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In Credit

16 NOVEMBER 2020

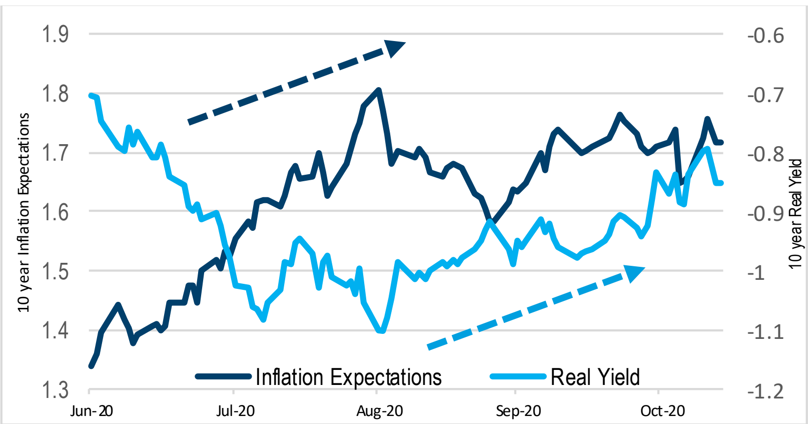
Where the bonds have more yield.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	0.90%	8 bps	-0.1%	8.1%
German Bund 10 year	-0.55%	7 bps	-0.7%	2.8%
UK Gilt 10 year	0.35%	8 bps	-1.2%	6.2%
Japan 10 year	0.02%	0 bps	0.1%	-0.9%
Global Investment Grade	117 bps	-6 bps	1.0%	6.1%
Euro Investment Grade	98 bps	-10 bps	0.6%	2.1%
US Investment Grade	121 bps	-4 bps	1.2%	7.7%
UK Investment Grade	112 bps	-5 bps	0.3%	5.0%
Asia Investment Grade	241 bps	-6 bps	0.5%	5.6%
Euro High Yield	418 bps	-32 bps	2.7%	0.5%
US High Yield	463 bps	-4 bps	2.6%	2.8%
Asia High Yield	665 bps	-7 bps	1.2%	3.5%
EM Sovereign	348 bps	-19 bps	3.3%	3.6%
EM Local	4.4%	3 bps	4.1%	-2.0%
EM Corporate	363 bps	-16 bps	1.6%	4.5%
Bloomberg Barclays US Munis	1.3%	-1 bps	0.7%	3.8%
Taxable Munis	2.3%	-5 bps	1.6%	9.5%
Bloomberg Barclays US MBS	51 bps	-1 bps	0.0%	3.6%
Bloomberg Commodity Index	157.78	1.2%	2.6%	-8.5%
EUR	1.1830	-0.3%	1.6%	5.5%
JPY	104.62	-1.2%	0.0%	3.8%
GBP	1.3192	0.3%	1.9%	-0.5%

Source: Bloomberg, Merrill Lynch, as at 13 November 2020.

Chart of the week: US 10-year inflation expectations and real yields



Source: Bloomberg and Columbia Threadneedle Investments, as at 13 November 2020.

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Macro / government bonds

It was a rollercoaster ride for core government bonds last week, which ultimately ended up higher in yield.

The annoucement that Pfizer had developed a vaccine for Covid-19 with an exceptionally high efficacy prompted an extention of the post-Biden victory sell off in risk-free assets while equities and credit markets did well. The yield on the benchmark 10-year US Treasury nearly touched 1% for the first time since March of this year. Such yields were around below 50bps in early August. The yield curve also steepened as the front end of the curve remains anchored by low current and expected rates while the long end feels the pressure of reflation fears (expectations have risen by around 35bps since the mid point of the year) and rising real rates (real yields have risen by around 25bps since the end of August) **(see chart of the week).** By the end of the week, some order was restored, however, as the grim reality of the growth in Covid-19 cases in the US and Europe hit home and yields fell somewhat.

In terms of data, US inflation failed to meet expectations and was flat month-on-month and only 1.2% higher than a year earlier (core rate is 1.6% y/y). There was better news from weekly jobless claims, however, which fell to a post pandemic low of 709k. In Europe, industrial production was weak and fell by 0.4% in the last month and has contracted by nearly 7% over the last year. Meanwhile, there was little progress in establishing an agreement between the UK and Europe over Brexit.

Investment grade credit

Corporate credit had another very contructive week.

The vaccine news, Biden victory and a constructive earning seasons helped investment grade spreads continue to tighten and helped more stressed sectors such as travel and leisure do better. In all, the global investment grade spread reached the tightest level since February by mid-week before selling off by a couple of basis points into the weekend. For context, global spreads are still wider than at the start of the year (around16%) with euro-denominated debt only 4% wider and outperforming over this period.

High yield credit

US high yield bond prices were mixed over the past week as a strong rally on Monday in response to positive vaccine news was followed by consolidation over the remainder of the week as investors weighed a sharp month-to-date rally in the context of a worsening pandemic.

The ICE BofA US HY CP Constrained Index returned 0.46% and spreads were 5bps tighter over the week. The asset class reported a $4.6 billion inflow over the week, the largest weekly inflow since June, which offset the previous two week’s outflows.

European high yield also experienced a sharp market rally as spreads contracted by 32bps for the week, bringing month-to-date to -71bps, and back to the 5-year average. Performance year-to-date is back into positive territory. The asset class experienced positive flows, again, with €352 million inflow. CCC strongly outperformed BB by 3 folds. Covid-sensitive names were particular beneficiaries of the promising news. The primary market returned with €3.2 billion of euro-equivalent supply; for once, most of this was in sterling, including Travis Perkins, Thames Water, M&S, Encore and NatWest AT1.

Better quality high yield names have almost finished their Q3 reporting, coming in generally with better than expected news. Reporting is now moving to higher risk issuers which could bring a different picture.

In company specific news, Thyssen Krupp is in talks for up to €5 billion of state aid, indicating that support is still seen as needed. M&A news continues with rumours of a merger between Solway and Hexel (€4.5 billion enterprise value), though the news was denied by both companies. If a merger were to occur it will likely cause an increase in leverage overall.

Even with the improved possibility of a vaccine, there is still the reality that it will be a while before things return to 'normal'. A straight-line return to growth is unlikely with some sectors rebounding more slowly than others. For many companies, access to capital remains key for firms to survive long enough until a sustainable level of improvement is seen in the market.

US leveraged loans

Leveraged loan prices (referencing the J.P. Morgan Leveraged Loan index) increased +$0.75 to $95.70 over the past week with the average price for BB loans increasing $0.57 to $97.86, Single B loans increasing $0.60 to $97.30, and Split B/CCC increasing $2.07 to $83.17. Meanwhile, loan yields and spreads (3-year) decreased 24bps and 27bps over the past week to 5.63% and 533bps, which included Tuesday's lowest yield for the loan index (5.60%) since June 2015. While the loan market outperformed bonds during the late-October period of broader market weakness, the asset class materially lagged November's recovery in credit markets. And thus the loan product has held in comparably well through the past few sessions of consolidation. Primary activity has been quiet with only $5.1 billion issued thus far month-to-date. The asset class reported a small $4 million outflow over the week.

Structured credit

The Agency MBS market was flat on the week, outperforming other high-quality, investment grade sectors which struggled as rate move higher on promising vaccine news.

CMBS spreads followed the good news and tightened as well despite a second wave of Covid-19 and certain cities even entering a second lockdown. Housing remains a bright spot and is supportive on non-agency RMBS. We are also seeing encouraging performance in sub-prime auto and consumer loans.

Emerging markets

Like other risk assets, emerging markets also performed strongly last week, as hard currency and corporates moved -19bps and -13bps tighter, respectively. Local bonds also performed well as EM FX strengthened on the back of US dollar weakness. Inflows into the asset class continued, more than doubling the previous week's size with $2.7 billion, almost in equal size to both hard currency and local EM bond funds.

In central bank news, Turkey kept rates unchanged. However, the Turkey 'story' does not end there as the market was surprised this week by an Erdogan speech announcing that tough decisions would be made to manage inflation and support the economy. This was a far cry from the usual announcements by Erdogan as they gave hope for a more orthodox framework. Mexico also kept rates unchanged at 4.25%, a cautious hold for now as the central bank re-evaluates the tick up in inflation. Differently, Egypt cut rates by 50bps to 9.25%, still leaving real rates high.

On the political front, Peru impeached its president on bribery charges. Protests erupted very quickly as locals took to the street and voiced their support for the ousted president who had been campaigning against corruption. The situation remains tense as the first interim president has already stepped down with a second put in place with the start of this week. In African news, Zambia is looking for a vote by bond holders to accept delay which is likely to be rejected. As the 30-day coupon grace period expires soon this will put the country in default.

Asian fixed income

The Trump administration has issued an Executive Order to prohibit US investments in Chinese companies with alleged military links. Earlier in June and August, the US Department of Defense (DoD) had designated a total of 31 Chinese companies in its Military List. According to the DoD, these Chinese companies supported the modernization of the People's Liberation Army (PLA) through the access to advanced technologies and expertise acquired or developed by Chinese companies, universities and research programmes that appear to be civilian entities. This DoD Military List includes China National Chemical (ChemChina), Sinochem, China Three Gorges Corporation, China State Construction Group, China Mobile and China Telecom. This Executive Order takes effect on 11 January 2021 and US persons have to divest by 11 November 2021.

The State Administration for Market Regulation (SAMR) of China has laid out the draft regulations to curb monopolistic practices by internet companies such as Alibaba Group and Tencent Holdings. The regulations will examine whether customers are treated in different ways by the internet companies based on payment ability, consumption preference and usage habits. In October, the Financial Stability and Development Committee highlighted the need to promote fair competition and to enforce anti-monopoly law. The SAMR is gathering public review and feedback for the draft regulations till 30 November.

Vedanta reported good Q2 results, driven by the rebound in its zinc and aluminium business, which offset the weakness in the oil and gas segment. Cairn India Holding Limited, an overseas subsidiary of Vedanta Ltd has provided an inter-company loan of $956 million to Vedanta Resources Ltd (VRL). Vedanta Ltd has only passed through around one-third of the dividends it received from Hindustan Zinc to VRL. Further dividend pass-through is subject to the Board's decision, which will be based on the liquidity situation, commodity prices and other circumstances.

Commodities

The commodity index rallied 1.2% over the course of last week. Crude oil was up 8%, driven by Pfizer vaccine announcement and the OPEC+ decision to delay production hikes until mid 2021. Production was originally expected to increase in January 2021. Base metals rallied by 1.2%. This was pushed higher by China's continued recovery in manufacturing. Chinese fixed asset investment went up by 0.8% year-on-year in September. Copper rallied by 2.2%, due to Chinese demand, but also as the political crisis in Peru potentially threatens supply. Peru, the world's second largest copper producer, is currently without a president following the impeachment of the former president on Monday as mentioned earlier. In precious metals, gold and silver fell by 3.1% and 2.8% respectively. The was driven by optimism in the market following the announcement of the Pfizer coronavirus vaccine efficacy.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

16th November 2020

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	■ The spread tightening of the last 5 months leaves valuations much closer to long-term averages, and a more modest overweight to credit risk is warranted. There are still enough attractive opportunities to build a portfolio that is overweight credit risk, although some sectors are offer little upside. ■ Technicals are positive across the board. The Fed's new strategy underlines lower for longer and targeting easy financial conditions. The demand for credit products remains high. ■ Fundamentals continue improving, even if slower than in the summer. Vaccine progress is coming steadily.	■ The Feb garbles its messaging in how it will carry out its new policy framework ■ Cooler weather leads to virus acceleration and school closures hamper labour productivity. ■ The damage done to the labour market is deep & long-lasting. ■ Vaccine development slows.
Duration (10-year) ('P' = Periphery)	P ¥ $ Short -2 -1 0 +1 +2 Long £ €	■ Renewed virus concerns and economic disruption to keep nominal growth subdued ■ Reflation credibility still low, despite Fed framework review ■ Fed QE and high personal savings underpin demand for treasuries ■ ECB readying new stimulus effort, while supply declines ■ Duration remains best hedge for further risk asset correction	■ Vaccine development pace exceeds expectations, permitting rapid normalisation ■ Permanent fiscal policy shift rebuilds reflationary credibility ■ Fiscal largesse steepens curves on issuance expectations ■ Risk hedge properties deteriorate
Currency ('E' = European Economic Area)	¥ E EM £ Short -2 -1 0 +1 +2 Long A$ $	■ A Biden presidency should see a weaker dollar through the reduction of trade war risk premium. ■ Longer term, expensive valuations and twin deficits presage a weaker Dollar	■ Fiscal gridlock continues in the US, which undermines growth and risk sentiment ■ Extension of Covid restrictions in Europe and accommodative ECB policy
Emerging Markets Local (rates (R) and currency (C))	R Under-weight -2 -1 0 +1 +2 Over-weight C	■ Favourable advanced economy setting support EM assets near term ■ EM real interest rates relatively attractive, curves steep	■ 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	■ The stable/weaker USD over the last 4 months has eased fundamental and technical pain. ■ EM IG has tightened inside long-term averages versus US IG, but EM BB/B remains attractive versus US BB/B. ■ The peak in defaults and restructurings has passed and the landscape of EM is relatively stable. ■ The wave of global liquidity is reaching EM, but after it ran through developed market credit.	■ The USD strengthens. ■ Growth scars from COVID persist and hurt commodity prices & ability to grow out of deficits. ■ Governments show little willingness to address deficits post-COVID.
Investment Grade Credit	Under-weight -2 -1 ■0 +1 +2 Over-weight	■ IG valuations were the most directly affected by the Fed and normalized most quickly. Valuations are now at long-term medians, but the index duration is 30% longer. ■ Fundamentals have been more positive than expected. Leverage has risen, but so too has cash. ■ With Treasury yields likely very low for an extended period of time, technicals favour IG as a safe asset substitute.	■ The Fed does not renew its Corporate Credit Facilities. ■ Foreign buyer flow stops for geopolitical, financial, or regulatory reasons. ■ The cash stockpiles taken out at the depths of the crisis are deployed on large-scale M&A instead of deleveraging.
High Yield Credit	Under-weight -2 -1 ■0 +1 +2 Over-weight	■ Spreads & new issue supply underline that companies with sounds economics have no issue accessing financing. Valuations are mostly back in line with long-term ranges and are moderately attractive versus IG, but less compelling than earlier in the recovery. ■ The ability to access financing has dramatically improved the prospects for many companies, and the impact of COVID on companies with bonds >$80 is manageable.	■ Prolonged COVID-19 related slump in activity would hurt these companies most. ■ The sector most sensitive to changing financial conditions.
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, although the Fed's quantity of buying is overwhelming the market. ■ Forbearances have been better than expected, and are still relatively low (including GNMA, which has been hit hardest).	■ Fed reallocating MBS purchases towards Treasuries. ■ Bonds will underperform other spread product in a sharp risk-on move. ■ Renewed interest rate or curve volatility.
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 is the strongest sector in the economy thanks to low interest rates and desire for more space for continued WFH. CMBS: Retail tenant payments & hotel occupancy are improving. Office is still struggling but valuations reflect this. ■ Valuations vary wildly, but are broadly attractive. Given performance, trimming some riskier positions & doubling down on conviction credit is due.	■ Changes in consumer behaviour in travel and retail last post-pandemic. ■ Work From Home continues full-steam-ahead post-pandemic. ■ Built-up savings from fiscal stimulus/enhanced unemployment benefits are drawn down and mortgage forbearance increases.
Commodities	Under-weight -2 -1 ■0 +1 +2 Over-weight	■ o/w Copper vs Aluminium ■ o/w Lead vs Zinc ■ u/w Natural gas ■ o/w Soybeans vs Corn ■ o/w refining margins (o/w products, u/w Brent)	■ Oil production disruption