INFORMATION FOR INVESTMENT PROFESSIONALS

COLUMBIA THREADNEEDLE INVESTMENTS

Your success. Our priority.

In Credit

6 APRIL 2020

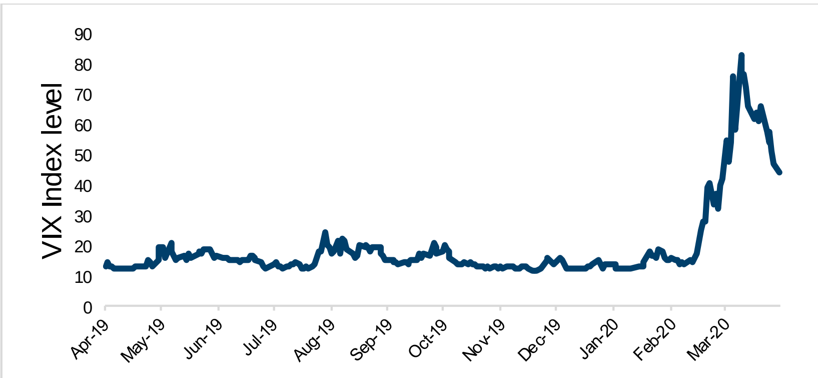
What goes up must come down.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	0.65%	-3 bps	0.6%	9.5%
German Bund 10 year	-0.40%	7 bps	0.2%	2.2%
UK Gilt 10 year	0.35%	-1 bps	0.6%	7.4%
Japan 10 year	0.01%	-1 bps	0.3%	0.0%
Global Investment Grade	284 bps	-10 bps	0.2%	-4.2%
Euro Investment Grade	239 bps	-1 bps	-0.1%	-6.2%
US Investment Grade	308 bps	-16 bps	0.3%	-3.8%
UK Investment Grade	205 bps	-13 bps	1.1%	-2.1%
Asia Investment Grade	307 bps	7 bps	-0.1%	-0.6%
Euro High Yield	789 bps	-11 bps	0.0%	-14.5%
US High Yield	943 bps	44 bps	-2.4%	-15.2%
Asia High Yield	946 bps	40 bps	-0.1%	-11.1%
EM Sovereign	597 bps	24 bps	-0.7%	-12.4%
EM Local	5.5%	2 bps	-2.5%	-17.3%
EM Corporate	607 bps	15 bps	0.0%	-10.2%
Bloomberg Barclays US Munis	2.3%	39 bps	-1.8%	-2.4%
Taxable Munis	2.9%	-10 bps	0.1%	0.1%
Bloomberg Barclays US MBS	63 bps	22 bps	0.1%	2.9%
Bloomberg Commodity Index	133.55	-0.8%	0.5%	-22.9%
EUR	1.0817	-3.1%	-2.1%	-3.7%
JPY	109.17	-0.5%	-0.9%	0.1%
GBP	1.2269	-1.5%	-1.2%	-7.5%

Source: Bloomberg, Merrill Lynch, as at 06 April 2020.

Chart of the week: Volatility Index (VIX) LTM.



Source: Bloomberg, Columbia Threadneedle Investments, as at 6 April 2020.

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Macro / government bonds

Government bond prices were little moved in the last week after a 'helter skelter' few weeks.

In terms of data the Eurozone PMI was very weak (less than 30). This was led lower by an especially low print from Italy (20.2 composite). These numbers seem consistent with a 10% contraction in eurozone growth. The US employment report showed the loss of 700k jobs (exp -100k). There is more to come.

There was though better COVID-19 news out of Spain, Italy and NYC. The pace of new cases and fatality growth is slowing suggesting a peaking out of the pandemic in these areas. There are tentative signs of something similar in the UK.

Market volatility came down sharply over the week, after reaching levels last seen in the Great Financial Crisis of 2008-2009 – **see chart of the week.** An indicator that more stability has returned to the market.

Investment grade credit

Investment grade credit spreads were tighter last week led by the US market, while March proved to be the weakest month for excess returns (relative to government bonds) since 1997 at -9%.

In signs of improved stability, the new issue market has been very busy with over €90 billion in Europe and over $115 billion in the US dollar market. Deals have typically gone well and been oversubscribed; while new issue premia are generally falling. Liquidity remains challenged especially in the short end of the market.

High yield credit

US high yield bonds extended their recovery over the past week amidst a modest reopening of capital markets, the continued spread of the COVID-19 outbreak in the US and a late-week surge in oil prices driven by speculation regarding potential for production management measures from OPEC and Russia. The asset class experienced its largest weekly inflow on record of $7.1 billion according to Lipper, which equates to approximately 4.2% of assets under management. The high yield new issue market reopened this week after three weeks of inactivity with four issues pricing just under $3.0 billion of bonds.

European High Yield (EHY) spreads continued the tightening of the previous week as they came in -11bps (1.4%). CDS experienced spread widening of 65bps. The average bond price is showing at 85 but with quite a wide dispersion, while liquidity continues to remain poor with wide bid-offer spreads. EHY fund flows turned positive last week with an inflow of €251million, of which 40% related to ETFs (€101 million). The year-to-date outflow is now at €7.5 billion. Downgrades in EHY, including a couple with multiple notch downgrades (ex. S&P cut Europcar from BB- to B-), continued to accelerate as Moody's reduced ratings on 51 issuers while S&P cut ratings on 44 issuers in Europe. Views on EHY default outlook for 2020 were released last week, ranging from 5% to 8%.

Leveraged loans

Following historic volatility in US bank loans, the sector ended the week on a high note posting a 2.64% total return.

Loan prices recovered $6 off the lows and ended the week at $82.36. Notably, the current share of the bank loan sector trading below $80 is now 28% of the index, vs 58% on 24 March 2020. Year-to-date, quality has outperformed with CCC-rated loans posting double the losses of B rated loans at down nearly 27%. Higher quality bank loans outperformed on the way down, AND on the way up. Energy, gaming/leisure, metals/mining, and retail have felt most of the pain so far. All four of these sectors are down -20+% on a total return basis; energy is down -34% and no sector has done better than -9%.

The yield on the sector is now over 10% and spreads are roughly 985bps. Yields on BB loans are inside 6%, single B loans are trading around 9%, and split B/CCC loans are trading 22+%. Defaults are expected to meaningfully rise. By our account, a weaker economy stemming from COVID-19, as well as stress in the energy sector, could result in defaults rising to 8-10% of the sector. Rating agency downgrades are happening quickly, and more are on the way. CCC% baskets in CLOs are in the high single digits today and could approach approximately 10% very soon.

Emerging markets

Emerging market hard currency spreads finished the week wider by 24bps, ending at 597bps. Corporates saw spread widen by 3% to 556bps. Local debt was also down as with much of the negative performance coming from currencies. The week started weak but improved as the days went on. Still, the asset class experienced net inflows of $250 million though that was mainly due to hard currency fund with inflows of $900 million into hard currency funds compared to an outflow of $650 million for local currency funds. Price action in emerging markets has also become a bit more orderly. Compared to a week or two ago, it has started market liquidity has improved but bid-offer spreads still remain quite wide.

Looser monetary policy from central banks continued last week with rate cuts by Chile (-50bps to 0.5%) and Sri Lanka (-25bps to 6% for standing deposit facility and 7% for standing lending facility rate). More fiscal measures were also announced by countries as Indonesia announced a major fiscal package of $25 billion, while also temporarily suspending the budget deficit ceiling. After a previous move from 2% to 3%, they have now raised it to 5% of GDP. Brazil announced that it would launch a 51 billion Reis programme to help preserve jobs.

In Ukraine, its parliament passed the land reform bill. Though watered down, this is still a positive step in the right direction, as it will be the key to unlocking a substantial IMF programme. The country also approved a second economic support package to support the economy during the containment period. Ukraine hard currency bonds were 200 to 250bps tighter on news.

Weaker credits are using COVID-19 to launch restructuring debt with Zambia being the latest. The country has been in financial distress for a long period of time. Bond prices were lower on the news. But credit rating downgrades also persisted with Moody's lowering Argentina (Ca from Caa2) and Ecuador (Caa3 from Caa1), while Fitch moved lower South Africa (BB from BB+), Guatemala (BB- from BB), Colombia (BBB- from BBB), and Oman (BB from BB+). S&P reduced Angola's rating (CCC+ from B-). Fitch also downgraded Pemex (BB from BB+) citing the sharp fall in oil prices as a concern.

Asian fixed income

A number of Asian companies saw negative ratings action by the rating agencies, notably in Indonesia.

The affected Indonesian companies are Gajah Tunggal, Alam Sutera, Agung Podomoro, Lippo Karawaci and Indika Energy. Moody's downgraded Gajah Tunggal by a notch to Caa1 (negative outlook) to reflect the currency risk, high debt and weaker EBITDA margin. Moody's also downgraded Alam Sutera by a notch to Caa1 (negative outlook) due to its high refinancing risks, with the internal cash sources likely to fall short in covering the 2021 bond maturity. For Agung Podomoro, Moody's downgraded it by a notch to B3 (outlook negative) to reflect the weak operating cash flow and the increase in liquidity risks over the coming 12 months. Indika Energy reported weak FY19 results, but its liquidity position continues to be solid. Fitch revised the outlook on Indika Energy to negative. Indika Energy's FY19 revenue fell 6.1% y/y to USD2.78bn and EBITDA declined 35.4% y/y to $404 million due to the pressure on coal price. Positively, Indika has no near-term liquidity concerns with debt maturities below $100 million annually in 2020 and 2021. Fitch also cut the outlook of Lippo Karawaci's B- ratings to negative because the agency expects Lippo's presales to fall 50% y/y in 2Q20 and Lippo's presales in 2020 could decline sharply to IDR 500 billion (previous expectation: IDR 2 trillion).

Commodities

The commodities index was down 0.8% for the week, in spite of the strong rally in crude oil. All other sectors were stable to lower, including precious metals.

After falling to below $20 (in the case of WTI), crude oil prices rallied more than 30% last week (Brent 32%, WTI 37%) as even Trump tweeted that oil prices were too low. Conversations between Trump and Putin occurred, saying that their oil ministers would embark on a conversation on the oil market. Mention was made of a willingness to reduce production if US sanctions on Russia were reduced/removed. At one point, Trump was tweeting that there could be an agreement of cutting production by 10 million barrels/day and then later by 15 million barrels/day. The rumours of a deal helped, on Thursday, with WTI up 37% and Brent up 45% at one point on that day alone. However, Saudi Arabia remains unwilling to change its stance and has, instead, been increasing inventories at key storage facilities (Egypt). The International Energy Agency (IEA) stated on Friday that a 10 million barrel a day cut would still not be enough to stabilise the markets, given the sharp drop in demand on the back of the COVID-19 ramifications.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

6th April 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 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)	E A$ EM £ 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. ▪ 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	▪ 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)	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 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	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 ▪ u/w Crude	▪ Severe global recession