

# In Credit

3 FEBRUARY 2020

## Europe GDP – Low and difficult to grow

### Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	1.54%	-15 bps	2.6%	2.6%
German Bund 10 year	-0.43%	-10 bps	2.0%	2.0%
UK Gilt 10 year	0.53%	-4 bps	3.8%	3.8%
Japan 10 year	-0.06%	-4 bps	0.4%	0.4%
Global Investment Grade	107 bps	7 bps	2.0%	2.0%
Euro Investment Grade	95 bps	3 bps	1.1%	1.1%
US Investment Grade	109 bps	8 bps	2.4%	2.4%
UK Investment Grade	108 bps	2 bps	2.8%	2.8%
Asia Investment Grade	200 bps	9 bps	1.5%	1.5%
Euro High Yield	356 bps	19 bps	0.1%	0.1%
US High Yield	403 bps	35 bps	0.0%	0.0%
Asia High Yield	568 bps	29 bps	0.7%	0.7%
EM Sovereign	299 bps	7 bps	1.7%	1.7%
EM Local	5.0%	-9 bps	-1.3%	-1.3%
EM Corporate	322 bps	10 bps	1.5%	1.5%
Bloomberg Barclays US Munis	1.5%	-6 bps	1.8%	1.8%
Taxable Munis	2.6%	-15 bps	5.5%	5.5%
Bloomberg Barclays US MBS	48 bps	7 bps	0.7%	0.7%
Bloomberg Commodity Index	159.03	-3.2%	-7.4%	-7.4%
EUR	1.1061	0.6%	-1.1%	-1.1%
JPY	108.57	0.8%	0.2%	0.2%
GBP	1.3099	1.0%	-0.4%	-0.4%



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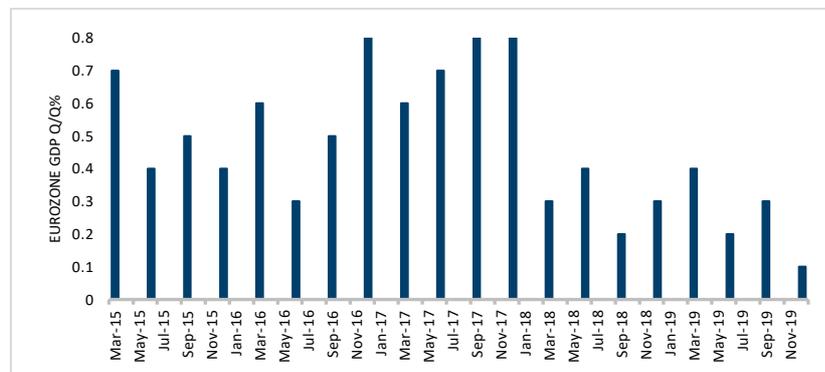
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Source: Bloomberg, Merrill Lynch, as at 3 February 2020 for the month of January 2020.

### Chart of the week: Eurozone quarterly GDP, 2015-2019



Source: Bloomberg, Columbia Threadneedle Investments, as at 31 January 2020.

## Macro / government bonds

Financial markets remain driven by the fear of the spread of the coronavirus that originated in China. As the number of cases reported rose so equity markets fell, and core bond markets rallied. This comes at a time when the monetary policy toolkit is fairly empty and market valuations are rather full. We will not have a clear picture of the impact of the virus on economic data for a few weeks yet.

In other news, the US economy expanded at a 2.1% annualised rate in Q4, 2019 – close to expectations and the same rate recorded in Q3. The core inflation measure was low at 1.3%, down from 2.1%. Consumer sentiment rose to 131.6, which exceeded market expectations (128.0) in the best reading since late 2018. Finally, the Chicago PMI dipped to 42.9 (from 48.2) most likely driven by the halt in production of the Boeing 737MAX.

Consumer confidence also rose in Germany and France last week but that was where the good news ended in the eurozone last week. GDP data for Italy presented a contraction of 0.3% q/q (forecast +0.1%) while France fell by 0.1% in the first negative reading since Emmanuel Macron came to power. The European economy, as a whole, grew by 0.1% in the last three months of the year - [see chart of the week](#).

In the UK, the Bank of England kept policy rates unchanged (0.75%) at the last MPC meeting with Mark Carney as Governor (he will be replaced by Andrew Bailey in March). The committee voted by a 7:2 margin. This was good news for sterling, which ended the week higher.

## Investment grade credit

Global investment grade credit spreads ended the week wider.

Having traded below 100bps over government bonds a week or so ago spreads are now around 8% wider. This was driven by the rising risk aversion described earlier. Sectors of particular weakness included commodity and travel related areas of the market.

Fund flows remain positive though gross supply was at record levels in January. The UK market performed the strongest in the last month during a post-election honeymoon period.

## High yield credit

US high yield bond prices were also modestly lower over the past week amid heavy primary activity and as investors assess the growth risks surrounding the coronavirus outbreak.

A considerable \$12.7 billion of high yield issuance priced over the past week following an eight-week high of \$12.1 billion the prior week. As such, month-to-date high yield bond issuance now totals \$33.1 billion, albeit only \$5.3 billion net of refinancing. For reference, high yield primary markets priced \$17.6 billion in January 2019, and January has averaged \$26.6 billion since 2010. The asset class reported a \$719 million inflow. This was the third consecutive inflow according to Lipper.

The price action was similar in Europe with spreads wider by around 11% from the tightest spreads of the year with weakness felt in similar areas as in investment grade credit.

## Leveraged loans

Demand for US leveraged loans soured quickly last week alongside other risk assets.

The sector reported its biggest mutual fund outflow since October 2019 (according to JP Morgan). Yield to a 3-year take-out now sits just under 6% and at a spread of 458bps over Libor. Asset managers also made a decided shift back towards upper-tier loans. This week should be interesting with more data prints (ISM, PMI, Auto Sales, Jobless claims, etc) and the much anticipated first round of the US presidential elections, aka the Iowa caucuses.

## Emerging markets

Emerging market spreads were over 20bps wider in the last month. Hard currency outperformed local currency markets.

As in the other credit markets most weakness was exhibited in higher risk, commodity dependent areas (e.g. Ecuador which was wider by around 100bps).

## Asian fixed income

China has responded to the economic pressure from the coronavirus outbreak by injecting more liquidity into its financial system. The PBoC, Ministry of Finance, China Securities Regulatory Commission and other regulatory bodies announced a package of 30 financial measures. These include open market operations, the provision of CNY300 billion funds to banks in affected regions, and the extension of credit support to manufacturers in the health and medical sector. The PBOC also plans to provide CNY1.2 trillion via reverse repo operations to the banking sector.

The Indonesian Supreme Court's decision to hold Saka Energi liable for taxes and penalties of \$255.4 million will weaken Saka's liquidity position. The Supreme Court's ruling reversed the Tax Court's decision, which was in favour of Saka. Consequently, Moody's placed the Ba2 ratings on Saka Energi on review for downgrade. Fitch has also highlighted the credit negative implication of the tax liabilities on Saka's Energi BB+ (Negative Outlook) rating albeit there was no immediate ratings action. Saka Energi plans to pursue legal avenues to counter the ruling. On a related note, S&P affirms PGN's BBB- rating but it cut the SACP (stand-alone credit profile) from "bbb-" to "bb+". PGN wholly owns Saka Energi. While S&P expects the parent PT Pertamina to continue to provide extraordinary support to PGN, S&P expects PGN's stand-alone credit profile to come under pressure from Saka's weak operating performance and the tax liabilities. In the Indonesia high yield property sector, Moody's has downgraded Alam Sutera from B2 to B3 to reflect the deterioration in financial metrics and liquidity from the slowdown of its land sales to China Fortune Land Development.

## Commodities

Commodity prices were lower over the week driven by the energy complex. Precious metals bucked this trend and were modestly stronger over the week.

## Summary of fixed income asset allocation views

### Fixed Income Asset Allocation Views

3<sup>rd</sup> February 2020



Strategy and positioning (relative to risk free rate)	Views	Risks to our views
<b>Overall Fixed Income Spread Risk</b> 	<ul style="list-style-type: none"> <li>Global economic data continues to register at low or contractionary levels across many sectors and regions. There are modest signs of stabilization, however spread levels appear to reflect this already. Trade headlines continue to fly back &amp; forth, but we see risks that are more fundamental than these.</li> </ul>	<ul style="list-style-type: none"> <li>Fast and fierce fiscal stimulus, especially in Europe or China.</li> <li>Reacceleration of growth trends</li> </ul>
<b>Duration (10-year)</b> (P = Periphery) 	<ul style="list-style-type: none"> <li>Coronavirus risks derailment of nascent global recovery</li> <li>Manufacturing uptick may have been leveling off anyway</li> <li>Phase One trade deal fulfilment unrealistic</li> <li>Lower pace of US growth expected this year</li> <li>Policy normalisation remains</li> </ul>	<ul style="list-style-type: none"> <li>Global trade détente stimulates improvement in risk sentiment</li> <li>Chinese efforts to successfully contain virus with minimal growth disruption</li> <li>US economy stages consumption-driven cyclical upswing</li> </ul>
<b>Currency</b> (E = European Economic Area) 	<ul style="list-style-type: none"> <li>The Dollar is richly valued on the basis of growth outperformance and high carry. With the US economy catching down and the Fed cutting rates, the twin pillars of support should give way to the structural drag of the twin deficits</li> <li>An improvement in global risk sentiment due to progress on Phase 1 trade deal may undermine some of the dollar's 'safe haven' demand.</li> </ul>	<ul style="list-style-type: none"> <li>Further leg lower in global growth driven by increasing trade frictions.</li> </ul>
<b>Emerging Markets Local (rates (R) and currency (C))</b> 	<ul style="list-style-type: none"> <li>EM real interest rates still relatively attractive</li> <li>EM growth likely to outperform DM, while inflation benign</li> <li>Fiscal and external fundamentals still largely sound</li> </ul>	<ul style="list-style-type: none"> <li>Sharp escalation in global risk aversion</li> <li>Broad dollar strength</li> </ul>
<b>Emerging Markets Sovereign Credit (USD denominated)</b> 	<ul style="list-style-type: none"> <li>Fundamentals have been not deteriorated as much as would have been expected given a strong USD and catering global trade</li> <li>While spreads have tightened much like other asset classes, pockets of valuations gaps have open-ended up</li> <li>The number of idiosyncratic blow-ups is increasing. First Argentina, now Ecuador and Lebanon are precipitously deteriorating</li> </ul>	<ul style="list-style-type: none"> <li>Oil &amp; commodity rally will boost sentiment and current account balances.</li> <li>A rapidly weakening USD will ease financial conditions</li> <li>Reversal of recent electoral trend towards market-friendly candidates.</li> </ul>
<b>Investment Grade Credit</b> 	<ul style="list-style-type: none"> <li>Broad valuations have become unattractive on an absolute basis, even before considering higher debt levels and decelerating growth</li> <li>Fundamentals don't show signs of imminent crisis, but several of the tailwinds are fading. Valuations look even more offside when considering this</li> </ul>	<ul style="list-style-type: none"> <li>A re-acceleration of growth especially in the more downturned European and Asian economies</li> <li>Beneficial technicals from low and negative yields globally continue to funnel cash to the market.</li> </ul>
<b>High Yield Credit</b> 	<ul style="list-style-type: none"> <li>Valuations are unattractive relative to other asset classes.</li> <li>Forecasted default rates have started rising faster than expected earlier this year.</li> <li>Technicals remain positive as net supply remains very negative through rising stars &amp; called bonds.</li> </ul>	<ul style="list-style-type: none"> <li>Oil quickly rebounds, likely from supply side shocks.</li> <li>US fiscal stimulus or unexpectedly large sentiment boost from trade war resolution boosts valuations.</li> </ul>
<b>Agency MBS</b> 	<ul style="list-style-type: none"> <li>Prepayments have increased as a result of lower rates, however they have lagged expectations given the fall in Treasury yields.</li> <li>Spreads have widened to near post-GFC widths despite relatively muted prepayment activity.</li> </ul>	<ul style="list-style-type: none"> <li>Interest rates continue falling aggressively as they did through the summer</li> <li>Rate volatility increases.</li> </ul>
<b>Non-Agency MBS &amp; CMBS</b> 	<ul style="list-style-type: none"> <li>Fundamentals remain relatively strong as the Household balance sheet is strong and house price appreciation is still positive.</li> <li>Leverage trends within these sectors have continued to be contained, especially compared to rising asset valuations.</li> <li>Valuations in CMBS are notably less attractive than non-agency MBS.</li> </ul>	<ul style="list-style-type: none"> <li>Tightening in credit conditions for US consumer.</li> <li>Housing activity begins to contract.</li> <li>Stress in traditional mall-based retail becomes more entrenched across the board.</li> </ul>
<b>Commodities</b> 	<ul style="list-style-type: none"> <li>o/w Cu vs Zinc</li> <li>o/w Corn vs u/w Wheat</li> <li>o/w Brent vs WTI</li> <li>o/w Platinum vs Aluminium</li> <li>o/w Gasoline vs Distillates</li> <li>o/w Silver</li> </ul>	<ul style="list-style-type: none"> <li>Material China slow down, weighing on economic growth, metals &amp; petrol</li> </ul>

**Important information: For investment professionals only, not to be relied upon by private investors.**

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