

In Credit

10 AUGUST 2020

Credit enjoying the summer lull

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	0.56%	4 bps	-0.2%	10.2%
German Bund 10 year	-0.51%	1 bps	-0.2%	2.6%
UK Gilt 10 year	0.14%	4 bps	-0.8%	9.2%
Japan 10 year	0.01%	-1 bps	-0.1%	-0.6%
Global Investment Grade	134 bps	-6 bps	0.3%	6.0%
Euro Investment Grade	123 bps	-5 bps	0.1%	0.3%
US Investment Grade	135 bps	-6 bps	0.3%	8.5%
UK Investment Grade	130 bps	-4 bps	-0.2%	4.8%
Asia Investment Grade	250 bps	-7 bps	0.5%	5.5%
Euro High Yield	495 bps	-17 bps	0.6%	-2.7%
US High Yield	506 bps	-10 bps	0.6%	0.4%
Asia High Yield	665 bps	-13 bps	0.7%	2.5%
EM Sovereign	384 bps	-17 bps	1.3%	3.1%
EM Local	4.4%	1 bps	-0.9%	-4.9%
EM Corporate	396 bps	-13 bps	0.8%	2.9%
Bloomberg Barclays US Munis	1.1%	-7 bps	0.5%	4.3%
Taxable Munis	2.2%	-1 bps	0.1%	12.2%
Bloomberg Barclays US MBS	47 bps	-11 bps	0.1%	3.8%
Bloomberg Commodity Index	151.21	2.6%	2.6%	-12.6%
EUR	1.1771	0.1%	0.1%	5.1%
JPY	105.99	-0.1%	-0.1%	2.6%
GBP	1.3063	-0.3%	-0.3%	-1.5%

Source: Bloomberg, Merrill Lynch, as at 10 August 2020.



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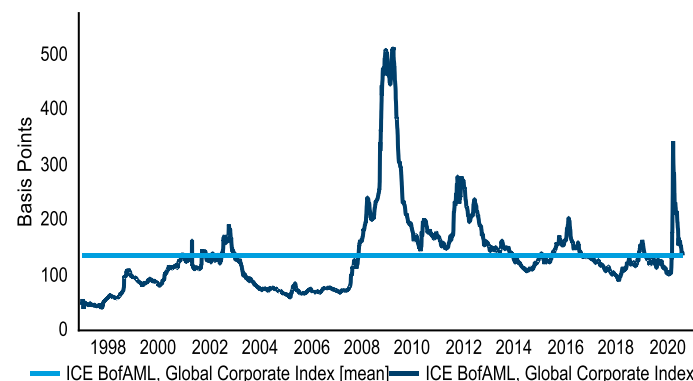
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Chart of the week: Global investment grade spreads



Source: Macrobond and Columbia Threadneedle Investments, as at 10 August 2020.

Macro / government bonds

Core government bond yields were marginally higher with the rise in risk sentiment.

Non-farm payroll in the US hit a three-month streak of positive gains, with jobs rising and unemployment falling more than expected (rate now 10.2% vs 10.6% expected). The eurozone economy continued to show signs of healing as the composite PMI rose to 54.9 for July (previous 48.4, expected 54.8).

In the UK, the MPC unanimously decided to keep rates at 0.10% as well as the Asset Purchase Facility at £745 billion, both in line with expectations. It still expects the economy to rebound back to the 2% target in two years' time.

President Trump signed four executive orders on Saturday for coronavirus relief, including a temporary payroll tax deferral, eviction protection, relief for student borrowers and \$400 a week for the unemployed. The technical legality of this is still unclear as he does not have the authority to control federal spending. The signing came after the two weeks of talks between White House officials and Congress did not come to any resolution for a broad relief plan.

President Macron hosted a virtual conference over the weekend in collaboration with United Nations. Over 24 world leaders gathered to pledge almost \$300 million to help Lebanon repair the damage caused by the recent port explosion in Beirut. Repairs are likely to cost billions as the blast not only devastated the city's main port but damaged more than 200,000 homes.

Investment grade credit

Global spreads continued to tighten last week, to a level last seen in the beginning of March ([see chart of the week](#)). Total return is 6% year-to-date. UK, European and Asian investment grade spreads followed suit, also finishing the week tighter.

New issuance was low this week and lighter than this time last year. With earnings season now around 75% of the way through we should start to see issuance pick up.

Rolls Royce took a hit from Fitch this week as it was downgraded to high yield. Senior unsecured debt is now rated BB+ from BBB- with outlook remaining negative. This follows S&P and Moody's downgrade of the company to high yield over the last three months. Impact from the coronavirus disruption wasn't the only unhelpful factor in this, as fixes to the Trent-1000 engines had created a short-term business risk (in late February, 35 planes were grounded as engine blades were corroding or cracking prematurely).

Structured credit

Mortgages did well last week with rates unchanged and prepay speeds slower than expectations. The US Agency MBS market was up 14bps, outperforming the US Aggregate Bond Index by 4bps. While mortgage applications for both purchases and refinancing were down 5% versus the prior week, the availability of credit with mortgage rates sub 3% have buoyed both the housing market and the US consumer. Expected delinquencies haven't materialized and forbearance requests continue to trend lower. The question on the table now is will the US consumer get another round of stimulus, potentially through payroll tax payment deferral and/or extended unemployment benefits, following executive actions taken Saturday.

CMO issuance remained strong in July, totalling \$22 billion – down roughly \$11 billion versus June, which was the largest single month of issuance since 2011. The non-qualified mortgage pipeline continues to grow, albeit it more slowly, and lack of supply in reperforming loans has set the stage for tightening spreads.

High yield credit

US high yield bond prices continued to move higher over the past week amid firm technicals, vaccine optimism and speculation that Democrats and Republicans would agree on a fiscal aid package by the end of the week. The ICE BofA US HY CP Constrained Index returned 0.58% and spreads were 10bps tighter. The asset class reported its largest weekly inflows (\$4.39 billion) since the week ending 10 June with seven of the eight largest on record now occurring since March (inflows for high yield now total \$60 billion since 25 March). It was also a near record week for new issue volume with \$18.8 billion pricing over the week, easily the most active week for high yield issuance since a record \$22.7 billion in the week ending 19 June.

European High Yield (EHY) returned to spread tightening last week, contracting 17bps and bringing the spread to under 500bps, to 495bps. The asset class experienced its first outflow in more than four months with €289 million of outflows, largely in ETFs (-€197 million). Primary markets took a pause last week with the absence of any new issuance.

EHY saw two more defaults announced last week, taking the year-to-date number to €3.3 billion over eight issuers. This takes the 12-month trailing default rate to 1.8% (JPMorgan).

Leveraged loans

Leveraged loan prices continued to grind higher over the past week and have not fallen more than \$0.03 in a session since 29 June. The average price on the J.P. Morgan Leveraged Loan Index increased \$0.36 to \$93.39 over the past week with the average price for BB loans increasing \$0.30 to \$96.73, Single B loans increasing \$0.29 to \$95.24, and Split B/CCC increasing \$0.76 to \$76.91. Meanwhile, loan yields and spreads (3-year) decreased 13bps apiece over the past week to 6.33% and 612bps, which compare to 5.81% and 452bps on 21 February. Leveraged loan funds reported rare concentrated inflows totaling +\$70 million for the week ended 5 August, only the sixth inflow for the asset class in the last 89 weeks.

Emerging markets

Emerging markets rallied again as EM hard currency and corporate spreads continued their spread tightening into the first week of August. The asset class experienced its fifth straight week of inflows (\$362 million), back to largely being for hard currency bonds (\$342 million) but still with a small positive inflow into local currencies (\$20 million).

In LATAM news, Argentina was the strongest performer last week on news that key bond holder groups had reached an agreement with the government regarding debt reprofiling. This follows Ecuador's successful agreement, last week, with bond holders on restructuring of the country's debt.

Turkey was the other big mover this week, although in the opposite direction as bonds, equities and the currency weakened on news that Turkey regulators would be rolling back on rules that had earlier supported a boost in loans by lenders. This came as the country's central bank also announced it would start to reduce liquidity measures implemented earlier this year to support to the market given the ramifications of the pandemic on the economy.

In central bank news, Brazil cut rates another 25bps to 2%, bring the overall easing, this cycle, to 450bps. Romania also cut rates by 25bps to 1.5% at an unscheduled meeting last week.

In political news, the parliament election results in Sri Lanka came in line with expectations as the president's party won a decent majority. This should allow the IMF disbursement, which had been held up due to the elections, to go ahead.

Asian fixed income

The H1 operating results of HKT Trust & HKT Limited (51.94% owned by PCCW) were resilient. While both revenue and EBITDA were weaker y/y, the reported financial metrics are broadly stable, liquidity remained strong on continued capex discipline and cost control. PCCW will transfer its PCCW Media business to HKT for a cash consideration of \$250 million (around HKD1.95 billion). This transaction positions HKT as the only quad-play operator that covers broadband, mobile, fixed-line and pay-tv in Hong Kong. Furthermore, management expects to generate more service cross-selling and operating efficiency.

The Trump administration has escalated the tensed relationship with China by issuing an Executive Order to prohibit US residents from using and transacting on WeChat (Tencent's application). This will take effect beginning 45 days after the date of the order (6 August). The risks ahead include the potential retaliation from the Chinese government and whether the Trump administration could impose more restrictions on other products from Tencent or other major Chinese internet and software companies.

Commodities

Commodities were higher this week on the back of the strong rally in energy and metals.

Energy rose 9.2% on the week as crude oil prices were up 2.5%. API (American Petroleum Institute) figures showed a significant draw on crude oil inventories in the US, about 8.6 million barrels. Natural gas prices exploded higher, rising more than 25% on the week, due to both the forecast of hotter expected temperatures for the rest of the summer, as well as due to loss of production in the New England area of the US because of a power outage.

Base metals rallied this week, even unloved metals such as zinc and aluminium. This was on news out of China on strong demand for all base metals. Precious metals remained on a rallying tone, even platinum which had been lagging up to late, as the price of gold climb another 3.5% finishing the week at \$2035/oz.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

10th 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 u/w Crude o/w Soybeans vs Corn u/w Softs o/w refining margins (o/w products, u/w Brent) 	<ul style="list-style-type: none"> Oil production disruption

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