COLUMBIA THREADNEEDLE INVESTMENTS

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In Credit

12 OCTOBER 2020

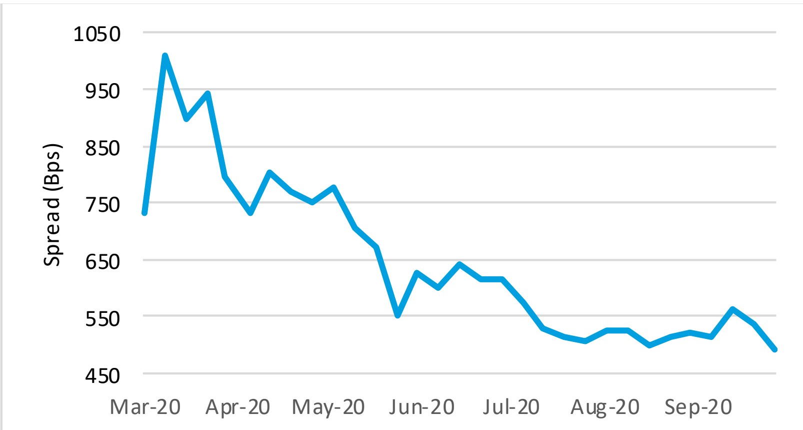
Biden his time until victory?

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	0.77%	7 bps	-0.7%	8.5%
German Bund 10 year	-0.54%	0 bps	0.1%	2.7%
UK Gilt 10 year	0.27%	3 bps	-0.9%	7.2%
Japan 10 year	0.03%	1 bps	-0.1%	-0.9%
Global Investment Grade	130 bps	-7 bps	0.2%	5.1%
Euro Investment Grade	111 bps	-5 bps	0.5%	1.2%
US Investment Grade	135 bps	-8 bps	0.1%	6.7%
UK Investment Grade	124 bps	-4 bps	0.0%	4.6%
Asia Investment Grade	253 bps	-5 bps	0.0%	5.1%
Euro High Yield	466 bps	-19 bps	1.1%	-1.5%
US High Yield	492 bps	-46 bps	1.4%	1.1%
Asia High Yield	672 bps	-15 bps	0.8%	2.9%
EM Sovereign	374 bps	-23 bps	1.4%	1.7%
EM Local	4.5%	-2 bps	1.8%	-4.7%
EM Corporate	388 bps	-14 bps	0.7%	3.3%
Bloomberg Barclays US Munis	1.4%	6 bps	-0.4%	2.9%
Taxable Munis	2.3%	8 bps	-1.1%	8.8%
Bloomberg Barclays US MBS	56 bps	-3 bps	0.0%	3.6%
Bloomberg Commodity Index	156.98	4.9%	3.4%	-9.1%
EUR	1.1801	0.9%	0.9%	5.5%
JPY	105.44	-0.3%	-0.1%	2.9%
GBP	1.3027	0.8%	0.9%	-1.7%

Source: Bloomberg, Merrill Lynch, as at 12 October 2020.

Chart of the week: US high yield spreads, Mar-Oct 2020



Source: Bloomberg and Columbia Threadneedle Investments, as at 12 October 2020.

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Macro / government bonds

US government bonds continued to sell off modestly, taking 10-year yields towards the upper end of a long-held range (0.6-0.8%).

The 'sell off' reflects increased confidence (according to pollsters) that the Democrats can capture the US Senate and that Joe Biden will win the election. In so doing, the chances of a material fiscal spend would have risen after the present stalemate. The US Federal Reserve seems to be on hold, for now. Meanwhile (and supportive for core government bonds), the spread of Covid-19 continues in Europe, the UK and the US. This brings the increased chance of revisiting lockdowns and the negative effect that would have on economic activity.

In specific data, UK GDP growth for August disappointed with a 2.1% increase (expected 4.5%+) as did French and German industrial output. The macro outlook for the UK remains fairly bleak when you include Brexit uncertainty. In the eurozone, the head economist at the European Central Bank gave a fairily dovish speech at the weekend. This week's data releases includes Consumer Price Inflation data in both the eurozone and US as well as retail sales numbers in the latter.

Investment grade credit

Investment spreads ground tighter over the week, leaving the Global Investment Grade index spread at 130bps more than government bonds. These spreads are now 6% tighter for the fourth quarter thus far but 37% wider year-to-date.

Market themes include ongoing consolidation within the European banking system (eg, Spain) as well as M&A speculation (eg, BT and KPN in the telecoms sector). As with all risk markets, the increased chance of US fiscal stimulus is supportive for spreads while valuations look very close to their long-run average.

The week sees the start of the latest earnings season in the US, commencing with financials (eg, JP Morgan and Blackrock).

High yield credit

US high yield bond spreads tightened sharply over the week alongside the best weekly performance for equities in months (+3.5%) amid speculation that a US fiscal stimulus deal will eventually be agreed upon. The ICE BofA US HY CP Constrained Index returned 1.3% and spreads were 46bps tighter over the week **(see chart of the week).** After $7 billion of outflows over the previous two weeks, flows reversed sharply with a $4 billion inflow for the week, according to Lipper. Primary market activity has also picked back up but remains below early September's pace; high yield issuance totalled $7.8 billion over the week. As such, October's new issue volume totals $10.5 billion (or $5.8 billion net of refi), down from September's pace, which produced $50.9 billion of issuance.

European high yield had another positive week as spreads tightened in almost 20bps even as flows were almost flat for the week, with only €6 million into the asset class. The primary market remained strong with €4.3 billion from eight issuers (ex.Primo Water, Cheplepharm, a US dollar deal from Jaguar Land Rover, as well as a hybrid from ENI) and which included a jumbo issuance by Schaeffler, a recent Fallen Angel, who printed €1.5 billion via two tranches.

In issuer specific news, we are seeing more government support and a pick-up in M&A activity. Ford received a $440 million support package from the Canadian government to develop electric vehicles in Canada – bonds performed positively on the news. Boparan (BOPRLN) secured its sale of Fox's biscuit company to Ferraro the Nutella company, while K&S confirmed the sale of its

US business with a valuation at $3.2 billion. DuFry got an additional capital injection from Alibaba to strengthen its balance sheet. More M&A news in the offing included a non-binding takeover for TALKTALK from Toscafund (an existing shareholder), while Accor announced it had hired advisers for debt restructuring. Some of the debt in question is the €930 million, which is coming due next year. However, there was tough news on the food front with Pizza Express announcing it had filed for Chapter 15 in the US. The firm has already received the green light from the UK authorities for a debt to equity swap.
Overall, more downgrades are likely as S&P reported it had put more firms on 'negative' outlook.

US leveraged loans

Leveraged loan prices continued to climb over the past week amid a firm tone for credit and equities with prices recovering a net +$0.39 since 25 September after falling -$0.79 between 16-25 September. The average price on the J.P. Morgan Leveraged Loan index increased $0.35 to $94.85 over the past week with the average price for BB loans increasing $0.28 to $97.34, Single B loans increasing $0.40 to $96.66, and Split B/CCC decreasing $0.07 to $80.34. Meanwhile, loan yields and spreads (3-year) decreased 14bps and 16bps over the past week to 5.87% and 560bps, which compare with as low as 5.69% and 545bps on 16 September. While the outflow trend for the asset class continued with the 91st outflow over the last 97 weeks, the net outflow was quite modest at only $6 million. Additionally, loan ETFs saw nearly $300 million of inflows over the week against the risk-on backdrop and a 4-month high for 10-year US treasury yields.

Structured credit

Agency MBS posted a modest decline last week of 5bps. The sector provided positive excess returns on a steeper yield curve. Black Knight forecasts roughly 15% of Agency MBS borrowers exiting forbearance in October, likely stemming from the 20% of borrowers that are current in their payments. In non-agency RMBS the number of loans in forbearance saw its single largest weekly decline since the pandemic began. The total number of loans fell below $3 million for the first time since April. Spreads in the non-agency RMBS remained mostly unchanged on the week. Spreads in ABS continued to move tighter. Consumer debt increased .42% y/y, which was the lowest positive rate since the Great Recession.

Emerging markets

Emerging markets had another strong week with hard currency and corporate spreads tightening. Local EM also returned a positive performance, largely due to FX moves as US dollar continued its weakening trend, last week. There were strong inflows of $1.7 billion into EMs, easily surpassing the previous week's amount of inflows as well as going into both hard and local currency funds.

It was another strong primary week as issuers looked to get new bonds launched before the US presidential election on 3 November. Issuers included Pemex ($1.5 billion issue); Kernel, the largest Ukraine sunflower oil producer; and the Turkish government. Corporates, in general, appear to be taking out 2022 and 2023 bonds with the aim to extend their maturity structure.

In central bank news, Mexico and India left rates unchanged but both kept an accommodative policy stance leaving room for rate cuts, if necessary. Central banks in Peru and Poland did the same saying that it was appropriate to keep an expansionary policy for an extended period. For some positive credit rating news: Bulgaria was upgraded by Moody's to Baa1 (from Baa2) with stable outlook.

Asian fixed income

S&P has placed the BBB- ratings of Semiconductor Manufacturing International Corp (SMIC) on a ‘negative’ outlook due to the uncertainty about the scope of the restriction on SMIC under the US Export Administration Regulations (EAR). SMIC could face material disruption in supply chains because the exports of certain semi-conductor equipment, tools and input materials from the US are subject to the EAR. S&P plans to resolve the ‘negative’ outlook within 90 days after it evaluates the scale of the EAR impact on SMIC.

The US administration is reportedly exploring potential restrictions on ANT Group (33% owned by Alibaba Group Holding) and Tencent Holdings Ltd with respect to their digital payment platforms on national security concerns. ANT Group responded that its business is primarily in China and that it is unaware of any plans by the US administration to impose restrictions on its operations.

Cebu Air Inc (67.8%-owned by JG Summit) plans to raise further capital by issuing $250 million convertible preference share issue and $250 million of convertible bonds. The airlines’ H1 revenue declined 61% y/y due to the pandemic and the company is in the midst of reducing its fleet.

The reverse book building in the delisting of Vedanta Ltd was conducted between 5-9 October. However, the delisting was unsuccessful because only 1.26 billion of tendered shares have been confirmed, compared with the minimum required level of 1.34 billion of shares.

Commodities

The index rallied 4.9% last week driven primarily by crude and natural gas.

Crude oil rallied 4.65%, driven upwards in the latter stages of the week ahead of the expected US stimulus package, which is currently proposed at $1.8 trillion. Storm Delta, which had shut 92% of oil prodction in the US, made landfall in Louisiana. Storage levels of natural gas currently stand at record levels and mild weather is expected for the rest of October. In agriculture, soybean futures are heading towards its highest close since 2018, on the back of US stockpiles falling below estimates. In metals, gold rallied by a modest 1.29% following a volatile week of trading. Iron has been supported by China’s robust demand for steel, with producers in Brazil and Australia operating at maximum capacity to meet this demand.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

12th October 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	▪ The spread tightening of the last 5 months leaves valuations much closer to long-term averages, and a more modest overweight to credit risk is warranted. There are still enough attractive opportunities to build a portfolio that is overweight credit risk, although some sectors are offer little upside. ▪ Technicals are positive across the board. The Fed's new strategy underlines lower for longer and targeting easy financial conditions. The demand for credit products remains high. ▪ Fundamentals continue improving, even if slower than in the summer. Vaccine progress is coming steadily.	▪ The Feb garbles its messaging in how it will carry out its new policy framework ▪ Cooler weather leads to virus acceleration and school closures hamper labour productivity. ▪ The damage done to the labour market is deep & long-lasting. ▪ Vaccine development slows.
Duration (10-year) ('P' = Periphery)	P ¥ $ Short -2 -1 0 +1 +2 Long € £	▪ Recovery pace to slow as government support wanes, consumption rebound fades ▪ Reflation credibility still low, despite Fed framework review ▪ Fed QE and high personal savings underpin demand for treasuries ▪ Policy to aim for lower, flatter curves ▪ Duration remains best hedge for further risk asset correction	▪ Unexpected medical advance allowing full, rapid economic re-opening ▪ Permanent fiscal policy shift rebuilds reflationary credibility ▪ Fiscal largesse steepens curves on issuance expectations ▪ Risk hedge properties deteriorate
Currency ('E' = European Economic Area)	£ E EM Short -2 -1 0 +1 +2 Long A$ ¥ $	▪ Recent USD weakness has come as a result of relatively worse interest rate, Covid and fiscal dynamics. This is now largely priced and we expect a pause in the downtrend. ▪ Longer term, expensive valuations and twin deficits presage a weaker Dollar	▪ A second Trump term could lead to USD strength through more aggressive trade policy ▪ Reimposition of Covid restrictions in Europe
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	▪ The stable/weaker USD over the last 4 months has eased fundamental and technical pain. ▪ EM IG has tightened inside long-term averages versus US IG, but EM BB/B remains attractive versus US BB/B. ▪ The peak in defaults and restructurings has passed and the landscape of EM is relatively stable. ▪ The wave of global liquidity is reaching EM, but after it ran through developed market credit.	▪ The USD strengthens. ▪ Growth scars from COVID persist and hurt commodity prices & ability to grow out of deficits. ▪ Governments show little willingness to address deficits post-COVID.
Investment Grade Credit	Under-weight -2 -1 0 +1 +2 Over-weight	▪ IG valuations were the most directly affected by the Fed and normalized most quickly. Valuations are now at long-term medians, but the index duration is 30% longer. ▪ Fundamentals have been more positive than expected. Leverage has risen, but so too has cash. ▪ With Treasury yields likely very low for an extended period of time, technicals favour IG as a safe asset substitute.	▪ The Fed does not renew its Corporate Credit Facilities. ▪ Foreign buyer flow stops for geopolitical, financial, or regulatory reasons. ▪ The cash stockpiles taken out at the depths of the crisis are deployed on large-scale M&A instead of deleveraging.
High Yield Credit	Under-weight -2 -1 0 +1 +2 Over-weight	▪ Spreads & new issue supply underline that companies with sounds economics have no issue accessing financing. Valuations are mostly back in line with long-term ranges and are moderately attractive versus IG, but less compelling than earlier in the recovery. ▪ The ability to access financing has dramatically improved the prospects for many companies, and the impact of COVID on companies with bonds >$80 is manageable.	▪ Prolonged COVID-19 related slump in activity would hurt these companies most. ▪ The sector most sensitive to changing financial conditions.
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. ▪ But valuations are much more neutral now, although the Fed's quantity of buying is overwhelming the market. ▪ Forbearances have been better than expected, and are still relatively low (including GNMA, which has been hit hardest).	▪ Fed reallocating MBS purchases towards Treasuries. ▪ Bonds will underperform other spread product in a sharp risk-on move. ▪ Renewed interest rate or curve volatility.
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 is the strongest sector in the economy thanks to low interest rates and desire for more space for continued WFH. CMBS: Retail tenant payments & hotel occupancy are improving. Office is still struggling but valuations reflect this. ▪ Valuations vary wildly, but are broadly attractive. Given performance, trimming some riskier positions & doubling down on conviction credit is due.	▪ Changes in consumer behaviour in travel and retail last post-pandemic. ▪ Work From Home continues full-steam-ahead post-pandemic. ▪ Built-up savings from fiscal stimulus/enhanced unemployment benefits are drawn down and mortgage forbearance increases.
Commodities	Under-weight -2 -1 0 +1 +2 Over-weight	▪ o/w Copper vs Aluminium ▪ u/w Crude, u/w natural gas ▪ o/w Soybeans vs Corn ▪ o/w refining margins (o/w products, u/w Brent)	▪ Oil production disruption

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