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In Credit

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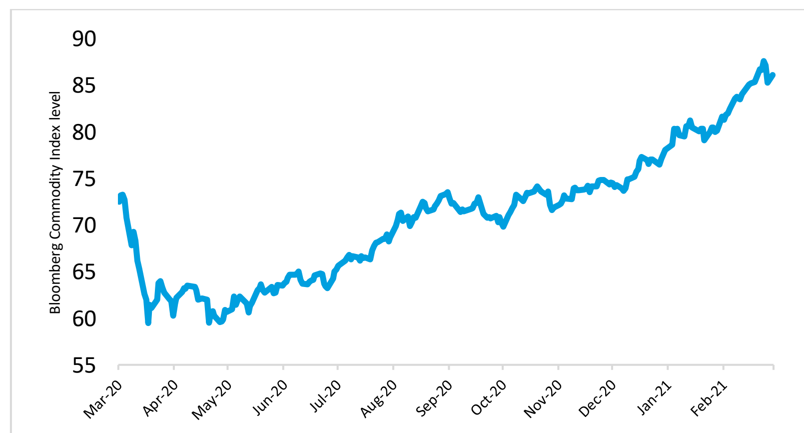
Bad start to the year… for bonds.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	1.44%	10 bps	-2.3%	-3.4%
German Bund 10 year	-0.30%	1 bps	-1.9%	-2.4%
UK Gilt 10 year	0.79%	9 bps	-5.8%	-7.5%
Japan 10 year	0.16%	5 bps	-0.9%	-1.2%
Global Investment Grade	95 bps	1 bps	-1.7%	-2.5%
Euro Investment Grade	89 bps	3 bps	-0.8%	-0.9%
US Investment Grade	95 bps	1 bps	-2.0%	-3.2%
UK Investment Grade	91 bps	0 bps	-3.0%	-3.9%
Asia Investment Grade	205 bps	-12 bps	-0.5%	-0.5%
Euro High Yield	334 bps	10 bps	0.5%	1.0%
US High Yield	357 bps	16 bps	0.3%	0.7%
Asia High Yield	551 bps	-11 bps	0.7%	0.6%
EM Sovereign	329 bps	14 bps	-2.6%	-3.7%
EM Local	4.7%	20 bps	-2.7%	-3.7%
EM Corporate	300 bps	-5 bps	-0.1%	-0.2%
Bloomberg Barclays US Munis	1.3%	22 bps	-1.6%	-1.0%
Taxable Munis	2.3%	7 bps	-2.5%	-2.6%
Bloomberg Barclays US MBS	20 bps	2 bps	-0.7%	-0.6%
Bloomberg Commodity Index	183.55	0.0%	6.5%	9.3%
EUR	1.2048	-0.4%	-0.5%	-1.2%
JPY	106.73	-1.1%	-1.7%	-3.0%
GBP	1.3957	-0.6%	1.6%	1.9%

Source: Bloomberg, Merrill Lynch, as at 26 February 2021.

Chart of the week: Rising Commodity Prices - LTM



Source: Bloomberg, Columbia Threadneedle Investments, as at 1 March 2021.

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Macro / government bonds

It has not been an easy start to the year for government bonds.

Yields are higher around the globe for a second month as can be seen on the '**Markets at a glance'** table. This means that total returns are negative. UK gilts have been the main underperformer with 10-year yields up by over 60bps after two months. This reflects a relatively successful Covid-19 vaccination rollout thus far and the hopes this brings of a rapid and sustainable reopening of the economy. The US is not far behind with yields up around 45bps while German yields up by less than 30bps. Faith in the new government in Italy means that yields are up by less than 20bps. Japan was the strongest of major markets with 10-year yields only up 16bps.

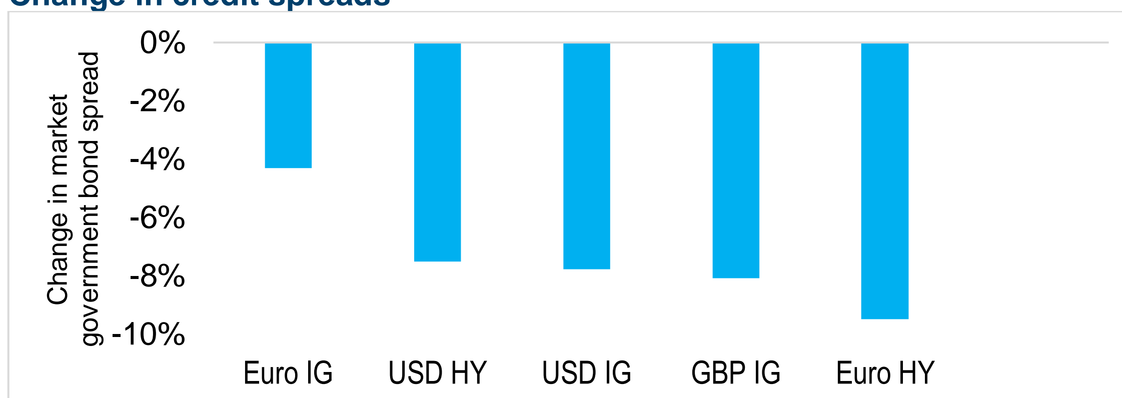
Yields were initially driven higher last month by increasing inflation expectations and better growth data before rising real yields added to the problem in the second half. In all, 10-year US inflation expectations have risen from 0.55% in Spring 2020 to 2.15% at end February 2021. Real yields for the same maturity rose from around -1% at the end of last year to around -0.75% today. There is increased optimism about the outlook for economies as the rollout of vaccines continues and the effect of fiscal stimulus is taken into account. Last week, Deutsche Bank (as an example) increased its GDP forecast to 7.5% for the US leading to the potential for double digit nominal growth; ie, once inflation is taken into account.

Credit market review – February 2021

The chart below shows that major credit markets have all enjoyed tighter spreads so far this year. On a risk-adjusted (percentage) basis the 'winner' and the 'loser' are both euro-denominated markets with euro high yield spreads nearly 10% tighter while euro investment grade spreads lagged somewhat and were around 4% tighter.

From a total return perspective, the lower duration high yield markets have fared far better and are still in positive territory year-to-date. Sterling IG credit nudged its US dollar cousin into second bottom place given the sharp rise in UK gilts described earlier. All the major IG markets have delivered a negative return in 2021.

Change in credit spreads



Source: Bloomberg, ICE BofAML Indices and Columbia Threadneedle Investments, as at 1 March 2021.

Investment grade credit

As mentioned, credit markets enjoyed a strong start to February (from a spread perspective) before ending the month on a flatter trajectory.

Spreads for the global investment grade market started the month at 103bps and ended tighter at 95bps (with US dollar and sterling outperforming euro credit). Market valuations are now well through shorter-term averages (five-year) and lower than the long-term (20-year) measure. Consequently, the support the appeal the market has from a valuation perspective is lessened.
Investment grade markets have also become more interest rate sensitive in recent years which has been to the detriment of returns given the poor performance from government bonds (The duration of the US market has risen from less than seven years at the end of 2018 to around 8.2 years according to ICE BofAML data). If there is a 'silver lining' it is that yields are now higher – 'good news' if that is your preferred measure of value!

Corporate results have been more supportive than market valuations. With most of the US results behind us, it seems around 80% have beaten expectations on earnings and around 70% on sales. We continue to expect credit quality to improve going forward; clearly this will be aided should the better economic performance alluded to earlier become reality. Likewise, more technical aspects such as primary supply and investor demand look encouraging with expectations for lower bond supply this year.

High yield credit

US high yield bond yields rose, and spreads were wider over the week amidst retail outflows and surging US treasury yields. The ICE BofA US HY CP Constrained index returned -0.66% and spreads were 11bps wider. The yield-to-worst of the index increased 0.28% to 4.20%. According to Lipper, the asset class reported a $2.2bn retail outflow for the week. This is the fourth $1bn outflow for the year-to-date period and left total outflows at $4.6bn so far this year. For the month of February, the asset class returned 0.33% with lower-rated issuers continuing their outperformance trend. BB, B and CCC-rated issuers returned -0.07%, 0.42% and 1.63% respectively over the month.

European high yield spreads had a reversal last week, widening 10bps, even as higher beta credits still outperformed with CCC producing a positive return compared to the negative returns for BB and B. Outflows continued for the asset class, this week rising to €617m with half via ETFs. This brings the year-to-date figure to -€1.4bn. The European primary market was even lighter than the previous week with only Victoria Carpet (€500m) and the largest green bond offering ever in European high yield from Ardagh Metal Packaging ($2.8bn). Weakness is being seen in the longer-dated maturities given the steepening of core government yields curves. Still, travel and leisure names got a strong boost with the announced schedule for loosening of lockdown rules in the UK.

Another Rising Star for 2021 with the upgrade of Smurfit Kappa by both S&P and Moody's to BBB-/Baa3 this past week. The rating agencies cited the packaging firm's reduced leverage target with the aim of achieving an IG rating.

In M&A news, Ardagh Metal announced it is looking to spin off its metals business into a SPAC, which will allow them to get the business added to the IPO pipeline 'on the cheap'. The plan is to retain 80% ownership. While proceeds from the spin-off will be used to pay down $2bn of debt.

Leveraged loans

Leveraged loan prices were not immune to the week's rate driven volatility but fared better than fixed rate securities. The average price of the J.P. Morgan Leveraged Loan index increased $0.14 over the week to $98.43. The asset class reported its seventh consecutive weekly inflow of $686m, leaving year-to-date inflows at $7bn. For the month of February, the asset class returned 0.63%. As with US high yield, lower-rated issuers outperformed with 0.36%, 0.59% and 1.79% returns for BB, B and CCC-rated issuers respectively.

Structured credit

Mortgages struggled as rates sold off dramatically last week. The Agency MBS market was down 29bps overall with 2.5% bearing the brunt of the move. Prepay risk is now lower with mortgage rates above 3% and the percentage of the market having incentive to refi, while still very elevated, has declined to approximately 75%. In the non-agency RMBS market the sell-off in US treasuries signalling better growth and/or higher inflation is likely a longer-term positive; however, week-over-week spreads experienced some widening alongside a broader macro risk-off tone. Agency CMBS held in well relative to RMBS given the lack of negative convexity and continued bank demand. ABS spreads held firm to slightly tighter despite rate volatility. The sector is mostly very short duration, which has insulated it from the steepening yield curve

Asian fixed income

In Macau gaming, SJM Holdings improved its quarterly results sequentially in Q4 but EBITDA continued to be negative at HKD323m (Q3,20: negative HKD782m, Q4, 2019: positive HKD1.2bn). The company maintains its plans to open the Grand Lisboa Palace (GLP) in Q2, 2021. The estimated total project cost is HKD39bn, of which the company has already spent HKD36bn. Bharti Airtel plans to fund the acquisition of an additional 20% in its direct-to-home business (Bharti Telemedia) from Warburg Pincus through a cash payment of up to INR10.38bn and an equity placement of INR21.84bn.

China Fortune Land, which is 25% owned by Ping An (China's largest insurance company) has defaulted on a $530m bond that matured on 28 Feb 2021. China Fortune Land's US dollar-denominated debt totalled $4.6bn. The company had missed payment of around $820m on its onshore loans in Feb 2021. China Fortune Land is 25% owned by Ping An, which is China's largest insurance company. The shareholder Ping An is not stepping in directly to support China Fortune Land but together with ICBC, Ping An is leading a creditor committee to come up with a debt resolution plan.

Emerging markets

EMD was weaker as the asset class got caught up in some of the turmoil from core markets. Hard currency spreads widened 11bps on the back of the rise in US Treasury yields while corporate EM was wider by 2bps. Local currencies return was negative largely due to FX. More positively, inflows returned with $1.7bn coming into the EMD, mainly into local currencies ($1.8bn) as hard currency bond funds still experienced a small outflow (-$87m), through both ETFs and managed funds.

In central bank news, Zambia raised rates (the second country to do so since the pandemic) due to spiralling inflation. In Brazil, currency worries as the central bank intervened and sold $1.5bn to stabilise the weakening Rial (already down 7% year-to-date). Turkey also saw its central bank make efforts to boost its currency while it raised banks' required reserves.

The earnings reporting season has finally started in the EM world with strong figures from gold names, telcos, and fertilisers (all Covid-19 resilient names). Many of them were able to shift sales easily from one region to next (specifically from Europe to China). Things to watch out for is how long companies who had to cut their capex last year can continue to do so for this year.

In country specific news, India's emphasis on fiscal consolidation is now being re-focused to use fiscal support to encourage growth. In South Africa, the budget announcement last week, showed plans for accelerating fiscal adjustment to achieve a faster fiscal consolidation, but without tax hikes, even while using conservative growth assumptions. This all sounds quite positive and the market response was very positive, with strong demand for South African government bonds. Finally, in not surprising Argentinian news, an IMF deal is looking more unlikely until after October elections given the inevitable requirement of austerity goals (which is not normally a favourite campaign topic.) However, the country does still have use of the IMF special drawing rights (SDRs) to pay an upcoming principal loan of $1.9bn.

Commodities

The commodity index ended flat (-0.3%) after a volatile week though the market has been strong so far this year **(see chart of the week).**

Energy markets performed strongly with WTI and Brent rallying 7% before falling back and finishing up 3.7% as curves remain steeply backwardated. The market awaits the OPEC meeting on Thursday, while enhanced co-operation between members is apparent compared to this time last year. A key decision will be whether production will be cut by 0.5 million barrels in April 2021.

Base metals were down 1.1% on the week. The biggest losses came from nickel and lead, both down 5.2%. Both were adversely impacted by rising US treasury yields, as appetite for commodities has been driven by investors seeking enhanced returns. Earlier in the week nickel prices exceeded $20,000 a ton, its highest level since 2015.

Agricultural commodities finished the week up 1.4% following a volatile week of trading. Soybeans and corn led the rally up 1.8% and 1.1% respectively. The market was supported by a pickup in Chinese imports. Looking ahead, forecasted heat and dryness in Argentina has sparked concern for soybean production. In precious metals, gold and palladium declined by 2.7% and 8.3% respectively.

Gold suffered its worst month since late 2016 as economic optimism reduces demand for the safe haven asset.

Responsible investments

Last week we heard that Hyundai Motor will have to recall approximately 82,000 electric cars from around the world after the South Korean government found faults in some of the vehicles' battery cells. Models include the Kona, Ioniq and Elec City buses. There have been 16 reported cases of the batteries catching fire, with one Kona imploding in an underground car park in South Korea. The automaker has said the cells were made by LG Energy Solution in China. The cost of replacing all batteries will be around $900m, but it's unfortunate timing as Hyundai is currently running a large marketing campaign for the upcoming sale of its Ioniq 5 model in Europe.

A new type of ESG bond, namely 'Nature-Linked' bonds could come to the market soon. Its aim is to link sovereign debt to targets for biodiversity and carbon emissions. Early adopters of this nature-linked bond are rumoured to be Pakistan, who recently released plans to use greener energy as well as plant around 10 billion trees by 2023.

NatWest also came to the market this week with a €1bn social bond, proceeds of which are to solely finance new and existing affordable housing lending.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

1st March 2021

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	■ 2021 has started with continued positive credit performance – and not for nothing: fundamentals in 2021 should continue to improve as economic activity normalizes amid more widespread vaccination. ■ Despite this outlook, valuations matter. Most spread sectors are well inside long-term averages. ■ We have likely already seen peak liquidity in financial markets. We do not expect material tightening in financial conditions next year, but spreads at these levels no longer offer cushion for unforeseen hiccups. ■ We have a modestly positive outlook but realistic returns are lower than in 2020.	■ Rapidly rising Treasury yields tighten financial conditions or make all in yields of credit less attractive. ■ A recovering economy propels spreads to all-time tights, especially if vaccinations accelerate quickly ■ The recovery gets bungled by vaccine delays, geopolitical interruptions, or a limping back to normality in the services sector
Duration (10-year) ('P' = Periphery)	P $ (+1) ¥ (0) Short -2 -1 0 +1 +2 Long £ € (+1)	■ Pandemic scarring likely to keep growth subdued ■ Reflation credibility still low, although risks from fiscal policy ■ 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	■ 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)	¥ £ EM (0) Short -2 -1 0 +1 +2 Long E (-1) A$ (0) $ (+1)	■ US growth outperformance on back of fiscal stimulus boosts USD ■ ECB increasingly sensitive to Euro appreciation	■ Vaccine rollout in Europe improves and narrows growth gap ■ Failure to pass substantial fiscal package in US
Emerging Markets Local (rates (R) and currency (C))	R (+1) Under-weight -2 -1 0 +1 +2 Over-weight C (0)	■ Favourable advanced economy policy settings support EM assets in 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	■ EM economies have been given very long leashes to respond to COVID: deficits and debt have skyrocketed with no plans for reigning them in. Any slowdown will likely exacerbate these 'back burner' issues. ■ Valuations are still a slight benefit to EM, particularly EM HY credits. ■ Low yields, lots of liquidity, and global recovery still could provide tailwinds for EM in 2021, but could be offset quickly if the USD fails to weaken further.	■ 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. ■ Governments show little willingness to address deficits post-COVID.
Investment Grade Credit	Under-weight -2 ■ -1 0 +1 +2 Over-weight	■ IG companies continue to adapt well to the economic environment, given that they are the best-in-class operators in their industries. ■ Valuations are the biggest drawback: with spreads this tight, widening could very quickly more than offset carry. ■ Technicals remain strong, especially as global investors survey the universe of high-quality assets and see extremely low government bond yields.	■ 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	Under-weight -2 -1 ■ 0 +1 +2 Over-weight	■ Spreads are inside LT averages, even adjusting for the better quality of today's index. But higher yields give more cushion than slightly higher quality bonds. ■ The ability to access financing has dramatically improved the prospects for many companies, especially for COVID-affected industries. ■ The positive effects of easy financial conditions hit HY later than higher quality sectors, and tighter conditions will hit HY first.	■ Upside risks include: intensified reach for yield keeps drawing new investors, M&A lifts HY companies into larger IG conglomerates. ■ Downside risks include: travel & leisure habits slowly revert to pre-COVID, commodity sell-offs, or financial conditions suddenly tightening.
Agency MBS	Under-weight -2 ■ -1 0 +1 +2 Over-weight	■ Fed buying has overwhelmed highly negative fundamentals, as seen by the near-zero spreads in bonds the Fed buys and poor performance elsewhere. ■ Fed buying cannot be expected to increase in 2021, exposing negative fundamentals and valuations ■ Prepays remain and will remain high, with >70% of mortgages having incentive to refinance.	■ 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.
Non-Agency MBS & CMBS	Under-weight -2 -1 0 ■ +1 +2 Over-weight	■ RMBS: Housing has been a major outperformer in this recovery, as demand rises and inventory remains low. Strong household balance sheets amongst homeowners has kept fundamentals strong as well. However, many of these bonds are now call-constrained. ■ CMBS: subsectors continue to perform divergently, although spreads even in the most affected areas, like office space & convention hotels, have recovered. ■ Our preference remains for non-agency RMBS in this area.	■ 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 ■ o/w Soybeans ■ u/w Sugar ■ u/w WTI	■ Oil production disruption

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