COLUMBIA THREADNEEDLE INVESTMENTS

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In Credit

15 JUNE 2020

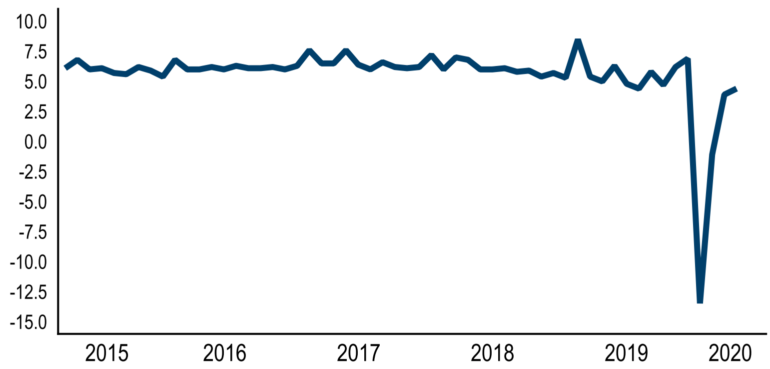
Unsettled by the second wave.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	0.67%	-22 bps	-0.2%	8.6%
German Bund 10 year	-0.45%	-18 bps	-0.1%	1.8%
UK Gilt 10 year	0.20%	-16 bps	-0.4%	9.8%
Japan 10 year	0.01%	-4 bps	-0.2%	-0.7%
Global Investment Grade	165 bps	9 bps	1.1%	2.4%
Euro Investment Grade	145 bps	13 bps	1.2%	-1.3%
US Investment Grade	169 bps	9 bps	1.1%	3.9%
UK Investment Grade	150 bps	2 bps	0.8%	3.0%
Asia Investment Grade	276 bps	-3 bps	1.1%	2.8%
Euro High Yield	554 bps	41 bps	1.8%	-5.1%
US High Yield	628 bps	78 bps	1.8%	-4.0%
Asia High Yield	732 bps	11 bps	2.6%	-1.0%
EM Sovereign	438 bps	23 bps	1.9%	-2.8%
EM Local	4.6%	-1 bps	1.6%	-5.9%
EM Corporate	445 bps	9 bps	2.1%	-0.8%
Bloomberg Barclays US Munis	1.5%	-9 bps	0.6%	1.8%
Taxable Munis	2.6%	-25 bps	1.8%	6.3%
Bloomberg Barclays US MBS	61 bps	0 bps	0.1%	3.7%
Bloomberg Commodity Index	133.80	-1.5%	0.3%	-21.0%
EUR	1.1252	-0.3%	1.4%	0.4%
JPY	107.46	2.1%	0.4%	1.2%
GBP	1.2539	-1.0%	1.6%	-5.4%

Source: Bloomberg, Merrill Lynch, as at 15 June 2020.

Chart of the week: China's industrial production YoY%



Source: Macrobond and Columbia Threadneedle Investments, as at 15 June 2020.

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Municipals

Macro / government bonds

Core government bonds enjoyed a strong week. The US treasury index is now up over 8.5% this year so far. Yields fell in major markets with the benchmark 10-year US government bond yield decreasing from the 1% level reached after the prior week's strong employment rebound. A second wave of Covid-19 virus is affecting some of the largest US states by population (ie, California, Texas and Florida) and this was the chief driver of market direction in what was a light week for economic data.

This week will bring further evidence as to the effect of the virus on economic performance. Key highlights will include the US retail sales and industrial production reports. We will also see the Bank of England meet where many expect delivery of an expansion of its quantitative easing programme.

Investment grade credit

The corollary of a stronger government bond market driven by rising Covid-19 cases was greater nervousness in equity and credit markets. The VIX volatility index reached its highest level since mid-April and credit spreads in investment grade and high yield were wider.

The Global investment grade index benchmark widened to 164bps from around 150bps; this comes at a time of strong asset class inflows.

High yield credit

US high yield bond prices also declined over the week driven by concerns over an emerging second wave of Covid-19 case in the US and a more cautious sentiment regarding the pace of economic recovery.

The ICE BofA US HY CP Constrained Index fell -1.5% and spreads were 78bps wider over the week. Despite the worsening sentiment, lower-rated credits outperformed with BB, B, and CCCs returning -1.53%, -1.68% and -0.71%, respectively. Primary market activity remains elevated with $10.5 billion pricing over the week. The inflow trend continued as well with a $5.1 billion inflow, according to Lipper. This is the fifth largest weekly inflow on record with all of the top five inflows occurring since April of this year.

The European High Yield (EHY) market was also down by about 1% as EHY spreads widened around 40bps. Technicals remain strong, as inflows were high with €861 million, of which €266 million went into ETFs. The primary market was led by TMT as it saw new € issues from Virgin Media, International Game Technology (UK gambling company) , and IQVIA (healthcare IT solutions) as well as a VW hybrid, and SIG Combibloc (a Swiss packaging company).

On the auto sector front, Europcar was downgraded to Caa3 (by 2 notches from Caa1) by Moody's due to its assessment of the longer-term impact that the pandemic will have on the car rental business – its outlook is now stable.

Leveraged loans

Leveraged loan returns remained positive over the week despite the volatility elsewhere.

The JP Morgan Loan Index returned 0.74% over the week, although it had returned 1.35% through Wednesday, while 3-year spreads decreased 20bps over the week to +658bps. Meanwhile, leveraged loan primary market activity remained subdued, as only seven loans priced for $1.8 billion, and only $24.8 billion of loans have priced since February. Gross loan issuance totals $219.8 billion year-to-date, while net issuance stands at $64.3 billion. Inflows for the leveraged loan asset class were modestly positive at $39 million for the week. This is the second inflow over the last three weeks but only the fifth over the last 81 weeks. The leveraged loan index has gained +2.01% thus far in June, providing losses totalling -3.75% year-to-date; split B/CCC loans (-16.56%) have underperformed meaningfully versus BB (-3.10%) and B (-3.34%) loans.

Emerging markets

Emerging markets also experienced some profit taking as hard currency sovereign spreads widened 23bps, while EM corporates spreads widened only 9bps, showing a little more resilience compared to sovereign debt. EM local currency returned -1.4% largely due to FX as the US dollar recovered from the previous two weeks of deterioration.

Demand for the asset class continues with the third week of inflows, in a row, this time of $2.6 billion (highest since January). This brings year-to-date flows to -$30 billion. Local currencies also had their second week of inflows after five weeks of outflows.

Global recovery is happening but on a subdued basis (more subdued than expected.) China is the first sign of what the world can expect on the pace of recovery (given it is the first to start to emerge from the situation.) Industrial production for May, more than two months after the relaxation of the lockdown, came in lower than expected (4.4% vs 5.0%) **- see chart of the week.**

The primary market for EM corporate continues to be quite strong with the first African issuance since March, Helios Towers (African telecoms), as well as Thai Oil (Refiner controlled by Thai government owned PTT Pcl). Both were well received by the market, many times oversubscribed.

In interest rate cutting news, Ukraine lowered its key rate by 2% to 6%. It was expected to be 1% but given the IMF sign-off on funding, the central bank had more rate cut flexibility. In LATAM, Ecuador's finance minister is looking more likely to resign, while its debt restructuring process continues with hope for an IMF programme.

Structured credit

In Agency MBS, Covid-19 has shown little signs of disrupting refinancing activity, which has kept prepay speeds surprisingly high.

Forbearance requests remain in-check with approximately 8.5% of the agency RMBS market currently in forbearance and only 60% of those borrowers not making payments (the remaining 40% of borrowers continue to pay as agreed). US Federal Reserve support has led to attractive valuations in the TBA market, especially in lower coupon mortgages. On the non-agency MBS side, housing activity has declined but valuations remain resilient. Similar to agency MBS, approximately 8% of borrowers are in forbearance but many of them are still making payments. Liquidity in non-agency MBS is strong and prices have recovered 75-100% of their declines. Consumer ABS has also tightened over recent weeks, aided by TALF programmes, limited supply and improved fundamentals. In the CMBS market, approximately 10% of borrowers did not make their April mortgage payments and prices are increasingly bifurcated across sub-sets of the market with weaker hospitality and retail credits lagging and office and industrial credits largely recovered. In line with the risk rally, lower quality CLOs have tightened of late driven by opportunistic capital raises.

Asian fixed income

S&P retained India's BBB- ratings with a stable outlook. While S&P recognizes that the growth risks are increasing, the agency expects India's economy and fiscal position will stabilize and start to recover from 2021 onwards. S&P also expects India to maintain a sound net external position.

For the Indian telecom sector, the Supreme Court's hearing for the AGR issue (Adjusted Gross Revenue), which has been delayed due to Covid-19, took place on 11 June. The Supreme Court is reportedly considering whether the 20-year payment period, as proposed by the Department of Telecommunications, is reasonable and whether the telco operators are willing to provide guarantees and commitments.

Bloomberg reported that Bharti Airtel and Vodafone Idea may offer certain spectrum and tangible assets as securities. Both Bharti Airtel and Vodafone Idea have to furnish a detailed roadmap for the AGR payment, including the guarantees and securities that they will provide for an extended payment period. The next hearing is on 18 June.

Commodities

Commodity prices were softer last week as the market saw a correction with the index falling 1.5%, largely on the back of the fall in energy prices.

Oil markets backed off due to weekly DoE number, which showed an eight million barrel build in US. Some of the dislocations in different grades of crude oil is now normalising. Still, the build-up of global inventories continues. Covid-19 concerns of a continued slowdown hit on oil prices.

In metals, precious metals were higher as gold price rose 3% on the risk off sentiment. Base metals were weaker except for copper, which rose 2.1%.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

15th June 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	▪ 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 be 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.	▪ Major economies cannot 'flatten the curve' of COVID-19 and 'recession' becomes 'depression'.' ▪ Reopening begets a widespread reclosing. ▪ Central banks pull back support too early and positive technicals vanish.
Duration (10-year) ('P' = Periphery)	P ¥ $ Short -2 -1 0 +1 +2 Long € £	▪ 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	▪ 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)	EM E Short -2 -1 0 +1 +2 Long $ A$ ¥ £	▪ 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 moves away from ultra accommodative stance ▪ Investors reappraise US crisis/fiscal response as more likely to speed a return to normality then other regions
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	▪ 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.	▪ 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	Under-weight -2 -1 0 +1 +2 Over-weight	▪ 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.	▪ 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	Under-weight -2 -1 0 +1 +2 Over-weight	▪ 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.	▪ 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	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, 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).	▪ 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	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 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.	▪ Consumer behaviour and employment are fundamentally changed by even a brief, successful 'social distancing effort. ▪ Housing prices begin to fall in contrast to current trend.
Commodities	Under-weight -2 -1 0 +1 +2 Over-weight	▪ o/w Base Metals ▪ u/w Crude ▪ o/w Soybeans vs Corn ▪ u/w Cotton	▪ Oil production disruption

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