

In Credit

17 AUGUST 2020

Parties, choose your candidates!

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	0.69%	13 bps	-1.2%	9.0%
German Bund 10 year	-0.43%	8 bps	-1.0%	1.8%
UK Gilt 10 year	0.24%	10 bps	-2.3%	7.5%
Japan 10 year	0.05%	4 bps	-0.5%	-1.1%
Global Investment Grade	132 bps	-2 bps	-0.6%	5.1%
Euro Investment Grade	115 bps	-8 bps	0.1%	0.3%
US Investment Grade	135 bps	0 bps	-1.0%	7.1%
UK Investment Grade	127 bps	-3 bps	-0.7%	4.2%
Asia Investment Grade	250 bps	0 bps	0.1%	5.1%
Euro High Yield	478 bps	-17 bps	1.1%	-2.3%
US High Yield	526 bps	20 bps	0.1%	-0.2%
Asia High Yield	658 bps	-7 bps	1.0%	2.8%
EM Sovereign	377 bps	-7 bps	0.7%	2.5%
EM Local	4.4%	6 bps	-0.8%	-4.8%
EM Corporate	391 bps	-5 bps	0.7%	2.9%
Bloomberg Barclays US Munis	1.2%	6 bps	0.2%	4.0%
Taxable Munis	2.2%	9 bps	-1.3%	10.6%
Bloomberg Barclays US MBS	54 bps	7 bps	0.0%	3.7%
Bloomberg Commodity Index	152.00	0.5%	3.1%	-12.2%
EUR	1.1851	0.5%	0.5%	5.6%
JPY	106.36	-0.6%	-0.7%	1.9%
GBP	1.3106	0.3%	0.0%	-1.3%

Source: Bloomberg, Merrill Lynch, as at 17 August 2020.



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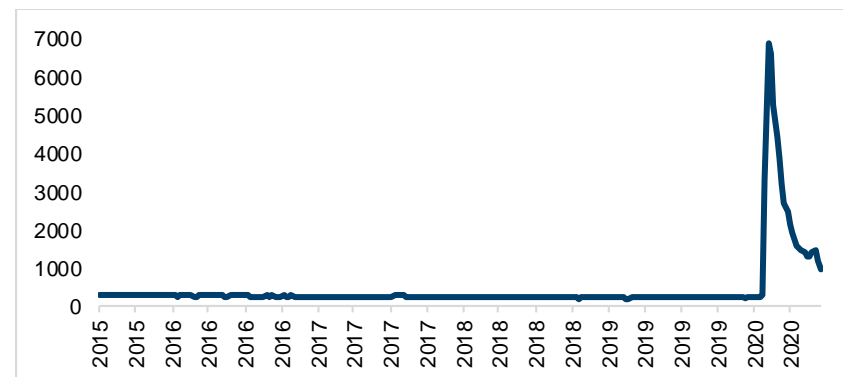
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Chart of the week: US Weekly Initial Jobless Claims



Source: Bloomberg and Columbia Threadneedle Investments, as at 17 August 2020.

Macro / government bonds

Core yields rose this week with the US 10-year reaching 0.69%, a level we haven't seen since late June.

The US still waits for any additional fiscal stimulus decisions as Democratic and Republican nominating conventions are taking place over the next few weeks, putting any discussions and decisions on hold. Both chambers of Congress aren't scheduled to return until mid-September. On a more positive note, US Weekly Initial Jobless Claims reported a fall this week of 223k, taking the figure under 1 million to 963k ([see chart of the week](#)), beating expectations. However, this is still five times the pre-crisis levels. It will still take some time to establish if this is a continuous trend.

In Covid-19 news, Singapore announced a further addition to fiscal stimulus of \$5.8 million to help the recovery from the pandemic effects. New Zealand made the decision to delay its national election by four weeks given the recent upward trend in virus cases. With Australia having its deadliest day and South Korea concerned it could become a hotspot again (197 more cases in a recent flare up), it's clear the virus is not slowing down and continues to bring less hope of 'V' shaped recoveries around the world.

More CPI data is due this week along with the US FOMC minutes being released this Wednesday.

Investment grade credit

European investment grade credit outperformed last week with US underperforming. Most spread markets are now back to long-term averages.

Supply to the market continues to be low with levels expecting to pick up nearer the end of this month.

With retail one of the worst impacted sectors from Covid-19, news of potential fundraising from one of the world's largest mall landlords, Unibail-Rodamco-Westfield, has sparked interest. The company operates all Westfield shopping centres across the US and Europe. Supposedly, it is considering a rights offer to raise €3 billion and is already in the early stages of talks with potential advisors. Unibail's share price was down 6.6% at the close of last week.

Structured credit

While the Agency MBS market finished marginally lower on the week, the sector strongly outperformed other duration-sensitive assets, including the US Bloomberg Barclays Aggregate Bond Index. The sector was given a boost by the GSE's surprise announcement to levy a 50-bps delivery fee on effectively all refinances with settlement dates after 1 September 2020. This is a strong tailwind for agency MBS as it is expected to slow repayment risk with mortgage originators pushing that fee along to consumers. A technical force continues in the form of US Fed support with purchases of Agency MBS now exceeding \$900 billion. In the non-agency MBS market, housing activity is exhibiting a 'V'-shaped recovery, aided by low rates. Approximately 7.5% of mortgage borrowers have opted for forbearance; a number that is far lower than expectations earlier in the year. CMBS is an area of concern with approximately 8.5% of CMBS borrowers not making their June mortgage payment. Especially hard hit are weaker retail and hospitality credits. CLO spreads have softened modestly on heavy new issue and supply in the market.

High yield credit

US high yield bond prices were modestly lower over the past week amid heavy issuance, a climb in US treasury yields and fading prospects for a quick resolution on fiscal stimulus with Congress set to recess for the rest of August. The ICE BofA US HY CP Constrained index returned -0.51% and spreads were 20bps wider. Primary issuance surged for a second straight week as issuers capitalize on historical low coupons available. An additional 28 deals for \$19.9 billion priced, which was the fourth largest week on record following the third largest on record the prior week (\$21.1 billion). Thus, month-to-date new issue volume totaling \$40.3 billion is already the most active August on record. Note \$34.7 billion or 86% of August's issuance has been refinancing related with only \$5.6 billion representing net new activity. The asset class reported inflows totalling +\$1.54 billion.

European high yield had another quiet week of spread tightening, contracting a mere 7bps to 478bps. The asset class experienced a marginal net inflow of €39 million, which was actually a result of inflows into ETFs but also an outflow from managed funds. It was another quiet summer week for the primary market.

In firm specific news, TUI is the latest company to receive €1.2 billion in government guaranteed loans. Bonds were up 8 points on the news.

Q2 earnings announcements have been generally positive with most beating the market's low expectations, showing pretty good cost control, and giving comforting comments on cash liquidity.

Leveraged loans

Leveraged loan prices continued to climb over the past week with the index now rising in 12 consecutive sessions. The J.P. Morgan Leveraged Loan index average price increased \$0.43 to \$93.82 over the past week with the average price for BB loans increasing \$0.34 to \$97.08, Single B loans increasing \$0.41 to \$95.65, and Split B/CCC increasing \$0.75 to \$77.65. Meanwhile, loan yields and spreads (3-year) decreased 12bps and 18bps over the past week to 6.21% and 594bps, which compare to 5.81% and 452bps on 21 February. The Leveraged Loan index is providing a +0.92% gain in August following a +1.93% gain in July with Split B/CCC loans (+1.91%) outperforming BB (+0.70%) and B (+0.85%). Meanwhile, leveraged loan issuance totals only \$7.8 billion in August following only \$12.5 billion of issuance in July. The asset class returned to outflows following last week's modest inflow as \$238 million exited the asset class.

Emerging markets

Emerging markets rally continues as EM hard currency and corporate spreads further tightened last week (EMBI -7bps, CEMBI -5bps), with local EM returns also up on the week. The asset class experienced its sixth straight week of inflows (\$1.1 billion), largely into hard currency EM (\$936 million) but still with a small inflow into local currency funds.

In central bank news, Mexico cut rates 50bps to 4.5% as expected, with guidance that further rate cuts could be expected. Peru and Egypt both kept rates unchanged with the latter citing "the ongoing high level of global uncertainty". This keeps the world's top real rate for lending at 10.25%,

Asian fixed income

JG Summit's Q2 results were weak but the trend will likely improve in H2. The consolidated operating EBITDA fell 72% y/y affected by the Enhanced Community Quarantine (lockdown in Philippines). The company's airline business, petrochemical, malls and hotel business were negatively impacted, while its food business was more resilient.

Baidu's Q2 results were supported by its core business (search business and AI-related segment) but iQIYI continues to the loss-making segment. Tencent reported solid Q2 results with an operating profit of CNY37.6 billion (\$5.32 billion, +38% y/y). Management stated that the direct impact of the US restriction on the 'WeChat' application is limited because the US accounted for less than 1% of total advertisement revenue. As a percentage of global revenue, the US only contributes less than 2% to Tencent. The market is currently monitoring whether the US administration may expand the sanctions on Tencent's gaming business or its investments in various US businesses.

China has also resumed the issuance of tourist visas for Mainland residents to visit Macau on 12 August.

Adani Ports reported satisfactory Q1 results (quarter ended 30 June 2020), in light of the peak of the pandemic lockdown in India. The port operations have picked up in July, with 18.3 million tons of throughput (+6% y/y, +31% versus June 2020). Management said that the worst is behind it now.

Commodities

Commodities were marginally higher over the last week on the back of higher energy and agricultural numbers. Precious metals stepped back, after the last few weeks rallying, with gold lower by 4% and silver lower by 6%. The gold price fell back under 2000/oz but with \$1900 appearing as a good support level. The log jam on the fiscal stimulus bill in the US Congress helped to dampen gold prices.

Energy was up even as crude prices held steady as gasoline rose 3%. The Colonial pipeline was down, which tightened up oil to key refineries. Also, though DoE numbers were basically unchanged for the week, gasoline demand is now up at 9 million barrels/day in the US.

Reports from IEA, the US EIA and OPEC, published last week, were sobering as none see oil demand returning to 2019 levels by the end of 2020. Not surprisingly, transport fuel demands, particularly for aviation, look especially dire.

Agriculture numbers were up as more Chinese buying of soya beans, corn and meats were reported last week. Livestock sector was up 5% on the news. This is even as the 15 August China-US trade talks were postponed, once again.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views 17th August 2020



Strategy and positioning (relative to risk free rate)	Views	Risks to our views
Overall Fixed Income Spread Risk 	<ul style="list-style-type: none"> 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 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. 	<ul style="list-style-type: none"> 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) 	<ul style="list-style-type: none"> 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 	<ul style="list-style-type: none"> 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) 	<ul style="list-style-type: none"> 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. 	<ul style="list-style-type: none"> Federal Reserve moves away from ultra accommodative stance Investors reappraise US crisis/fiscal response as more likely to speed a return to normality than other regions
Emerging Markets Local (rates (R) and currency (C)) 	<ul style="list-style-type: none"> 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 	<ul style="list-style-type: none"> Further sharp escalation in global risk aversion EM funding crises drive curves higher and steeper
Emerging Markets Sovereign Credit (USD denominated) 	<ul style="list-style-type: none"> 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. 	<ul style="list-style-type: none"> 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 	<ul style="list-style-type: none"> 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. 	<ul style="list-style-type: none"> 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 center.
High Yield Credit 	<ul style="list-style-type: none"> 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. 	<ul style="list-style-type: none"> 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 	<ul style="list-style-type: none"> 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). 	<ul style="list-style-type: none"> 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 	<ul style="list-style-type: none"> 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. 	<ul style="list-style-type: none"> 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 	<ul style="list-style-type: none"> 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) 	<ul style="list-style-type: none"> Oil production disruption

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