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In Credit

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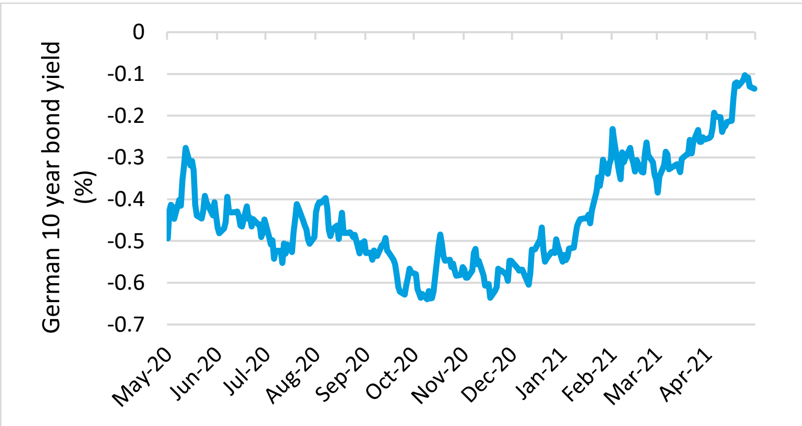
A farewell to negative yields?

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	1.61%	-2 bps	0.0%	-3.8%
German Bund 10 year	-0.13%	0 bps	-0.5%	-3.6%
UK Gilt 10 year	0.82%	-4 bps	-0.4%	-7.4%
Japan 10 year	0.08%	-1 bps	0.0%	-0.3%
Global Investment Grade	93 bps	-1 bps	0.0%	-2.5%
Euro Investment Grade	86 bps	1 bps	-0.4%	-1.1%
US Investment Grade	91 bps	-1 bps	0.2%	-3.2%
UK Investment Grade	93 bps	0 bps	-0.2%	-3.7%
Asia Investment Grade	215 bps	3 bps	0.0%	-1.7%
Euro High Yield	315 bps	-1 bps	-0.1%	2.1%
US High Yield	337 bps	2 bps	-0.1%	1.9%
Asia High Yield	553 bps	0 bps	0.4%	1.6%
EM Sovereign	308 bps	0 bps	0.6%	-2.3%
EM Local	5.0%	1 bps	1.5%	-3.1%
EM Corporate	295 bps	0 bps	0.4%	0.2%
Bloomberg Barclays US Munis	1.1%	-1 bps	0.1%	0.6%
Taxable Munis	2.4%	-1 bps	0.0%	-2.5%
Bloomberg Barclays US MBS	15 bps	2 bps	-0.3%	-0.9%
Bloomberg Commodity Index	193.67	-1.2%	0.6%	16.5%
EUR	1.2209	0.3%	1.3%	-0.3%
JPY	108.94	0.4%	0.3%	-5.2%
GBP	1.4124	0.4%	2.4%	3.5%

Source: Bloomberg, Merrill Lynch, as at 21 May 2021.

Chart of the week: 10-year German Bond yields converge on 0%



Source: Bloomberg, Columbia Threadneedle Investments, as at 24 May 2021.

Macro / government bonds

US bond yields have stabilsed this quarter after the material sell-off in the first quarter. It has been a different story for yields in Europe, however, which have trended higher. This reflects a heavy supply schedule and speculation that the European Central Bank will announce (at its June meeting) a tapering of bond purchases. Perhaps this might prove to be a one of the last chances to buy German 10-year bonds with a negative yield? You will recall these yields were -0.85% in March of last year – **see Chart of the week.**

It was a week of data releases in the UK. Employment data showed some strength as the economy comes out of lockdown with a fall in the unemployment rate to 4.8% . Inflation (CPI) rose to 1.7% y/y driven by higher energy and clothing prices as shops reopened. Retail sales also rose very strongly and by 9% m/m; remarkable given non-essential shops only re-opened on 12 May 2021.

US Initial Jobless claims continued to decline in contrast to the Non-Farm Payroll release (weaker last month). PMI data came in stronger in France and Germany as well as the US.

Investment grade credit

Investment grade spreads remain remarkably unchanged in a period of very low volatility. We note that the Global index spread has been in a 10 basis point range this year so far. For context, 2020 had a range of 242bps. Valuations (spread) in most markets are well through five year and longer-term averages.

Eurozone car registrations were up over 250% y/y in Europe, reflective of the weakness a year ago. Primary activity remains relatively (to last year) quiet in both the US and European markets.

High yield credit

The US high yield market showed only a modest reaction to rising volatility and inflation concerns, large outflows and elevated capital market activity over the week with spreads 2bps wider to +332bps. The week's total return for the ICE BofA US High Yield CP Constrained Index was -0.09%. According to Lipper, the asset class reported a $1.7bn outflow, largely driven by withdrawals from active managers (as opposed to ETFs).

It was a stable week for the European High Yield (EHY) market as the index tightened only 1bps. Single Bs and CCCs outperformed while BBs produced a modest negative return for the week. Flows were light but negative as €208m exited the EHY market, evenly split between ETFs and managed funds.

Primary market slowed down a bit last as there were seven new issues but only for €2.1bn, with an average size of c€300m. The week was one of only two so far this year where new money (ie, issuers who are first timers to the EHY market) has accounted for less than 50% of any given week. If you exclude these two weeks, the proportion of new money is 78% on a weekly average. Additionally, these newcomers to the EHY market have increased the universe's market value to €464bn, from €430bn at the start of year. This is a change from 2020 where the growth of the market size was largely due to Fallen Angels.

In an unusual case for EHY, Lufthansa suspended coupon payments on its hybrid bond; this was even as the company has plenty of liquidity. The reason is that the European commission views coupon payments on hybrids as a violation of state support rules. As the German government owns 20% of Lufthansa, it may be a while before Lufthansa is allowed to pay these coupons.

Leveraged loans

The leveraged loan asset class continued to prove resilient relative to high yield bonds over the week with a total return of 0.22%, aided by modest new issuance and continued strong CLO demand. The asset class experienced its 19th consecutive weekly inflow with another $685m subscription. Year-to-date inflows total $21.5bn.

Asian credit

Over the weekend, Caixin (China news media) stated that Huarong Asset Management is nowhere near defaulting. This follows an earlier Caixin report that Huarong organised a meeting on 18 May to reassure bondholders that it will not impose significant losses on both offshore and domestic bondholders. Huarong has also reportedly secured funds to pay offshore debts that are maturing over the near-term.

Adani Green Energy announced that it will acquire the complete stake in SB Energy Holdings Ltd (SB Energy) for an enterprise value around $3.5bn. SB Energy is a 80/20 JV between Softbank Group and Bharti Group. The target portfolio comprises large-scale utility assets with solar power capacity, wind-solar hybrid and wind capacity. The operational capacity is 1.4GW of solar power while the remaining capacity of 3.55GW is under construction.

Adani Transmission Limited (ATL) is implementing a group restructuring that is credit neutral, according to both Moody's and Fitch. ATL is transferring its US dollar bonds (ADTIN '26s and '36s) to Adani Transmission Step-One Limited (ATSOL), a newly incorporated wholly-owned subsidiary. ATSOL will be the new holding company in place of ATL in the obligor group. ATL will continue to guarantee the US dollar bonds, which means the credit profile of the obligor group remains closely tied with ATL. In the new structure, the obligor group includes ATSOL and also retains the two wholly-owned subsidiaries; Maharashtra Eastern Grid Power Transmission Company Limited and Adani Transmission (India) Limited.

Structured credit

The US Agency MBS market declined 32bps on the week. The sector underperformed the broad investment grade fixed income market on some minor re-pricing as Fed governors spoke of a sooner-rather-than-later taper. Higher coupons in particular have been lagging this month as prepayment speeds have surprised to the upside (slowing on higher mortgage rates). In CMBS, spreads rallied with seasoned conduit mezzanine bonds outperforming. Supply has been tight in both primary and secondary trading, which bodes well for CMBS spreads overall. ABS spreads held firm with nearly $11bn of new supply across 13 issues easily absorbed by investors.

Emerging Markets

In central banking news South Africa held its base rate at 3.5% as the 2021 economic growth forecast was raised from 3.8% to 4.2%.

On the geopolitical front, President Biden waived the sanctions on Russia's Nord Stream 2 pipeline, a gas pipeline directly between Russia and Germany. Ukraine opposes the move as it would allow Russia to bypass Ukraine's pipelines. Elsewhere, both Turkey and India are considering purchasing Russia's S400 anti-aircraft system despite warnings from Washington. In Asia, Thailand is set to borrow $22bn to fund a Covid relief package as the Thai economy has been hard hit by the decline in tourism. Elsewhere in Asia, Caixin Media reported that Huarong is "nowhere near default," turning around an earlier comment that default was not out of the question.

Commodities

In commodities the rally cooled with a 1.2% decline; most sub-groups retreated except for precious metals.

Both WTI (-2.7%) and Brent (-2.9%) declined as the Iranian nuclear deal talks continued. Markets are concerned about Iranian barrels hitting the market following the resolution of the deal.

In agriculture, wheat declined (-4.7%) on reports from Kansas that the crop has withstood recent low temperatures and is thriving. Corn prices rebounded (+2.4%) on strong Chinese buying and dry weather concerns from Brazil.

In base metals copper (-3.7%) and aluminium (-3.8%) declined on the basis that China may ignore environmental concerns given high metal prices. The markets are also concerned with threats made by China to 'target speculators and hoarders' to curtail the commodity boom. Nickel fell 4.3%; the current bottleneck on EV production is limiting demand for nickel.

In precious metals, gold rallied 2.1% on the back of volatility in crypto currencies and dollar weakness; the dollar currently trades at its lowest since 2018. Some speculators see crypto currencies as digital gold; meaning volatility in the market somewhat reduces its 'safe haven' qualities.

Responsible investments

The UK launched its replacement of the EU carbon market last week, having been part of the EU's emissions trading system until January this year. The first few trades were made on Wednesday and aims to help guide the country towards the net-zero goal for 2050 by placing a price on carbon emissions. Given the UK market is much smaller than the European version, it will take a 'settling in' period before the differences can be a true measure for a comparison.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

24th May 2021

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	■ 2021 data is shaping up to be noisy once again, but in a much different way than 2020. This time, growth is going to be robust, especially in the US. In addition, issuers on the whole are coming into this environment with better liquidity than before the pandemic. ■ Valuations in most areas of credit provide much less cushion for volatility. But compared to similar spread levels in the decelerating global economy pre-COVID, we still prefer to carry more credit risk in today's accelerating economy. ■ Question marks on the sustainability of super easy financial conditions, inflation, & central bank reaction functions do increase uncertainty.	■ Rapidly rising Treasury yields tighten financial conditions or make all in yields of credit less attractive. ■ A recovering economy propels spreads to all-time tights, especially if vaccinations accelerate quickly ■ Geopolitical tensions rise above a simmer, particularly in the US and Russia or China
Duration (10-year) ('P' = Periphery)	P ¥ $ Short -2 -1 0 +1 +2 Long £ €	■ Rangebound government bond market likely, with bias to lower yields ■ Pandemic scarring keeps reflation credibility low ■ Fed QE and high personal savings underpin demand for treasuries ■ ECB likely to lean against rising financing rates ■ Duration remains best hedge for further risk asset correction	■ Permanent fiscal policy shift rebuilds reflationary credibility and raises r* ■ Fiscal largesse steepens curves on issuance expectations ■ Consumption rebound stimulates long-term inflation expectations ■ Risk hedge properties deteriorate
Currency ('E' = European Economic Area)	£ ¥ EM Short -2 -1 0 +1 +2 Long E A$ $	■ US growth outperformance on back of fiscal stimulus boosts USD ■ ECB increasingly sensitive to Euro appreciation	■ Vaccine rollout in Europe improves and narrows growth gap ■ US fiscal push fades
Emerging Markets Local (rates (R) and currency (C))	R Under-weight -2 -1 0 +1 +2 Over-weight C	■ Favourable advanced economy policy settings support EM assets in near term ■ EM real interest rates relatively attractive, curves steep	■ Sharp escalation in global risk aversion, leading to higher EM inflation via fx ■ EM funding crises drive curves higher and steeper
Emerging Markets Sovereign Credit (USD denominated)	Under-weight -2 -1 ■0 +1 +2 Over-weight	■ Political risk is rising at the same time as the pandemic is surging in many large EM's. There are several Latam elections this year with a wide array of possible outcomes, and worsening COVID and low growth is central to them. ■ Index composition changes over the last 5 years have added a lot of duration to the sector, leaving it vulnerable. ■ US growth outperformance is starting to cause weakness in EMFX, and financial conditions for EMs is tightening.	■ A replay of 2013 occurs with a taper tantrum or swift appreciation of the USD ■ Growth scars from COVID persist and hurt commodity prices & ability to grow out of deficits. ■ There are even further delays in mass vaccination outside of developed markets.
Investment Grade Credit	Under-weight -2 ■-1 0 +1 +2 Over-weight	■ Index spreads are back to pre-COVID levels, but the duration of US indices have also lengthened by ~10%. ■ Issuer balance sheets still look remarkably strong, and cash reserves remain very high. Our base case is that a fair amount of deleveraging can occur with this cash, but as the economic recovery accelerates and COVID moves to the rear-view mirror, the spectre of M&A and shareholder return still looms. ■ IG has been historically resilient in the face of inflation, even if other sectors may benefit more from it.	■ IG bonds further cement their place in global investors' portfolios as safe assets, replacing government bonds. ■ M&A and shareholder returns remain in the backseat of management's priorities for an extended period of time.
High Yield Credit	Under-weight -2 -1 ■0 +1 +2 Over-weight	■ Spreads are inside LT averages, even adjusting for the better quality of today's index. But spreads are still wider than pre-COVID. ■ Access to capital remains easy even through more volatile markets of late, and a return to normalcy disproportionately benefits low-quality credits. ■ The positive effects of easy financial conditions hit HY later than higher quality sectors, and tighter conditions will hit HY first.	■ Upside risks include: intensified reach for yield keeps drawing new investors, 2020's downgrade cycle turns quickly into an upgrade cycle. ■ Downside risks include: travel & leisure habits slowly revert to pre-COVID, commodity sell-offs, or financial conditions suddenly tightening.
Agency MBS	Under-weight -2 ■-1 0 +1 +2 Over-weight	■ Fed buying has overwhelmed highly negative fundamentals, as seen by the near-zero spreads in bonds the Fed buys and poor performance elsewhere. ■ These unattractive technicals may persist if the Fed continues buying. Fed buying cannot be expected to increase in 2021, ultimately exposing negative fundamentals and valuations. ■ Duration in the sector is now rising quickly as mortgage rates move higher.	■ Housing activity slows considerably and prepays move back down to normal levels, without denting households' ability to service mortgages. ■ The Fed maintains or increases MBS purchases next year.
Non-Agency MBS & CMBS	Under-weight -2 -1 0 ■+1 +2 Over-weight	■ Our preference remains for non-agency RMBS in this area. ■ RMBS: Housing continues to outperform in the recovery as HH balance sheets are strong, demographics are positive, and supply is constrained. Valuations are less compelling, but can provide stable carry in de-risking portfolios. ■ CMBS: favoured bonds are still 'story' bonds. A return to normal won't look 'normal' for sectors like office space or convention hotels ■ Spread tightening looks somewhat excessive along the margins of credit quality.	■ Changes in consumer behaviour in travel and retail last post-pandemic. ■ Work From Home continues full-steam-ahead post-pandemic (positive for RMBS, negative for CMBS). ■ Rising interest rates may dent housing market strength, but seems unlikely to derail it.
Commodities	Under-weight -2 -1 0 ■+1 +2 Over-weight	■ o/w Copper vs Aluminium ■ o/w Lead vs Zinc ■ o/w Soybeans ■ u/w Livestock ■ u/w Gold	■ US China trade war