COLUMBIA THREADNEEDLE INVESTMENTS

Your success. Our priority.

In Credit

4 MAY 2020

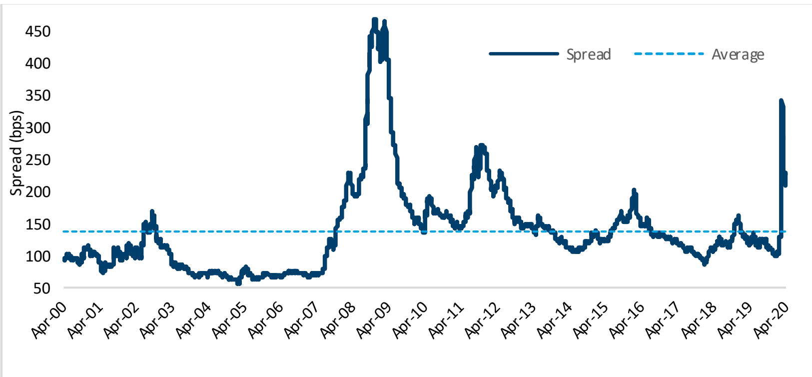
The storm before the storm.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	0.61%	1 bps	0.4%	9.2%
German Bund 10 year	-0.56%	-9 bps	1.1%	3.2%
UK Gilt 10 year	0.24%	-5 bps	3.2%	9.6%
Japan 10 year	-0.02%	0 bps	0.4%	-0.1%
Global Investment Grade	209 bps	-16 bps	4.64%	0.0%
Euro Investment Grade	183 bps	-13 bps	3.6%	-2.7%
US Investment Grade	218 bps	-18 bps	5.3%	0.8%
UK Investment Grade	173 bps	-10 bps	4.7%	1.1%
Asia Investment Grade	303 bps	3 bps	0.7%	0.2%
Euro High Yield	673 bps	-6 bps	5.9%	-9.5%
US High Yield	770 bps	-33 bps	3.8%	-10.1%
Asia High Yield	832 bps	-12 bps	5.0%	-6.6%
EM Sovereign	556 bps	-34 bps	2.2%	-9.8%
EM Local	4.9%	-16 bps	3.9%	-12.8%
EM Corporate	541 bps	-19 bps	4.1%	-6.5%
Bloomberg Barclays US Munis	2.2%	9 bps	-1.3%	-1.6%
Taxable Munis	2.8%	4 bps	2.3%	2.4%
Bloomberg Barclays US MBS	41 bps	-17 bps	0.6%	3.5%
Bloomberg Commodity Index	128.96	0.8%	-1.5%	-24.7%
EUR	1.0931	1.5%	-0.7%	-2.1%
JPY	106.78	0.6%	0.3%	1.6%
GBP	1.2447	1.1%	1.4%	-5.7%

Source: Bloomberg, Merrill Lynch, figures as at 30 April 2020.

Chart of the week: Global investment grade spreads, 2000-2020



Source: ICE BoAML Indices, Columbia Threadneedle Investments, as at 30 April 2020.

David Oliphant
Executive Director,
Fixed Income

'In Credit' contributors

David Oliphant
Macro / Government bonds, Investment Grade credit

Angelina Chueh
Euro High Yield credit, Emerging Markets, Commodities

Chris Jorel
US High Yield credit

Katherine Nuss
US Investment Grade credit

Kris Moreton
Leveraged Loans
Structured Credit

Justin Ong
Asian Fixed Income

Doug Rangel
Municipals

3069863 Issued May 2020 | Valid to end July 2020

Macro / government bonds

Core government bond yields were flat to lower on the week.

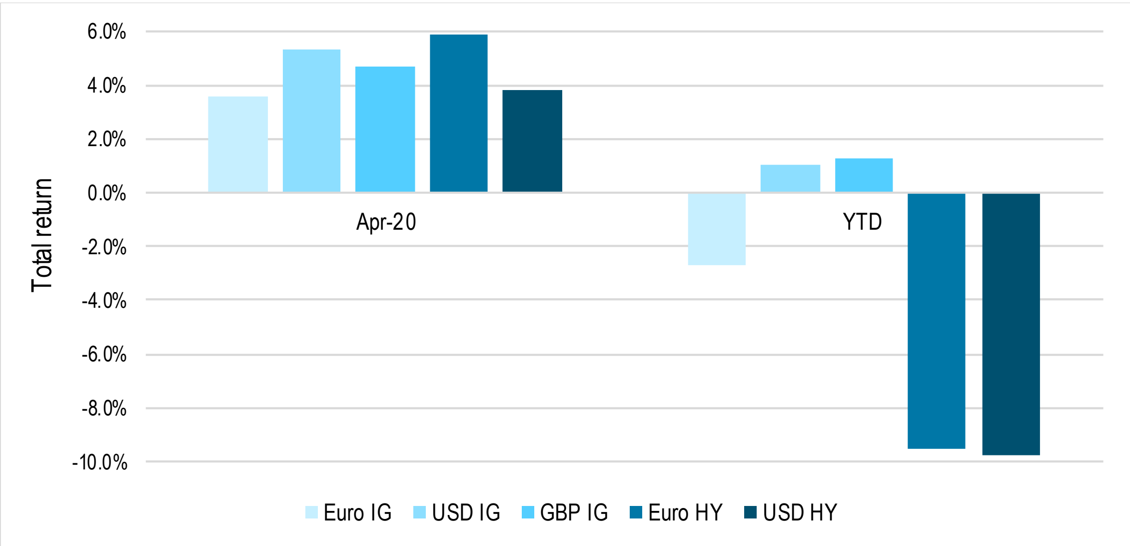
The benchmark US 10-year treasury note ended April with a yield of 0.64% and is about 1.3% lower than at the end of 2019. Hence, holdings of these so called 'risk-free' assets have delivered a strong positive return so far this year, with the US Treasury index up over 9% year-to-date. The long maturity index (over 15 years) is up nearly 23% so far in 2020.

The storm before the storm. We have been expecting grim economic data and were duly delivered a raft of said news. The Q1 20 GDP report from the US recorded an abrupt end to the expansion with a contraction of 4.8% (the worst since Q4, 2008) and a sharp decline in personal consumption of 7.6% (worst since 1980). The eurozone data showed a contraction of 3.8% in the first three months of the year (worst since 1999). The same data for Q2, 2020 will be much worse for both the US and Europe.

Credit market performance – April 2020

April was a return to form with strong positive returns reported in all markets. Credit markets outperformed risk free assets with spreads materially tighter, while investment grade (IG) outperformed high yield on a risk-adjusted basis. US dollar IG was the real standout with spreads over 30% tighter in the month and short maturity (1-5 year) spreads 40% tighter. Year-to-date, the effects of duration can be felt in US dollar IG where total returns are now positive for the year as a whole. The index has a duration of eight years.

Credit market total returns – April 2020



Source: ICE BoAML Indices, Columbia Threadneedle Investments, as at 30 April 2020.

Investment grade credit

Investment grade spreads continue to contract. **The chart of the week** plots the spread of the global corporate bond index over government bonds for the past 20 years. The spread at the end of April is around one standard deviation (SD) wide of the long-term average. This measure of value reached three SDs cheap in late March from around 0.5 SDs expensive in January 2020.

Attractive market valuations and a co-ordinated policy response that has impressed in its speed, scale and scope to the Covid-19 pandemic have overwhelmed the fears about the economic reality outlined earlier.

In company news, there remains numerous examples of credit supportive actions including dividend cuts (eg, Shell first time since WW2) and abandoned share buybacks, but plentiful ratings downgrades. In recent weeks companies downgraded by the ratings agencies include Boeing, Disney, Anglo American, Deutsche

Telecom, Daimler and Engie. European bank earnings followed the trend set in the US; financial markets businesses have been strong but there is a rise in expected credit losses, increased demand for corporate liquidity and rising deposits.

The primary market pipeline remains healthy and it is noteworthy that new issue premia have fallen from the illiquid market conditions that prevailed at the start of the month.

High yield credit

US high yield bond prices traded off over the past week amid heavy issuance, weak economic data, ambiguous earnings and historic volatility in oil prices.

US high yield bond prices edged higher over the past week as the earnings season gathered pace and countries prepare to relax lockdowns. The total return for the ICE BofA US High Yield Cash Pay Constrained Index for the week was 0.54% and spreads were 34bps tighter. New issue activity slowed off its strong pace with eight deals totalling $3.75 billion pricing over the past week. While April's gross volume of $35.7 billion was a little above a typical April (avg. $32 billion since 2010), the net issuance figure of $27.6 billion was the second highest monthly total on record as issuers used proceeds to bolster liquidity. According to Lipper, the asset class reported inflows of $743 million, which extends the inflow streak to five weeks and a total of $19.6 billion.

European high yield saw spreads tighten in 6bps last week, finishing at 673bps.

This takes the spread back down 331bps from the widest level seen in March. Inflows last week were €221 million with €171 million via ETFs. The big movers last week were in the car rental space. The market news was very idiosyncratic with Hertz, on one end, in negotiations with lenders after the firm missed their lease payments on their fleet. On the other end of the spectrum, Europcar finalised a second tranche of financing, guaranteed by the Spanish government worth €31.25 million. France also confirmed a government guaranteed €220 million loan. Continuing on the auto front, Renault, a 2020 Fallen Angel, received EU approval for a French government €5 billion loan allowance. Last week's market focus was on index rebalancing given the March postponement of this normally monthly exercise. Eight new names entered the European high yield indices at the end of the week, amounting to €40 billion in outstanding bonds, making up 7% of the index. Year-to-date, the index has increased 12% due to Fallen Angels.

Leveraged loans

The US leveraged loan sector posted a strong April following a dismal March.

Prices increased +$3.00 on average to $85.69 boosting total return for the month to +4.2%. Returns favoured riskier sectors, those beaten up most in March, including Energy, Information Technology, Gaming, Metals and Mining and Consumer Non-durables. That said, more conservative sectors such as Utilities and Food & Drug also posted significant gains. Yields to a 3-year take-out are now in the 8.8% range, down from 10.3% in late March and spreads are 847bps. Loan new issue activity resurfaced in the final week of the month after remaining dormant since the sell-off. Leveraged loan volume totalled $7.7 billion in April, compared to $4.3 billion in March, with both representing the lightest activity since January 2012. Defaults are rising; a record 19 companies filed for bankruptcy or missed an interest payment in April, and one company completed a distressed exchange. The affected $35.7 billion impacted $24 billion in high yield bonds and $11.7 billion in loans and represented the fifth largest monthly default volume on record. For loans, the par-weighted default rate ended April at 2.97% which is a 5-year high. Investor inflows were short lived with an outflow last week to the tune of $204 million across mutual funds and ETFs.

Municipals

Municipal yields continued to gravitate higher over the course of the week until Friday's session brought a bit of a firmer tone.

Excess returns for the month of April ended down -1.84%, and the continued underperformance versus US treasuries pushed muni/treasury yield ratios higher with 5-year and 10-year ratios ending the month at 319% and 235% respectively. Though flows out of the asset class appear to have slowed, the municipal market was left to contend with pressure from other sides, namely the return of the new issue calendar and headline driven volatility from Washington. Without consistent inflows to help digest the new issue calendar, new supply (primarily high-grade issuers) has generally created weakness in the secondary markets as investors take the opportunity to trade up-in-quality on the margins. Political infighting over the size and scope of additional stimulus funds for states also created a bit more concern over the stretched budgets of state and local governments. On the positive side, delay from Congress prompted the US Federal Reserve to revise and expand its Municipal Liquidity Facility, broadening the scope of issuers who can tap the liquidity facility, though not increasing the overall size of the program.

Emerging markets

Last week, the asset class saw hard currency spreads tighten 30bps while EM corporate spreads were 10bps tighter. There was $ 1.5 billion of outflows for the week, taking year-to-date outflows to €32.5 billion.

South Africa experienced another credit down grade last week, this time by S&P who moved their rating to BB- (the lowest of the three rating agencies) from BB stating this was due to Covid-19 related issues. The rating agency sees the current lockdown causing quite a negative headwind to GDP with an expectation that the economy will shrink by 4.4% by the end of 2020. It forecasts the fiscal deficit rising to 13.3% (widest in the country's history).

EM countries are getting into the act of implementing their form of QE. Russia said it was considering a money printing mechanism to allow state-controlled lenders to buy government bonds, which could then be passed to the central bank for repo funding. So far, South Africa and Indonesia both have some sort of monetisation mechanism. These government programmes can be supportive for local bonds, but inevitably, add negative pressure to the local currency.

Asian fixed income

Melco Resorts has abandoned its plans to invest in Crown Resorts due to the impact of Covid-19 and the suspension of operations in Macau. China Merchants Group (CMG) is reportedly exploring the potential of privatizing China Merchants Port Holdings, which is currently 63% owned by CMG. S&P has also lowered the A- ratings outlook of China National Travel Service Group Ltd and China Travel Services HK to 'negative' due to the significant impact of Covid-19 and the uncertainty regarding its recovery.

In India, Reliance Industries plans to issue $7.1 billion of new shares in a rights offering, which will support the company's plan to reduce its net debt to zero by early 2021. The Indonesia credit market was impacted by a series of negative ratings action. S&P downgraded Alam Sutera from B- to CCC+ with a 'negative' outlook due to the lack of progress in the company's refinancing plans for the $175 million notes due April 2021. S&P also downgraded several SOEs (state-owned enterprises) in Indonesia. On 20 April, S&P lowered the Indonesia sovereign ratings outlook to 'negative'. S&P expects the Indonesian government to be more discerning in extending support to the various SOEs. In this regard, S&P expects lower scope for government support to these three SOEs due to the profitable and commercial nature of their operations. Moody's also downgraded the Ba2 ratings of Saka Energi to B1 with a 'negative' outlook. Moody's views the strategic importance of Saka to its parent Perusahaan Gas Negara (PGN) to have weakened, following PGN's plan to restructure its subsidiaries and focus on its midstream and downstream businesses. Saka operates in the upstream segment of producing feedstock for PGN's gas pipeline – the upstream segment is viewed as less strategic.

Commodities

The index returned 0.8% for last week, mainly led by energy, which rallied 3% as crude oil prices rose 22% as production cuts by Norway and OPEC+ went into effect last week.

Also supporting the energy rally was the EIA (Energy Information Administration) report showing a smaller than expected rise in crude oil inventory (9 million barrels vs 9.8 million barrels) On a more worrisome front, storage facilities are nearing capacity as indicated by a report on Cushing, Oklahoma oil hub, the storage home for WTI crude oil. Also causing a bit of volatility for crude oil prices last week was the decision by S&P to roll all of its oil index contracts from June to September in one day, last week, as versus over the normal 5-day period. Precious metals were negative last week as gold prices fell, but still held just above $1700.00/oz.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

4th 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