COLUMBIA THREADNEEDLE INVESTMENTS

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In Credit

17 FEBRUARY 2020

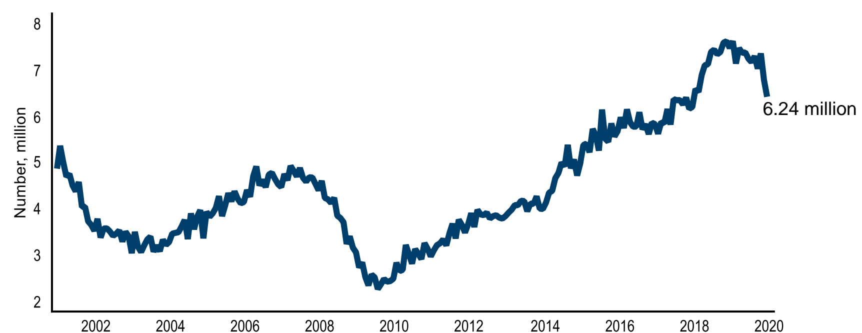
Has the tide turned?

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	1.58%	0 bps	-0.3%	2.3%
German Bund 10 year	-0.40%	-2 bps	-0.4%	1.6%
UK Gilt 10 year	0.63%	6 bps	-0.9%	2.9%
Japan 10 year	-0.03%	1 bps	-0.3%	0.2%
Global Investment Grade	101 bps	-2 bps	0.1%	2.2%
Euro Investment Grade	90 bps	-2 bps	0.0%	1.2%
US Investment Grade	102 bps	-2 bps	0.2%	2.6%
UK Investment Grade	106 bps	-1 bps	-0.4%	2.3%
Asia Investment Grade	197 bps	-1 bps	0.2%	1.7%
Euro High Yield	328 bps	-10 bps	0.8%	0.9%
US High Yield	356 bps	-19 bps	1.1%	1.1%
Asia High Yield	549 bps	-6 bps	1.1%	1.8%
EM Sovereign	287 bps	-5 bps	0.6%	2.4%
EM Local	4.9%	-2 bps	0.5%	-0.8%
EM Corporate	308 bps	-3 bps	0.6%	2.2%
Bloomberg Barclays US Munis	1.5%	-1 bps	0.0%	1.8%
Taxable Munis	2.7%	0 bps	-0.1%	5.3%
Bloomberg Barclays US MBS	43 bps	2 bps	0.1%	0.8%
Bloomberg Commodity Index	160.61	0.9%	0.8%	-6.6%
EUR	1.0846	-1.1%	-2.4%	-3.4%
JPY	109.87	0.0%	-1.3%	-1.0%
GBP	1.3041	1.2%	-1.2%	-1.6%

Source: Bloomberg, Merrill Lynch, as at 17 February 2020.

Chart of the week: US job openings (JOLTS Index) 2001-2020



Source: Macrobond and Columbia Threadneedle Investments, as at 17 February 2020.

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Macro / government bonds

The market outlook was more subdued this week as the US JOLTS release **(see chart of the week)**, the disappointing US January retail sales release and the cautionary tone from US Federal Reserve Chairman Powell cast a cloud over the recent positive economic news. Adding to the global concern was China's announcement of an additional 15,000 coronavirus cases due to a change in how cases are diagnosed (now including CT scans as well as lab results).

The sharp fall in the JOLTS index, over November and December, combined, is a 13% drop and could be a harbinger for recession. As shown in the graph, the last time the US experienced such a sharp drop was at the start of 2008. At the Humphrey-Hawkins testimony this week not only did Powell mention concerns of the economic impact of the coronavirus but also, unusually, stated that given where interest rates are "means that it would be important for fiscal policy to support the economy if it weakens." Powell also made it clear that it could use tools used in the last recession (QE and forward guidance) but was also adamant that negative interest rates was not one of the tools the Fed was considering as an option.

In Europe, Q4 GDP came in at an annualised rate of 0.9% y/y, marginally undershooting the consensus. Weak domestic demand appears to be a trend across the region and performance diverged somewhat as Germany stalled, while GDP fell outright in Italy and France. In the UK, the government's power struggle came to the fore as PM Boris Johnson sacked a number of his cabinet ministers and Sajid Javid (chancellor) resigned. Javid's resignation comes less than a month before the budget was due to be announced and could signal a shift to expansionary fiscal policy as the new chancellor – Rishi Sunak – is well-known for his loyalty to Johnson.

Chart 2 of the week: Euro area interbank rate

Source: Columbia Threadneedle Investments, February 2020.

The need for fiscal policy was echoed by the European Central Bank and the Bank of England as both Christine Lagarde and Mark Carney indicated that "monetary policy cannot and should not be the only game in town". With the downward trajectory in eurozone interest rates since 2011 **(see chart 2 of the week)**, it is clear that there is very little room for the central bank to manoeuvre should the economic picture seriously weaken. For further context of the decline in yields, Greek 10-year government bond yields fell below 1% for the first time last week – a far cry from the 37% yield they offered at the start of February 2012.

Investment grade credit

The market continued to absorb the new issuance as spreads were stable to slightly tighter. Sterling credit remains the best performer year-to-date. New issuance year-to-date is around 20% ahead of 12 months ago, according to Bloomberg.

Earnings continue to generally beat expectations. For the banking sector while there are some signs of margin pressure for European banks; however, capital levels are stable or better. Elsewhere, Kraft Heinz results were weak and the company's bonds came under pressure due to management's reluctance to cut the dividend and address the $29 billion debt pile. Investor caution appeared warranted as both S&P and Fitch downgraded the company to high yield (both from BBB- to BB+), citing the company's lack of deleveraging.

There was big news in US telecoms as a federal judge ruled that T-Mobile and Sprint (3rd and 4th largest wireless carriers in the US) may merge. It is a strong indicator that the government sees three players as sufficient for the 5G world.

Another week, another mega deal. Following hot on the heels of LVMH's issuance last week was Carrier Global, which came to the market with a multi-tranche $9.25 billion deal. Carrier Global is a spin off from United Technologies, who in turn will use the proceeds to pay down debt ahead of its merger with Raytheon.

High yield credit

It was a strong week for European high yield. All credit ratings saw positive returns, with higher credit quality names outperforming. The activity in the primary market subsided in comparison to previous weeks as the market focused on corporates reporting full year 2019 results. However, we still saw a few deals from the telecommunications space, with British Telecom issuing a €500 million bond and another from TalkTalk. The asset class saw net inflows last week. In corporate news Kraft Heinz was downgraded to high yield (see Investment grade credit above) and will enter the indices next month.

Emerging markets

Emerging markets had another week of strong performance as hard currency spreads tightened -5bps on the week and local currency bonds also performed well ending the week +0.57%.

China's PBoC cut interest rates and added further stimulus in response to the worsening coronavirus. The PBoC offered $29bn equivalent of one-year loans and lowered the rate by 10bps to 3.15%. There was also another rate cut from Mexico which cut its base rate by 25bps to 7.00%. The MPC cited weaker growth as the reason for the cut and the market expects further cuts in due course as Mexico offers one of the highest real rates in emerging markets.

One of the few exceptions to the strong asset class performance was Argentina, which saw a local auction fail resulting in the re-profiling of the maturing bond. ArgDuo 2020's maturity will now be delayed until the end of September 2020. This is the third time that the roll over for this bond has been attempted with little take up from the public and the third re-profiling since the August presidential elections last year. This past week's meeting between President Fernandez and the IMF indicated how hard President Fernandez will negotiate to avoid bankruptcy, but how willing he will be to force debt holders to take a steep haircut on outstanding Argentine public debt. Lebanon was the other exception as the government saw its bonds drop 10% to 15% on the news that the government had called for IMF assistance. With public debt of 155% of GDP and an upcoming $1.2 billion maturity in March, there is market concern of the government's ability to repay its debt.

Asian fixed income

Asia credit performed better last week, as spreads tightened by 4bps and US treasury yields were lower. The year-to-date total return stands at 1.9%. The US Department of Justice (DoJ) charged Huawei with racketeering and the theft of trade secrets under the Racketeer Influenced and Corrupt Organizations Act (RICO). This new indictment builds on earlier allegations that Huawei violated trade sanctions against Iran. This latest episode highlights the ongoing US pressure on Huawei and the potential for further escalation, despite the easing of trade tension at other fronts.

In India, the Supreme Court has rejected the modification plea of Bharti Airtel and Vodafone Idea for an extended period to pay the AGR dues (Adjusted Gross Revenue). The Supreme Court also filed contempt proceedings against the two companies for not paying the AGR dues in January. The two companies have to deposit the AGR dues by 17 March 2020. On 17 February, Bharti made a part payment of INR100 billion ($1.4 billion) to the Department of Telecom (DoT). Bharti is in the process of completing its self-assessment exercise before making the balance payment. Previously, Bharti stated that it may be liable for up to $4.8 billion of AGR dues. Adani Transmission completed the transaction to sell a 25.1% stake in Adani Electricity Mumbai Limited to Qatar Investment Authority for INR32.2 billion (around $452 million), which includes equity consideration of around $170 million and shareholder subordinated debt of $282 million.

Hutchison Port Holdings Trust (HPHT) reported weak FY19 results due to lower y/y throughput (-4% y/y) from the drop in outbound cargoes to the US (-9%). Net debt/EBITDA, however, improved to 3.6x (prior year: 3.8x), which compares favourably with management's target to keep this below 5x. HPHT has also prudently lowered its DPU (distribution per-unit) to HKD11 cents (prior year: HKD17 cents), which was at the lower end of management's guidance of HKD11-17 cents. Management's guidance for the DPU in 2020 is HKD8-11 cents. MGM China stated that the company was performing well in January before the coronavirus outbreak. Specifically, the company was earning around $2.5 million per-day (4Q: around $2 million per day). During the current 15-day suspension, the operating cost is around $1.5 million per-day.

The primary market was more active, with $10.3 billion of issuance, while year-to-date supply is $18 billion (+30% y/y).

Commodities

The asset class was up +0.9% on the week, bringing year-to-date returns to -6.6%.

Crude oil prices rose with WTI higher by 3.5% and Brent up by 4.4%. Base metals rallied at the end of the period in response to the stimulus from China.

OPEC was in negotiations with Russia this week to get the reluctant partner to agree to output cuts. The urgency to get an agreement was heightened as OPEC sharply revised lower (by a third) its forecasts for global oil demand given the coronavirus effect.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

17th February 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 we see risks that are more fundamental than these.	■ Fast and fierce fiscal stimulus, especially in Europe or China. ■ Reacceleration of growth trends
Duration (10-year) ('P' = Periphery)	¥ $ Short -2 -1 0 +1 +2 Long € P £	■ Coronavirus risks derailment of nascent global recovery ■ Manufacturing uptick may have been levelling off anyway ■ Phase One trade deal fulfilment unrealistic ■ Lower pace of US growth expected this year ■ Policy normalisation remains	■ Global trade détente stimulates improvement in risk sentiment ■ Chinese efforts to successfully contain virus with minimal growth disruption ■ US economy stages consumption-driven cyclical upswing
Currency ('E' = European Economic Area)	E EM A$ Short -2 -1 0 +1 +2 Long ¥ $ £	■ The Dollar is richly valued on the basis of growth outperformance and high carry. Twin deficits indicate a weaker dollar longer term ■ The global reflation trade, which would have provided near term impetus for USD weakness, has been set back by the growth impact of the Coronavirus	■ Further leg lower in global growth driven by increasing trade frictions and Coronavirus
Emerging Markets Local (rates (R) and currency (C))	R Under-weight -2 -1 0 +1 +2 Over-weight C	■ EM real interest rates still relatively attractive ■ EM growth likely to outperform DM, while inflation benign ■ Fiscal and external fundamentals still largely sound	■ 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 would 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 will boost sentiment and current account balances. ■ A rapidly weakening USD will ease financial conditions ■ Reversal of recent electoral trend towards 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 growth ■ Fundamentals don't show signs of imminent crisis, but several of the tailwinds are fading. Valuations look even more offside when considering this	■ A re-acceleration of growth especially in the more downtrodden 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 war resolution boosts valuations.
Agency MBS	Under-weight -2 -1 ■0 +1 +2 Over-weight	■ Prepayments have increased as a result of lower rates, however they have lagged expectations given the fall in Treasury yields. ■ Spreads have widened to near post-GFC wides 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 within 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 slowdown, weighing on economic growth, metals & petrol

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