COLUMBIA THREADNEEDLE INVESTMENTS

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In Credit

27 JANUARY 2020

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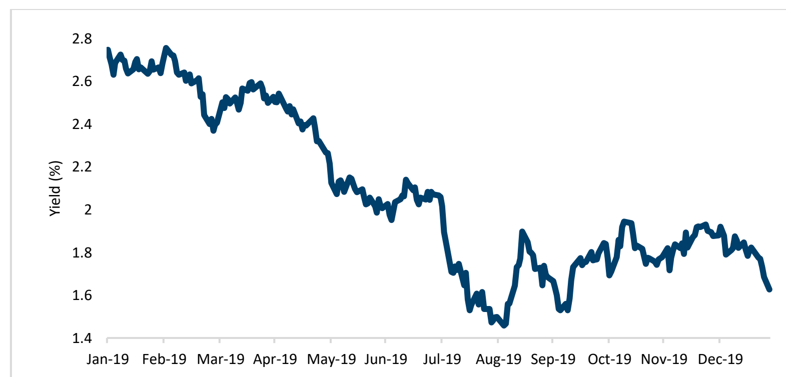
Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	1.64%	-18 bps	1.6%	1.6%
German Bund 10 year	-0.35%	-13 bps	1.1%	1.1%
UK Gilt 10 year	0.54%	-9 bps	3.3%	3.3%
Japan 10 year	-0.04%	-5 bps	0.1%	0.1%
Global Investment Grade	100 bps	0 bps	1.6%	1.6%
Euro Investment Grade	92 bps	-1 bps	0.8%	0.8%
US Investment Grade	101 bps	2 bps	1.8%	1.8%
UK Investment Grade	106 bps	-2 bps	2.7%	2.7%
Asia Investment Grade	191 bps	1 bps	1.0%	1.0%
Euro High Yield	337 bps	17 bps	0.5%	0.5%
US High Yield	368 bps	29 bps	0.3%	0.3%
Asia High Yield	539 bps	10 bps	1.4%	1.4%
EM Sovereign	292 bps	14 bps	1.0%	1.0%
EM Local	5.1%	-7 bps	-0.1%	-0.1%
EM Corporate	312 bps	9 bps	1.4%	1.4%
Bloomberg Barclays US Munis	1.5%	-6 bps	1.4%	1.4%
Taxable Munis	2.8%	-16 bps	3.8%	3.8%
Bloomberg Barclays US MBS	41 bps	3 bps	0.5%	0.5%
Bloomberg Commodity Index	163.30	-3.1%	-4.3%	-4.3%
EUR	1.1033	-0.6%	-1.7%	-1.7%
JPY	109.04	0.8%	-0.6%	-0.6%
GBP	1.3075	0.4%	-1.4%	-1.4%

Source: Bloomberg, Merrill Lynch, as at 27 January 2020.

Chart of the week: 10-year US treasury yield - LTM



Source: Bloomberg, Columbia Threadneedle Investments, as at 27 January 2020.

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Concerns about the spread of a deadly coronavirus from China has amplified market risk aversion in the last couple of weeks. Notably, Asian markets are weaker as is the price of oil. This has provided support for core government bond markets. The benchmark 10-year US government note, which offered a yield of around 1.9+% at the year-end, closed the week around 1.65%. See **chart of the week.**

In the UK, the November unemployment rate came in unchanged at 3.8% with wage growth also steady at 3.2% y/y. There were another 208k jobs created in the last three months. There was also good news with a large leap in optimism (+23%) from the CBI Industrial Trends survey. The week ended with the Markit composite PMI data recording a significant move higher to 52.4 from 49.3 the prior month. Such strength reduces the probability of an interest rate cut by the Bank of England next week but is at odds with the weakness seen from recent retail sales and GDP data.

Similar data from Europe recorded an unchanged composite PMI measure (50.9) with a rebound in Germany but (strike affected) softness in France. Italian spreads tightened as populist Matteo Salvini failed to garner significant support in a regional election.

The coming week will bring an FOMC meeting in the US with no expectation of a change in policy rates and a similar meeting from the Bank of England. As mentioned, a rate cut in the UK hangs in the balance.

Investment grade credit

Global corporate bond spreads continued to squeeze tighter as the New Year's new issuance surge starts to fade, and the earnings season gets into full swing. All the while, demand for income remains a powerful positive force in markets. The risk aversion described earlier did act as a brake on further spread tightening.

So far, much of the new bond supply has been from financial issuers. Bloomberg noted that Austrian Bank Erste launched a so-called CoCo bond (the riskiest type of loss absorbing bank debt) at the second lowest coupon on record for this type of security (3.375%) last week. Phoenix Life issued a US dollar perpetual bond, which was oversubscribed by over 10 times and rallied by over 2.5% in the first day of trading.
Globally valuations (spreads at 100bps) are through the long run (20-year) average (136bps).

High yield credit

US high yield bond prices were modestly lower over the past week amid heavy primary activity and as investors assess the growth risks surrounding the coronavirus outbreak.

A considerable $12.7 billion of high yield issuance priced over the past week following an eight-week high of $12.1 billion the prior week. As such, month-to-date high yield bond issuance now totals $33.1 billion, albeit only $5.3 billion, net of refinancing. For reference, high yield primary markets priced $17.6 billion in January 2019, and January has averaged $26.6 billion since 2010. The asset class reported a $719 million inflow. This was the 3rd consecutive inflow according to Lipper.

The European high yield market also has had a fair amount of new issuance with six new issues in the last week, which included Techem and Stena, the Swedish shipping services business. The coupons offered on these deals could hardly be called 'high' yield (2% and 3.75% respectively). In a world of negative interest rates and government bond yields maybe every little counts?

As regards investment grade credit, the current spreads (337bps) are well inside the long-term average (585bps) with spreads wider in the week.

Leveraged loans

The demand tide is also turning for the US leveraged loan sector with positive retail flows of $83 million across mutual funds and ETFs last week, which follows a $41 million inflow the week prior (Lipper).

Prices were slightly off on a general 'risk-off' tone in the market, although they remain more than $2 above where they stood at the end of October. Total returns are positive roughly 80bps thus far in 2020 and, in contrast to 2019, are being led by lower quality issuers rated B and CCC. The top performing industries month-to-date are metals / mining and energy. With considerable repricings on the forward calendar, gross new issuance has increased to a record high ($94 billion).

Emerging markets

Emerging markets also experienced a dose of heightened risk aversion last week that pushed spreads wider, led by lower credit quality issuers.

As with investment grade and high yield, there was also a hefty weight of primary issuance to digest – skewed towards the euro market. Deals included a new issue from Ukraine, which was absorbed by ongoing demand for the asset class and inflows.

Emerging market central banks continue to keep the door open to rate cuts. The latest example being Malaysia that reduced interest rates by 25bps to 2.75% in the face of weaker economic growth and low inflation.

Commodities

Commodity prices were also weaker in the last seven days - led lower by energy (-6%) and industrial metals (-4.4%). The exception was a 'safe haven' bid for precious metals (+0.6%) in the face of worries around the spread of the coronavirus.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

27th 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 slowdown, weighing on economic growth, metals & petrol

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