COLUMBIA THREADNEEDLE INVESTMENTS

Your success. Our priority.

In Credit

10 FEBRUARY 2020

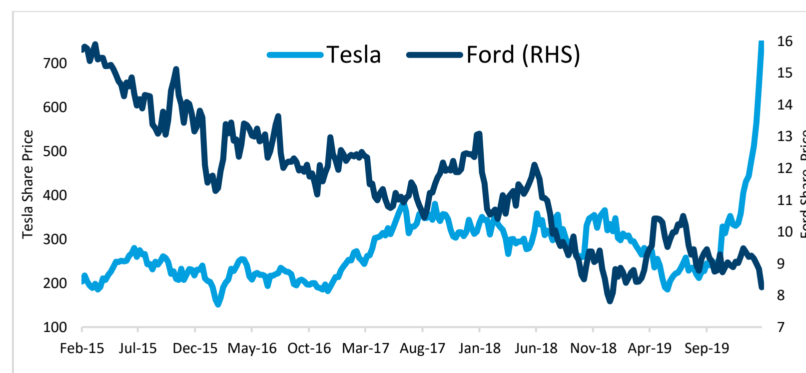
Out with the old, in with the new.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	1.57%	7 bps	-0.3%	2.3%
German Bund 10 year	-0.40%	4 bps	-0.5%	1.5%
UK Gilt 10 year	0.57%	5 bps	-0.6%	3.1%
Japan 10 year	-0.06%	1 bps	-0.2%	0.2%
Global Investment Grade	103 bps	-4 bps	0.1%	2.0%
Euro Investment Grade	92 bps	-3 bps	-0.1%	1.0%
US Investment Grade	104 bps	-5 bps	0.1%	2.5%
UK Investment Grade	107 bps	-1 bps	-0.2%	2.5%
Asia Investment Grade	198 bps	-3 bps	0.0%	1.5%
Euro High Yield	338 bps	-18 bps	0.4%	0.6%
US High Yield	375 bps	-28 bps	0.6%	0.6%
Asia High Yield	555 bps	-13 bps	0.6%	1.3%
EM Sovereign	292 bps	-8 bps	0.2%	1.9%
EM Local	5.0%	-3 bps	-0.1%	-1.3%
EM Corporate	312 bps	-10 bps	0.3%	1.9%
Bloomberg Barclays US Munis	1.5%	4 bps	-0.1%	1.7%
Taxable Munis	2.7%	6 bps	-0.3%	5.1%
Bloomberg Barclays US MBS	41 bps	-7 bps	0.1%	0.8%
Bloomberg Commodity Index	158.74	-0.1%	-0.1%	-7.4%
EUR	1.0951	-1.3%	-1.3%	-2.4%
JPY	109.77	-1.3%	-1.3%	-1.0%
GBP	1.2905	-2.4%	-2.4%	-2.8%

Source: Bloomberg, Merrill Lynch, as at 10 February 2020.

Chart of the week: Tesla & Ford - Share prices 2015-2020



Source: Bloomberg, Columbia Threadneedle Investments, as at 7 February 2020.

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Macro / government bonds

As optimism that the coronavirus is being contained grew, the 'risk premium' contained in core government bond markets was unwound and yields headed a little higher. However, uncertainty about the economic effects of the virus remain heightened, taking yields down from the high level of the week.

The monthly US employment report showed that 225,000 jobs had been created. This was more than expected (165k). Meanwhile, wages rose by 3.1% over the last year. A key feature in many developed nations has been the failure for these tight labour market conditions to transform into a large rise in wage inflation. This has been variously 'blamed' on ageing populations (and a rising propensity to save), the effects of technology (e.g. Amazonification) and globalisation and the de-unionisation of the work force and the effect this has on collective bargaining.

In the UK, the service sector ISM (a measure of business confidence) rose to 53.9 suggesting that post-election businesses feel more certain. This is another in a series of so-called 'soft' measures that are displaying a bounce in sentiment.

There was no such optimism in Europe, which saw another tranche of horribly weak industrial production figures (France -2.8% m/m, -3.0% y/y) and factory goods data (Germany -8.7% y/y).

Investment grade credit

Confidence also returned to credit markets last week. Investment grade spreads were tighter as the market retraced over half of its recent widening. Demand for investment grade credit remains very high indeed after another record week of market inflows.

Luxury goods company LVMH was among a series of issuers that used these more supportive market conditions and buoyant demand to raise debt. In its case, this was to fund the purchase of jeweller Tiffany & Co. The deal came in seven tranches in euros and sterling and is the largest (€9 billion+) since brewer AB InBev came to market in the Spring of 2016. In other news, the earnings season seems to be progressing well; an exception might be US auto major Ford who reported poor results and guidance as it faces major secular pressures in the auto industry. The company's US dollar 10-year bonds have widened from under 280bps to over 300bps this year.

Responding to concerns of the coronavirus outbreak effect on the HK region, HSBC announced $4 billion equivalent relief to wholesale customers via forebearance, easing borrowing terms.

High yield credit

High yield spreads also tightened in the last five days led by lower rated credits.

US high yield bond prices rebounded over the past week as investors seem to be expecting minimal lasting impact on the global economic backdrop from the coronavirus. Primary markets continue to churn out a record amount of refinancing volume. High yield issuance volume totalled $13.7 billion over the past week, albeit only $4.6 billion net of refinancing. The asset class reported outflows totalling -$784 million over the week, according to Lipper.

In Europe, supply remains strong with €2.6 billion new supply out of last week's €3.8 billion gross issuance. New deals continue to be well absorbed by the market.

The effects of the coronavirus came into sharp focus with technology company Nokia noting supply chain issues and Burberry withdrawing earnings guidance.

In contrast to the fortunes of Ford described earlier, CCC rated Electric Car company Tesla has seen its share **(see chart of the week)** and bond prices rally strongly**.** The company's five-year credit default swap spread has tightened from over 700bps in June of last year to less than 180bps at the end of last week.

Leveraged loans

US leveraged loans lagged the global risk-on rally last week with prices declining slightly. The average price for the Credit Suisse Leveraged Loan index now stands at $96.64, which is $0.42 below January's high amid heavy re-pricing activity and above average volatility related to coronavirus. Compared to its high yield bond counterparts, which are up 65 bps, leveraged loans have produced -6bps of total return month-to-date. The lowest quality rung within the sector leads with roughly double the return.

The story continues to be record levels of loan issuance with weak appetite by retail investors. Following $123 billion of loan issuance priced in January, leveraged loan volume in February totals $18.4 billion month-to-date. Meanwhile, retail investors withdrew $150 million from mutual funds and $110 million from ETFs. While still in net outflows, the volume of redemptions has declined considerably from a year ago.

Defaults remained low in January following a light December. Two defaults in January impacting $1.6 billion of bonds and loans compares to an average of $4.3 billion defaults/distressed exchanges per month in 2019. The par-weighted loan default rates ex-commodities has fallen to 1.46% on a trailing 12-month basis.

Emerging markets

Emerging market spreads were also stronger last week even though it was flat week for market flows. Local currency underperformed hard currency, largely driven by FX movements.

In another sign of the renewed global market confidence, B rated issuer Ghana brought a three-tranche deal, which was heavily oversubscribed. The longest dated (40-year) bond came with an 'unfashionably' high coupon rate of 8.75%. Indian Rail also came to market; the investment grade rated quasi sovereign issued 10-year debt at a more 'fashionably' tight spread of 160bps. This deal also attracted considerable interest. (7 times oversubscribed).

In central bank action, more rate cuts were the theme. The Thai central bank reduced rates to a record low of 1% (there are fears that the coronavirus will negatively affect tourism in the country). Brazil was also recipient of a reduction in rates, this time by 25bps to 4.25%. The move was widely expected. Russia followed suit with a cut of 25bps to 6% in the face of low inflation. Philippines' Monetary Authority reduced its key interest rate by 25bps to 3.75% on growth concerns with the Governor citing that a further rate cut could be possible by mid-year.

Asian fixed income

The spotlight in the Asian credit market was firmly on the impact of the coronavirus outbreak.

The Macau government imposed a 15-day suspension of the casino operations from 5 February. Wynn Resorts stated that it will lose around $2.5 million a day in Macau from the ongoing suspension. Melco Resorts also dropped its plan to buy a second- tranche stake (9.99%) in Crown Resorts, highlighting the impact of the coronavirus and the temporary suspension of operations in Macau. S&P has put Melco Resorts' BB ratings and Studio City Ratings on Watch Negative to reflect the downside risk on financial metrics if the coronavirus outbreak lasts into 2Q, 2020 and 3Q, 2020.

Moody's downgraded SK Innovation and SK Global Chemical from Baa1 to Baa2 as the agency does not expect the companies' financial profiles to improve over the next 12-18 months due to the weakness in the core refining and petrochemical businesses. Hon Hai has cut its 2020 revenue growth to 1% to 3% (previous growth projection: +3% to 5%), due to the disruption of the coronavirus epidemic on its operations.

Commodities

The asset class was down slightly on the week, bringing year-to-date returns down -7.4%.

Crude oil prices fell with WTI lower by -2.5% and Brent down by -4.0% while oil products (gasoline, and heating oil) were up for the week due to inventory issues. Precious metal remained stable while base metals were lower. Grain prices were mixed due to expected delayed buying by China.

OPEC announced last week that it will cut production by 600,000 barrels/day, but Russia remains reluctant to follow suit. Worryingly, on the back of the coronavirus outbreak effect, Chinese companies are beginning to claim "Force Majeur" on their inability to take delivery of supplies due to constraints, including port closures. China National Offshore Oil Corp, China's largest liquified natural gas buyer, informed suppliers it would not take delivery while Guanxi Nanguo, a Chinese copper smelter, also refused delivery of supplies.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

10th 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, however 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)	¥ (0) $ (+1) Short -2 -1 0 +1 +2 Long € (0) P (+1) £ (0)	■ 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 (+1) Under-weight -2 -1 0 +1 +2 Over-weight C (+1)	■ 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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