

# In Credit

13 JULY 2020

## Gold continues to grind higher

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	0.63%	-4 bps	0.4%	9.4%
German Bund 10 year	-0.45%	-2 bps	0.2%	2.4%
UK Gilt 10 year	0.16%	-3 bps	0.2%	9.8%
Japan 10 year	0.04%	1 bps	0.2%	-0.8%
Global Investment Grade	152 bps	-2 bps	1.0%	4.1%
Euro Investment Grade	142 bps	-1 bps	0.4%	-0.9%
US Investment Grade	152 bps	-2 bps	1.3%	6.2%
UK Investment Grade	141 bps	-3 bps	0.7%	4.1%
Asia Investment Grade	269 bps	-4 bps	0.5%	3.7%
Euro High Yield	541 bps	-1 bps	0.5%	-4.5%
US High Yield	614 bps	-3 bps	1.1%	-3.7%
Asia High Yield	710 bps	0 bps	0.6%	0.3%
EM Sovereign	426 bps	4 bps	0.9%	-0.9%
EM Local	4.5%	-3 bps	1.3%	-5.6%
EM Corporate	430 bps	-5 bps	0.7%	0.5%
Bloomberg Barclays US Munis	1.4%	-9 bps	0.5%	2.6%
Taxable Munis	2.3%	-8 bps	1.0%	9.6%
Bloomberg Barclays US MBS	63 bps	-4 bps	0.1%	3.6%
Bloomberg Commodity Index	142.11	1.5%	2.6%	-17.3%
EUR	1.1316	0.5%	0.6%	0.8%
JPY	107.07	0.5%	0.9%	1.6%
GBP	1.2603	1.1%	1.8%	-4.8%

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



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### Chart of the week: Gold: 2010-2020



Source: Macrobond and Columbia Threadneedle Investments, as at 13 July 2020.

## Macro / government bonds

On the surface, core government bond yields continued to remain in a tight trading range, finishing unchanged to a couple of basis points lower from the start of the week.

However, US treasury yields actually fell to the low last seen in mid-April as the UST 10-year yield touched 0.57% before rebounding on Friday to finish the week almost unchanged. This came on the back of further evidence that a Covid-19 second wave has taken hold in the US as the number of cases continued to rise in major southern states. The risk off-tone also saw a flattening of the US treasury yield curve given the strong demand in the UST 30-year auction. This was only reverted late Friday on news of a potential Covid-19 vaccine, resulting in government yields rising and equity markets and credit markets rallying.

In the UK, the Chancellor's summer comments, most already leaked, are the government's latest attempts to boost the economy in combination with the ease of the lockdown through directed VAT cuts and subsidies, as well as stamp duty reductions. They came as more major UK businesses announced layoffs in the thousands.

In Europe, the German economic minister said that, in exceptional cases, the government may take an equity stake in companies especially impacted by the pandemic or if there was a strong strategic rationale.

## Investment grade credit

Credit spreads tightened last week only bps in both US dollar and euro markets. Flows were light for euro investment grade with only €215 million of inflows, while sterling investment grade experienced a £64 million outflow.

The heavy issuance of the last weeks has slowed down to a trickle in these first days of July given the Q2 reporting season will start soon.

Specific numbers were put behind the US Federal Reserve's support of the corporate bond market as purchases of \$1.3 billion directly of corporate bonds as well as ETFs, in late June, was confirmed. This brings the total to \$1.8 billion of corporate debt bought by the Fed.

Within euro BBB's, 1/3 of the BBB-rated securities (€83 billion) are currently on negative watch/negative outlook. This gives a sense of what more can be expected for European High Yield.

## High yield credit

US high yield bond prices were modestly higher over the past week, as confidence in policy support and a recovery in the economy have largely outweighed the spread of Covid-19 infections across certain parts of the country. The ICE BofA US HY CP Constrained Index returned 0.27% and spreads were 3bps tighter over the week. The primary calendar eased from June's torrid pace with \$7.4 billion of issuance over the week. According to Lipper, the asset class saw a \$2.1 billion inflow, following the prior week's \$5.5 billion outflows.

The European High Yield (EHY) market again took a pause, as spreads remained basically unchanged last week. The asset class continued to experience inflows, registering €271 million into the asset class for next week. Primary market activity remains strong as shown that 28% of 2020's issuance happened over the last couple of weeks. Issuers Verisure, a home security firm who was the first to issue after the March market shutdown, Saipem (Italian oilfield services company), Autodis (car parts firm), Diebold Nixdorf (the cash management machine and systems group), and Avantor (the healthcare materials firm) were all relatively well or very well received by the market.

Within the EHY space, as more Fallen Angels join the EHY ranks, the landscape has changed from a universe of small to medium sized issuers, to include large, long established corporates. These companies are much less likely to default given the liquidity support offered by governments and central banks, right the way down the credit spectrum. Default expectations have more than halved from the end of Q1 2020 forecasts with figures now at 4%. Default risk is now considered most likely in small cap names, which are much less likely to impact the total universe given their size in what is now a much larger market.

## Leveraged loans

Leveraged loan prices rose modestly over the past week, as credit markets continue to take the rise in virus infections in stride. Leveraged loan prices, referencing the JP Morgan Leveraged loan index, increased \$0.25 to \$91.83 over the past week, with the average price for BB loans increasing \$0.31 to \$95.71, Single B loans increasing \$0.30 to \$93.82, and Split B/CCC falling -\$0.28 to \$75.66. Meanwhile, loan yields and spreads (3-year) decreased 11bps and 10bps each over the past week to 6.93% and 670bps, which compare to as low as 6.62% and 634bps in early June. Outflows continued for the asset class with a \$207 million outflow for leveraged loan funds over the past week. This was the 80th withdrawal over the last 85 weeks.

## Structured credit

The securitized component of the Bloomberg Barclays US Aggregate Index delivered 0.11% in total return last week, outperforming duration-neutral US treasuries by 0.07%. Spreads modestly tightened, including in the agency mortgage space where current coupon spreads reached levels last seen in early February, prior to the Covid-19 blowout. This tightening increases the likelihood that the 30-year mortgage rate will drop below 3% in the immediate future. Black Knight reported the largest week-over-week decline in forbearance since data tracking began this Spring, and total loans in forbearance declined a full percentage point to 7.8%. Supply continues to be scarce in the ABS space, but the new issue pipeline continues to fill.

## Emerging markets

Emerging markets were also stable last week as spreads finished only marginally wider on the week for hard currency sovereigns, while tightened for EM corporates. Local EMs saw yields fall lower by a few basis points. The asset class experienced strong inflows of \$1.3 billion, due to inflows into hard currency funds (+\$1.6 billion) while local currency funds continued to see outflows.

Positive news for Ecuador (who had defaulted earlier in the year), as the government reached an agreement with 45% of bond holders to restructure the outstanding debt (\$17.4 billion). Ecuador bond prices rose on the news. This is in marked contrast to Argentina where the bondholders and the government are still at a stalemate. In Covid-19 specific news, President Bolsonaro of Brazil, President Anez of Bolivia, and Diosdado Cabello, Venezuelan politician and head the United Socialist party, have all announced they have tested positive for virus.

In Asian news, the central bank of Indonesia announced their own QE program with the central bank buying up to \$40 billion (3.6% of GDP) of government bonds. This is in addition to the \$14 billion bonds already purchased. The news was well received by the market with local bonds yields falling on the news. Malaysia also had positive news as elections saw the incumbent prime minister re-elected.

## Asian fixed income

In Asia, GMR Infrastructure announced the completion of the sale of its 49% stake in GMR Airport (GAL) to Group ADP for INR107.8 billion or \$1.43 billion. This is a positive development for GMR Infrastructure which has a weak financial profile.

Sina Corp which owns a 44.9% in Weibo, received a non-binding privatisation offer from New Wave. New Wave is controlled by Mr Charles Chao who is also the Chairman and CEO of Sina Corp. New Wave owns a 12.2% stake in Sina with a 58% voting right.

## Commodities

Commodities index was higher at 1.5% for the week. This week, it was metals which led the asset class as base metals rose 5%. Copper was the star performer, up 6.6% on increased concerns of supply disruptions (ex. Chilean miners' strike) in Latam as well as strong demand from China due to targeted stimulus measures into infrastructure programmes. It was closely followed by aluminium (up 4.6%) as well as a number of other base metals, which were all up about 4%. In precious metals, gold broke through and maintained a price above the psychological level of \$1800/oz, reaching a high of \$1818/oz before finishing the week back down at \$1800/oz. This price was last seen in September 2011 and reinforces the risk-off sentiment portion of the market even as equities continue to rally. See [chart of the week](#).

Energy was relatively stable, up only 0.5%, with crude oil and refined product prices up about 1% this past week. The US Department of Energy revised up its forecast for global consumption for the year. However, it still sees global demand for crude at 92 million/day vs. 2019 demand of 100 million/day. This is significant for the industry as, due to price, overall the industry is making a lot less in 2020 vs 2019.

## Summary of fixed income asset allocation views

### Fixed Income Asset Allocation Views

13<sup>th</sup> July 2020

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>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.</li> <li>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).</li> <li>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.</li> </ul>	<ul style="list-style-type: none"> <li>Major economies cannot 'flatten the curve' of COVID-19 and 'recession' becomes 'depression'.</li> <li>Reopening begets a widespread receding.</li> <li>Central banks pull back support too early and positive technicals vanish.</li> </ul>
<b>Duration (10-year)</b> (P = Periphery) 	<ul style="list-style-type: none"> <li>Disinflationary global recession now a base case</li> <li>Consumption to flatten out after initial sequential recovery surge</li> <li>Monetary policy will seek lower, flatter curves and more than an offset in increased issuance</li> <li>Duration remains best hedge for further risk asset correction</li> </ul>	<ul style="list-style-type: none"> <li>Unexpected medical advance allowing full, rapid economic re-opening</li> <li>Extraordinary fiscal/monetary accommodation inspires consumption-driven cyclical upswing and higher inflation</li> <li>Fiscal largesse steepens curves on issuance expectations</li> </ul>
<b>Currency</b> ('E' = European Economic Area) 	<ul style="list-style-type: none"> <li>The Dollar is richly valued on the basis of growth outperformance and high carry. Twin deficits indicate a weaker dollar longer term.</li> <li>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.</li> </ul>	<ul style="list-style-type: none"> <li>Federal Reserve moves away from ultra accommodative stance</li> <li>Investors reappraise US crisis/fiscal response as more likely to speed a return to normality than other regions</li> </ul>
<b>Emerging Markets Local (rates (R) and currency (C))</b> 	<ul style="list-style-type: none"> <li>Many EMs lack the policy space to offset demand destruction</li> <li>Currencies likely pressure valve as central banks finance fiscal deficits</li> <li>EM real interest rates relatively attractive</li> </ul>	<ul style="list-style-type: none"> <li>Further sharp escalation in global risk aversion</li> <li>EM funding crises drive curves higher and steepen</li> </ul>
<b>Emerging Markets Sovereign Credit (USD denominated)</b> 	<ul style="list-style-type: none"> <li>Balance sheets will be stretched by the fundamental COVID-19 shock, and exaggerated by DM financial turmoil, cheap oil, and a stronger USD.</li> <li>Valuations have become more attractive even in the more stable credits.</li> <li>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.</li> </ul>	<ul style="list-style-type: none"> <li>COVID-19 begins to spread rapidly in countries with poor health infrastructure, causing higher death rates.</li> <li>The US dollar remaining at all-time highs will regardless be a headwind</li> <li>Reversal of recent electoral trend towards market-friendly candidates.</li> </ul>
<b>Investment Grade Credit</b> 	<ul style="list-style-type: none"> <li>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.</li> <li>Credit quality has nonetheless deteriorated, meaning credit spreads are less attractive versus historical comps.</li> </ul>	<ul style="list-style-type: none"> <li>The Fed's purchases go all to maintain 'liquidity' are overwhelmed by economic deterioration.</li> <li>Foreign buyer flow stops for geopolitical, financial, or regulatory reasons.</li> <li>Downgrade pressures remain front and centre.</li> </ul>
<b>High Yield Credit</b> 	<ul style="list-style-type: none"> <li>Though not as positive as IG, HY technicals have improved. Markets are functioning again.</li> <li>Fundamentals remain challenged for these lower-quality balance sheets, especially in the energy sector. There has been improvement in ..</li> <li>Valuations: the breakneck speed of the rally means spreads are much closer to fair, but still mildly attractive.</li> </ul>	<ul style="list-style-type: none"> <li>Prolonged COVID-19 related slump in activity would hurt these companies most.</li> <li>Potential corporate QE lures investors to higher quality assets, instead of encouraging reallocation into lower quality credit.</li> </ul>
<b>Agency MBS</b> 	<ul style="list-style-type: none"> <li>The Fed's QE including Agency MBS has been a significant tailwind for a sector with worse fundamentals, although fundamentals are better than expected</li> <li>But valuations are much more neutral now, and the Fed's purchases have been meaningfully tapered.</li> <li>However, forbearances have been better than expected, and are still relatively low (outside of GNMA, which has been hit hardest).</li> </ul>	<ul style="list-style-type: none"> <li>Interest rates continue falling aggressively and volatility rises again.</li> <li>Bonds will underperform other spread product in a sharp risk-on move.</li> <li>Fed continues to taper purchases.</li> </ul>
<b>Non-Agency MBS &amp; CMBS</b> 	<ul style="list-style-type: none"> <li>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.</li> <li>CMBS: Non-payment by retail tenants, lockdowns on travel, and work-from-home have had serious fundamental worries to certain issuers and deals.</li> <li>The sector has been uniformly punished and there exist many opportunities to pick out attractive property profiles &amp; structures.</li> </ul>	<ul style="list-style-type: none"> <li>Consumer behaviour and employment are fundamentally changed by even a brief, successful 'social distancing' effort.</li> <li>Housing prices begin to fall in contrast to current trend.</li> </ul>
<b>Commodities</b> 	<ul style="list-style-type: none"> <li>o/w Base Metals</li> <li>u/w Crude</li> <li>o/w Soybeans vs Corn</li> <li>u/w Cotton</li> </ul>	<ul style="list-style-type: none"> <li>Oil production disruption</li> </ul>

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