single B loans increased by $0.87 to $95.07, and Split B/CCC increased by $0.20 to $76.07. Meanwhile, loan yields and spreads (three-year) decreased 31bps and 29bps over the past week to 6.46% and 624bps, which are down 68bps and 67bps in July. The leveraged loan market has now recouped 701bps or 80% of the 873bps of spread widening between 21 February and 23 March (452bps/1,325bps). Loan

issuance remains light with only $8.3 billion pricing month-to-date, following a four-month high $28.8 billion in June. Outflows continued for the asset class with another $221 million withdrawal over the week.

Structured credit

Agency mortgage spreads tightened early last week as demand outpaced supply, but widened later on with the rally in rates. The Bloomberg Barclays US MBS Index ultimately gave back 10bps in excess return on Friday to end the week at -0.17%. Housing continues to be the bright star in today's anemic economy, as new home sales surged almost 14% month-over-month to the highest level in 13 years. In credit, eight deals priced during the week for $6 billion in volume, which reflects a decline of 27% versus last year and expectations are light for the coming week.

US municipals

Technicals remain the driving force behind recent municipal performance, and month-to-date nearly 50% of municipal supply has come in the form of taxable debt. With the taxable market pulling supply away from the tax-exempt side, even the relatively modest inflows into tax-exempts have been more than enough to support new issue and keep dealer inventories light. Lipper fund flows for the past week reported $2.1 billion of positive flows, marking the tenth straight week of inflows and flipping the year-to-date number back into positive territory. Riskier portions of the market continued their outperformance last week – HY Muni has returned +2.15% month-to-date, and BBB-rated +2.56% versus +1.08% for AAA-rated issuers. All eyes are fixed on Washington this week, as the possibility of stimulus for state and local governments could provide another positive for the asset class.

Emerging markets

Emerging markets saw another week of strong performance as EM hard currency and corporate spreads continued to tighten. Local EM followed suit with tightening spreads and positive return. Flows into the asset class continued for the fourth straight week, this time $1.3 billion into both hard and local EM, largely into managed funds.

In central bank news, Turkey and Ukraine kept rates unchanged while Russia cut its rates by 25bps to 4.25%, less than the 50bps expected by the market. In all cases, it was noted that further rate cuts in 2020 were still possible.

There was big news in Chile as the senate voted in in favour of allowing the withdrawal of up to 10% of pension funds. This could be quite negative for government bonds, especially the longer end of the government curve, as private pensions own about 75% of local government debt. In response, the Chilean central bank said it would use tools and mechanisms available to mitigate the effect of the withdrawals, if necessary.

Asian fixed income

Fitch upgraded Greenko Energy Holdings' (GEH) rating from BB- to BB with a stable outlook. The restricted groups within GEH comprise Greenko Solar Mauritius (GSM), Greenko Investment Company (GIL) and Greenko Dutch BV (GBV). These restricted groups have accumulated substantial cash from operations and GEH has committed not to take dividends from them. Instead, the restricted groups will use the cash to reduce their respective debt while GEH will fund new projects with shareholder equity.

AAC Technologies (AACTEC) has reorganised its optical products and solutions under the name AAC Communications. The optical business is AACTEC's growth business but it is still a minor contributor to group revenue at just 6%. AACTEC's traditional core products are acoustics, electromagnetic miniature components used in smartphones. Four strategic investors – Xiaomi Corp, Oppo, Shenzhen Huiyou and Nanjing Huarui – will invest CNY1.15 billion for a 9.58% stake in the subsidiary AAC Communications.

Hindustan Zinc released a weak set of Q1 results which is not surprising given the weaker commodity prices – LME zinc price (29% year-to-year to $1,971 per tonne). The outlook commentary, however, was constructive, helped by its expectation for cost of production to stay below $1,000 per tonne (one of the 20% lowest cost zinc producers globally). Management expects the mined metal production level (ie zinc, lead and other precious metals excluding silver) to be higher year-on-year at around 925,000-950,000 tonnes for FYE March 2021. For FYE March 2020, the production level was 917,000 tonnes. This implies a quarter-on-quarter ramp-up in production levels over the remaining quarters (Q2-Q4). The closure of higher-cost mines owned by competitors, is supportive for zinc prices.

Commodities

The index was up 2.5% this week, largely on the back of the rally in precious metals. Gold broke through the 2007 high of $1,900 while silver rallied almost 16% over the past week.

Oil markets remained relatively quiet, getting some uplift from a weaker US dollar (supporting all commodities, especially soft commodities). In refined products, distillates are now at a 30-year high, so containment issues are be expected. Supply remains an issue as gasoline demand, which was recorded at nine million barrels a day, is stalling there. Normally at this time of the year it should be at 10.5 million barrels a day.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

27th July 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)	P ¥ $ Short -2 -1 0 +1 +2 Long € £	■ Disinflationary global recession now a base case ■ Consumption to flatten out after initial sequential recovery surge ■ Monetary policy will seek lower, flatter curves and more than offset 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: 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 ■ 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 Copper vs Aluminium ■ u/w Crude ■ o/w Soybeans vs Corn ■ u/w Softs	■ Oil production disruption

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