COLUMBIA THREADNEEDLE INVESTMENTS

Your success. Our priority.

In Credit

30 MARCH 2020

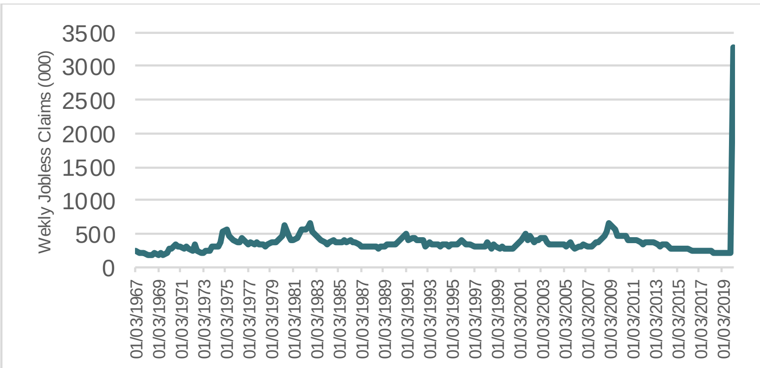
‘Previously unthinkable’.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	0.68%	-17 bps	3.1%	8.7%
German Bund 10 year	-0.51%	-19 bps	-1.1%	2.3%
UK Gilt 10 year	0.33%	-24 bps	2.5%	7.8%
Japan 10 year	0.01%	-8 bps	-1.6%	-0.4%
Global Investment Grade	294 bps	-35 bps	-7.8%	-5.2%
Euro Investment Grade	240 bps	9 bps	-6.9%	-6.2%
US Investment Grade	324 bps	-63 bps	-8.6%	-5.3%
UK Investment Grade	218 bps	1 bps	-5.9%	-3.6%
Asia Investment Grade	299 bps	9 bps	-3.2%	-0.6%
Euro High Yield	800 bps	-73 bps	-13.7%	-15.1%
US High Yield	899 bps	-110 bps	-13.0%	-14.4%
Asia High Yield	906 bps	-73 bps	-11.1%	-10.4%
EM Sovereign	573 bps	-45 bps	-12.6%	-11.8%
EM Local	5.5%	-40 bps	-10.6%	-14.8%
EM Corporate	593 bps	-13 bps	-11.5%	-10.2%
Bloomberg Barclays US Munis	2.0%	-155 bps	-3.3%	-0.3%
Taxable Munis	3.0%	26 bps	-11.0%	-2.3%
Bloomberg Barclays US MBS	41 bps	-74 bps	1.1%	2.8%
Bloomberg Commodity Index	132.54	2.6%	-11.6%	-22.2%
EUR	1.1080	4.2%	1.0%	-0.6%
JPY	108.08	2.6%	0.1%	0.6%
GBP	1.2373	7.1%	-2.8%	-6.0%

Source: Bloomberg, Merrill Lynch, as at 30 March 2020.

Chart of the week: US initial jobless claims – 1967-2020



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

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3017268 Issued March 2020 | Valid to end May 2020

Macro / government bonds

Government bond prices were much higher on the week as the policy agenda and the purchase of such instruments helped add to the appeal of the asset class.

The positive impact was felt especially in peripheral European spreads, which were much tighter. Actual yield ranges on the 10-year US treasury were the lowest since late February. We note a reestablishment of the traditional inverse correlation between this market and risk markets, such as equities.

Economic data has been largely ignored but the release of US weekly initial jobless claims prompted one notable economist to describe the increase in claims (3.3 million) as 'previously unthinkable'. The previous worst week was 665k during the global financial crisis – **see chart of the week**.

Investment grade credit

Investment grade credit spreads were much tighter in the last week as bid side illiquidity was replaced by offer side illiquidity.

The unveiling of corporate bond buying by the US Federal Reserve, as well as other policy support measures, provided support at a time of very wide credit spreads. The move tighter was much more meaningful in the US than elsewhere. It was most profoundly felt at the shorter end of the credit curve and in better quality credits (e.g. AAA). Weakness remains in more cyclical areas such as autos, leisure and retail whereas less cyclical industries such as utilities are faring better.

The new issue market also restarted in the last few days. There was over $110 billion in the US and €75 billion of euro-denominated debt. These deals were typically coming with attractive new issue premia and are being well received with high degrees of oversubscription.

In other news, the European Central Bank has insisted that banks stop all equity distributions as a means of shoring up capital. We think this adds between 0.5-1.0% to ratios. This is expected to continue until at least October of this year. Meanwhile, the credit rating agencies were very busy downgrading issuers across a number of sectors including banking and autos (over 50 last week). Notably, Ford, the car giant, was cut to sub investment grade, as was UK retailer Marks and Spencer.

High yield credit

After surpassing the +1,000bps spread mark for the third time in history on Friday (20 March), US high yield bonds endured a historic three-day bounce beginning Wednesday of last week as investors responded to unprecedented measures by policymakers. Notably, the $2.22 price increase in the JP Morgan US High Yield index on Thursday exceeded the largest on record of $1.79 on 14 October 2008.

The asset class reported a $2.0 billion outflow over the week according to Lipper, a relative improvement over the prior four week's outflows of $2.9 billion, $4.9 billion, $5.1 billion and $4.2 billion.

It was also a relatively better week for the European high yield market. Spreads tightened in by 73bps (8.4%) to 800bps – though are still out on a year-to-date basis by 472bps. European high yields also fell down from the high of this year so far (8.6%, reached last Monday), finishing the week at 7.5%. Flows were still negative with an outflow of €1.4 billion (2.8% AUM) last week, though the amount attributed to ETFs was marginal at €84 million. This brings the year-to-date outflow to €7.6 billion.

Trading liquidity marginally improved with the market recovery but was still very difficult in the secondary market with wide bid / offer spreads or only one-sided pricing where pricing was available. Price gaps were strongly evident. In the European market, the downgrades are coming fast and furious. Last week saw 98 downgrades and 42 credit watching warnings. Fallen Angels were seen in the retail sector with the Italian supermarket chain, Essalunga (to Ba1/BB+) in addition to the full downgrade of M&S (to Ba1/BB+). Given the decision by ICE to hold off re-balancing, these will not enter the index until the start of May.

Leveraged loans

A historic week of volatility in the US leveraged loans market resulted in prices swinging from $78.65 to $76.54 mid-week and bouncing back to $80.47 by EOD Friday on the CS Leveraged Loan index. Five of the six largest daily declines in the market's history have now occurred in the past two weeks and prices overall are down approximately $16 since 21 February 2020.

March's losses for leveraged loans now exceed the worst of the global financial crisis (i.e., Nov-08 -8.47%, Oct-08 -13.87%). And these prices have not been seen since the financial crisis when prices bottomed at $61. The yield today on the sector is 11.4% and the spread to a 3-year life is 1,082bps. At these prices and spreads investors historically have been richly rewarded.

Emerging markets

The asset class saw some improvement this week, specifically by mid-week, as hard currency sovereign spreads narrowed 45bps (7.3%) to 573bps. EM corporates continued to weaken as spreads rose further by 34bps (+4.3%) to 817bps. ETFs continued to hold their small premium as the asset class experienced some small inflows.

More central banks cut rates this week with Bank of Thailand, Pakistan, Colombia, Singapore, China and Philippines. Downgrades have accelerated – last week saw S&P and Moody's downgrade Mexico to BBB, outlook negative; Nigeria to B-; Kuwait to AA-; Oman to BB-/Ba2; Angola to CCC+; Botswana to BBB+; Ecuador to CCC-, credit watch negative; and South Africa to Ba1. In the case of Mexico, the rating agency cited the damage the coronavirus pandemic, as well as the sharp fall in oil prices, will cause the country's economy to contract for the second year in a row. (3rd and 4th quarter 2019 real GDP figures were -0.3 and -0.5, respectively). The downgrade of South Africa completes the sweep of downgrades to high yield status, started by the other agencies in 2017. Moody's cited the "continuing deterioration in fiscal strength and structurally very weak growth", given "the government's own capacity to limit the economy deterioration, current shock and more durably is constrained." South Africa has already said it would look to the IMF for financial assistance in light of the COVID-19 crisis.

Ecuador paid on a bond maturity due this week, surprising the market, but followed the payment with the announcement that they will look for voluntary re profiling on some upcoming maturities.

Asian fixed income

The COVID-19 pandemic continues to take its toll on Asian corporates.

Sands China has obtained a waiver on certain covenants related to its $2 billion revolving credit facility. The provisions in the credit facility requires Sands China to maintain consolidated leverage of up to 3x and consolidated interest coverage ratio of at least 2.5x. Sands China has also requested for an extension to the time required to produce its audited consolidated financial statements.

Moody's has downgraded Thai Oil from Baa1 to Baa2 because the company's credit metrics are unlikely to improve due to the weak outlook for refined products.

Moody's downgraded Delhi International Airports to Ba3 (previous: Ba2 Stable) and cut the outlook to 'review for possible downgrade' due to the negative impact of the coronavirus outbreak on travel that will result in a sharp decline in passenger traffic at Delhi Airport. Furthermore, Delhi Airport is approaching the peak phase of its INR98 billion expansion programme. Moody's also lowered the outlook of Hyderabad Airport's Ba1 ratings to 'review for possible downgrade'. Hyderabad Airport is also entering the peak phase of its INR55 billion expansion project.

Commodities

Commodities were surprisingly strong last week, in spite of the continued fall in energy prices as crude oil prices fell sharply, for the fifth week in a row, down almost 8% for Brent and 4% for WTI. Oil continues to be negatively impacted both by the fall in demand and the sharp increase in supply by producers. More refineries announced shutdowns on lack of demand for products and the greater challenge in storing refined products. Crude oil surplus is building up at 10 to 15 million barrels a day due to the drop-in demand. Storage constraints are already being seen for crude as well as capacity levels are closing in. Saudi Arabia and Russia have made clear that any discussion on production cuts cannot be only dependent on OPEC+.

Precious metals were strong on the week as gold rose 11%, returning back above $16000/oz and silver also showed strong recovery, rising 17% on the week. However, platinum and palladium were the big winners, up 21% and 38%, respectively, supported by the rally in gold and the lockdown in South Africa, which is expected to significantly curtail of platinum and palladium production. Base metals were mixed with aluminium and iron ore down and copper higher. China manufacturing coming back online is supportive, but production cuts are beginning to happen around the world.

Agriculture was also strong but there is some dislocation in the market. Grains showed positive performance for the week, especially high protein feed (ex. wheat and soybean) with demand but also due to logistical issues given port closures

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

23rd March 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	■ 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)	P ¥ $ Short -2 -1 0 +1 +2 Long € £	■ Disinflationary global recession now a base case ■ Central bank accommodation back in play; flatter, lower curves a policy goal ■ Duration remains best hedge for further risk asset correction ■ Phase One trade deal fulfilment unrealistic	■ Global trade détente stimulates improvement in risk sentiment ■ Rapid levelling off of virus infection rate ■ Fiscal/monetary policy inspires consumption-driven cyclical upswing
Currency ('E' = European Economic Area)	E EM A$ Short -2 -1 0 +1 +2 Long $ £ ¥	■ 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 disappoints the market's expectations for policy easing.
Emerging Markets Local (rates (R) and currency (C))	R Under-weight -2 -1 0 +1 +2 Over-weight C	■ COVID-19 threatens global risk sentiment and populated EM positions ■ Investor capitulation has left EM real interest rates relatively attractive	■ Further sharp escalation in global risk aversion ■ Broad dollar strength
Emerging Markets Sovereign Credit (USD denominated)	Under-weight -2 -1 0 +1 +2 Over-weight	■ 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	Under-weight -2 -1 0 +1 +2 Over-weight	■ 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 anytime since 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	Under-weight -2 -1 0 +1 +2 Over-weight	■ 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	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 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	Under-weight -2 -1 0 +1 +2 Over-weight	■ 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	Under-weight -2 -1 0 +1 +2 Over-weight	■ o/w Cu vs Zinc ■ o/w Brent vs WTI ■ o/w Silver	■ Severe global recession