

In Credit

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“Dimly aware of a certain unease in the air”

Markets at a glance



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	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	1.28%	0 bps	0.0%	-1.3%
German Bund 10 year	-0.47%	0 bps	0.4%	-0.5%
UK Gilt 10 year	0.55%	-2 bps	0.6%	-2.5%
Japan 10 year	0.02%	-1 bps	0.0%	0.4%
Global Investment Grade	95 bps	2 bps	-0.1%	0.2%
Euro Investment Grade	86 bps	1 bps	0.1%	0.8%
US Investment Grade	95 bps	2 bps	-0.2%	-0.1%
UK Investment Grade	90 bps	0 bps	0.5%	-0.6%
Asia Investment Grade	205 bps	-5 bps	0.8%	0.7%
Euro High Yield	317 bps	4 bps	0.2%	3.6%
US High Yield	337 bps	1 bps	-0.4%	3.6%
Asia High Yield	674 bps	17 bps	1.7%	-2.0%
EM Sovereign	324 bps	2 bps	0.2%	-0.3%
EM Local	5.0%	2 bps	-2.0%	-5.7%
EM Corporate	310 bps	-1 bps	0.4%	1.9%
Bloomberg Barclays US Munis Taxable Munis	0.9%	0 bps	-0.3%	1.6%
	2.0%	-3 bps	0.4%	2.9%
Bloomberg Barclays US MBS	38 bps	5 bps	-0.3%	-0.4%
Bloomberg Commodity Index	197.33	-4.2%	-5.3%	16.8%
EUR	1.1719	-0.8%	-1.4%	-4.2%
JPY	110.03	-0.2%	-0.1%	-5.9%
GBP	1.3662	-1.8%	-2.0%	-0.3%

Source: Bloomberg, Merrill Lynch, as at 20th August 2021.

Chart of the week: US Consumer Sentiment Index 2001-21



Source: Bloomberg and Columbia Threadneedle Investments, as at 23 August 2021. Refers to the University of Michigan Consumer Sentiment Index.

Macro/government bonds

We borrowed a line from a Pink Floyd song for this week's title, which seemed to sum up the mood in markets last week. The rise in cases of the delta variant of Covid brings fears of a pause in upward economic momentum. Safe haven assets such as the US dollar and core government bonds were seen as appealing. The benchmark 10-year US Treasury was flirting again with the 1.25% mark at the time of writing. Meanwhile commodity prices and cyclical stocks have struggled, as have credit markets – albeit only to a limited extent.

Other than the spread of the virus, economic data presented a rather mixed message. US retail sales were weak, yet the weekly jobless claims number reached a post-pandemic low. Industrial production was stronger than expected, while the University of Michigan consumer sentiment data collapsed to nearly the lowest level in a decade ([see Chart of the week](#)). Elsewhere UK retail sales were also weak and inflation missed expectations at both a headline and core level.

This week we expect to hear about the timing and type of tapering the US Federal Reserve is planning from Jay Powell at the Jackson Hole (virtual) symposium. We will also get the latest barometers of economic pressure with PMI data from around the globe. At time of writing, both Japan and Australian data had exhibited a decent fall in these measures of business confidence.

Investment Grade credit

In spite of some weakness in equity and commodity markets, there was only a minor ripple in the calm that has beset corporate bond spreads in recent weeks. The global index reached a spread of 95bps by the end of the week which is the widest spread since early May. That said, the move is hardly emphatic. Spreads were 89bps at the "tights" this year which was back in early June. So we sit at the middle of this year's very tight spread range. This year has been characterised by very low volatility in investment grade markets globally.

In company news, the battle for UK supermarket chain Morrisons continued with a raised bid from private equity firm CD&R. There is also speculation that rival Sainsbury may be another target for these types of fund.

New issuance remains very quiet though we would expect to see a pickup in September.

High Yield credit

US high yield bond prices were slightly lower over the week amid ongoing Delta variant concerns and Fed tapering weighing on broader risk sentiment. The ICE BofA US HY CP Constrained index returned -0.09% and spreads were 2bps wider. The index is on pace for its first negative monthly total return since September with a -0.41% return thus far month to date. Primary market activity slowed this week with <\$5bn priced, leaving the MTD total at \$34 billion. Outflows were a modest \$4 million over the week, according to Lipper, leaving YTD outflows at \$14.5 billion.

European High Yield had a weaker tone last week, with credit spreads widening 4bps to 317bps, and a small negative return, but with single Bs being the weakest and only CCCs experiencing a positive return.

Some weaknesses seen over the week were in the auto sector due to news of Toyota cutting production on renewed chip shortages as well as in the travel sector on the back of macro and geopolitical headwinds. Still, overall the market remains quite resilient in spite of Delta variant concerns.

The asset class was in outflow mode with €100 million exiting, both in ETFs as well as managed accounts. The primary market was again quiet with zero issuance – for the second week in a row since the end of 2020. It has been noted that there has been a fair amount of cash-raising

happening in the high yield space as the market looks toward what it expects to be a busy September on the new issuance front (there is talk of €15 to 20 million of new bonds.)

In M&A news, media and telecoms company United Group announced it is buying Wind Hellas. ThyssenKrupp, also, announced the sale of its carbon component business to Action Composites.

Leveraged loans

The average price of the JP Morgan Leveraged Loan index increased \$0.04 despite equity volatility and slightly wider spreads in HY as heavy CLO origination and steady retail inflows met slowing supply. Loan yields (three-year) and spreads (three-year) decreased 2bps and 3bps over the past week to 4.85% and 433bps. The Leveraged loan index is providing a +0.21% gain in August and the 62bps of outperformance versus bonds is the largest since September. The week's retail inflow totalled \$352 million, below the average YTD inflow of \$681 million, but the 31st inflow over the previous 32 weeks, nonetheless.

Structured credit

The US Agency MBS market posted a slightly negative return on the week, down 5bps on modestly wider spreads. The Fed's minutes seem to suggest a taper closer to year-end which helped support the market. The FHFA released its proposal on affordability goals which notch up low-income target levels. Prepays are off to a relatively slow start in August. In ABS, the quarterly Household Debt and Credit Survey reported growth in total household debt in Q2 2021 up \$313 billion from Q1 2021 and \$691 billion year on year. The growth continues to be most notable in mortgages (+6.8%) and autos (+5.4%). Conversely, credit card debt is down 4% year on year. New issuances surpassed \$30 billion in July and was led by products such as Prime and Subprime Auto. Performance remains strong with delinquencies across ABS trending lower, especially in the lowest FICO buckets.

Asian credit

S&P lowered its long-term issuer ratings on several entities in the Genting Bhd Group because EBITDA will only recover to pre-pandemic levels in 2023, instead of 2022. Genting Bhd and Genting Malaysia Bhd were cut by a notch to BBB-. The group's operating entities in the US, comprising Resorts World Las Vegas and Genting New York, were cut to BB+. The ratings outlook of the entities was raised to stable from negative given S&P's expectation that credit quality will stabilize. The major investment cycle has completed and the higher vaccination rates in key markets will support operational recovery over the next two years.

The China National People's Congress (NPC) has passed the Personal Information Protection Law (PIPL), a stringent privacy law which will be implemented from 1 November 2021. The combination of the Cybersecurity Law, the Data Security Law and the PIPL will comprehensively cover the regulation on data protection, data processing and cross-border data transfer. The Cybersecurity Law was implemented in June 2017 while the Data Security Law, which was passed in June 2021, will be effective from 1 September 2021.

China Huarong Asset Management (HRAM) announced a state-backed government financial support which features a strategic investment of around CNY50 billion from a CITIC Group-led consortium. The consortium includes China Insurance Investment, China Life Asset Management Company, China Cinda and Sino-Ocean Capital Holding Limited. HRAM will also undertake further asset sales to raise up to CNY50 billion. Based on preliminary calculations, HRAM announced a FY20 net loss attributable to shareholders of CNY109.2bn (versus FY19 net profit of CNY1.424bn).

Emerging Markets

Emerging markets were not immune to the general sense of “risk-off”. The widening in spreads was light however and only a few basis points. High yield credit underperformed, led wider by weakness in Argentina and Brazil and African issuers. Investment grade was largely unmoved.

In terms of news, Brazil has become something of a focus as fiscal concerns are raised ahead of next year’s election and the fall in popularity of President Bolsonaro. There are fears that to bolster his chances there could be increased spending which has also had a negative effect on the currency and local rates markets.

Commodities

Fears that the spread of Covid will weigh on growth (e.g. in China and the US) has had a meaningful impact on commodity prices.

The oil price is now around 15% lower than was the case at the end of June as an example. The broader Bloomberg commodity index meanwhile is at the lowest level since mid-June though still by around 18% year to date.

Summary of fixed income asset allocation views

Strategy and positioning (relative to risk free rate)	Views	Risks to our views
Overall Fixed Income Spread Risk 	<ul style="list-style-type: none"> The worsening Delta variant is threatening global reopening/growth stories as case counts rise and restrictions return. In areas with high vaccination rates, low mortality rates may deter policy moves. 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 & upgrade activity exist. We are past the peak of central bank accommodation. The pullback in liquidity won't be aggressive, but it leaves opportunity for market volatility. Uncertainty is rising as Delta threatens the recovery, monetary & direct fiscal support wane, and unemployment benefits expire. 	<ul style="list-style-type: none"> 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. Downside risks Delta variant cases worsen and restrictions return, threatening returns to schools, offices and travel. Once spreads hit these extreme levels, future returns are rarely good. Both fiscal and monetary stimulus are removed just as growth decelerates could cause a sell off
Duration (10-year) ('P' = Periphery) 	<ul style="list-style-type: none"> Rangebound government bond market likely, with bias to lower yields Pandemic scarring keeps reflation credibility low Fed QE and high personal savings underpin demand for treasuries ECB likely to lean against rising financing rates Duration remains best hedge for further risk asset correction 	<ul style="list-style-type: none"> Permanent fiscal policy shift rebuilds reflationary credibility and raises r* Fiscal largesse steepens curves on issuance expectations Consumption rebound stimulates long-term inflation expectations Risk hedge properties deteriorate
Currency ('E' = European Economic Area) 	<ul style="list-style-type: none"> US growth outperformance on back of fiscal stimulus boosts USD ECB increasingly sensitive to Euro appreciation 	<ul style="list-style-type: none"> Vaccine rollout in Europe improves and narrows growth gap US fiscal push fades
Emerging Markets Local (rates (R) and currency (C)) 	<ul style="list-style-type: none"> Selective opportunities Still-favourable global liquidity conditions Dollar resilience may crimp scope for EMFX performance EM real interest rates relatively attractive, curves steep in places 	<ul style="list-style-type: none"> Central banks tighten aggressively to counter fx weakness EM inflation resurgence EM funding crises drive curves higher and steeper
Emerging Markets Sovereign Credit (USD denominated) 	<ul style="list-style-type: none"> 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. 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). US growth outperformance is starting to cause weakness in EMFX, with the exception of countries aggressively hiking rates (like Russia and Brazil). 	<ul style="list-style-type: none"> A replay of 2013 occurs with a taper tantrum or swift appreciation of the USD Growth scars from COVID persist and hurt commodity prices & ability to grow out of deficits. There are even further delays in mass vaccination outside of developed markets.
Investment Grade Credit 	<ul style="list-style-type: none"> US spreads are the tightest since 2005, when average credit quality was higher and duration was 50% lower. IG has been historically resilient in the face of inflation, even if other sectors may benefit more from it. Good fundamentals after most recent earnings, with strong balance sheet management and deleveraging from capital management & sales growth 	<ul style="list-style-type: none"> IG bonds further cement their place in global investors' portfolios as safe assets, replacing government bonds. M&A and shareholder returns remain in the backseat of management's priorities for an extended period of time.
High Yield Credit 	<ul style="list-style-type: none"> Spreads are nearly to all-time tights, although credit quality has improved through defaults and ample liquidity The best performing parts of these sectors have been the most volatile and lowest quality. Defaults are set to drop dramatically in 2021 in part due to the rapid recovery, but also due to an ability to remove near-term maturities by companies across the credit spectrum. 	<ul style="list-style-type: none"> The reach for yield continues to suppress spreads. Waves of ratings upgrade begin to occur this year. There are few exogenous shocks that shake the tight spread environment.
Agency MBS 	<ul style="list-style-type: none"> The Fed has been the 1000lb gorilla in this market since COVID hit, and it is progressively getting closer to tapering. The Fed will taper MBS alongside USTs, but tapering will still be a headwind to the market. Banks, the other major buyers, have slowed their purchases as well. With interest rates falling again, fundamentals worsen as prepayment speed will remain elevated. Changes to FHFA housing policies could also be marginally negative for fundamentals over time. 	<ul style="list-style-type: none"> Housing activity slows considerably and prepays move back down to normal levels, without denting households' ability to service mortgages. The Fed maintains or increases MBS purchases next year. The Fed maintains or increases MBS purchases next year.
Non-Agency MBS & CMBS 	<ul style="list-style-type: none"> Our preference remains for non-agency RMBS in this area. RMBS: Housing continues to outperform in the recovery as HH balance sheets are strong, demographics are positive, and supply is constrained. Valuations are less compelling, but can provide stable carry in de-risking portfolios. CMBS: favored bonds are still 'story' bonds. A return to normal won't look 'normal' for sectors like office space or convention hotels and recently has lagged. Spread tightening looks somewhat excessive along the margins of credit quality. 	<ul style="list-style-type: none"> Changes in consumer behaviour in travel and retail last post pandemic Work From Home continues full steam ahead post pandemic (positive for RMBS, negative for CMBS). Rising interest rates may dent housing market strength, but seems unlikely to derail it.
Commodities 	<ul style="list-style-type: none"> o/w Copper & Lead vs Zinc o/w Grains u/w Livestock u/w Gold u/w Natural Gas o/w Soybeans 	<ul style="list-style-type: none"> US China trade war Renewed Covid lockdowns

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