

In Credit

18 MAY 2020

Dismal data and downgrades continue.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	0.65%	-4 bps	0.0%	9.3%
German Bund 10 year	-0.54%	0 bps	-0.5%	2.7%
UK Gilt 10 year	0.21%	-3 bps	-0.6%	9.6%
Japan 10 year	-0.01%	-1 bps	-0.4%	-0.4%
Global Investment Grade	213 bps	0 bps	-0.6%	-0.6%
Euro Investment Grade	196 bps	7 bps	-1.0%	-3.7%
US Investment Grade	220 bps	-2 bps	-0.5%	0.5%
UK Investment Grade	179 bps	5 bps	-0.7%	0.6%
Asia Investment Grade	302 bps	-4 bps	0.6%	0.9%
Euro High Yield	696 bps	7 bps	-1.0%	-10.4%
US High Yield	778 bps	26 bps	0.0%	-9.9%
Asia High Yield	795 bps	-25 bps	2.2%	-4.6%
EM Sovereign	530 bps	-4 bps	2.2%	-7.8%
EM Local	4.7%	-4 bps	0.1%	-11.8%
EM Corporate	527 bps	-6 bps	1.3%	-5.2%
Bloomberg Barclays US Munis	1.9%	-15 bps	1.9%	0.0%
Taxable Munis	2.8%	-5 bps	-0.1%	2.2%
Bloomberg Barclays US MBS	70 bps	29 bps	0.0%	3.5%
Bloomberg Commodity Index	134.22	-1.1%	1.3%	-23.5%
EUR	1.0812	-0.2%	-1.2%	-3.5%
JPY	107.27	-0.4%	0.1%	1.5%
GBP	1.2125	-2.4%	-3.8%	-8.6%



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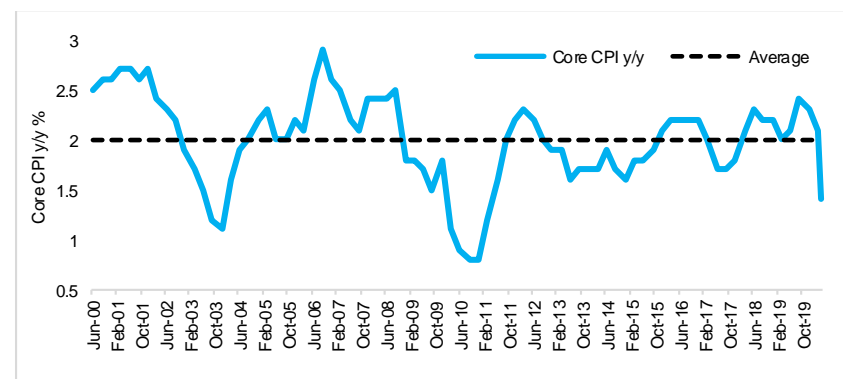
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Source: Bloomberg, Merrill Lynch, figures as at 18 May 2020.

Chart of the week: US core (ex-food/energy) CPI inflation (2000-20)



Source: ICE BoAML Indices, Columbia Threadneedle Investments, as at 13 May 2020.

Macro / government bonds

Core government bond yields were little moved last week.

Covid-19 news continues to improve in developed economies with cases up 0.9% to 4.7 million and fatalities up 0.7% to 0.315 million. Deutsche Bank noted that this is the smallest rise in new cases since late February.

Last week revealed the effects of the collapse in energy prices on US inflation (gasoline down around 21%). The April reading for consumer prices fell 0.8% on the month while the core measure fell by a record 0.4%. This takes the annual growth in core inflation to 1.4% – **see chart of the week**. In other data releases US industrial production fell by 11.2% (worst on record) and retail sales by 16.4% (worse than expected).

Industrial production in the eurozone also fell sharply (by 11.3% in March), with the annual rate coming in at -12.9%. German GDP declined by 2.2% in Q1 2020. The UK recorded its largest quarterly decline in GDP since the Global Financial Crisis in Q1 2020 with a contraction of 2.0%. This period contained only a few days of lockdown so much worse is set to come in Q2.

Investment grade credit

Global investment grade spreads have been fairly stable these last few weeks though they were a few basis points higher in the last five days. The US dollar market outperformed with cyclical businesses such as autos doing better whereas more defensive sectors did less well.

Inflows into the market have met with very high levels of new issuance in both the US and Europe, which have caused a degree of indigestion in the market. Another theme is capital preservation with dividend cuts (eg, British Telecom last week) and share buybacks withdrawn. Meanwhile, US retailers JC Penney, J Crew and Neiman Marcus have all filed for bankruptcy as this area of the economy struggles globally.

High yield credit

High yield markets have had to contend with a deluge of so called 'Fallen Angel' credits. Ratings agency Fitch note that there have been over \$150 billion of euro or US dollar debt that has been downgraded since the start of March. The chief driver of this trend has been the US oil and gas sector (most notably Occidental with around \$40 billion of debt). Other notable areas include Arcelor Mittal in the Steel sector, Delta Airlines and auto companies Renault and Ford.

US high yield bond prices came under modest pressure over the past week alongside steeper losses for stocks with the past week's focus on trade tensions; progress towards a reopening of economies; ongoing retail inflows; and an active new issue market. According to Lipper, the asset class reported a \$4.5 billion inflow for the week. This is the fourth largest weekly inflow on record and extends the inflow streak to seven weeks totalling nearly \$28 billion. Primary markets remain active with another \$11.5 billion priced over the week. General Corporate Purposes (GCP) remains the theme as the primary use of proceeds with issuers continuing to add liquidity to the balance sheet.

European High Yield (EHY) spreads widened 7bps last week, finishing at 684bps. Spreads have been trading more or less in a 30bps range over the last four weeks. Inflows last week were €245 million, of which only €125 million were via ETFs. The primary market in EHY picked up last week as €2 billion was raised. However, one potential deal from Sappi, the South African paper company (BB rated), was pulled at the last minute due to lack of demand. However, other deals from BMC Software, Rubis Terminal Infra, Synlab and PPF Telecom all did go through. This takes month-to-date issuance to €3+ billion, already much higher than the €1.9 billion issued in April.

The market is showing signs of distress as more issuers announce coupon payment delays, taking advantage of the allowed grace period. On Friday, Takko, the German apparel retailer, announced suspension of payment on its 2023 bonds. This follows other issuers (Solocal, the French advertising firm, Codere, the Spanish gaming company, and Travelex, the Foreign Exchange group) giving notice to bond holders of suspension of coupon payments and the start of negotiations on covenant waivers or deferment of payment, where relevant.

Leveraged loans

The US leveraged loan market posted 27bps of positive total return last week, well outpacing its high yield bond counterparts.

It was a low-quality rally with B/CCC loans beating BB by a wide margin; however, those lower quality issuers continue to have an average price of sub \$70. Outflows persist and were slightly higher than the prior week at net out \$282 million (mutual funds plus ETFs). The story in the leveraged loan market now centres on mounting rating agency downgrades. CLOs, which account for approximately 60% of the loan market, allow for a basket of CCC—rated loans, typically 7.5%. As more loans get downgraded, those baskets are being breached, which could ultimately impact payments to investors and cause downgrades of CLO rated bonds.

US municipals

Eleven straight days of positive performance for municipal bonds has pulled year-to-date total returns for the Bloomberg Barclays Municipal Bond Index to within one basis point of positive territory.

Lipper reported \$582 million of inflows to municipal bond funds last week, and 'secondary breaks' of some key primary issues were very strong. Despite the clear optimism that the market has displayed, it is difficult to disregard negative data regarding state and local government budgets where data is just now becoming available. Many market participants appear to be hanging hopes on another round of stimulus from Washington, and while the opening negotiation from the Democrats offers much needed help for municipalities, it remains to be seen how much the final agreement will hold.

All eyes last week were on the State of Illinois (BBB-/Baa3/BBB-), which floated an \$800 million state GO deal. The issue was well-received with over \$8.5 billion in orders, which tightened pricing yields by 10-15bps across maturities, and when released for secondary trading, some maturities traded 30-40bps tighter. This deal is relatively small compared to the size of budgetary holes Illinois needs to fill, but it at least offers hope that municipal investors are showing a bid for risk again.

Emerging markets

Emerging market hard currency spreads and corporate spreads both ended a few basis points tighter last week. Over the period, the asset class experienced an inflow of \$458 last week bringing the year-to-date figure to -\$33 billion. Flows were heavily weighted in favour of hard currencies with modest outflows in local currencies.

In central bank news, Mexico cut rates by 50bps as expected to 5.5%. The market is looking for another 50-100bps over the rest of 2020. On country specific news: In Brazil, one of the leading newspapers reported having a tape of President Bolsonaro influencing the change of the chief of police due to an issue regarding protection of his sons. The news caused a 10bps widening of the spread on the sovereign debt. In Ukraine, the banking reform bill was passed with greater than expected majority and goes to President Zelensky to be signed. Once signed, a meeting with the IMF will be announced taking the country a step closer to receiving IMF support.

Deals wise: new issuance supply came out of the GCC countries via their respective quasi sovereigns. Abu Dhabi and Kuwait both issued bonds, totalling \$1.5 billion for 5-year and 10-year notes – the book size was \$7 billion.

Asian fixed income

The Finance Ministry of India provided further details on the INR20 trillion (\$266 billion; around 10% of GDP) fiscal package which was announced by PM Modi on 12 May.

The focus of the first tranche of the fiscal package is to ease the liquidity situation for MSME (micro, small and medium enterprises); NBFCs; and the state-owned DISCOMs (distribution companies). This is positive for the major NBFCs, and the non-SOE Indian corporates, notably the utilities/transmission and renewable energy sector. The electricity distribution companies (DISCOMS) will receive up to INR900 billion (around \$12 billion) from Power Finance Corp and Rural Electrification Corporation. The DISCOMs need the liquidity infusion to pay their outstanding dues to the generation and transmission companies.

Vedanta Resources Limited (VRL) has made a privatization offer to Vedanta Ltd for INR87.5/share. VRL currently owns a 50.1% stake in Vedanta Limited. The privatisation offer values the 49.9% minority stake in Vedanta Ltd at around \$4.2 billion. This transaction, if successfully executed, will simplify VRL's corporate structure and enable VRL to access its subsidiaries' cash flow with less dividend leakages. Currently, the dividend upstreaming from Vedanta Ltd to VRL is inefficient because 49.9% is paid to minority shareholders.

Tencent's Q1 results were positive, with revenue up 26% y/y and operating profit up 25% y/y. The key drivers were the strong demand for online games (boosted by stay-at-home consumers) and online advertising. Management expects the Q2 revenue growth to ease as consumer return to work and the online gaming consumption to normalize.

Las Vegas Sands is dropping its bid for a casino license in Japan and it will instead focus on its operations in Macau and Singapore

Commodities

The index was down 1% for last week, largely on base metals which were down 2% to 4% as inventories build up and there are concerns about the slow speed of countries coming out of lockdown. This was in spite of the better than expected Chinese industrial production data.

Crude oil prices were helped by the fall in inventory numbers (for the first time since January there was a fall of 3 million barrels for delivery for storage at Cushing.) Gasoline has also improved but is still down 10% y/y.

Precious metals were higher with gold up 2.5% on the week. The gold price moved higher, reacting to the extension of US fiscal stimulus (now over \$3 trillion). The gold price is now at the highest level seen since 2012 and this is now due to real investor demand (as versus jewellery or central bank demand).

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

18th May 2020

Strategy and positioning (relative to risk free rate)	Views	Risks to our views
Overall Fixed Income Spread Risk 	<ul style="list-style-type: none"> 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. 	<ul style="list-style-type: none"> 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) 	<ul style="list-style-type: none"> 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 	<ul style="list-style-type: none"> 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) 	<ul style="list-style-type: none"> 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. 	<ul style="list-style-type: none"> Federal Reserve moves away from ultra accommodative stance Investors reappraise US crisis/fiscal response as more likely to speed a return to normality than other regions
Emerging Markets Local (rates (R) and currency (C)) 	<ul style="list-style-type: none"> Many EMs lack the policy space to offset demand destruction Currencies likely pressure valve as central banks finance fiscal deficits EM real interest rates relatively attractive 	<ul style="list-style-type: none"> Further sharp escalation in global risk aversion EM funding crises drive curves higher and steeper
Emerging Markets Sovereign Credit (USD denominated) 	<ul style="list-style-type: none"> 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. 	<ul style="list-style-type: none"> 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 	<ul style="list-style-type: none"> 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. 	<ul style="list-style-type: none"> 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 	<ul style="list-style-type: none"> 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. 	<ul style="list-style-type: none"> 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 	<ul style="list-style-type: none"> 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). 	<ul style="list-style-type: none"> 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 	<ul style="list-style-type: none"> 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. 	<ul style="list-style-type: none"> 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 	<ul style="list-style-type: none"> o/w Base Metals u/w Crude o/w Soybeans vs Corn o/w Livestock 	<ul style="list-style-type: none"> Oil production disruption

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