

In Credit

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Swapshop. Markets at a glance



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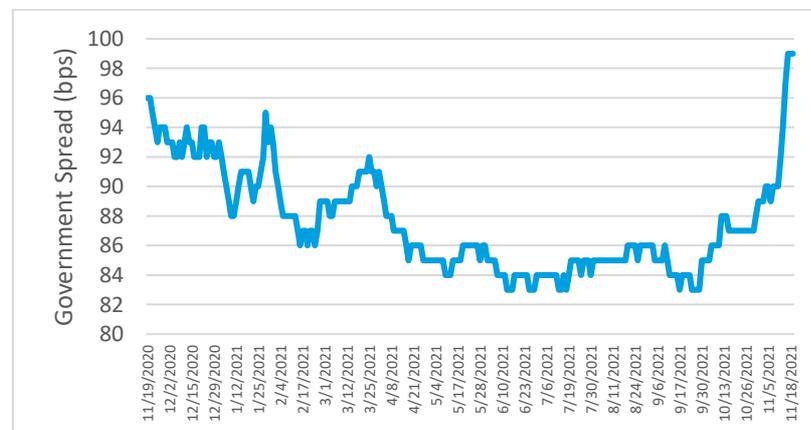
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	Price / Yield / Spread	Change 1 week	Index QTD return	Index YTD return
US Treasury 10 year	1.57%	0 bps	0.2%	-2.5%
German Bund 10 year	-0.34%	-8 bps	1.8%	-1.1%
UK Gilt 10 year	0.89%	-2 bps	1.4%	-4.2%
Japan 10 year	0.08%	0 bps	0.1%	-0.1%
Global Investment Grade	98 bps	4 bps	0.2%	-0.8%
Euro Investment Grade	99 bps	7 bps	0.8%	-0.3%
US Investment Grade	94 bps	3 bps	0.0%	-0.9%
UK Investment Grade	94 bps	1 bps	0.9%	-2.1%
Asia Investment Grade	194 bps	2 bps	0.2%	-0.2%
Euro High Yield	343 bps	4 bps	0.4%	3.5%
US High Yield	324 bps	15 bps	0.0%	4.5%
Asia High Yield	807 bps	-27 bps	1.2%	-11.1%
EM Sovereign	326 bps	7 bps	0.0%	-1.5%
EM Local	5.7%	8 bps	-1.4%	-8.9%
EM Corporate	304 bps	2 bps	0.1%	1.1%
Bloomberg Barclays US Munis Taxable Munis	1.1%	1 bps	0.6%	1.1%
	2.3%	-2 bps	0.3%	1.9%
Bloomberg Barclays US MBS	29 bps	2 bps	-0.1%	-1.0%
Bloomberg Commodity Index	218.18	-0.5%	-1.0%	31.1%
EUR	1.1278	-1.4%	-2.3%	-7.6%
JPY	114.12	-0.1%	0.0%	-9.4%
GBP	1.3424	0.3%	-1.7%	-1.6%

Source: Bloomberg, Merrill Lynch, as at 22 November 2021.

Chart of the week: Euro IG credit spreads – LTM



Source: ICE BoML Indices, Bloomberg, Columbia Threadneedle Investments, as at 22 November 2021.

Macro / government bonds

Core government bond markets were a little calmer last week with yields a shade lower. This week should be relatively quiet as the US celebrates Thanksgiving on Thursday. We also expect the US President to announce if Jay Powell will continue as Chair of the US Federal Reserve or whether Lael Brainard will be selected as a replacement. Meanwhile, the spread of Covid-19 in Europe remains a focus for markets, with Austria going into lockdown.

Last week, there was more good news on the economy. In the US, after the strong employment reviewed last week, retail sales and industrial production data were both better than expected and higher than the prior month. In the UK, a similar picture emerged with an increase in employment and fall in the unemployment rate to 4.3%. Inflation also surprised to the upside at 4.2%.

Investment grade credit

After months of trading sideways in a period of historically low volatility, credit spreads are widening. This is most evident in the euro credit market. The ICE BoML index spread is now some 16% wider since the end of the quarter and now wider year to date ([see chart of the week](#)). This has also been the case directionally in the US, but not to the same severity. Why have euro bonds underperformed?

The reason is, we believe, a bit technical in nature. What has happened is that euro government bonds have become expensive relative to euro swap rates. So, in turn, while credit markets relationship to swap rates is little changed (spread barely changed since end of Q3), the difference between (richer) German government bonds and credit yields has widened. This reflects ongoing central bank buying. By the end of the week though wider spreads seem to have attracted investor interest.

High yield credit

US high yield bond prices were lower over the week with strong economic data raising concerns about a faster than expected withdrawal of central bank support. The ICE BofA US HY CP Constrained index returned -0.36% and spreads were 15bps wider. According to Lipper, asset class flows were largely negligible, with a \$99m contribution over the week.

Leveraged loans

The average price of the J.P. Morgan Leveraged Loan index was \$0.03 lower this week amid heavy primary activity and rising pressure on fixed rate bonds amid inflation concerns. That said, loans outperformed high yield bonds amid a second consecutive week of strong inflows. The asset class reported a \$959m inflow, nearly double the average weekly inflow over the last six months.

Emerging markets

In Chile, right wing populist José Antonio Kast is set to win the first round of the election, with 28% of the vote. Kast opposes abortion, same sex marriage and “political correctness”. His campaign has centred on migration, public security, and conservative social values.

Tension continues to build on the Ukrainian boarder, with US intelligence indicating a build-up of artillery and 90,000+ troops, prepared for operations in rough terrain and freezing conditions, for what could be a prolonged occupation. There are also reports of tens of thousands of reservists being called up.

In South Asia, Pakistan revived its proposed \$6bn IMF bailout; as part of the deal Pakistan must implement key fiscal and institutional reforms. The first \$1bn of the package will be released to top up the country's FX reserves; the Pakistani Rupee has fallen 14% against the US dollar over the past six months. Pakistan has \$7.6bn of US dollar debt maturing in the next five years, with \$2bn maturing at the end of 2022.

Asian fixed income

China Evergrande announced that it will divest its entire 18% stake in HengTen Networks Group (internet streaming company with video platform) for \$273m to Allied Resources Investment. Given the sizable near-term coupon payments (including \$255m of coupon payments at end-Dec) and outlay for its ongoing projects, Evergrande needs to make further divestment progress in its property services, life insurance business and online marketplace. Agile Group will launch a 5-year bond (HKD2.145bn), exchangeable to ordinary shares of A-Living Smart City Services (property management unit). The proceeds will be helpful for the company to address its near-term maturities which include private placement notes.

Yango has successfully completed the consent solicitation and exchange offer for three USD bonds and it will issue new notes (around \$670m, 10.25% due September 22) for the validly tendered bonds. China Huarong Asset Management (HRAM) will issue shares to the CITIC-led consortium to raise up to \$6.6bn. The consortium includes CITIC, China Insurance investment, China Cinda, China Life Asset Management and ICBC. With respect to non-core asset disposals, HRAM will sell a 79.9% stake in Huarong Financial Leasing and a 40.5% stake in Xiangjiang Bank .

Commodities

WTI fell by 4.7% on the week due to a combination of rising covid cases across Europe, the subsequent partial lockdown of Austria and the prospect of a co-ordinated strategic petroleum reserve (SPR) release. US president Biden is reported to have reached out to China, India, South Korea and Japan to an effort to synchronize a release of their SPR supplies.

Natural gas prices rallied 5.4% on the week as Germany suspended the approval process for the Nord Stream 2 pipeline. The German regulator stated it would not resume the approval process until the Nord Stream 2 company transfers its assets and staffing budget to Germany. Critics of the pipeline (including Boris Johnson) fear the pipeline will be used as geopolitical weapon and will weaken Ukraine, who will lose out of gas transit revenues via mainland pipelines.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views 22nd November 2021



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 highs 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 highs. Spreads have spent extended periods near highs 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"> Yields have broken out of their earlier tight ranges but likely to remain capped by structural downtrend in real yields and growth. Pandemic scarring keeps reputation 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"> Inflation becomes more persistently entrenched, warranting much higher rate structure. Permanent fiscal policy shift rebuilds inflationary 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"> The US leads the way on the economic recovery from the pandemic, which drives a monetary wedge between the Federal Reserve and ECB. Window for dollar underperformance has narrowed as central banks globally turn more hawkish on inflation expectations at the expense of growth. 	<ul style="list-style-type: none"> Re-acceleration of global growth forecasts led by reversal of China credit contraction. US fiscal push fades.
Emerging Markets Local (rates (R) and currency (C)) 	<ul style="list-style-type: none"> Selective opportunities. 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. Tightening global financing conditions.
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 highs, 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 u/w Livestock u/w Gold o/w Soybeans o/w Oil 	<ul style="list-style-type: none"> US China trade war Renewed Covid lockdowns Global Recession

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