COLUMBIA THREADNEEDLE INVESTMENTS

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In Credit

25 AUGUST 2020

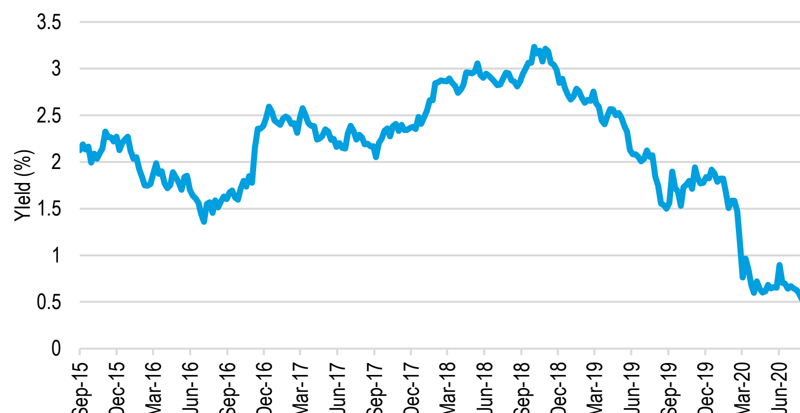
Summer slumber soothes markets.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	0.65%	-6 bps	-0.8%	9.5%
German Bund 10 year	-0.49%	-6 bps	-0.3%	2.6%
UK Gilt 10 year	0.21%	-3 bps	-2.0%	7.8%
Japan 10 year	0.03%	-2 bps	-0.5%	-1.1%
Global Investment Grade	134 bps	2 bps	-0.3%	5.4%
Euro Investment Grade	116 bps	1 bps	0.5%	0.7%
US Investment Grade	138 bps	3 bps	-0.7%	7.4%
UK Investment Grade	126 bps	-1 bps	-0.5%	4.5%
Asia Investment Grade	253 bps	4 bps	0.2%	5.2%
Euro High Yield	484 bps	6 bps	1.1%	-2.2%
US High Yield	525 bps	-1 bps	0.1%	-0.1%
Asia High Yield	668 bps	10 bps	0.9%	2.6%
EM Sovereign	386 bps	9 bps	0.6%	2.4%
EM Local	4.4%	3 bps	-1.5%	-5.5%
EM Corporate	395 bps	4 bps	0.8%	3.0%
Bloomberg Barclays US Munis	1.2%	5 bps	-0.1%	3.6%
Taxable Munis	2.2%	-7 bps	-0.6%	11.4%
Bloomberg Barclays US MBS	58 bps	4 bps	0.0%	3.7%
Bloomberg Commodity Index	153.24	0.9%	4.1%	-11.3%
EUR	1.1834	-0.4%	0.2%	5.2%
JPY	105.77	0.7%	0.0%	2.7%
GBP	1.3120	0.0%	0.0%	-1.3%

Source: Bloomberg, Merrill Lynch, as at 24 August 2020.

Chart of the week: US 10-year yield (last five years)



Source: Bloomberg and Columbia Threadneedle Investments, as at 24 August 2020.

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Macro/Government bonds

It was a relatively quiet week – though core bond yields managed to drift a little lower. **Chart of the week** illustrates the lack of yield volatility in recent weeks.

The concern about the outsized CPI reading of the prior week seems to have been allayed. The US dollar also seems to have found some support. This probably reflects weaker business sentiment data out of Europe while the US enjoyed an improvement in such confidence. Peripheral European market spreads widened a little as this week holds a large amount of news issuance, especially from Italy.

This week is light in terms of economic data, though markets will look to the Jackson Hole Symposium for any forward guidance about monetary policy.

Investment grade credit

Spreads were little changed last week, though it has been a positive month thus far for investment grade credit. The US market struggled to make headway against a backdrop of heavy new issuance. The holiday season meant that this was not the case in Europe. Some of the new issuance reflected M&A funding (eg, Johnson and Johnson). We are almost through reporting season which has not been as bad as most feared. In stock-specific news, UK retailing giant Tesco announced the creation of 16,000 permanent jobs in its online business (such businesses have enjoyed great success in the lockdown).

Structured credit

The Agency MBS market was essentially flat last week. Rates rallied on some economic misses, the FOMC minutes were underwhelming, and heavy origination volume was well absorbed by the market. Housing activity data was positive and is expected to continue as a result of low mortgage rates and slowing prepay speeds given capacity constraints. There was little change in the non-qualified mortgage market with spreads largely unchanged. Supply remains light as Agency rfis continue to take centre stage.

High yield credit

US high yield bond prices were largely unchanged over the week while the asset class battled a supply hangover and digested the implications of recent interest rate volatility. The ICE BofA US HY CP Constrained index returned 0.01% and spreads were unchanged. The new issue market remained active heading into the typical summer shutdown, albeit at a more modest pace than the prior two weeks. Specifically, $12.4 billion of new bonds priced for the week, which compares with $22.2 billion and $19.9 billion of new-issue volume the prior two weeks (the largest and fifth largest weekly totals on record), leaving month-to-date issuance as the most active August on record with more than a week left in the month.

European HY experienced modest spread widening last week as the market took a breather with the summer lull and lack of primary issuance. Flows were light with only €81 million of inflows, mostly into managed funds.

S&P released an update on EHY default expectations for 2021. It indicates a base case of 8.5% for 2021 with best case as 3.5% and worst case as 11.5%. There was a cold splash of reality as

Goldman Sachs issued a report highlighting that flooding the market with liquidity will not stop a company from defaulting.

In stock specific news, French hospitality firm ACCOR's senior bonds were downgraded by S&P to BB+. Interestingly this comes at the same time as a swirl of M&A stories for ACCOR (Intercontinental and Travelodge).

Earnings season has come to a close. In general, companies have met or beat expectations; they are, however, vague on outlook or guidance.

Leveraged loans

Leveraged loan prices increased $0.08 to $93.91 during the week, which is two cents down from Wednesday's post-March high. The average price of the JP Morgan Leveraged Loan index of $93.91 compares with $97.47 on 21 February. Meanwhile, loan yields and spreads (three-year) decreased 3bps and 1bps w/w to 6.17% and 594bps, respectively, which compares with 5.81% and 452bps on 21 February. The Leveraged loan index is providing a +1.10% gain in August, with Split B/CCC loans (+3.16%) outperforming BB (+0.62%) and B (+1.06%). The outflow trend continued with another $301 million exiting the asset class according to Lipper.

Emerging markets

Emerging markets also experienced modest widening last week. Still, the asset class experienced inflows of $1.2 billion which, though largely into hard currency, also marked the fifth straight week of flows into local currency bond funds. Pricing for high quality EM is now back to pre-Covid levels.

In central bank news, Philippines, Turkey, and Indonesia all kept rates on hold last week as some sign of economic rebound was seen. In LATAM news, Brazil's lower house showed overwhelming support to President Bolsonaro's veto on wage increases, showing that fiscal reform remains strongly on the agenda. In Eastern European news, the Belarus story continues to evolve with the Kremlin announcing support for Lukashenko while the people demand he step down post the recent elections showing Lukashenko won over 80% of the vote, while the embattled president is calling for a new constitution.

Asian fixed income

Melco Resorts' Q2 results were weak as expected with an operating loss of USD370.8 million (prior year Q2: operating profit of USD208 million) but Q3 may be better as visitor volume trends higher over the coming weeks. The issuance of IVS (Individual Visa Scheme) resumed on 12 August for mainlanders from Zhuhai, a border city. Applicants must show a negative Covid test within the past seven days and get a green health code to receive the visa. The IVS issuance may be extended to the rest of Guangdong province on 26 August and subsequently to residents across China on 23 September, ahead of the Chinese Golden Week holidays in the first week of October.

Alibaba reported a strong set of Q1 results (quarter ended 30 June 2020). Q1 revenue rose to CNY153.75 billion (+34% y/y), helped by Core Commerce revenue. The adjusted EBITA grew 31% y/y to CNY45.37 billion, anchored by the contribution of Core Commerce (+24.9% y/y to

CNY51.24bn), which compensated for the negative EBITA from Cloud Computing, Digital Media and Entertainment and other segments.

The Q2 operating results of Press Metal Aluminum (PMA) were satisfactory despite the 6.8% q/q decline in EBITDA, in light of the pandemic-driven impact on commodity demand. Positively, EBITDA was higher 4.9% y/y, thanks to lower alumina and carbon anode prices. PMA is committed to execute its expansion as planned and will commission its Phase 3 smelter in January 2021 which may increase its capacity by 42% from 760kt to 1.08mmt/annum. PMA has a new 15-year power purchase agreement for an additional 500MW of power with Sarawak Energy (low-cost electricity).

Genting Hong Kong has suspended debt service payments to its creditors which negatively impacted sentiment on the whole Genting Berhad and Genting Singapore complex. Genting Hong Kong, however, is a separate entity which is around 70% owned by Kien Huat Realty (controlled by the Lim family). Kien Huat Realty holds a 42.8% stake in Genting Berhad which itself holds an indirect 53% stake in Genting Singapore Ltd. So far, Genting Berhad has not shown any indications that it will step in to financially support Genting Hong Kong.

Commodities

The asset class was up almost 1% on the week, largely on the back of base metals and energy. Crude oil prices held steady last week while gasoline and natural gas rose with the increased summer demand on the back of improving travel news and the heat wave going across the US.

Gold was volatile as it briefly reached a high of 2015 before ending, overall, marginally lower on the week at $1940.00/oz.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

24th August 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 ▪ Consumption to flatten out after initial sequential recovery surge ▪ Monetary policy will seek lower, flatter curves and more than offset 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. Even with a bounce in oil prices, no US companies are profitable if these prices persist ▪ 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 ▪ 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 Copper vs Aluminium ▪ u/w Crude ▪ o/w Soy beans vs Corn ▪ u/w Softs ▪ o/w refining margins (o/w products, u/w Brent)	▪ Oil production disruption

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