COLUMBIA THREADNEEDLE INVESTMENTS

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In Credit

27 APRIL 2020

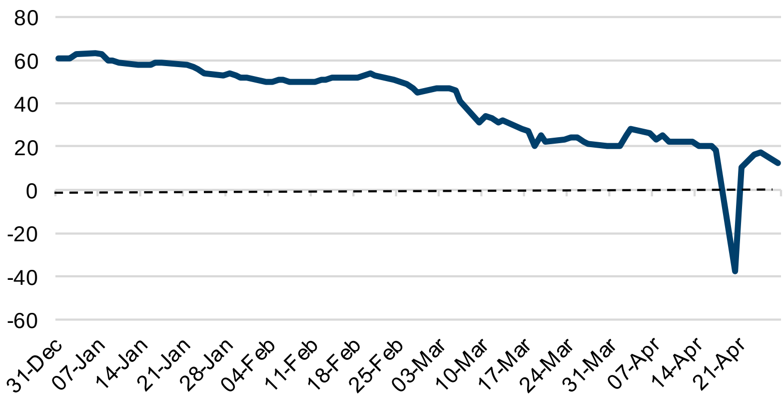
Oil prices down, credit downgrades up.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	0.62%	-2 bps	0.7%	9.6%
German Bund 10 year	-0.47%	1 bps	0.4%	2.4%
UK Gilt 10 year	0.29%	-1 bps	2.7%	9.7%
Japan 10 year	-0.04%	-6 bps	0.3%	-0.1%
Global Investment Grade	225 bps	0 bps	4.3%	-0.3%
Euro Investment Grade	196 bps	-5 bps	2.6%	-3.6%
US Investment Grade	236 bps	2 bps	5.2%	0.9%
UK Investment Grade	183 bps	0 bps	3.8%	0.5%
Asia Investment Grade	300 bps	0 bps	0.7%	0.2%
Euro High Yield	679 bps	10 bps	5.3%	-10.0%
US High Yield	803 bps	72 bps	3.0%	-10.5%
Asia High Yield	844 bps	31 bps	4.5%	-7.0%
EM Sovereign	590 bps	27 bps	0.5%	-11.3%
EM Local	5.0%	-2 bps	0.9%	-14.5%
EM Corporate	560 bps	9 bps	3.4%	-7.1%
Bloomberg Barclays US Munis	2.1%	18 bps	-0.5%	-1.1%
Taxable Munis	2.8%	-7 bps	2.9%	2.9%
Bloomberg Barclays US MBS	58 bps	-3 bps	0.3%	3.1%
Bloomberg Commodity Index	127.71	-3.0%	-2.6%	-25.3%
EUR	1.0840	-0.5%	-1.9%	-3.5%
JPY	107.24	0.0%	0.0%	1.1%
GBP	1.2424	-1.1%	-0.4%	-6.7%

Source: Bloomberg, Merrill Lynch, as at 27 April 2020.

Chart of the week: WTI May Oil futures price – year-to-date



Source: Bloomberg, Columbia Threadneedle Investments, as at 27 April 2020.

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Macro / government bonds

Core government bond yields remain close to the low point of their recent range, but were little changed last week.

Italian bond spreads tightened towards the end of the week on news that rating agency Standard and Poor's had left the country's BBB rating on hold, albeit with a 'negative' outlook. Meanwhile, the rates of change of both new cases and fatalities of Covid-19 appear to be slowing – with a number of countries detailing plans to reopen economies.

As expected economic data remain dire. PMI data has collapsed, as has durable goods orders and retail sales (aside from food and online). US initial unemployment claims were lower, but still over 4.4 million.

Investment grade credit

Investment grade spreads were little moved last week, which means they outperformed their high yield and emerging market cousins. Global spreads are now some 22% tighter than at the end of Q1,20 but around 134% wider year-to-date.

We are in the midst of reporting season with European banks following on from the results from US financial institutions last week. There was a similar trend of strong performance from investment banking / markets but a rising 'cost of risk''. This is a measure of expected rather than realised losses. Meanwhile, companies continue to draw on credit lines and both retail and corporate deposits are growing strongly.

In spite of it being reporting season there was a healthy amount of new issuance last week.

High yield credit

US high yield bond prices traded off over the past week amid heavy issuance, weak economic data, ambiguous earnings and historic volatility in oil prices. According to Lipper, the past week's $2.2 billion inflow for high yield retail funds extends a four-week stretch that included inflows totalling a record $7.66 billion, $1.88 billion and $7.09 billion. $18.9 billion of inflows to the asset class over the past four weeks have effectively recouped the record $19.2 billion exodus the preceding five weeks. Capital markets continue to reopen to high yield issuers; a notable 24 deals totalling $20.6 billion priced over the past week, the second heaviest stretch of volume in history. As such, April's new issue volume has risen to $33.0 billion, or $25.3 billion net of refinancing. While the gross number is comparable to a typical April (avg. $32 billion since 2010), the net issuance figure is approaching the all-time high of $32 billion in September 2013.

European high yield had a negative return of -0.4% with spreads widening 10bps to 679bps. Still, the asset class experienced another week of inflows of + €426 million even as there was - €40 million of ETF outflows. Primary issuance is showing more signs of picking up with two new European issues last week. Netflix offered € and $ issues, for a $1 billion offering that was eight times oversubscribed. Merlin Entertainments announced a new €500 million senior secured bond, which finally priced only 50bps tighter (7% coupon) than an existing unsecured bond.

It is looking more like the European Central Bank may eventually follow the US Federal Reserve in supporting the high yield market. The first step was taken last week when the ECB announced it would accept high yield as collateral, subject to having an investment grade rating prior to 7 April. Though this is still not the same as including high yield as part of an asset purchase programme, it shows the ECB's aim of doing "whatever it takes" to maintain market liquidity in the system.

With this week finishing with month end, high yield indices will finally re-balance 'Fallen Angels' into their respective indices, after the March postponement. Given the size and number of 'Fallen Angels' in March and April, the size of European high yield indices will increase by around 10%. There were many more downgrades last week, with special focus on the car rental sector as Hertz was downgraded three notches by Moody's to Ca from Caa1.

Leveraged loans

It was a tough week for the US leveraged loan market. The sector was down 73bps on the week given historic volatility in oil prices and continued weak economic data. Prices were down marginally but the market remains two-way in terms of buyers and sellers. The sector is up almost 10% since the lows in mid-March, however, year-to-date returns are still -9.5% with CCCs underperforming. Libor floors are coming back. After a round of re-pricings over the last several years where 0% floors were more common than not, investors are reinstating the 1% floor to ground interest payments at acceptable levels. Flows were positive for the week! Inflows totalled $216 million (across mutual funds and ETFs), versus outflows of $564 million during the five business days ended 15 April. Capital markets remain tentative about new issuance; just a few selective deals came to market last week.

Emerging markets

Emerging market hard currency spreads widened 27bps, ending at 590bps. EM market flows turned negative, again, with outflows of -$579 million last week, taking the year-to-date to -$31.1 billion.

Interest rate cuts continued last week with an emergency rate cut in Mexico, of 50bps to 6%. The central bank also announced other liquidity measures in a separate statement. In Turkey, the central bank cut rates, for the 8th time, by a larger than expected 100bps to 8.75%. Finally, Russia also followed with a rate cut of 50bps to 5.50%. On the credit rating front, Fitch was busy cutting Hong Kong's rating to AA- (from AA), followed by a reduction of Sri Lanka's rating to B- (from B).

In country specific news, South Africa announced a 5 billion rand support package, which is about the same size of ESKOM's debt. Mexico, following the credit downgrades the previous week, did $6 billion of issuance across three tranches. This offering was well received and 4.7 times oversubscribed.

Asian fixed income

The Indonesian textile sector was hit with negative ratings action. The Indonesia property sector has also seen more pressure on credit quality. Fitch downgraded Alam Sutera from B to B- with a rating watch 'negative' to reflect the company's refinancing risks and that its liquidity position will fall short of covering the repayment of the $175 million bond due in April 2021.

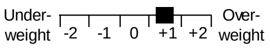
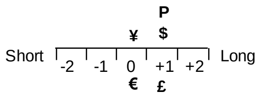
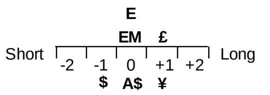
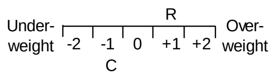
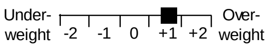
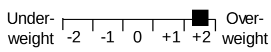
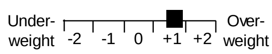
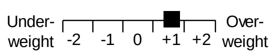
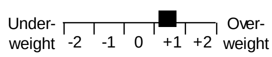
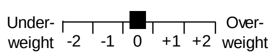
Sands China Ltd announced a weak set of Q1 results due to the suspension of casino operations in March and the Covid-19 impact. Liquidity, however, remained robust with $2.8 billion in cash and undrawn reserves, compared with a favourable absence of major debt maturities until 2023. SK Hynix's Q1 y/y performance was also impacted by Covid-19, but the q/q trend was positive). Over the near-term through Q2,20, management expects the demand for DRAM associated with servers and personal computers to be more resilient, compared with the DRAM for smartphones. The uncertainty for semiconductor demand in H2,20, however, remains high.

Commodities

The index was down 3% again last week, led by energy as crude oil prices fell as low as to $ 6.5/barrel (WTI) with oil futures in negative territory (low of -$37.63 **– see chart of the week**. Only gold and silver showed positive performance with gold breaking back up through $1700/oz on market risk off sentiment. Over the weekend, Saudi Arabia announced production cuts, ahead of OPEC+'s May start supply cut date. OPEC's decision to cut production by 10%, however, may have come too late, as figures show that the fall in demand is as great as a third more than the production reduction. On the agricultural front, the corn and sugar markets are likely to be affected by the fall in oil prices as 40% of corn production (in the US) and 50% of sugar production (in Brazil) goes to ethanol production. Separately, stories of meat processing concerns have hit headlines as 20% of meat processing has been shut down due to Covid-19.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views
27th April 2020

Strategy and positioning (relative to risk free rate)		Views	Risks to our views
Overall Fixed Income Spread Risk		■ COVID- 19 has begun to wreak havoc on the economy-even if only temporary. Uncertainty is the word on fundamentals, but large fiscal stimulus could stem the tide. In tandem with monetary measures this could make the situation 'less bad' enough to improve markets ■ Valuations have cheapened from elevated levels to compensate for a 'normal' recession. Overall, spread risk looks attractive on a medium term horizon, however caution is warranted due to uncertainty being at or above Financial Crisis levels.	■ Major economies cannot 'flatten the curve' of COVID-19 and 'recession' becomes 'depression' ■ Fiscal and monetary stimulus is extremely successful and buoying demand and there is significant innovation on the medical fight against COVID-19
Duration (10-year) ('P' = Periphery)		■ Disinflationary global recession now a base case ■ Central bank accommodation back in play; flatter, lower curves a policy goal for most ■ Monetary trumps fiscal policy: QE buying to outweigh increased issuance ■ Duration remains best hedge for further risk asset correction	■ Rapid levelling off of virus infection rate ■ Extraordinary fiscal/monetary accommodation inspires consumption-driven cyclical upswing and higher inflation expectations ■ Fiscal largesse steepens curves on issuance expectations
Currency ('E' = European Economic Area)		■ 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))		■ COVID-19 threatens global risk sentiment and populated EM positions ■ Many EMs lack the policy space to offset demand destruction ■ Investor capitulation has left 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)		■ Technicals in other credit markets are exaggerated in EM, leaving the current market extremely challenged. ■ Many oil exporters use the proceeds to fund their government and/or maintain currency valuations, which are now under pressure ■ 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 continues, a key source of demand for many economies will be back	■ COVID-19 begins to spread 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		■ Fundamentals have worsened, like in all credit sectors, but not as uniformly as spreads have widened. But, companies still have levers to pull to prevent the most dramatic of credit deterioration. ■ Valuations are as attractive as any time since 2009. ■ The potential for Corporate QE in the US & expansion in Europe is beginning to be discussed and would be a significant technical tailwind.	■ The existing Fed credit facilities do not alleviate the market's liquidity problems. ■ Prolonged recession begins to weaken even the strongest business models and balance sheets.
High Yield Credit		■ HY remains an energy-heavy sector, and these energy companies are extremely vulnerable to prolonged periods of WTI crude <$50. HY companies are rated as such because of their vulnerability to recession. This gives us caution. ■ Valuations imply a 9% default rate, and it may get worse in the short term. But historically, these spread levels imply strongly positive returns 6-12 months in the future	■ Prolonged COVID-19 related slump in activity would hurt there companies most ■ Potential corporate QE lures investors to higher quality assets, instead of encouraging reallocation into lower quality credit
Agency MBS		■ The Fed's QE including Agency MBS has been a significant tailwind for a sector with quickly deteriorating fundamentals ■ The precipitous decline in mortgage rate + weaker household balance sheet leads to worse fundamentals	■ Interest rates continue falling aggressively ■ Bonds will underperform other spread products in a sharp risk-on move
Non-Agency MBS & CMBS		■ Households entered 2020 in a relatively healthy pace, but they are being put to the test relatively quickly with unemployment expected to rise sharply. ■ Direct fiscal stimulus (checks to households) during 'social distancing' may not bring back service jobs, but it can lessen the blow and prevent widespread delinquencies and bankruptcies ■ The CMBS market is understandably taking a hit from less shopping and travel, however valuations are widening to match these expectations. Many of these structures have robust credit enhancement and are attritive high quality assets	■ Consumer behaviour and employment are fundamentally changed by even a brief, successful 'social distancing' effort. ■ Housing – which was set up for a great 2020 – starts to feel pressure
Commodities		■ o/w Base Metals ■ u/w Crude ■ o/w Soybeans vs Corn ■ o/w Livestock	■ Severe global recession