INFORMATION FOR INVESTMENT PROFESSIONALS

COLUMBIA THREADNEEDLE INVESTMENTS

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In Credit

8 JUNE 2020

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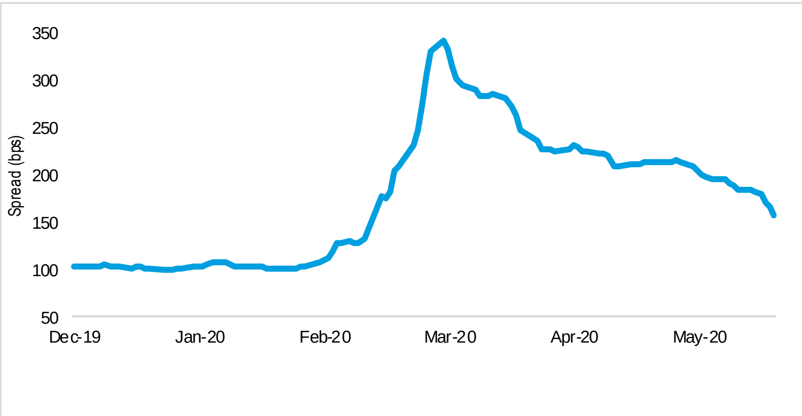
Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	0.92%	26 bps	-1.6%	7.2%
German Bund 10 year	-0.28%	17 bps	-1.5%	0.3%
UK Gilt 10 year	0.35%	17 bps	-2.7%	7.3%
Japan 10 year	0.05%	5 bps	-0.5%	-0.9%
Global Investment Grade	156 bps	-27 bps	0.5%	1.8%
Euro Investment Grade	132 bps	-35 bps	1.1%	-1.4%
US Investment Grade	160 bps	-25 bps	0.4%	3.1%
UK Investment Grade	148 bps	-17 bps	-0.1%	2.0%
Asia Investment Grade	279 bps	-12 bps	0.2%	1.8%
Euro High Yield	513 bps	-84 bps	2.8%	-4.1%
US High Yield	550 bps	-121 bps	3.3%	-2.6%
Asia High Yield	722 bps	-56 bps	2.3%	-1.4%
EM Sovereign	415 bps	-48 bps	2.1%	-2.7%
EM Local	4.6%	8 bps	3.0%	-4.5%
EM Corporate	436 bps	-43 bps	1.6%	-1.3%
Bloomberg Barclays US Munis	1.6%	2 bps	0.0%	1.2%
Taxable Munis	2.8%	13 bps	-1.4%	3.0%
Bloomberg Barclays US MBS	61 bps	-12 bps	-0.1%	3.5%
Bloomberg Commodity Index	138.58	1.8%	1.8%	-19.8%
EUR	1.1309	1.7%	1.7%	0.7%
JPY	109.53	-1.6%	-1.6%	-0.9%
GBP	1.2690	2.6%	2.6%	-4.4%

Source: Bloomberg, Merrill Lynch, as at 8 June 2020.

Chart of the week: Global investment grade spreads - YTD



Source: ICE BofAML, Columbia Threadneedle Investments, as at 8 June 2020.

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Macro / government bonds

It was a very weak period for core government bonds.

The biggest reason was the bumper US employment on Friday. Normally the market gets excited by a beat or miss of expectations of +/- 50,000 jobs. The May report showed a beat to expectations of 10 million people – a record surprise we imagine. Specifically, the market expected the Non-Farm Payroll report to record a loss of 7.5 million jobs. In actuality, it came in at an additional 2.5 million jobs. Likewise, the unemployment rate actually fell to 13.3%, not the 19% expected. It was the leisure & hospitality sector that saw the largest creation of jobs. Good news for the economy, bad news for the bond market.

This came after a robust increase to the Pandemic Emergency Purchase Pan (PEPP) by the European Central Bank and a large boost to fiscal expansion by Germany in the last week.

In the end, yields were higher with the benchmark 10-year US treasury reaching nearly 1%, while peripheral spreads in Europe tightened and credit and equity markets rallied strongly. The yield curve has also steepened as many expect the US Federal Reserve to announce some form of yield curve targeting at this week's FOMC meeting, which would anchor the short end of the curve while heavy supply weighs on the longer end of the US treasury curve.

Investment grade credit

For the reasons outlined earlier, it was a very strong week for credit markets.

European spreads have tightened by around 20% this month driven by the policy support from the ECB and Germany. The US market is tighter by 14% with the UK lagging at only 10% tighter. For context, the global market offers a premium to government bonds of 156bps, which is a little over 50% wider than the end of last year. At the wides (in March) this spread was around 340bps **– see chart of the week.**

The rally is being led by more cyclical areas of the market such as autos, basic materials and travel. Some notable higher quality areas of the market such as Nordic Senior Preferred bonds and FMCG issuers, such as Unilever, are back to the tight spreads of the year. There was little company specific news to dwell on though there was a market rumour of a merger between Pharma giants Astra Zeneca and Gilead.

It was a lighter week for primary issuance while there remain strong inflows into the market.

High yield credit

US high yield bond prices continued to rise over the past week, with the focus on more stimulus and easing restrictions reinforcing expectations that global activity has bottomed and will recover. The ICE BofA US HY Index returned 3.3% and spreads were 121bps tighter, ending the week at +550bps. Perhaps more notable, the index total return year-to-date is now only -2.6%. The asset class also continues to endure a record stretch of retail inflows, and capital markets activity is recovering at a rapid clip. Inflows over the past week totalled $5.75 billion, the fourth largest inflow on record. Meanwhile, the new-issue market remains very active, with $16.5 billion priced over the past week, a fourth consecutive $10 billion-plus week of volume.

It was also a very strong week for European High Yield (EHY) as spreads tightened in 84bps over the week, about the same as the spread tightening seen for the whole month of May. The asset class saw inflows of €308 million, of which €112 was in ETFs.

It was a 'risk on' week as higher beta names outperformed with single Bs and CCCs strongly outperforming BBs, as CCC's performance was almost 4x that of BBs. On a sector basis, the more cyclical ones (ex. autos) outperformed while more stable ones (ex. TMT) were challenged to keep up. About 65% of bonds in the EHY index are now within 5 points of their Pre-Covid-19 price levels. Due to a lack of dealer inventory, as well as an unwillingness to short bonds, the compression trade was very strong last week.

Only two new bonds came to the market over the week: Ardagh Packaging, the Irish packaging company, issued a €790 million 6-year bond while Virgin Media offered a £500 million 8-year bond. Both were well oversubscribed.

Leveraged loans

Strong risk momentum last week pushed total returns up 1.97% for the leveraged loan sector.

Lower quality led with Split B/CCC loans increasing nearly twice as much in price vs their higher quality peers and loan prices overall have now recovered $14 off the lows in March. Spreads (3-year) tightened 71bps during the week to 663bps. Leveraged loan primary market activity rebounded this week as six loans priced for $3.7 billion, which was the second highest weekly total over the last 13 weeks. In terms of defaults across the broader high yield market, eight companies defaulted in May totalling $11.2 billion: $5.1 billion in bonds and $6.1 billion in loans, which ranks as the 13th highest monthly default total on record. We now have 41 companies that have defaulted totalling $70.7 billion in bonds and loans and a par-weighted default rate ended May at a five-year-high 3.17% for the loan sector.

Flows continue to be negative. For the five business days ended 2 June, outflows totalled $187 million (including mutual funds and ETFs).

Emerging markets

Emerging Markets (EM) debt had a very good week as sovereign spreads tightened by 48bps (10%). The same was true for EM Corporate spreads, which were 43bps tighter (8%). EM local currency bonds returned 3%, outperforming hard currency sovereigns (EMBI, 2.1% and CEMBI 1.6%), largely due to EM FX. The asset class had a second week of inflows (two weeks of successive inflows was last seen in February). There was $1.6 billion into hard currency and $305 million into local funds. EM sovereign spreads are now 1.7 standard deviations vs. the long-term average.

The constructive market tone was largely driven by energy related credit as crude oil prices returned to the $40/barrel level on the back of the extension of the OPEC+ production cuts.

Still, more credit rating cuts occurred, this time for India (Moody's, Baa3) and Peru (Fitch, BBB+). In the case of India, the rating agency noted that the government will be seriously challenged to manage through the low growth outlook, given the deteriorating fiscal picture and the stress on the financial sector.

There was positive news this past week for Ecuador and Argentina as both countries negotiated with bondholders on debt restructuring; Argentina now has a 9 June deadline regarding reprofiling of its debt. As a result, Argentine bonds have run up from price levels in the 20s to 40s. Ecuador prices are also back to the 40s level. Separately, Ukraine continues to make progress with the IMF talks and President Zelensky is now hopeful for the 5 billion loan from the IMF by early July; a decision is expected this coming week.

The primary market has been strong in EM with high quality names such as Singapore Telecom (high rated government related issuer). This new issuance was partially driven by reverse inquiry and came with a +123bps spread, which is exceptional as it is rare to see this issuer with triple digit spreads.

Asian fixed income

As mentioned above, Moody's has downgraded India's ratings to Baa3 with a negative outlook (previous: Baa2, stable outlook). While the downgrade was anticipated by the market, the negative outlook was a surprise. Moody's highlighted that the Indian government's ability to implement policies to mitigate the risks of a sustained phase of relatively low growth will be challenged. There will be significant deterioration in the government's fiscal position as well as financial sector stress. Moody's also clarified that the ratings action was not directly driven by the Covid-19 pandemic. Instead, the vulnerabilities of India's credit profile were amplified by the pandemic.

The Indian sovereign rating downgrade also resulted in Moody's downgrade of numerous financial and non-financial corporates. These included State Bank of India, Export-Import Bank of India, Indian Railway Finance Corp, ONGC, HPCL, Indian Oil Corp, NTPC and Power Grid Corp. Moody's also cut the Baa3 ratings outlook of Adani Ports, Adani Transmission Ltd and Adani Electricity Mumbai from stable to negative.

In Indonesia, S&P placed the BBB- credit rating of Perusahaan Gas Negara (PGN) on ‘credit watch negative’. S&P also lowered the stand-alone credit profile of PGN from “BB+” to “BB” due to weaker cash flow generation due to the government’s intervention to cap the industrial gas prices at $6 mmbtu in April 2020 for seven industrial sectors. S&P also downgraded Saka Energi (a subsidiary of PGN) from BB to B+ with a stable outlook. S&P highlighted that the weaker standalone credit worthiness of PGN has reduce the latter’s ability to provide extraordinary financial support to Saka Energi.

Reliance Industries just announced the sixth investment in its Jio platform. Mubadala Investments (Abu Dhabi sovereign investor) will invest INR90.9 billion or around $1.2 billion for a 1.85% stake. Cumulatively, since April, Jio has sold a 17.1% stake for $10.3 billion to Facebook, Silver Lake, Vista Equity Partners, General Atlantic and KKR.

ReNew Power India is reportedly close to selling its wind farm projects in Karnataka to Ayana Renewable for INR15 billion (or $200 million), which would be an incrementally positive for ReNew Power to lower its leverage.

Municipals

Municipal demand has remained strong into the first week of June; however, the demand has shifted from the highest quality segments to BBB-rated and High Yield (HY) securities.

Through the end of the first week, index returns show BBB & HY up .95% and 2.12% respectively month-to-date, while AAA and AA-rated segments are down -.20% and -.13%. Given the strong performance in May, it is perhaps not surprising that investors begin to shift further down the quality spectrum for better relative value; however, we caution against complacency in taking additional HY risk. So far, much of the HY performance has been concentrated in the most liquid segments of the HY market – namely tobacco bonds and Puerto Rico-related credits – while smaller one-off credits still trade by appointment only. Credit challenges for many of these smaller HY and non-rated issues remain a high probability later this year. Continuation of this positive momentum may offer investors opportunities to unload weaker credits ahead of any such adverse credit events.

Commodities

The Commodities index was up 1.8% for the week, on the back of strong performance from energy as crude oil prices rose 10%, breaking above $40/barrel.

Oil prices got a boost with OPEC+ agreeing to extend production cuts by another month on the contingency that the countries that had so far not complied with productions cuts, would comply. Iraq and Nigeria, two of the non-compliant countries, have this time agreed to put in the production cuts with the aim of maintaining the lower production levels through to September. Weather related support for oil prices is the tropical storm currently brewing in the Gulf of Mexico, which could be disruptive for production.

However, overall demand remains weak as the weekly US Dept of Energy figures show that demand is still running two to three million barrels below the previous year’s demand. On a global basis, the figure is even higher indicating that inventory build-up is still a continuing issue as production cuts have failed to match the fall in demand.

Precious metals were down with gold falling 4% as the price fell back below $1700/oz. Industrial metals were up 4% on the week, led by copper and nickel, due to both China and general industrial demand driven.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

8th June 2020

COLUMBIA THREADNEEDLE INVESTMENTS

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, as well as in potential relapses (of market volatility and/or COVID-19 infections). ▪ Fundamentals remain challenging for large swaths of issuers, and there are many value traps lurking. Sorting out those 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'.' ▪ Returning to normalcy brings resurgence in case counts, which ultimately puts the economy on ice for longer. ▪ 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. Even with a bounce in oil prices, no US companies are profitable if these prices persist. ▪ Valuations: historically, spreads this wide typically lead to positive excess returns 6-12 months in the future.	▪ 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 Base Metals ▪ u/w Crude ▪ o/w Soybeans vs Corn ▪ Neutral Livestock	▪ Oil production disruption

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