

# In Credit

21 FEBRUARY 2022

## Close to the edge.

Markets at a glance



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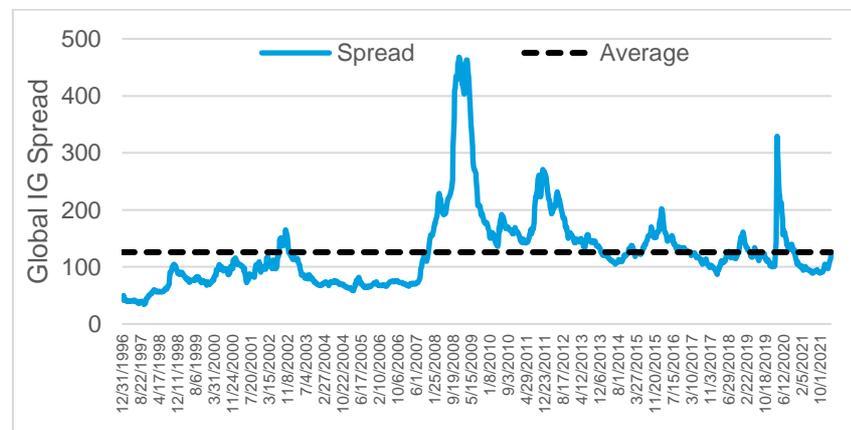
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Emerging Markets

	Price / Yield / Spread	Change 1 week	Index QTD return	Index YTD return
US Treasury 10 year	1.93%	-1 bps	-1.3%	-3.2%
German Bund 10 year	0.22%	-8 bps	-1.6%	-2.7%
UK Gilt 10 year	1.41%	-14 bps	-0.5%	-4.5%
Japan 10 year	0.21%	-2 bps	-1.0%	-1.7%
Global Investment Grade	123 bps	9 bps	-2.1%	-4.6%
Euro Investment Grade	127 bps	7 bps	-1.9%	-3.2%
US Investment Grade	120 bps	10 bps	-2.4%	-5.4%
UK Investment Grade	114 bps	3 bps	-1.3%	-4.2%
Asia Investment Grade	198 bps	8 bps	-1.1%	-2.6%
Euro High Yield	411 bps	16 bps	-1.8%	-3.3%
US High Yield	378 bps	12 bps	-1.6%	-4.3%
Asia High Yield	744 bps	46 bps	-1.9%	-5.7%
EM Sovereign	355 bps	6 bps	-1.6%	-4.5%
EM Local	5.9%	-3 bps	1.9%	1.9%
EM Corporate	330 bps	10 bps	-1.1%	-2.8%
Bloomberg Barclays US Munis Taxable Munis	1.9%	5 bps	-0.6%	-3.3%
	2.9%	0 bps	-1.7%	-4.8%
Bloomberg Barclays US MBS	28 bps	2 bps	-1.4%	-2.9%
Bloomberg Commodity Index	238.48	1.6%	3.5%	12.6%
EUR	1.1365	-0.2%	0.8%	-0.4%
JPY	114.86	0.3%	0.1%	0.1%
GBP	1.3633	0.2%	1.1%	0.4%

Source: Bloomberg, Merrill Lynch, as at 21 February 2022.

### Chart of the week: Global IG spreads, 1996-2022



Source: ICE BoML, Bloomberg, Columbia Threadneedle Investments, as at 21 February 2022.

## Macro / government bonds

The market fixation with inflation and tightening monetary policy was diverted to a focus on the risk of conflict in Ukraine. Ongoing rhetoric from Western leaders suggests they believe that war is likely and is imminent. Unsurprisingly, this background upset the tone in 'risk' markets such as equities (prices lower) and corporate credit (spreads wider). Conversely government bonds, seen as a safe haven, performed better and were little moved on the week and indeed rallied on Thursday and Friday.

Over the weekend, it appears that France's President Macron has brokered a summit between Presidents Biden and Putin to be held later this week, which encourages some hope that conflict can be averted though it remains a very fluid and unclear situation.

This week brings global 'flash' PMI data and towards the end of the week important Personal Consumption Expenditure inflation numbers. The central case is that the US Federal Reserve will raise rates by 25bps at its March meeting.

## Investment grade credit

As mentioned, credit spreads continue to widen against the background of geopolitical uncertainty around Ukraine.

This weakness has meant that valuations / spreads that looked stretched at the start of the year are getting back closer to long-term averages ([see chart of the week](#)). This is especially the case in euros, which has been the weakest market globally on a percent spread widening basis. Indeed, while global spreads are around 23% wider so far in 2022, euro-denominated bonds are more like 30% wider. Sterling credit has been the outperformer.

The market weakness has meant that new issues in the primary market are coming with a more attractive premium than has been the case. This comes at a time of outflows from the market.

## High yield credit & leveraged loans

European high yield had another week of spread widening and the sixth straight week of negative returns. It was a fairly duration-led performance as BBs, given their generally relatively longer durations, underperformed single Bs. Outflows continued with month-to-date already double the size experienced in January, bringing the year-to-date to -€1.8bn. Funds are still exiting via ETFs while flows out of managed accounts are also now appearing to pick up pace. The primary market was shut last week, as issuers were side-lined given the geopolitically induced market volatility and the lighter market participation due to school holidays.

Good news on the leisure front as Carnival reported that cruises booking levels are returning to pre-Omicron trends. Overall, 2022 levels are strong (at industry level +19% vs '19) with top line pricing remaining at above pre-pandemic level (which seems to be the case with travel in general). Overall, the duration of market has increased as many callable bonds are now pricing to the farther call date with the fall in bond prices.

## Asian credit

Based on sales registration data (CREIS), the property sales during the Lunar New Year period in 28 cities fell 35.3% y/y, which could be attributed to the Covid-driven domestic travel restriction that affected home purchases by migrant workers as well as negative home buyers' sentiment.

The collapse in property sales is currently driving some incremental measures to stimulate demand. At the provincial and city level, there are media reports about easing in the down payment requirements and lower mortgage rates. The down payment ratios for first home buyers in Heze, Chongqing and Ganzhou have reportedly been cut from 30% to 20%. In Guangzhou, according to Nanfang Daily, the mortgage rates for first-home buyers are cut to 5.4% (previous: 5.6%) and those for second home buyers are reduced to 5.6% (previous: 5.8%).

## Emerging markets

In China, technology companies have been selling off again in anticipation of a further crackdown amid regulatory warnings over metaverse scams. The decline began on Friday when shares of delivery giant Meituan plunged after Beijing rolled out a new policy to curb delivery fees. China's year long siege on technology firms has wiped off more than \$1.5trn in market value from the sector.

Chinese property names also suffered as Zhenro Properties group said it may not have sufficient cash to meet debt payments next month. Elsewhere, a fantasia property bondholder is suing the company for alleged inaccurate and misleading announcements; management announced the developer "had no liquidity issues" just two weeks before the company defaulted.

In corporate news, Russian phosphate-based fertiliser producer Phosagro announced strong results following surging fertiliser prices. Q4 and FY 2021 revenue rose 117.2% and 65.6% y/y respectively.

In central bank news, Turkey, the Philippines and Zambia all held rates; Turkey is waiting for the effects of its previous aggressive rate-cutting to come to fruition. Russia last raised rates on 11 February by 100bps to 9.5%.

## Commodities

Commodities have overall been a beneficiary of escalating Russian tensions, with the BCOM index rallying a further 1.5% supported by natural gas and select base metals. Nickel (+4.9%) and Palladium (6.4%) continued rallying given Russia's major contribution to global supply.

Gold rallied 3.1% driven by sharp inflows into gold ETFs. Holdings in the world's largest ETF (SPDR Gold Shares) surged by 50 tonnes after hitting a 20-month low in December.

Brent prices continued to moderate following the advancement of nuclear deal talks with the US and Iran. The prospect of more Iranian barrels on the market is the key concern for energy markets. China is planning to conduct all purchases of iron ore through a single state-backed platform; Chinese steel mills currently negotiate their own spot prices. The move is an effort to consolidate buying power to control soaring iron ore prices.

## Summary of fixed income asset allocation views

## Fixed Income Asset Allocation Views

21<sup>st</sup>February 2022

Strategy and positioning (relative to risk free rate)	Views	Risks to our views
<b>Overall Fixed Income Spread Risk</b> 	<ul style="list-style-type: none"> <li>Although credit spreads have widened slightly, they are still near all-time tights and leave little room for the growth story to get derailed. Pockets of opportunity with deleveraging &amp; upgrade activity exist.</li> <li>We are past the peak of economic growth, with high expectations for tightening at March FOMC. The pullback in forecasted liquidity has left opportunity for market volatility.</li> <li>Uncertainty remains elevated as the Omicron variant spreads, inflation fears revive, supply disruptions continue, monetary &amp; direct fiscal support wane, and unemployment benefits expire.</li> </ul>	<ul style="list-style-type: none"> <li>Upside risks: the unique COVID recovery in fundamentals allow spreads to rocket past all-time tights. Spreads have spent extended periods near tights in other periods as well.</li> <li>Downside risks: Omicron worsens. Supply chain disruptions and inflation persist to H2 2022. Simultaneous low unemployment, hiking and slowing growth could cause a sell off or recession.</li> </ul>
<b>Duration (10-year)</b> ('P' = Periphery) 	<ul style="list-style-type: none"> <li>Carry offered by front end yields now attractive</li> <li>Longer yields continue to be capped by long-run structural downtrends in real yields</li> <li>Inflation likely to normalize over medium term</li> <li>Hiking cycles to be shortened by easing inflation and moderating demand</li> </ul>	<ul style="list-style-type: none"> <li>Inflationary dynamics become structurally persistent</li> <li>Labour supply shortage persists; wage pressure becomes broad and sustained</li> <li>Fiscal expansion requires wider term premium</li> <li>Long run trend in safe asset demand reverses</li> </ul>
<b>Currency</b> ('E' = European Economic Area) 	<ul style="list-style-type: none"> <li>The potential for an end to negative rates in the eurozone is significant for the Euro given non-linearities around the zero bound</li> <li>Experience of past cycles suggests the Dollar fares less well at the start of a cycle, turn neutral USD for now</li> </ul>	<ul style="list-style-type: none"> <li>ECB concludes no risk of second round inflation effects and leaves policy on hold</li> <li>BoE meets lofty market expectations for hikes</li> </ul>
<b>Emerging Markets Local (rates (R) and currency (C))</b> 	<ul style="list-style-type: none"> <li>Selective opportunities</li> <li>Aggressive Fed pricing may now open the door to selective EMFX performance</li> <li>EM real interest rates relatively attractive, curves steep in places</li> </ul>	<ul style="list-style-type: none"> <li>Central banks tighten aggressively to counter fx weakness</li> <li>EM inflation resurgence</li> <li>EM funding crises drive curves higher and steeper</li> <li>Tightening global financing conditions</li> </ul>
<b>Emerging Markets Sovereign Credit (USD denominated)</b> 	<ul style="list-style-type: none"> <li>Valuations are getting more attractive, although for reason DM tightening financial conditions will unevenly impact EM credit and EMFX as many countries have already responded to inflation through hikes</li> <li>Dispersion in outlooks across EM is rising as the recovery begins at different paces. Countries with commodity exposure and better fiscal adaptability rise to the top.</li> <li>Index composition changes over the last 5 years have added a lot of duration to the sector, leaving especially IG EM vulnerable. We prefer HY EM (selectively).</li> </ul>	<ul style="list-style-type: none"> <li>Spillover from China's credit woes or Russia-Ukraine aggression</li> <li>A replay of 2013 occurs with a taper tantrum or swift appreciation of the USD</li> <li>Growth scars from COVID persist and hurt commodity prices &amp; ability to grow out of deficits.</li> <li>There are even further delays in mass vaccination outside of DM</li> </ul>
<b>Investment Grade Credit</b> 	<ul style="list-style-type: none"> <li>US spreads are the tightest since 2005, when average credit quality was higher and duration was 50% lower.</li> <li>IG has been historically resilient in the face of inflation, even if other sectors may benefit more from it. 2021 Q3 earnings supported this, now looking to Q4 results.</li> <li>Good fundamentals, with strong balance sheet management, M&amp;A and deleveraging from capital management &amp; sales growth</li> </ul>	<ul style="list-style-type: none"> <li>IG bonds further cement their place in global investors' portfolios as safe assets, replacing government bonds.</li> <li>M&amp;A and shareholder enhancing activities pick up, but most are leverage neutral.</li> </ul>
<b>High Yield Bonds and Bank Loans</b> 	<ul style="list-style-type: none"> <li>Spreads are nearly to all-time tights, although credit quality has improved through defaults and ample liquidity Runway left in HY recovery trade rising stars</li> <li>Bank loans are attractive as they have shown better performance relative to corporates, although flows amid hiking expectations have increased valuations</li> <li>The best performing parts of these sectors have been the most volatile and lowest quality.</li> <li>Defaults are set to continue near historic lows due to the rapid recovery and ability to remove near-term maturities by companies across the credit spectrum.</li> </ul>	<ul style="list-style-type: none"> <li>The reach for yield continues to suppress spreads, although mounting negative headwinds (inflation, supply disruptions) are increasing pressure for higher yields.</li> <li>Waves of ratings upgrade begin to occur into this year.</li> <li>There are few exogenous shocks that shake the tight spread environment.</li> </ul>
<b>Agency MBS</b> 	<ul style="list-style-type: none"> <li>Overall, the risk/reward mix remains asymmetric.</li> <li>Valuations continue to widen on hawkish language; however, valuations remain rich and carry in many Specified Pools and CMO deals remain unattractive.</li> <li>Spreads still tight to similar Fed taper and QT regimes</li> <li>The Fed's taper was well advertised and saw a muted market reaction upon official announcement.</li> </ul>	<ul style="list-style-type: none"> <li>Housing activity slows considerably and prepaids move back down to normal levels, without denting households' ability to service mortgages.</li> <li>Uncertainty the Fed taper schedule and long-term position</li> </ul>
<b>Structured Credit Non-Agency MBS &amp; CMBS</b> 	<ul style="list-style-type: none"> <li>Our preference remains for Non-Agency RMBS and CLOs</li> <li>Spread tightening seems somewhat excessive per credit quality but seeing replicating risk premiums in new issues.</li> <li>Keeping an eye on sentinel slight upticks in defaults</li> <li>RMBS: Housing continues to outperform in the recovery with constrained supply and strong balance sheets &amp; demographics. Affordability waning but near average. Anticipating more supply in 2022. Valuations less compelling but offer stable carry in de-risked portfolios.</li> <li>CMBS: Most segments maintain strong fundamentals with retail &amp; hospitality improving. Spreads outperforming other structured segments.</li> <li>CLOs: Attractive with fundamentals, waiting for issue pickup</li> </ul>	<ul style="list-style-type: none"> <li>Attractive shorter duration deals coming into market, provide less carry</li> <li>Changes in consumer behavior in travel and retail last post-pandemic.</li> <li>Work From Home continues full steam-ahead post-pandemic (positive for RMBS, negative for CMBS).</li> <li>SOFr transition slows CLO new issuance</li> <li>Rising interest rates may dent housing market strength but seems unlikely to derail it</li> </ul>
<b>Commodities</b> 	<ul style="list-style-type: none"> <li>o/w Copper &amp; Lead vs Zinc</li> <li>u/w Livestock</li> <li>u/w Gold</li> <li>o/w Oil</li> </ul>	<ul style="list-style-type: none"> <li>Renewed Covid lockdowns</li> <li>Global Recession</li> </ul>

**Important information:** For use by Professional and/or Qualified Investors only (not to be used with or passed on to retail clients). Source for all data and information is Bloomberg as at 21.02.2022, unless otherwise stated.

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