COLUMBIA THREADNEEDLE INVESTMENTS

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In Credit

13 JANUARY 2020

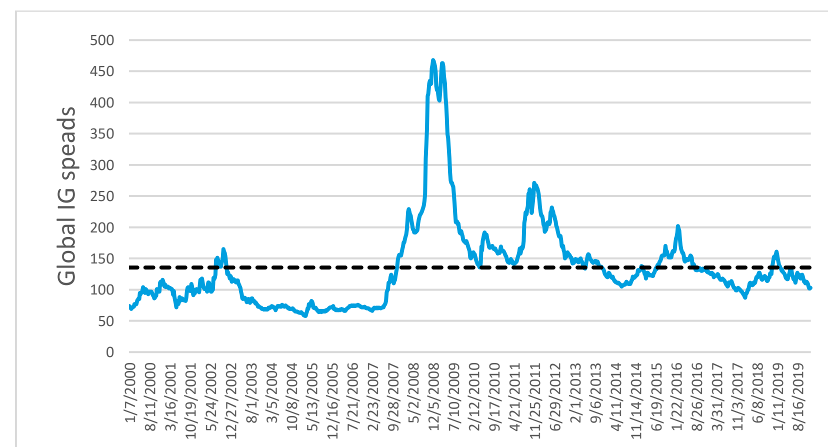
Supply begets demand.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	1.84%	5 bps	0.5%	0.5%
German Bund 10 year	-0.18%	10 bps	0.2%	0.2%
UK Gilt 10 year	0.75%	1 bps	0.7%	0.7%
Japan 10 year	0.00%	1 bps	-0.2%	-0.2%
Global Investment Grade	102 bps	-1 bps	0.5%	0.5%
Euro Investment Grade	95 bps	0 bps	0.1%	0.1%
US Investment Grade	101 bps	-2 bps	0.6%	0.6%
UK Investment Grade	110 bps	-2 bps	0.8%	0.8%
Asia Investment Grade	193 bps	-1 bps	0.4%	0.4%
Euro High Yield	329 bps	1 bps	0.2%	0.2%
US High Yield	348 bps	-13 bps	0.5%	0.5%
Asia High Yield	536 bps	-4 bps	0.9%	0.9%
EM Sovereign	283 bps	-6 bps	0.4%	0.4%
EM Local	5.2%	-4 bps	0.2%	0.2%
EM Corporate	309 bps	-8 bps	0.7%	0.7%
Bloomberg Barclays US Munis	1.7%	-5 bps	0.7%	0.7%
Taxable Munis	3.0%	2 bps	1.4%	1.4%
Bloomberg Barclays US MBS	38 bps	-5 bps	0.3%	0.3%
Bloomberg Commodity Index	171.46	-0.8%	-0.2%	-0.2%
EUR	1.1122	-0.4%	-0.8%	-0.8%
JPY	109.80	-1.2%	-0.7%	-0.7%
GBP	1.2991	-0.1%	-1.5%	-1.5%

Source: Bloomberg, Merrill Lynch, as at 13 January 2020.

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



Source: Bloomberg, Columbia Threadneedle Investments, as at 9 January 2020.

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Macro / government bonds

The rise (and subsequent fall) in tensions and combative rhetoric in the Middle East has been the key driver for 'risk 'free' assets such as core government bonds. All in all, bonds were weaker on the week as a 'crisis' seems to have been averted.

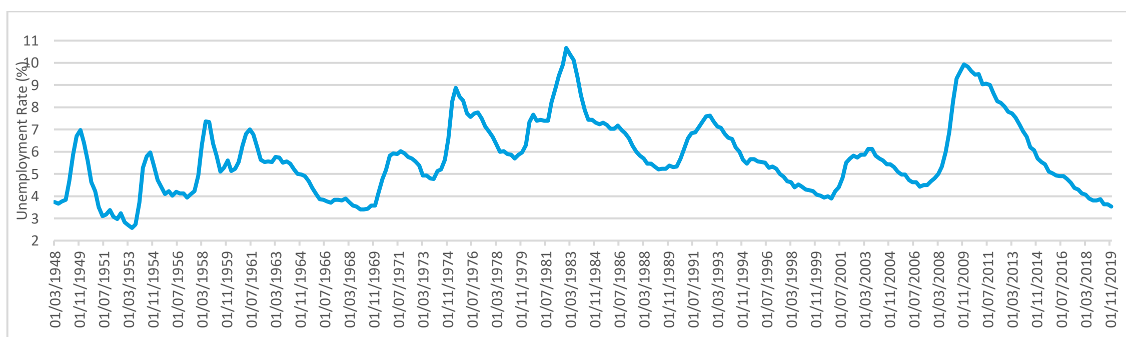
A trend higher in government yields commenced in August 2019 and has taken 10-year European and US yields around 40-50bps higher. These more attractive valuations make us more constructive about the market outlook (especially the US and UK) against an outlook of low growth, low inflation and benign interest rate expectations.

In terms of data, the European Central Bank will be pleased to see that inflation is rising (a little). The headline rate of Consumer Prices growth rose to 1.3% y/y at the end of last year and is now in line with the core rate. There were mixed messages from the weak German manufacturing sector where factory orders collapsed by 6.5% y/y, while industrial production 'only' contracted by 2.6% over the same period and was actually up on the month. Exports, however, fell by 2.3% in the last month.

US manufacturing is also struggling, as last week's weak ISM Manufacturing index indicated. By contrast the US Service sector measure rose to (a better than expected) 55.0 in the highest reading since the summer of last year. The difference between sentiment in manufacturing and services is the most stretched since 2015 and close to the highest level in the last couple of decades, according to Deutsche Bank.

In other news, the US trade deficit was the lowest since Q3 2016. The week concluded with the non-farm payroll data for December. After a very strong prior month 145,000 jobs were created, which was a little less than expected (160k). The unemployment rate came in at 3.5% (lowest since the late 1960s) **- see Second Chart of the week** and wages rose by only 2.9% y/y.

Second Chart of the week: US unemployment rate, 1947-2019



Source: Bloomberg, Columbia Threadneedle Investments, as at 10 January 2020.

Investment grade credit

Last week, the direction of credit markets was influenced by the same geopolitical factors described above. The de-escalation of tensions helped the market end with a tightening bias.

Globally, spreads (102bps) are a lot tighter than a year ago (160bps) and lower than the long-term average (130+bps) see **– see Chart of the week.** This prompts us to have a more cautious view about the outlook for investment grade credit markets and also reflects elevated leverage and a weak (albeit positive) economic growth outlook. Offsetting this, markets remain supported by very low interest rates and QE (in Europe), as well as structural demand for income.

The second week of the year produced a deluge (biggest week ever in Europe) of primary issuance, which was skewed towards financials. Deals priced close to the secondary market, with little new issue concession and indicative of good technical (demand) support for the market at this stage. This demand feature was underlined by Lipper reporting a very strong $8.2 billion (0.6% of AUM) inflow into the US market for the week ending 8 January (a record) versus an average of less than $3 billion per week in 2019.

In the UK, the British Retail Consortium reported that the sector suffered its worst annual performance on record, with sales declining by 0.1% y/y. Consumption had been a pillar of strength in the UK economy buoyed by better inflation-adjusted wage growth. This sector exhibits brutal price pressure and a move to 'on-line' shopping.

High yield credit

US high yield bond prices rose modestly over the past week as Iran and the US stepped back from a deeper military conflict. A re-opening of the primary financing window to energy issuers was among the key market developments this week with three senior unsecured transactions pricing in this space. According to Lipper, the asset class reported a $1.1 billion inflow for the week.

European high yield spreads were flat as the market absorbed the high issuance of the week. The primary market saw €3.3 billion in new issuance in Europe. It was mostly new money and the bonds were, generally, well over-subscribed. The European high yield market continues to be supported by the low rate environment and the secondary effect of the ECB's QE purchasing programme. There is more and more talk of US issuers looking across the pond to issue in euros, to the tune of € 10 to €15 billion in the first quarter of 2020, alone. These are expected to likely be single B or lower rated credit.

Leveraged loans

Credit risk was a critical concern in 2019 given where we are in the credit cycle and that theme is expected to continue into 2020.

The rating agencies downgraded more issuers in 2019 than 2018 and 2017 combined. That said, a risk-on market rally and reduced supply led a lower quality rally in December, with CCC loans materially outperforming B and BB. This was a reversal of trend witnessed throughout the year. On average, US bank loans are now priced at $97.50, offering a yield to investors of 6.1%. The default rate remains benign at 1.6%, well below the historical average of 3%. Our expectation is that defaults will rise modestly this year and move closer to longer-term averages by year-end 2021. In favour of keeping defaults low is a maturity wall that dates out to 2022 and beyond. Without that looming pressure to refinance, issuers should get some breathing room. The technical environment remains stressed in retail mutual funds with outflows continuing. Fortunately, primary issuance was 36% y/y and the forward calendar looks light. CLO issuance was also down 8% vs 2018 and we expect that trend to continue into 2020.

Structured credit

The US residential mortgage sector had a strong December. Excess returns were 34bps, which marked the 4th straight month of positive excess returns.

Strong performance has tightened yield premiums but the sector remains relatively attractive. In the non-agency RMBS sector, housing fundamentals remain healthy. Better wages and slower home price appreciation has improved affordability. Supply should tick up in Q1 as built-up originations in the back-half of 2019 are securitized. Spreads are modestly attractive.

In ABS, consumer fundamentals remain healthy and performance in-line with expectations. Shorter, more defensive positions for consumer loans as well as subprime auto offer attractive compensation. Finally, in CMBS, significant supply in Q4 weighed on valuations particularly in single-asset single borrower deals.

Asian fixed income

The Indonesian government has capped the coal production target for 2020. It is concerned that a sustained high level of coal production could weigh negatively on coal prices and state revenues. Bharti Airtel has launched its fund-raising programme, which aims to raise up to $3 billion, comprising $2 billion through a share placement and up to $1 billion issuance of convertible notes. The combination of the agrochemical businesses of China National Chemical Corporation Limited (ChemChina) and Sinochem has no ratings impact on Syngenta AG.

Positively for the renewable energy sector in India, the collection of receivables in Andhra Pradesh has improved. ReNew Power Ltd has received INR4,499 million ($63.5 million) for 774.MW in December 2019 and January 2020. ReNew Power has 14% of capacity exposure to Andhra Pradesh. S&P revised Lippo Karawaci's B- ratings outlook to negative because the company's liquidity position has diminished since the rights issue in July 2019 due to operating expenses, financial charges and working capital. S&P also lowered Posco's BBB+ ratings outlook from positive to stable, on expectation that the operating performance will be soft over the next 12 months from low steel prices and weak demand.

Emerging markets

In emerging markets, spreads were 2% tighter over the week with hard currency spreads coming in at 283bps. Market interest in the asset class continues as the year started well with inflows of $1.7 billion last week.

The market was helped by the de-escalation of the tension in the Middle East. In other news, the Sultan of Oman, the longest ruling leader of the region, passed away last week. His successor has already said the country will continue with the existing government policies.

In Lebanon, the central bank has asked local investors of a Lebanese eurobond to swap it into a new longer-dated bond with a higher coupon. With local ownership at 60% of the $1.2 billion bond issue, a swap by local investors would help the government manage its current debt crisis. Lebanon remains in turmoil as it deals with its economic crisis, one of the worst in many years, with street protests over corruption and mismanagement.

In South America, Argentine president Fernandez announced plans for restructuring the country's public debt with 31 March as the deadline and, most importantly, with the IMF's approval.

Commodities

The index was down 80 bps last week, largely due to the energy sector which was down 5.8%.

Brent oil prices fell from almost $70 to close at $65.13/barrel. The large 'pull back' in oil price came on the back of the de-escalation in the Middle East. Additionally, the Dept of Energy's numbers on supply were fairly weak, last week, helping to put pressure on WTI prices which also fell from $64.25 to finish at $59.30 by last Friday.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

13th January 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)	¥ $ Short -2 -1 0 +1 +2 Long € P £	■ Global manufacturing remains in stagnation ■ US trade policy undermines business investment at home and abroad ■ US and global monetary policy continues to respond to softening macro backdrop	■ Global trade détente stimulates improvement in risk sentiment ■ US economy stages consumption-driven cyclical upswing
Currency ('E' = European Economic Area)	EM $ A$ E Short -2 -1 0 +1 +2 Long ¥ £	■ 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 ■ An improvement in global risk sentiment due to progress on Phase 1 trade deal may undermine some of the dollar's 'safe haven' demand.	■ Further leg lower in global growth driven by increasing trade frictions.
Emerging Markets Local (rates (R) and currency (C))	R Under-weight -2 -1 0 +1 +2 Over-weight C	■ 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 Soybeans, Corn vs u/w Wheat ■ o/w Sugar ■ o/w Brent vs WTI ■ o/w Platinum vs Aluminium ■ o/w Gasoline vs Distillates	■ Material China slow down, weighing on economic growth, metals & petrol

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