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In Credit

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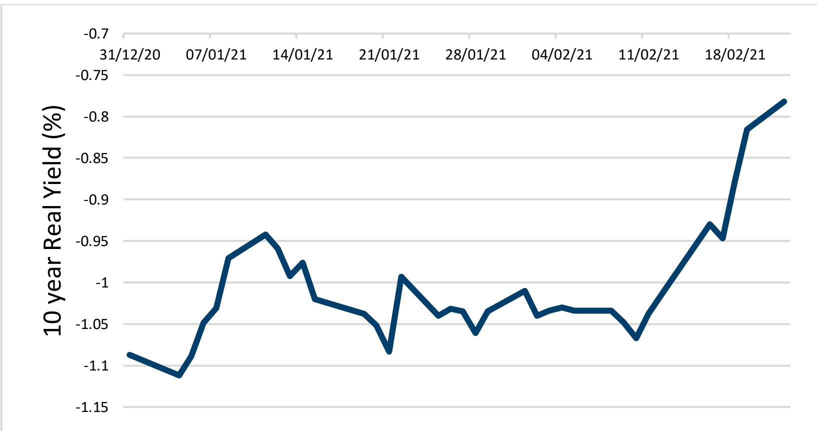
Yields are rising…. really!

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	1.36%	15 bps	-1.5%	-2.7%
German Bund 10 year	-0.32%	11 bps	-1.8%	-2.2%
UK Gilt 10 year	0.70%	18 bps	-4.4%	-6.1%
Japan 10 year	0.13%	6 bps	-0.4%	-0.7%
Global Investment Grade	94 bps	-3 bps	-0.9%	-1.7%
Euro Investment Grade	86 bps	-2 bps	-0.4%	-0.5%
US Investment Grade	94 bps	-3 bps	-1.1%	-2.3%
UK Investment Grade	91 bps	-1 bps	-2.0%	-2.9%
Asia Investment Grade	217 bps	-6 bps	0.0%	0.1%
Euro High Yield	324 bps	-9 bps	0.9%	1.4%
US High Yield	341 bps	-7 bps	1.0%	1.3%
Asia High Yield	562 bps	-24 bps	0.9%	0.8%
EM Sovereign	314 bps	2 bps	-0.8%	-2.0%
EM Local	4.5%	19 bps	-0.5%	-1.5%
EM Corporate	305 bps	-8 bps	0.4%	0.4%
Bloomberg Barclays US Munis	1.0%	15 bps	-0.4%	0.2%
Taxable Munis	2.2%	9 bps	-2.0%	-2.1%
Bloomberg Barclays US MBS	18 bps	1 bps	-0.4%	-0.3%
Bloomberg Commodity Index	182.50	1.5%	6.5%	9.3%
EUR	1.2132	0.0%	-0.1%	-0.8%
JPY	105.61	-0.5%	-0.7%	-2.0%
GBP	1.4028	1.2%	2.2%	2.5%

Source: Bloomberg, Merrill Lynch, as at 22 February 2021.

Chart of the week: Rising US 10-year real yields in 2021.



Source: Bloomberg, Columbia Threadneedle Investments, as at 22 February 2021.

3460777 Issued February 2021 | Valid to end April 2021

Macro / government bonds

If there is something to characterise this year by it would be that of rising bond yields and equity prices (I'm not going to mention Bitcoin).

Until recently, the composition of these rising government bond yields has been one of increasing inflation expectations, led by the prospect of a blockbuster fiscal package in the US and the successful rollout of coronavirus vaccinations in places like the US and UK. Equity and credit markets have shrugged off this move as being largely one that is good news. Banks have enjoyed a steeper yield curve as well.

Interesting, then, that the end of last week saw the other component of nominal yields (real yields) rise for the first time in months. The 10-year inflation protected bond in the US, for example, saw its yield rise from -1.1% around the year end to -0.77% last week. This is hardly the stuff of panic but notably the equity market stopped rallying. Real yields are (obviously) still very low; the average is closer to 1.5% since this type of security was first issued in 1996, but a rising discount rate is certainly worth watching for its effect on risk markets.

It was a moderate week for economic releases especially in the US. Broadly the monthly data was positive with retail sales, PPI, composite PMI, industrial production and building permits. Less constructive and more contemporary was a rise in weekly jobless claims, which notched the highest level in around a month. In the UK house prices grew by 8.5% y/y led by tax breaks while in the eurozone vehicle registrations shrank by over 25% in the last year, with the composite PMI coming in below 50.

Investment grade credit

As mentioned, the rise in inflation expectations and real yields has registered little effect on spreads in investment grade credit markets. Indeed, global spreads are around the tightest this year (94bps) and well below the short- and long-term average. Like all risk markets credit has been supported by super accommodative policy conditions. Should inflation expectations challenge that ongoing support there is less justification for these tight spreads.

That said, investment grade companies continue to adapt well to the economic environment and are expected to improve in credit quality in the coming years. Meanwhile, technicals are supportive with the expectation of much lower primary issuance this year.

Bank results point to lower cost of risk and higher capital levels so thematically the focus will be on capital return going forward. Mining companies have delivered solid results with deleveraging evident; utilities have proved resilient while toll roads have done better than airports as might be expected.

High yield credit

US high yield bond spreads tightened modestly over the week, partially offsetting the rise in interest rates and resulting in a negligible total return for the week. The ICE BofA US CP Constrained Index total return was -0.05% while spreads were 7bps tighter. The yield-to-worst of the index was unchanged at 3.92%. According to Lipper, the asset class reported a $1.4bn outflow over the week.

European high yield experienced more spread tightening last week. Positive performance was from higher beta credits as BB returns were flat with B and CCC credit outperforming. The asset class experienced another week of small net outflows due to ETF sales as actively managed accounts are still seeing inflows.

Primary markets took a breather with only €1.9bn in new issuance, mainly from IQVIA (health care) bond refinancing of €1.45bn. Demand was especially strong as buying interest was not only from high yield but also investment grade investors.

In auto sector news, EU car sales for January were down -24% to 726k. This was not totally unexpected after the big five auto markets showed mostly double-digit losses. Guidance for 2021 is still for a growth of 11% as the outlook remains constructive, while several firms are demonstrating plans for huge investments into electric vehicles.

In a sign of the growing influence of ESG, Constellium (aluminium producer) earlier this year issued a sustainability bond with a coupon linked to a recycling feature. A linking call structure in high yield bonds to ESG features is potentially something the market will be seeing more going forward.

Leveraged loans

The average price of the J.P. Morgan Leveraged Loan index rose +$0.05 to $98.29 during the week, increasing in 11 of the last 12 sessions, amid ongoing inflows and heavy CLO origination. The Loan index is providing a +0.51% gain in February with Split B/CCC loans (+1.08%) outperforming B loans (+0.52%) and BB loans (+0.32%). The largest industry gainers of the month are Diversified Media (+0.89%), Energy (+0.87%), and Gaming/Leisure (+0.84%). Inflows for the asset class continued with a $575mm contribution over the week, the 6th consecutive week of sizeable inflows.

Structured credit

Amidst further bear steepening, the Agency MBS market posted -20bps of total return last week. Improving vaccine and hospitalisation data alongside the possibility of a greater stimulus package and higher inflation expectations pushed longer US treasury yields higher. At the same time, conventional borrowers were granted another three months of forbearance and Ginnie borrowers an extra six months if needed. That ultimately is the question with forbearance rates and new delinquencies all trending down. Prepay speeds continue at a rapid pace, while OAS on new production coupons are now negative in most prepayment scenarios. While TBA dollar rolls and carry remain attractive, increased hedging costs (longer durations) dampen hedge-adjusted carry. In the Non-QM Market, the first securitisations backed by freshly originated loans carried a mix of Full Doc, Bank Statement, and other underwriting with a blended three months average loan age. Prior deals came with nine or more months of seasoned loans indicating origination volumes are beginning to pick up. In asset-backed securities, consumer performance continued to exceed expectations, but we are starting to see signs of mean reversion. Most of the capital stack now trades through pre-covid tights on strong demand and limited supply.

Asia fixed income

Bank Indonesia, as part of several temporary measures to boost the economy, has announced the increase of the loan-to-value (LTV) for property loans to a maximum 100% for all types of house (previous LTV: 90-95%). This LTV increase is appliable from March to December 2021. Only banks with non-performing loans (NPL) of below 5% are allowed to offer the 100% LTV – albeit banks have the final discretion in making the property loans.

Moody's has affirmed the B2 corporate rating of Vedanta Resources Limited (VRL) and the Caa1 rating on the senior unsecured notes. Moody's has also revised the outlook to negative from "ratings under review". VRL has lowered its immediate refinancing risks through recent fund-raising, which include the $1bn bond issuance in December 2020. The liquidity position, however, remains weak and the holding company continues to have significant debt maturities, which is reflected by the negative outlook.

ReNew Power Ltd is reportedly planning to list its shares in the US via the SPAC route with a valuation of $4bn. ReNew Power has been interested on a public listing in India too over the last few years, which will provide an avenue for its main shareholder GS Wyvern (Goldman Sachs private equity fund) to reduce its stake in the company.

Emerging markets

The move in EMD spreads was muted with a 2bps widening for hard currency sovereign and 3bps tightening for corporates. Local currency returns were negative due to both rates and currencies with the strength of the US dollar. Flows turned negative last week, for the first time in seven months, as the asset class saw a net $380m exit the asset class, mainly from hard currency funds as local currency still experienced some inflows.

In central bank news, Turkey kept rates unchanged at 17%, as expected, though the central bank maintained a hawkish bias. Indonesia moved to another rate cut, to a new low of 3.5%, while also relaxing rules on property and automotive loans to stimulate an economic recovery. The IMF agreed to revive Pakistan's $6bn bailout programme (after the government raised power tariffs in January). This should help Pakistan to come to market soon with already talk of a $500m green eurobond. Kenya also inched closer to a $2.4bn IMF loan programme.

There was some good news for two major EM energy/utility companies. In North America, the Mexican government announced "significant" support for Pemex, which will likely be in the form of tax cuts. There is also talk of capital injections to take place in the coming weeks. In South Africa, the court ruled that ESKOM, the beleaguered South African utility company, can recover 10bn rand in tariffs. Offsetting this was news from Brazil where President Bolsonaro announced the replacement of Petrobras' CEO with a former general. This follows a dispute after the company brought fuel prices in line with international rates.

Commodities

The commodity index rallied 1.5% on the week taking year to date returns to 9.3%. This was largely led by metals.

Industrial metals rallied sharply (+4.5%) as China returned from Chinese New Year celebrations. Tin (+10.9%) and Copper (+7.6%) were the strongest performers. Copper was supported by the emerging tightness in supply as enhanced demand was driven by the global electrification theme. Significantly, more Copper is needed for EV's and their battery charging infrastructure. Tin has also been driven by this theme, due to its use in soldering electrical components. In precious, gold declined by 2.5% following the rise in US yields.

Energy markets were down 1.7% overall. Though crude markets were steady, heating oil and gasoil gained 2.1% and 3.4%, respectively. The market was driven by a severe temperature drop in Texas (-15℃) leaving millions of homes without power. The freeze cut off gas supplies to refineries and power plants. In agriculture, soybeans and corn rallied 0.6% and 1.0% respectively, as the US announced it will seed the largest ever growth area due to rising demand and prices.

Responsible investments

Ford Motor Co. has announced a $1bn investment into its German assembly plant to transform the output to be only fully electric-powered vehicles by the end of the decade. It aims to be exclusively selling plug-in hybrids and fully electric cars by mid-2026 and only be selling petrol powered vans and trucks via its commercial-vehicle business. The optimism around Ford's future plans has sent the stock price up 31% this year so far.

Social bond issuance has already surpassed a quarter of last year's issuance year to date ($54bn year-to-date). The real increase, however, has been in sustainability-linked bonds (SLBs), with 35 individual bonds issued so far when only 46 were issued over the entire year of 2020. We are not far from exceeding total issuance of SLBs either with just over $3bn to go until we rise above that tide mark. JPMorgan anticipates SLBs will reach $120bn in total issuance this year. However, there is a realisation that some companies are using relatively easy targets to claim the sustainable link label, minimizing the risk of penalties later down the line.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

22nd February 2021

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	■ 2021 has started with continued positive credit performance – and not for nothing: fundamentals in 2021 should continue to improve as economic activity normalizes amid more widespread vaccination. ■ Despite this outlook, valuations matter. Most spread sectors are well inside long-term averages. ■ We have likely already seen peak liquidity in financial markets. We do not expect material tightening in financial conditions next year, but spreads at these levels no longer offer cushion for unforeseen hiccups. ■ We have a modestly positive outlook but realistic returns are lower than in 2020.	■ Rapidly rising Treasury yields tighten financial conditions or make all in yields of credit less attractive. ■ A recovering economy propels spreads to all-time tights, especially if vaccinations accelerate quickly ■ The recovery gets bungled by vaccine delays, geopolitical interruptions, or a limping back to normality in the services sector
Duration (10-year) ('P' = Periphery)	P ¥ $ Short -2 -1 0 +1 +2 Long £ €	■ Renewed virus concerns and economic disruption to keep nominal growth subdued ■ Reflation credibility still low, although risks from fiscal policy ■ Fed QE and high personal savings underpin demand for treasuries ■ ECB bond buying scheme supports Eurozone market ■ Duration remains best hedge for further risk asset correction	■ Very aggressive re-normalisation of consumption ■ Permanent fiscal policy shift rebuilds reflationary credibility and raises r* ■ Fiscal largesse steepens curves on issuance expectations ■ Risk hedge properties deteriorate
Currency ('E' = European Economic Area)	¥ £ EM Short -2 -1 0 +1 +2 Long E A$ $	■ US growth outperformance on back of fiscal stimulus boosts USD ■ ECB increasingly sensitive to Euro appreciation	■ Vaccine rollout in Europe improves and narrows growth gap ■ Failure to pass substantial fiscal package in US
Emerging Markets Local (rates (R) and currency (C))	R Under-weight -2 -1 0 +1 +2 Over-weight C	■ Favourable advanced economy policy settings support EM assets in near term ■ EM real interest rates relatively attractive, curves steep	■ 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	■ EM economies have been given very long leashes to respond to COVID: deficits and debt have skyrocketed with no plans for reigning them in. Any slowdown will likely exacerbate these 'back burner' issues. ■ Valuations are still a slight benefit to EM, particularly EM HY credits. ■ Low yields, lots of liquidity, and global recovery still could provide tailwinds for EM in 2021, but could be offset quickly if the USD fails to weaken further.	■ A replay of 2013 occurs with a taper tantrum or swift appreciation of the USD ■ Growth scars from COVID persist and hurt commodity prices & ability to grow out of deficits. ■ Governments show little willingness to address deficits post-COVID.
Investment Grade Credit	Under-weight -2 -1 0 +1 +2 Over-weight	■ IG companies continue to adapt well to the economic environment, given that they are the best-in-class operators in their industries. ■ Valuations are the biggest drawback: with spreads this tight, widening could very quickly more than offset carry. ■ Technicals remain strong, especially as global investors survey the universe of high-quality assets and see extremely low government bond yields.	■ IG bonds further cement their place in global investors' portfolios as safe assets, replacing government bonds. ■ M&A and shareholder returns remain in the backseat of management's priorities for an extended period of time.
High Yield Credit	Under-weight -2 -1 0 +1 +2 Over-weight	■ Spreads are inside LT averages, even adjusting for the better quality of today's index. But higher yields give more cushion than slightly higher quality bonds. ■ The ability to access financing has dramatically improved the prospects for many companies, especially for COVID-affected industries. ■ The positive effects of easy financial conditions hit HY later than higher quality sectors, and tighter conditions will hit HY first.	■ Upside risks include: intensified reach for yield keeps drawing new investors, M&A lifts HY companies into larger IG conglomerates. ■ Downside risks include: travel & leisure habits slowly revert to pre-COVID, commodity sell-offs, or financial conditions suddenly tightening.
Agency MBS	Under-weight -2 -1 0 +1 +2 Over-weight	■ Fed buying has overwhelmed highly negative fundamentals, as seen by the near-zero spreads in bonds the Fed buys and poor performance elsewhere. ■ Fed buying cannot be expected to increase in 2021, exposing negative fundamentals and valuations ■ Prepays remain and will remain high, with >70% of mortgages having incentive to refinance.	■ Housing activity slows considerably and prepays move back down to normal levels, without denting households' ability to service mortgages. ■ The Fed maintains or increases MBS purchases next year.
Non-Agency MBS & CMBS	Under-weight -2 -1 0 +1 +2 Over-weight	■ RMBS: Housing has been a major outperformer in this recovery, as demand rises and inventory remains low. Strong household balance sheets amongst homeowners has kept fundamentals strong as well. However, many of these bonds are now call-constrained. ■ CMBS: subsectors continue to perform divergently, although spreads even in the most affected areas, like office space & convention hotels, have recovered. ■ Our preference remains for non-agency RMBS in this area.	■ Changes in consumer behaviour in travel and retail last post-pandemic. ■ Work From Home continues full-steam-ahead post-pandemic. ■ Built-up savings from fiscal stimulus/enhanced unemployment benefits are drawn down and mortgage forbearance increases.
Commodities	Under-weight -2 -1 0 +1 +2 Over-weight	■ o/w Copper vs Aluminium ■ o/w Lead vs Zinc ■ o/w Soybeans vs Corn ■ u/w Sugar ■ u/w WTI	■ Oil production disruption