COLUMBIA THREADNEEDLE INVESTMENTS

Your success. Our priority.

In Credit

16 MARCH 2020

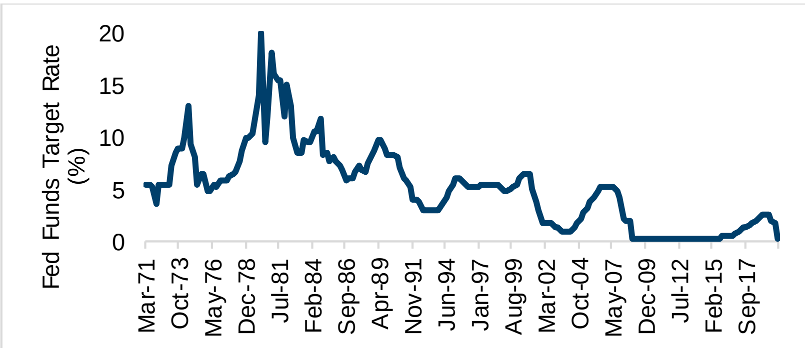
US rates back to zero.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	0.75%	-1 bps	1.1%	6.5%
German Bund 10 year	-0.52%	19 bps	0.4%	3.9%
UK Gilt 10 year	0.37%	13 bps	0.9%	6.2%
Japan 10 year	0.02%	14 bps	-1.2%	0.1%
Global Investment Grade	209 bps	66 bps	-4.4%	-1.7%
Euro Investment Grade	173 bps	46 bps	-3.0%	-2.2%
US Investment Grade	229 bps	80 bps	-5.4%	-1.9%
UK Investment Grade	163 bps	34 bps	-3.1%	-0.7%
Asia Investment Grade	256 bps	35 bps	-1.4%	1.4%
Euro High Yield	659 bps	189 bps	-8.3%	-9.9%
US High Yield	731 bps	167 bps	-7.7%	-9.1%
Asia High Yield	760 bps	130 bps	-5.9%	-5.1%
EM Sovereign	485 bps	106 bps	-8.4%	-7.6%
EM Local	5.5%	73 bps	-6.6%	-10.9%
EM Corporate	464 bps	82 bps	-5.6%	-4.1%
Bloomberg Barclays US Munis	2.1%	86 bps	-4.0%	-1.0%
Taxable Munis	2.4%	39 bps	-2.8%	6.8%
Bloomberg Barclays US MBS	105 bps	39 bps	-0.7%	1.0%
Bloomberg Commodity Index	132.97	-7.7%	-8.0%	-19.0%
EUR	1.1128	-1.6%	0.7%	-0.9%
JPY	105.48	-2.2%	0.2%	0.7%
GBP	1.2240	-5.9%	-4.3%	-7.4%

Source: Bloomberg, Merrill Lynch, as at 16 March 2020.

Chart of the week: Federal Funds Rate (1970-2020)



Source: Bloomberg, Columbia Threadneedle Investments, as at 16 March 2020.

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Macro / government bonds

Core government bonds failed to gain further traction from jittery risk markets last week.

The benchmark 10-year US government note yield rose from 0.35% (intraday on 9 March) to around 0.80% only a few days later. The end of week's move probably reflects concern about the quantum of fiscal stimulus being offered by governments, but the prior moves higher in yield may be more to do with deleverage and the selling of more liquid markets because of 'troubles' elsewhere. Meanwhile, over the weekend the US Federal Reserve slashed rates by another 100bps and promised to increase asset purchases (government and mortgage bonds). This helped yields fall at the start of this week.

In the UK, there has been a combined monetary and fiscal response to the crisis. The Bank of England announced a series of emergency measures to provide liquidity to, and support for, the economy in general and small businesses in particular. Firstly, it has reduced the base lending rate to 0.25% (from 0.75%). Secondly, it has offered lenders special terms to access liquidity (probably in excess of £100 billion) to pass on to SMEs. Lastly, the BoE reduced capital requirements for UK banks, freeing up lending capacity. In addition, the UK government unveiled its own initiatives at the Budget. As widely expected, these included spending on infrastructure projects.

In Europe there was disappointment that the European Central Bank did not offer greater support for the economy. Indeed, the ECB seemed to hand over responsibility to the politicians. On Friday, however, Germany indicated a willingness to offer 'unlimiited liquidity' to small businesses and the European Commision indicated readiness to accept wider fiscal stimulus. This produced a short-lived change in fortunes for risk markets.

Investment grade credit

Credit spreads remain under considerable pressure. The move wider in spreads this year has taken global spreads from around 0.5 standard deviations rich to the long-term (20-year) average to around 1 standard deviation cheap.

Market	Spread	Spread (31/12/2019)	Change (bps)	Change (%)
USD	229	101	+128	+127%
Euro	173	94	+79	+84%
GBP	163	114	+49	+43%

Source: Bloomberg, Columbia Threadneedle Investments, as at 16 March 2020.

Unsurprisingly the new issue market is very quiet in Europe aside from a deal from Danone (which was around eight times oversubscribed) and several deals in the US.

High yield credit

US high yield bonds extended their most severe sell-off since the global financial crisis over the past week after last weekend's launch of an oil price war among Russia, Saudi Arabia, and US shale shocked credit markets already engulfed in the COVID-19 crisis. Notably, Thursday's 78bps of spread widening was the second largest of the credit cycle following Monday's 101bps of widening, which matched the largest of all-time (10 October 2008's 101bps).

Weakness was particularly acute in the energy sector with spreads widening by 361bps on Monday alone. Monday's move was four times more severe than 2015/2016's worst daily widening and energy spreads are now 1,866bps, above where they peaked in 2016. Retail outflows from the asset class have been meaningful. According to Lipper, the week saw a $4.94 billion outflow, the fifth largest weekly outflow on record, split evenly between active managers and ETFs. Over the last three weeks, the asset class has seen $14.3 billion of outflows, which is the largest outflow over a three-week period on record.

European high yield spreads widened 189bps by the end of the week, taking spreads back to 659bps, a level last seen in early 2016. ETFs are now trading at a 5% discount to NAV as outflows continue apace and the market is clearly showing signs of stress. European high yield had outflows of €2.0 billion, of which €724 million was in ETFs. This brings the year-to-date outflows in this asset class to €4.3 billion, of which €1.4 billion was in ETFs.

Leveraged loans

The US leveraged loan market was hit hard last week and posted a negative total return of 5.3% (CS Leveraged Loan Index). Unrelenting outflows totalling $1.8 billion (Lipper mutual fund universe) and $3.3 billion (total universe plus ETFs) pressured prices lower to $89 on average. The market overall is no longer bifurcated in terms of average price with 80-90% of the market trading in the $85-95 range.

Liquidity remains a fluid situation. Most Wall Street loan desks are working remotely this week in response to COVID-19, which will likely impact the velocity and efficiency of trading. There remains, for now, a natural buyer in CLOs, but price discovery may be extended. Fortunately, maturities over the next 18 months are far fewer than in the 2008/2009 financial crisis such that if this crisis is shorter lived, companies are in a better spot as it relates to refinancing. Coupons on bank loans, which float with 1-month Libor, have been impacted as Fed Funds declined to 0% over the weekend, with Libor to follow suit. The average coupon today is roughly 5% and with only 40% of the market tied to a Libor floor, coupons will move lower. It will take some time for Libor floors to be implemented across the board in revised documentation. Defaults remain low at less than 2%. Fortunately, energy only represents about 3.2% of the overall US loan market versus 12-13% of the high yield bond market.

Structured credit

Fundamentals have deteriorated as the MBA Refinancing Index ramped to its highest level since 2009. Capacity constraints at originators are serving as a modest constraint to elevated supply levels. Agency MBS is performing well with credit sectors under pressure. Affordability continues to improve given low mortgage rates and slowing home price appreciation. Adding support to the non-agency market is lower supply and historically low delinquencies.

Specialty sectors such as containers, aircraft, timeshare and rental cars have underperformed considerably, while generic AAA conduit spreads have outperformed single asset single borrower paper backed by destination hotels and shopping malls, as we would expect.

Emerging markets

It was another 'risk off' week as the asset class saw outflows of $7.2 billion across hard and local currencies. Hard currency spreads widened 28% over the week to 485bps and are 37% wider year-to-date, and 70% wider from the tightest spread seen earlier in 2020. ETFs are pricing at a 2.2% discount to NAV, which is a historical first. On an adjusted basis (i.e. to adjust for Venezuela's exclusion and GCC's inclusion last year), this is the largest spread widening since the financial crisis of 2008.

Following the US Fed's surprise 100bps cut over the weekend, South Korea's central bank followed suit with a 50bps cut taking the benchmark interest rate to 0.75%.

Asian fixed income

Last week, Asian credit generated a total overall loss of 4%, comprising a 3.3% loss in high grade and a 6.1% in high yield. By sector, Asian sovereigns was the main underperformer with a loss of 6.8% (corporates: -3.7% loss / quasi-sovereign: -3.1% loss).

In China, the property sales volume for January-February 2020 has declined 40% y/y and sales value is down 36% y/y. Construction new starts have also dropped 45% y/y during the same period. Since the COVID-19 outbreak, there were several easing measures such as the targeted RRR cuts, policy bank loans (CNY350 billion) and re-lending quota (CNY800 billion), to support liquidity in the market and the Chinese property developers. The Chinese property developers have been increasing domestic bond sales to take advantage of the liquidity in the market. For the week ended 13 March, Chinese property companies have issued CNY29.2 billion ($4.17 billion) of domestic bonds.

In India, the telecom companies (Bharti Airtel, Vodafone Idea, Tata Teleservices) have filed their self-assessments of the AGR dues (Adjusted Gross Revenue), which are below the initial estimates of the Department of Telecom (DoT). The DoT reportedly will need at least six months to evaluate these self-assessments.

With the collapse in the oil price, Petronas will assess its budget, but it plans to maintain its domestic capex and the planned dividend payment of MYR24 billion in 2020.

Commodities

Crude oil prices continued to fall last week, with Brent prices falling by 23% to close the week at $35.13. Saudi Arabia announced an increase in production of two million barrels/day, taking overall production to 12.3 million barrels a day, above its longer-term sustainable capacity.

China announced it is looking to add to its reserves, by up to 100 million barrels, given the recent sharp fall in prices. At the same time, it cancelled earlier promised soya bean orders.

By the end of the week, all commodities were lower, including precious metals. A severe dislocation in the market saw investors rushing to raise cash, selling whatever they could. Gold fell 8.8% on the week, of which 5% was on Friday. Silver fell 10% on Friday out of a week's price depreciation of 15%. It was later learnt that part of this dislocation was due to hedge funds' selling.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

16th March 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	■ 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)	P ¥ $ Short -2 -1 0 +1 +2 Long € £	■ COVID-19 likely to derail nascent global recovery, mutating from supply chain disruption to serious demand shock ■ Central bank accommodation back in play ■ Duration remains best hedge for risk asset correction ■ Phase One trade deal fulfilment unrealistic	■ Global trade détente stimulates improvement in risk sentiment ■ Rapid levelling off of virus infection rate ■ US economy stages consumption-driven cyclical upswing
Currency ('E' = European Economic Area)	E EM A$ Short -2 -1 0 +1 +2 Long $ £ ¥	■ 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.	■ Federal Reserve disappoints the market's expectations for policy easing.
Emerging Markets Local (rates (R) and currency (C))	R Under-weight -2 -1 0 +1 +2 Over-weight C	■ COVID-19 threatens global risk sentiment and populated EM positions ■ EM real interest rates still relatively attractive ■ EM growth likely to outperform DM, while inflation benign ■ Fiscal and external fundamentals still largely sound	■ Further 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 Brent vs WTI ■ o/w Gasoline vs Distillates ■ o/w Silver	■ Severe global recession

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