

In Credit

3 AUGUST 2020

Economy interrupted.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	0.57%	-2 bps	1.2%	10.3%
German Bund 10 year	-0.51%	-6 bps	0.6%	2.8%
UK Gilt 10 year	0.11%	-3 bps	0.4%	10.0%
Japan 10 year	0.03%	1 bps	0.4%	-0.6%
Global Investment Grade	140 bps	1 bps	2.6%	5.8%
Euro Investment Grade	128 bps	3 bps	1.5%	0.2%
US Investment Grade	141 bps	2 bps	3.2%	8.1%
UK Investment Grade	134 bps	0 bps	1.6%	5.0%
Asia Investment Grade	257 bps	-2 bps	1.7%	5.0%
Euro High Yield	512 bps	9 bps	1.8%	-3.3%
US High Yield	516 bps	-13 bps	4.8%	-0.2%
Asia High Yield	678 bps	-14 bps	2.0%	1.7%
EM Sovereign	401 bps	-7 bps	3.7%	1.8%
EM Local	4.4%	-6 bps	3.0%	-4.1%
EM Corporate	409 bps	-10 bps	2.3%	2.2%
Bloomberg Barclays US Munis	1.2%	-7 bps	1.7%	3.8%
Taxable Munis	2.2%	-7 bps	3.3%	12.1%
Bloomberg Barclays US MBS	58 bps	-12 bps	0.2%	3.7%
Bloomberg Commodity Index	147.86	0.8%	5.7%	-14.8%
EUR	1.1708	1.0%	4.8%	5.0%
JPY	106.39	0.3%	2.0%	2.6%
GBP	1.3010	2.3%	5.5%	-1.3%

Source: Bloomberg, Merrill Lynch, as at 3 August 2020.



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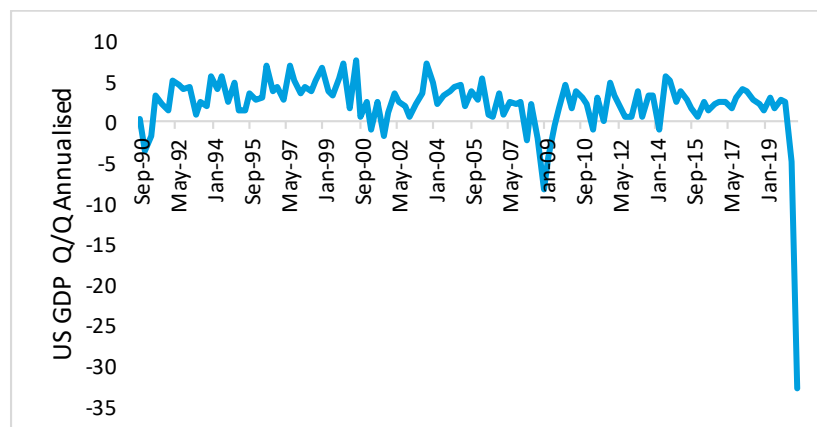
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Chart of the week: US GDP Q/Q Annualised (1990-2020)



Source: Bloomberg and Columbia Threadneedle Investments, as at 3 August 2020.

Macro / government bonds

Core government bonds performed reasonably well last week with yields lower in most places.

Backward looking economic news pointed to the interruption of economic activity between March and June. Data in the US ([see chart of the week](#)) illustrated an over 9% decline in quarterly output, while in Europe German GDP fell by over 10% and worse still Spain showed an 18.5% contraction. For Europe as a whole there was a quarterly decline of 12.1%

These 'risk free' markets were also buoyed by the lack of progress in fiscal policy in the US where the \$600 a week payment to some workers came to an end at the close of the week without a replacement.

Meanwhile, the US Federal Reserve met mid-week and seemed to conclude that its policy reaction will depend on the effect that the ongoing rise in Covid-19 cases will have on the economy.

This week brings PMIs from around the world as well as the widely watched US employment report on Friday.

Investment grade credit

Credit markets struggled given the news described earlier to tighten with most markets a few basis points wider.

Global spreads ended the month at 140bps more than government bond yields. This reflects a tightening of around 13% or 21bps. Such spreads remain around 40% wider for the year so far, however.

We are in the midst of reporting season. The clear 'winners' at this time are food retailers, technology and telecoms as well as pharmaceutical companies. It has been much more difficult for retailers, transport and real estate exposed to the retail sector. Meanwhile, in banking the winners appear to be those with substantial investment banking businesses where fee income from the deluge of fixed income issuance has been supportive. New issuance was light given the reporting season.

High yield credit

US high yield bond prices continued to climb over the past week amid a firm technical, a dovish Fed, and a better-than-feared earnings season. Simultaneously, investors are beginning to worry about the pace of the economic rebound in light of the spread of the virus with US treasury yields touching a fresh low and gold prices a new high. The ICE BofA US HY CP Constrained Index returned 0.88% over the week and spreads were 12bps tighter. Inflows to the asset class continued for the fourth consecutive week with another \$295 million inflow, according to Lipper. July's high-yield new-issue activity totals \$25.6 billion following a record \$61.5 billion of volume in June.

European High Yield (EHY) took a pause last week, as spreads widened a few basis points on the back of poor macro figures. Still, for the month of June, EHY returned +1.8% as BBs outperformed lower-rated credits. Flows into EHY remain steady, now in its 18th week of inflows with €229 million, of which only €86 million went into ETFs.

The primary market picked up from the previous week with a total of €4 billion issued last week, over seven corporate issuers including Fauercia (French auto parts), DoValue, (Italian loan manager service), Payment Sense (UK payment processing), Phoenix PIB (UK insurance), Ado Properties (German real estate). This has resulted in almost €8.2 billion of issuance, a record high for the month of July.

Although technicals should remain supportive for both US and European high yield markets, the recent outperformance may leave US high yield with more limited upside. The US market faces more downside risks, with a higher number of Covid-19 cases, election uncertainty and higher default risk, resulting in a greater overhang in the US.

Leveraged loans

Leveraged loan prices were unchanged over the past week after having risen \$1.66 over the course of July. For context, loan prices have still not fallen more than \$0.03 in a session since 29 June. Valuations remained at 6.46% and spreads rose 2bps to 626bps over the past week. The loan yield-to-3-year takeout is now 13bps above yield for the US high yield index after trading 43bps below at month-end with high yield bonds outperforming sharply over the past month. The Leveraged Loan index is providing a +1.89% gain in July with BBs (+1.69%) outperforming B (+2.12%) and Split B/CCC loans (+1.65%). Loan funds reported an 83rd weekly outflow in the last 88 weeks with \$211 million exiting the asset class. Issuance now totals \$12.5 billion in July following a 4-month high \$28.8 billion in June.

Emerging markets

Emerging markets continued to rally last week as EM hard currency and corporate spreads further tightened. For July, hard currency was 33bps tighter and EM corporates were 27bps tighter, while EM local delivered 3%. It was another week of net inflows, the fifth straight week, into the asset class with \$326 million but, with a greater focus on local currency funds over hard currency funds. Inflows were mainly into ETFs over managed funds.

In central bank news, Colombia cut its lending rates 25bps to 2.25% while also lowering its GDP and CPI projections. In country specific news, the IMF was busy with positive news for the market. The IMF approved \$4.3 billion emergency funding for South Africa. This came a few days after the announcement that Angola's IMF programme had been upsized to \$4.5 billion (from \$3.7 billion).

In LATAM, a theme is developing regarding pension provisions. Following on the heels of similar measures in Peru and Chile, 10% pension withdrawal allowance discussion has restarted in Colombia; Mexico also announced it is considering this. Debt restructuring news continued as Ecuador's plans for debt restructuring almost stumbled last week as Contrarian Capital Mgt. sued to block the restructuring based on "false and misleading statements" by Ecuador. This was eventually overturned by the courts, so restructuring is likely to happen. There was less positive news for Argentina as the reprofiling negotiations continue to drag.

Asian fixed income

Sri Rejeki's Q2 operating performance was weak, and in line with a 20-25% y/y drop in FY EBITDA. Q2 EBITDA was \$49.8 million (-24.6% y/y). While the textile demand has been impacted by the pandemic, Sri Rejeki benefited from the higher demand for mask and PPE. Management estimates that the medical products in 2020 could amount to around \$100-\$130 million.

The Indian government again extended the deadline for the strategic sale of BPCL. This is the third extension, which could probably be attributed to the protracted negotiation over the valuation of BPCL. The potential bidders comprise Aramco, Rosneft and Reliance Industries. Reliance Industries' Q1 operating results were impacted by the weakness in its energy segment (refining, oil marketing and petrochemicals), which saw an EBITDA decline of 42% y/y to INR82.6 billion. Consequently, the consolidated Q1 EBITDA fell 11.8% y/y to INR215.85 billion. The mobile telecom sector (Jio) was the bright spot, with a 55% increase in EBITDA to INR78.2 billion. Altogether, Reliance Industries has raised INR1,520 billion (\$20.3 billion) from 13 investors in Jio, following which Reliance Industries will hold a 66.48% in Jio on a fully-diluted basis.

Bharti's Q1 results were positive, in light of what was a challenging quarter, when new subscriber addition and top-ups (prepaid mobile) were impacted by the Indian lock-down (24 March 2020 till 30 May, with a gradual easing in June). On a consolidated basis, Q1 EBITDA was INR106.4 billion (+25.3% y/y, +3% q/q) with an EBITDA margin of 44.4% (+0.9 ppt q/q).

PTT PLC is reportedly interested in acquiring a stake in ReNew Power. The Goldman Sachs private equity group, which holds a 48.6% in ReNew Power, has a long-held plan to divest its stake. The China Three

Gorges Corp is looking to sell a 10%-20% stake in its foreign businesses which could be worth as much as \$4 billion. Potential bidders which China Three Gorges Corp has contacted, include GIC and China Investment Corp. Press Metal Aluminium has announced a modified Dutch auction for a tender of up to \$200 million of the PMALMK '22s bonds. The price range in the tender is from 95pt to 100pt.

Commodities

Commodities rallied for another week, mainly on the back of metals as both base and precious metals prices continued to rise, resulting in the index being up almost 6% for July. Gold moved higher rising almost 4% and temporarily breaching \$1980/oz. It finished the week at \$1976/oz. Silver had an even stronger run, rallying more than 6%. This comes on the back of a weakening US dollar, which fell to a two-year low on concerns that the massive amount of US government spending could eventually result in higher inflation and lower consumer purchasing power. On Friday, Fitch changed its US outlook to negative while keeping the credit rating at AAA.

Energy fell last week as crude retreated 2.5%. The exception in the energy space was natural gas which rose 15% on the back of the heatwave hitting large swaths of the US.

In agriculture, record buying by the Chinese in corn while purchases in wheat and soybeans were also noted. However, the net buying is still far below the originally announced planned figures, running at 50% of expectations.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

3rd 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 centre.
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 o/w Crude o/w Soybeans vs Corn o/w Softs 	<ul style="list-style-type: none"> Oil production disruption

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