

In Credit

06 JULY 2020

A drift higher for risk markets.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	0.69%	5 bps	-0.1%	8.9%
German Bund 10 year	-0.44%	5 bps	-0.3%	1.9%
UK Gilt 10 year	0.21%	4 bps	-0.2%	9.4%
Japan 10 year	0.04%	3 bps	0.0%	-1.0%
Global Investment Grade	154 bps	-6 bps	0.3%	3.5%
Euro Investment Grade	143 bps	-4 bps	0.1%	-1.1%
US Investment Grade	154 bps	-8 bps	0.4%	5.3%
UK Investment Grade	144 bps	-2 bps	0.2%	3.5%
Asia Investment Grade	273 bps	-3 bps	-0.1%	3.1%
Euro High Yield	542 bps	-10 bps	0.4%	-4.7%
US High Yield	617 bps	-24 bps	0.8%	-4.0%
Asia High Yield	710 bps	-6 bps	0.2%	-0.1%
EM Sovereign	421 bps	-12 bps	0.8%	-1.1%
EM Local	4.5%	-2 bps	0.6%	-6.3%
EM Corporate	435 bps	-7 bps	0.2%	0.0%
Bloomberg Barclays US Munis	1.5%	1 bps	0.0%	2.1%
Taxable Munis	2.4%	2 bps	-0.1%	8.4%
Bloomberg Barclays US MBS	67 bps	-5 bps	0.0%	3.5%
Bloomberg Commodity Index	141.21	3.8%	1.0%	-18.6%
EUR	1.1300	0.3%	0.1%	0.3%
JPY	107.59	-0.3%	0.4%	1.1%
GBP	1.2488	1.2%	0.7%	-5.8%



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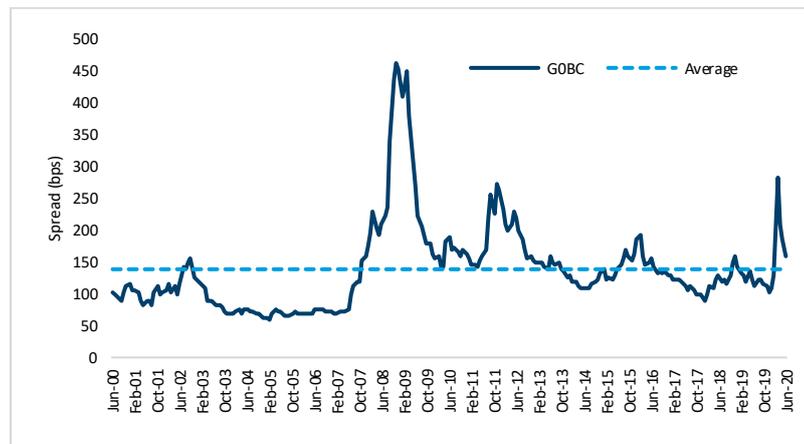
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Source: Bloomberg, Merrill Lynch, as at 6 July 2020.

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



Source: Macrobond and Columbia Threadneedle Investments, as at 30 June 2020.

Macro / government bonds

Core government bond yields were little changed in the holiday-shortened week.

There remains a sequential improvement in economic data yet a disturbing increase in Covid-19 cases in the US. Most notably the monthly US employment report detailed a sharp increase in jobs – approximately 5 million – and a decline in the unemployment rate to 11.1% (it was nearly 15% a couple of months ago).

Investment grade credit

Credit spreads were tighter over the week led by the US dollar market.

Against a long-term time horizon of 20 years, spreads now are around 0.2 standard deviations cheap – see [chart of the week](#). At one stage this number was three times. A noticeable feature of today's market is that cash bonds are trading very cheap to default swaps. It was a quiet week shortened by a US holiday that featured fewer new issues than has been the case. Indeed, supply in the US market year to end June was around \$1.2 trillion, around twice the amount issued last year. European issuance has been similarly robust.

High yield credit

The holiday-shortened week resulted in frontloaded issuance and light volumes for US high yield. The asset class navigated a volatile week in equities by charting its own more moderate course. The ICE BofA US HY CP Constrained index returned around 0.5% over the week and spreads were 24bps tighter. Trading volume was light and multi-point price moves rare as traders and investors weighed a raft of encouraging employment and manufacturing data against continued growth in Covid-19 case numbers and renewed China tensions. The primary market issued \$3.85 billion through Thursday via nine tranches for the leanest weekly new-print output since late April. The asset class saw an abrupt \$5.6 billion outflow over the week, according to Lipper.

The European High Yield (EHY) market rally resumed, as spreads tightened again last week, finishing at 542bps on a beta rally as CCCs outperformed. Inflows continued with €200 million invested into the asset class.

The primary market continued to be quite active last week as issuers Fiat, Thyssen Krupp Elevator, INWIT (Italian telecom), B&M Retail (UK retail), Leonardo (Aerospace/Defence), and Renk (German auto parts) all came to the market, with €6.2 billion supply in euro and sterling bonds. Issues were comfortably oversubscribed.

Deutsche Bank is the latest house to lower its 2020 default rate outlook for EHY, now calling for 4% for 2020, down from 7%, matching JP Morgan's current outlook.

With the latest supply of Fallen Angels to enter the EHY universe, the market cap for the asset class reached an all-time high at €370 billion.

Leveraged loans

Loan issuers allocated a number of deals over the past seven days, cleaning up the calendar heading into the Fourth of July holiday weekend, as the loan secondary had a rough stretch of trading sessions since the middle of last week. The secondary loan market (referencing the S&P/LSTA Leveraged Loan Index) returned a negative 0.87% over the week. The average bid of the S&P/LSTA Leveraged Loan Index—at 89.94 as of 2 July – dropped back below 90 for the first time since 3 June. As with US high yield, the leveraged loan asset class saw a notable spike in outflows with \$428 million of withdrawals over the week, according to Lipper.

Emerging markets

Emerging markets also returned to rallying mode as EM hard currency and corporate spreads tightened and local EM also showing a positive return, this time mainly driven by interest rates. However, the asset class experience outflows of \$1.4 billion, the largest in two months. This was largely from local currency portfolios as hard currency portfolios saw only \$441 million exit.

Fitch, the credit rating agency, stated that due to the pandemic, the market should expect more downgrades of sovereign ratings. The rating agency has already lowered the credit rating of 33 countries in the first half of 2020.

In central bank news, Columbia cut rates by 25bps and indicated that further rate cuts are possible. In an unusual turn of events, a new Ukrainian sovereign \$1.3 billion bond issue was pulled on news that the central bank governor of Ukraine suddenly quit.

Asian fixed income

Adani Ports and Special Economic Zone (APSEZ) may reportedly raise \$1 billion in offshore bonds of up to 30-year maturity. The proceeds will be largely used to fund the \$2 billion acquisition of a controlling stake in Krishnapatnam Port Co, a deal that was announced in January 2020.

S&P cuts Modernland's credit rating by a notch to CCC- and lowered its outlook to 'watch negative'. Modernland is facing a higher risk associated with the potential restructuring of its IDR150 billion bond (\$10.3 million) due 7 July.

In the US, the Federal Communications Commission (FCC) has designated Huawei Technologies and ZTE Corp as national security threats. This formalises the proposal raised by FCC in November 2019 that requires US telecom service providers to remove networking equipment from suppliers, which are designated as threats to national security.

Commodities

A strong week as commodities rose 3.4% on the back of strong performance in energy, metals and agriculture. Oil prices rose 4% with WTI now trading above \$42/barrel. The EIA (Energy Information Administration) reported crude oil inventories fell 7.2 million barrels the previous week. Still, inventories are above the 5-year average, although refinery figures suggest fuel demand is rising, albeit slowly.

In metals, base metals were up 1.75% with copper as one of the outstanding performers last week. The copper price, now back to the highs of January 2020, is reflecting a tightening situation as copper production in Peru and Chile are being taken off the market to make mines and smelting operations safer in a Covid-19 world. In precious metals, gold is fast closing in on the \$1,800 price point on the upside.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

6th July 2020



Strategy and positioning (relative to risk free rate)	Views	Risks to our views
Overall Fixed Income Spread Risk 	<ul style="list-style-type: none"> Valuations remain attractive at these wide levels, however the rally since March has taken moderated the opportunity. Worsening fundamentals argue for fair value being wider than before. Central bank support remains a key technical for now, one that will become more relevant if there are relapses (of market volatility and/or COVID 19 infections). Fundamentals remain challenging for large swaths of issuers, despite some signs that they may be better than recent expectations. Sorting out issuers with the combination of fragile balance sheets and lasting industry headwinds is key. 	<ul style="list-style-type: none"> Major economies cannot flatten the curve of COVID-19 and 'recession' becomes 'depression'. Reopening begets a widespread receding. Central banks pull back support too early and positive technicals vanish.
Duration (10-year) (P = Periphery) 	<ul style="list-style-type: none"> Disinflationary global recession now a base case Don't fight the Fed (most) central banks seeking flatter, lower curves Monetary trumps fiscal policy; QE buying to outweigh increased issuance Duration remains best hedge for further risk asset correction 	<ul style="list-style-type: none"> Unexpected medical advance allowing full, rapid economic re-opening Extraordinary fiscal/monetary accommodation inspires consumption-driven cyclical upswing and higher inflation Fiscal largesse steepens curves on issuance expectations
Currency (E = European Economic Area) 	<ul style="list-style-type: none"> The Dollar is richly valued on the basis of growth outperformance and high carry. Twin deficits indicate a weaker dollar longer term The convergence of policy rates is a material negative for the dollar, where carry advantage had kept it supported. Expect USD weakness vs safe havens. 	<ul style="list-style-type: none"> Federal Reserve moves away from ultra accommodative stance Investors reappraise US crisis/fiscal response as more likely to speed a return to normality than other regions
Emerging Markets Local (rates (R) and currency (C)) 	<ul style="list-style-type: none"> 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 	<ul style="list-style-type: none"> Further sharp escalation in global risk aversion EM funding crises drive curves higher and steeper
Emerging Markets Sovereign Credit (USD denominated) 	<ul style="list-style-type: none"> Balance sheets will be stretched by the fundamental COVID-19 shock, and exaggerated by DM financial turmoil, cheap oil, and a stronger USD. Valuations have become more attractive even in the more stable credits. Asia is close to returning to business as usual following COVID-19 curfews. The virus may return as this happens, but if the ramp up to normal continues, a key source of demand for many EM economies will be back. 	<ul style="list-style-type: none"> COVID-19 begins to spread rapidly in countries with poor health infrastructure, causing higher death rates. The US dollar remaining at all-time highs will regardless be a headwind Reversal of recent electoral trend towards market-friendly candidates.
Investment Grade Credit 	<ul style="list-style-type: none"> IG sits at the confluence of 3 key positives 1) balance sheets the best equipped to handle economic pain, 2) Fed acting as a non-economic buyer and backstop, and 3) valuations that are attractive relative to history. Credit quality has nonetheless deteriorated, meaning credit spreads are less attractive versus historical comps. 	<ul style="list-style-type: none"> The Fed's purchases goal to maintain 'liquidity' are overwhelmed by economic deterioration Foreign buyer flow stops for geopolitical, financial, or regulatory reasons. Downgrade pressures remain front and centre.
High Yield Credit 	<ul style="list-style-type: none"> Though not as positive as IG, HY technicals have improved. Markets are functioning again. Fundamentals remain challenged for these lower-quality balance sheets, especially in the energy sector. There has been improvement in.. Valuations: the breakneck speed of the rally means spreads are much closer to fair, but still mildly attractive. 	<ul style="list-style-type: none"> Prolonged COVID-19 related slump in activity would hurt these companies most Potential corporate QE lures investors to higher quality assets, instead of encouraging reallocation into lower quality credit.
Agency MBS 	<ul style="list-style-type: none"> The Fed's QE including Agency MBS has been a significant tailwind for a sector with worse fundamentals, although fundamentals are better than expected But valuations are much more neutral now, and the Fed's purchases have been meaningfully tapered. However, forbearances have been better than expected, and are still relatively low (outside of GNMA, which has been hit hardest). 	<ul style="list-style-type: none"> Interest rates continue falling aggressively and volatility rises again. Bonds will underperform other spread product in a sharp risk-on move. Fed continues to taper purchases.
Non-Agency MBS & CMBS 	<ul style="list-style-type: none"> Non-Agency MBS: fundamentals have held up better than expected into this crisis, and the housing market has quickly rebounded. New issues have begun, but at much wider spreads. CMBS: Non-payment by retail tenants, lockdowns on travel, and work-from-home have had serious fundamental worries to certain issuers and deals. The sector has been uniformly punished and there exist many opportunities to pick out attractive property profiles & structures. 	<ul style="list-style-type: none"> Consumer behaviour and employment are fundamentally changed by even a brief, successful 'social distancing' effort Housing prices begin to fall in contrast to recent trend.
Commodities 	<ul style="list-style-type: none"> o/w Base Metals u/w Crude o/w Soybeans vs Corn u/w Cotton 	<ul style="list-style-type: none"> Oil production disruption

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