INFORMATION FOR INVESTMENT PROFESSIONALS

COLUMBIA THREADNEEDLE INVESTMENTS

Your success. Our priority.

In Credit

11 MAY 2020

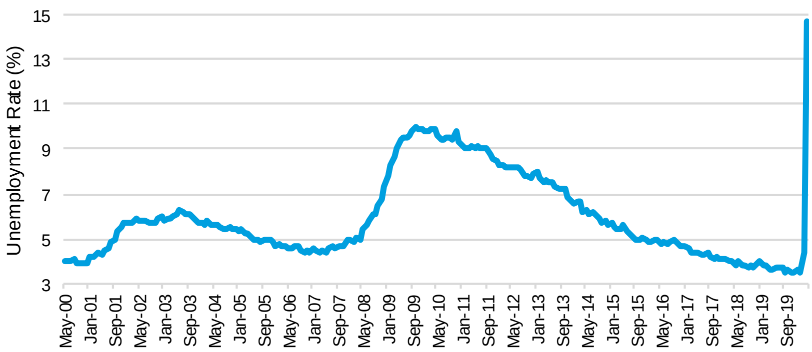
Reopening.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	0.69%	8 bps	-0.4%	8.8%
German Bund 10 year	-0.52%	7 bps	-0.5%	2.7%
UK Gilt 10 year	0.25%	1 bps	0.1%	10.3%
Japan 10 year	0.01%	3 bps	-0.3%	-0.3%
Global Investment Grade	213 bps	4 bps	-0.7%	-0.7%
Euro Investment Grade	189 bps	6 bps	-0.5%	-3.2%
US Investment Grade	222 bps	4 bps	-1.0%	0.0%
UK Investment Grade	174 bps	1 bps	-0.1%	1.2%
Asia Investment Grade	306 bps	4 bps	0.2%	0.4%
Euro High Yield	689 bps	16 bps	-0.6%	-10.0%
US High Yield	752 bps	-18 bps	0.7%	-9.2%
Asia High Yield	820 bps	-12 bps	0.9%	-5.8%
EM Sovereign	535 bps	-22 bps	1.4%	-8.5%
EM Local	4.7%	-15 bps	0.4%	-11.5%
EM Corporate	533 bps	-7 bps	0.7%	-5.9%
Bloomberg Barclays US Munis	2.0%	-17 bps	1.1%	-0.8%
Taxable Munis	2.9%	5 bps	-1.0%	1.3%
Bloomberg Barclays US MBS	41 bps	0 bps	0.1%	3.6%
Bloomberg Commodity Index	132.38	2.7%	2.3%	-22.7%
EUR	1.0822	-1.3%	-1.1%	-3.3%
JPY	107.30	0.3%	0.5%	1.9%
GBP	1.2326	-0.8%	-1.5%	-6.4%

Source: Bloomberg, Merrill Lynch, figures as at 11 May 2020.

Chart of the week: US unemployment rate, 2000-2020



Source: Bloomberg, Columbia Threadneedle Investments, as at 11 May 2020.

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Municipals

Macro / government bonds

Core government yields drifted modestly higher over the week in spite of more horrendously weak economic data.

At the end of the week, the US employment report recorded a rise in the unemployment rate to 14.7% (from 4.4% in March). This marks the highest rates of unemployment since the Great Depression – **see chart of the week**. As might be expected nearly half of the jobs lost came from the hospitality and leisure sectors. As these areas of the economy are often less well paid than in other professions, the rate of wage growth jumped much higher to nearly 8% y/y. In aggregate the number of jobs lost, and the rate of unemployment, were not as bad as many feared and should prove to be the worst reading of the year.

The spread of the Covid-19 virus seems to be stalling in core developed economies. This has led to plans to re-open parts of economies, often in a staged process. However, cases recorded in India, Brazil and Russia continue to advance.

Investment grade credit

Investment grade spreads were little moved in the last week.

The Global Index closed the week with a spread of around 213bps. These spreads, which were below 100bps in January, widened to over 340bps in March. Hence, the market has retraced more than half of spread widening. Spread tightening is being aided by asset class inflows; however, renewed interest and investor appetite is having to contend with a very heavy calendar of primary issuance in both the US and Europe. This is producing a degree of indigestion for the market.

As the reporting season comes to an end the ratings agencies continue to be busy (downgrading) with recent victims including Arcelor Mittal, as well as Ford and GM.

High yield credit

US high yield bond prices continued to move higher over the past week.

This came amid resilient stocks, an active new issue market, continued inflows and stabilisation within the energy sector, which continued to outperform, returning 4.5% with spreads 74bps tighter. According to Lipper, the asset class reported another strong inflow of $3.5 billion over the week. This extends the inflow streak to six weeks and $23.1 billion, more than offsetting February / March outflows of $19.2 billion.

European high yield spreads widened last week, finishing at 661bps.

Market inflows last week were around €200 million, of which only €28 million were via ETFs. The week finished with the news that the European Central Bank may be moving to the next step of high yield bond purchases. An ECB team has been assigned to analyse the advantages and disadvantages for the central bank of buying high yield bonds. Findings will be reported to the policymakers.

In M&A activity, the announcement of Telefonica's O2 and Liberty's Virgin Media's tie up (£31.4 billion deal) will create a new telecom giant.

Leveraged loans

Prices rose modestly higher on US bank loans, with spreads tightening to 842bps.

Lower quality, single B rated loans outperformed BB loans, which has been the recent trend. There has been a significant recovery in the current share of loans trading below $80 which now stands at 17% of the index, down from 57% on 23 March 2020. Overall, the sector has rallied alongside other risk assets on the list of liquidity programmes implemented by the US Federal Reserve and US Treasury.

Market technicals in recent weeks have also been much more stable. Primary activity has improved as evidenced by a $4 billion deal for T-Mobile and secondary trading levels, which are more actionable. Non-traditional buyers, including distressed funds, private equity funds, high yield accounts and hedge funds, have taken up some of the slack created by weak CLO formation and continued retail fund outflows.

On the fundamental front, defaults are rising but are expected to hold-up better than in the 2008/2009 period given less leverage and a benign maturity wall – only 4% of the index matures before 2022. At current spread levels, the market is trading at an implied market default rate of 9.5%. Rating agencies have been quick to downgrade issuers as well. 438 issuers, or 32% of the index, have been downgraded such that the percentage of CCC in the index has increased dramatically to 11%.

Structured credit

Sectors in the direct path of the Fed have experienced a swift recovery over the past month.

The Fed purchased $295 billion in agency MBS during April, tightening spreads and significantly reducing volatility. While prepayment uncertainty remains high, social distancing has somewhat mitigated refinancings. Forbearance requests have risen to approximately 6% of the total population of agency mortgages, but interestingly 60% of those same borrowers continue to make payments, seemingly 'buying' an option to not pay, should cashflow become more challenged.

In non-agency MBS, housing fundamentals are expected to soften with increased payment holidays. In this sector, approximately 7% of borrowers have opted for forbearance. Fortunately, forced selling by REITS and other levered investors has subsided, and prices have recovered 50-80% of their declines.

In ABS, certain sectors such as transportation are facing significant fundamental uncertainty and poor liquidity, while AAA consumer exposure has bounced back quickly aided by the Fed's ABS lending facility called TALF.

The CMBS sector rallied across the stack alongside other risk assets last week. While supply increased there was also greater depth of demand taking spreads tighter, with AAA tighter by 15bps and BBBs tighter by 50-75bps. Technicals are strong though there is concern of heightened downgrades and a possible spike in delinquencies specifically in weaker hospitality and retail credits. Approximately 10% of CMBS borrowers did not make their April mortgage payments and tiering has become more pervasive with industrial and office credit recovering the most in price.

US municipals

Municipals finally strung together a full week of strength, posting positive returns over each day last week and outperforming US treasuries in the process. Though yields were lower between 17-24bps across the curve, the muni curve ended steeper as demand inside of 5-years was quite strong. This was, in part, due to Federal programmes, which place a heavy emphasis on the front-end, but was also a recognition from retail investors that 2-year AAA Muni/Treasury yield ratios at 480% (30 April level) offer attractive value.

With no shortage of credit uncertainty, the higher quality ranges of the market continued to recover from the mid-March lows, while lower quality struggled to move higher. There were, however, some signs of life, as the New York MTA finally brought a new issue deal to market (both exempt and taxable varieties priced last week). After pushing the deal back a couple of times, a $1.125 billion dollar deal priced on Tuesday and immediately saw strong secondary bids, with 30-year paper trading 29bps inside of the new issue yield levels. With the State of Illinois set to test the market soon, investors will be watching closely to see if strong demand from last week can hold.

Emerging markets

Emerging market hard currency sovereign and corporate spreads were tighter last week while EM local bonds were down, though largely due to currency weakness. The asset class experienced an outflow of $914 million, bringing the year-to-date figure to $33.4 billion.

Monetary authorities rate action from last week included the Brazilian rate cut of 75bps to 3.0%, with forward guidance indicating another cut is likely at the next meeting. In country specific news, Argentina is expected give some concessions to bond holders, which was seen as market positive. The deadline for details on the concessions was expected at the end of this past week but the real deadline is 22 May.

On the new issuance front, Bahrain became the first single B sovereign to issue since the start of Covid-19 environment. Expectations are that the country's fiscal deficit could reach 15% given that oil revenues make up over 70% of the country's revenues.

Asian Fixed Income

Adani Ports reported solid operating results for FYE March 2020 although the 4Q performance was weak. While management expects port volume to pick up in Q2 FY21, it did not provide any guidance for the FYE March 2021 port volume. The company will put discretionary capex on hold, and it will reduce its capex (to INR18 billion-INR20 billion). Adani Ports will complete the planned acquisitions of KPCL (Krishnapatnam Port Company Limited) and Dighi by Q3, FY21.

Gaming revenue in Macau declined 97% y/y in April. The gaming sector is waiting for the resumption of the Individual Visit Scheme, which will drive up the visitations from Mainland China. Wynn Macau stated that it is spending around $2-2.5 million/day in operating expenses. Sands China recently reported that its run-rate operating expenses are $3.6 million/day.

Commodities

The index returned 2.7% for last week, led by energy prices, though metals (both base and precious metals) and agricultural also rose last week.

Oil prices were supported by a slower paced rise of US inventories while industrial metals rose on Chinese stimulus as copper prices rebounded with the 10.4% growth (higher than the expected 9.1%) in Chinese imports for the first four months of 2020, compared to the same 2019 period.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

11th May 2020

COLUMBIA THREADNEEDLE INVESTMENTS

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	▪ COVID- 19 has begun to wreak havoc on the economy-even if only temporary. Uncertainty is the word on fundamentals, but large fiscal stimulus could stem the tide. In tandem with monetary measures this could make the situation 'less bad' enough to improve markets ▪ Valuations have cheapened from elevated levels to compensate for a 'normal' recession. Overall, spread risk looks attractive on a medium term horizon, however caution is warranted due to uncertainty being at or above Financial Crisis levels.	▪ Major economies cannot 'flatten the curve' of COVID-19 and 'recession' becomes 'depression' ▪ Fiscal and monetary stimulus is extremely successful and buoying demand and there is significant innovation on the medical fight against COVID-19
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)	E EM 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	▪ Technicals in other credit markets are exaggerated in EM, leaving the current market extremely challenged. ▪ Many oil exporters use the proceeds to fund their government and/or maintain currency valuations, which are now under pressure ▪ 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 continues, a key source of demand for many economies will be back	▪ COVID-19 begins to spread 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	▪ Fundamentals have worsened, like in all credit sectors, but not as uniformly as spreads have widened. But, companies still have levers to pull to prevent the most dramatic of credit deterioration. ▪ Valuations are as attractive as any time since 2009. ▪ The potential for Corporate QE in the US & expansion in Europe is beginning to be discussed and would be a significant technical tailwind.	▪ The existing Fed credit facilities do not alleviate the market's liquidity problems. ▪ Prolonged recession begins to weaken even the strongest business models and balance sheets.
High Yield Credit	Under-weight -2 -1 0 +1 +2 Over-weight	▪ HY remains an energy-heavy sector, and these energy companies are extremely vulnerable to prolonged periods of WTI crude <$50. HY companies are rated as such because of their vulnerability to recession. This gives us caution. ▪ Valuations imply a 9% default rate, and it may get worse in the short term. But historically, these spread levels imply strongly positive returns 6-12 months in the future	▪ Prolonged COVID-19 related slump in activity would hurt there 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 quickly deteriorating fundamentals ▪ The precipitous decline in mortgage rate + weaker household balance sheet leads to worse fundamentals	▪ Interest rates continue falling aggressively ▪ Bonds will underperform other spread products in a sharp risk-on move
Non-Agency MBS & CMBS	Under-weight -2 -1 0 +1 +2 Over-weight	▪ Households entered 2020 in a relatively healthy pace, but they are being put to the test relatively quickly with unemployment expected to rise sharply. ▪ Direct fiscal stimulus (checks to households) during 'social distancing' may not bring back service jobs, but it can lessen the blow and prevent widespread delinquencies and bankruptcies ▪ The CMBS market is understandably taking a hit from less shopping and travel, however valuations are widening to match these expectations. Many of these structures have robust credit enhancement and are attritive high quality assets	▪ Consumer behaviour and employment are fundamentally changed by even a brief, successful 'social distancing' effort. ▪ Housing – which was set up for a great 2020 – starts to feel pressure
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