COLUMBIA THREADNEEDLE INVESTMENTS

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In Credit

22 JUNE 2020

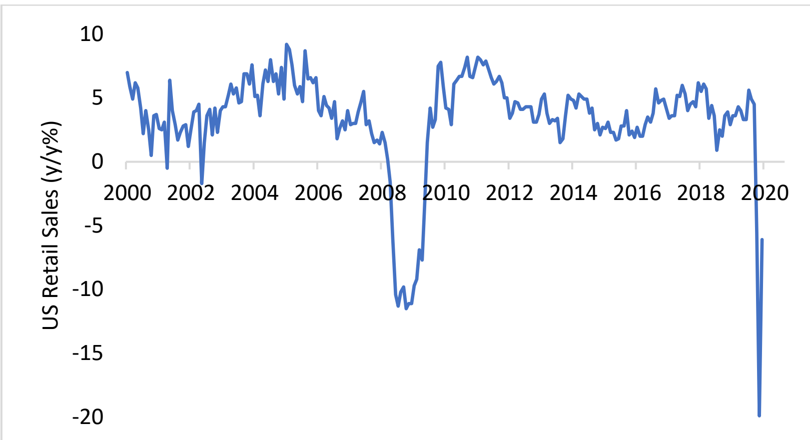
What shape recovery?

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	0.69%	-1 bps	-0.3%	8.6%
German Bund 10 year	-0.44%	0 bps	0.0%	1.9%
UK Gilt 10 year	0.21%	0 bps	-1.5%	8.6%
Japan 10 year	0.01%	0 bps	-0.3%	-0.8%
Global Investment Grade	156 bps	-9 bps	1.7%	3.1%
Euro Investment Grade	142 bps	-3 bps	1.4%	-1.2%
US Investment Grade	157 bps	-12 bps	2.0%	4.8%
UK Investment Grade	146 bps	-4 bps	0.7%	2.8%
Asia Investment Grade	278 bps	2 bps	1.2%	2.8%
Euro High Yield	536 bps	-18 bps	2.4%	-4.5%
US High Yield	602 bps	-26 bps	2.6%	-3.2%
Asia High Yield	722 bps	-10 bps	3.3%	-0.3%
EM Sovereign	426 bps	-12 bps	2.9%	-1.9%
EM Local	4.6%	-5 bps	1.1%	-6.3%
EM Corporate	440 bps	-5 bps	2.6%	-0.3%
Bloomberg Barclays US Munis	1.5%	0 bps	0.6%	1.9%
Taxable Munis	2.5%	-9 bps	2.6%	7.2%
Bloomberg Barclays US MBS	75 bps	14 bps	-0.2%	3.4%
Bloomberg Commodity Index	137.92	1.4%	1.6%	-19.9%
EUR	1.1214	-0.7%	0.7%	-0.3%
JPY	106.91	0.5%	0.9%	1.6%
GBP	1.2399	-1.5%	0.1%	-6.8%

Source: Bloomberg, Merrill Lynch, as at 22 June 2020.

Chart of the week: US Retail Sales (year-on-year) 2000-2020



Source: Macrobond and Columbia Threadneedle Investments, as at 22 June 2020.

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It was a week of data releases and an opportunity to get a glimpse as to whether an economic recovery is underway. The evidence would so far suggest that this is the case.

Specifically, US retail sales shocked with their strength. They grew nearly 18% in just a month, which was double what was expected, led by auto sales. Likewise, the Philadelphia Fed report saw a record jump higher to 27.5 from -43.1 (s**ee Chart of the Week**). May industrial production was up by 1.4%, which was positive but less than expected. Meanwhile, there was only a modest improvement in the Initial and Continuing Jobless Claims reports.

In the UK, the Bank of England voted unanimously to keep interest rates at 0.1% and to increase the stock of asset purchases by £100 billion to £745 billion. Meanwhile, UK retail sales also rebounded strongly and were up 12% month-on-month, though are still down around 13% annually.

Investment grade credit

Spreads were tighter through the week. The US Federal Reserve is "back in town". It reminded the market that it will buy short-dated corporate debt of US IG companies and some fallen angels. We knew this already, but it served as support for a market that was becoming more fragile in the face of rising Covid-19 cases in southern US states. As mentioned, this support pushed spreads tighter with the US market outperforming globally as a result. It was a bumper week for new issuance, meeting what has been strong investor demand for the asset class.

High yield credit

US high yield bond prices recovered a portion of last week's decline as a recovery in the economy and a Fed backstop offset increased evidence of rising Covid-19 cases in certain parts of the country and globally. Additionally, investors absorbed the largest weekly new-issue calendar on record as conditions continue to thaw rapidly in capital markets. The ICE BofA US HY CP Constrained Index returned 0.84% and spreads were 25bps tighter over the week. The asset class reported its seventh consecutive weekly inflow in excess of $1 billion, with $1.2 billion entering retail funds over the week.

European high yield returned to rallying mode as spreads tightened 18bps, finishing at 536bps. Inflows continued as €346 million was invested into the asset class week, largely into ETFs (€266 million). The primary market was strong last week with issuance by names such as Spanish telecoms operator Cellnex, Mexican building materials firm Cemex, UK chemical firm Synthomer, and Virgin Media, which marks the third week of issuance in a row for the media firm.

A new fallen angel is Schaeffler, the German auto parts company, which was downgraded by Moody's from Baa3 to Ba1, stable outlook. This came as Moody's wrapped up its auto sector review, affirming a negative outlook for the sector but only downgrading Schaeffler.

Expectations around defaults have started to retreat with JPMorgan lowering its default rate expectations to 4%. S&P and Moody's are still calling 8% their base case.

In issuer-specific news, Atlantia, the Italian infrastructure operator, is now asking the European Commission to intervene with the Italian government on Autostrade as there is still isn't a resolution on the highway concessions which will have to be handed back at the end of June when the new law comes into effect. ThyssenKrupp finally received EU approval for its elevator company sale. In the continuing story of Hertz, which was declared bankrupt last month, the firm's attempt to issue equity to raise cash, an unusual case for a chapter 11 firm, has been blocked by the SEC.

Leveraged loans

Leveraged loans lagged the recovery in bonds over the past week, after holding in relatively well during the course of the prior week's sell-off.

Referencing the JP Morgan leveraged loan Index, loan prices increased +$0.12 to $92.16 over the past week, with the average price for BB loans unchanged at $96.35, single B loans increasing +$0.28 to $94.38, and split B/CCC increasing +$0.56 to $75.38. Meanwhile, loan yields and spreads (three-year) decreased 6bp and 5bp respectively over the past week to 6.81% and 653bp, which compares with a range since mid-May of 6.62%-8.53% and 634bp-826bp. The leveraged loan index has gained +2.26% in June with double B (+1.45%) and single B (+2.21%) loans underperforming CCC (+5.46%) loans. The asset class reported a $563 million outflow for the week, the largest in more than two months.

Structured credit

Agency MBS posted slightly negative total returns last week, down 25bps, which dragged month-to-date returns down to -17 bps.

The Fed has purchased more than $750 billion of mortgages, or $550 billion on a net basis, year-to-date. At its June meeting the Federal Open Market Committee affirmed a pace of $40 billion on net purchases per month, which will increase its overall share of the market to 35% by year-end. In the non-qualified market, several new deals came to market last week, presumably to clear warehouse lines caught up in the pandemic. Volumes also picked up somewhat in RPLs/NPLs and spreads are tighter, leaving the curve lower and flatter than it was in late April/early May. The fundamental outlook for residential properties continues to improve. Home price appreciation is solid given strong demand and low supply. Forbearance remains in check versus expectations earlier in the year, with roughly 40% of borrowers in forbearance still making payments. And in the single-family rental market the number of properties for rent has surged and average weeks on the market remains low.

Emerging markets

Emerging markets also rallied last week as hard currency sovereign spreads tightened 12bps. EM corporates followed suit, though more moderately, coming in only 5bps tighter. However, demand for the asset class took a pause as it experienced outflows of $163 million, mainly driven by local currency outflows as hard currency funds experienced a small inflow (+$97 million). Much of the selling was in ETFs (-$249 million).

In credit rating news, a noteworthy exception in these markets and times was Moody's upgrade of Ukraine's country rating from Caa1 to B3. The rating agency cited both the easing of the country's funding challenges and the support from the IMF's new financing program, which the agency sees as helping secure the reform achieved so far.

Central bank rate cuts this past week were by Brazil (-75bps to 2.25%), Indonesia (-25bps to 4.25%) and Russia (-100bps to 4.5%, the largest rate cut in five years). Further rate cuts are still on the table. In LATAM, Argentinian province Mendoza defaulted, while the federal government and bond holders are still far apart on a deal regarding the reprofiling on the sovereign debt. The deadline for an agreement has been extended to July. News was more positive in Chile as the country's central bank topped the original rescue plan (funding for credit facility or FCIC) of $12 billion, with an additional $16 billion. The program will be paid for by savings and via the issuance of new debt. Additionally, the central bank announced a "Special asset purchase" program, up to $ 8 billion. Details will be announced in the coming days.

Asian fixed income

Rating agency Fitch has revised India's BBB- ratings outlook from stable to negative. Fitch's ratings action is not surprising given the agency has flagged the deterioration in India's sovereign debt level, fiscal deficit and the sharp drop in growth over the past few months. Specifically, Fitch expects general government debt to rise to 84.5% of GDP in FY21 from its estimate of 71% of GDP in FY20. Fitch highlighted that this is substantially higher than the median of 42.2% of GDP in the BBB category in 2019.

Reliance Industries is reportedly close to a transaction to acquire stakes in certain entities of Future Group. In May, Amazon was reported to be weighing making additional investments in Future Retail.

Moody's has concluded its "review for downgrade" for the Indian airports, which was initiated on 25 March. Moody's downgraded GMR Hyderabad Airport to B2 with a negative outlook (previous: Ba1 Rfd) because its financial metrics were significantly impacted by the tariff cut in April 2020, the additional debt to complete the airport expansion and the decline in airport traffic due to the Covid-19 epidemic. For Delhi Airport, Moody's retained the Ba3 rating but cut the outlook to negative (previous: outlook Rfd) because of the uncertain recovery in airport's traffic and India's weaker economic conditions.

Commodities

Commodities also rallied as the index rose 1.4%, led by energy, as crude oil prices rose 8%, breaching $40 a barrel, again. The asset class was also supported by the general rally in metals, both base and precious, with gold touching $1,745 per oz by the end of the week.

This week's Department of Energy figures showed that demand is recovering, albeit slowly. However, with oil prices back to $40 a barrel level, shale production is also starting to come back on-line. Supporting oil prices towards the end of the week was news that OPEC+ reached an agreement to enforce compliance of the production cuts. Additionally, the oil rig count across the US fell to an 11-year low of 189. This compared to 12 months earlier when there were 789 oil rigs operating. There is also some concern that the earlier sharp cuts in production, as well as cuts in Capex, may compromise the market's ability to produce enough crude oil when the increase in demand finally materialises.

The market noted an unprecedented physical demand for gold coming from the US, which for once was surpassing India and China. This will likely underpin the market for the immediate future.

Agriculture was mixed with soybean prices supported by the steady buying from China. The country imports 90% of its soybeans, largely from Brazil and the US. Due to concerns of possible supply disruptions around Covid-19, China has been a steady buyer these last months.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

22nd 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, 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 ■ 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. There has been improvement in .. ■ 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, although fundamentals are better than expected ■ 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 ■ u/w Cotton	■ Oil production disruption

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Source for all data and information is Bloomberg as at 22.06.2020, unless otherwise stated.

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